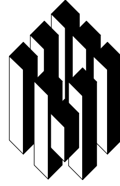

C.D. Howe Institute
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Communiqué

Embargo: For release *Thursday*, February 3, 2000, at 10:00 a.m.

Debt paydown and tax cuts can boost payoff in federal budget, says C.D. Howe Institute study

Ottawa should put debt retirement and tax cuts at the forefront of its fiscal strategy over the next five years, urges a *C.D. Howe Institute Commentary* released today. By lowering interest costs and boosting economic growth, says the study, such a program could add billions of dollars to the five-year budget payoffs outlined in the federal Finance Department's November 1999 *Economic and Fiscal Update*. The study advocates launching the program by using the current year's federal budget surplus to pay down debt and devoting the room for new initiatives in the February 2000 budget to sizable cuts in personal and business taxes.

The study, "Budgeting for Growth: Boosting Prosperity with Smart Fiscal Policy," was written by William B.P. Robson, Jack M. Mintz, and Finn Poschmann of the C.D. Howe Institute. They base their calculations on private sector projections published in the November update showing that — even after allowing for "prudence cushions" to guard against a return to deficits — the federal budget has room for an average of $4.6 billion in tax cuts or new spending initiatives in each of the next five years.

The authors estimate that cutting personal and business taxes could boost economic growth, raising the annual budget payoff by $0.9 billion. They also estimate that, if all unneeded prudence cushions and extra surpluses created by a strong economy were applied against the debt, lower interest costs would expand the annual budget payoff by an additional $0.2 billion. Smart federal policy aimed at reaping these larger payoffs would leave Canadians appreciably better off in the future.

Robson, Mintz, and Poschmann see no justification for diverting half of projected surpluses to new program spending, as the government has proposed. The authors note that the November update's projections allowed for federal program spending to grow at a pace equal to inflation and growth in Canada's population. The authors survey federal programs to see what contribution to future prosperity each is likely to make and whether Ottawa or the provinces would be better placed to carry out any needed action. After allowing for already committed increases in transfers to the elderly and to the provinces, they conclude that the budget can accommodate higher spending on defense, several research and development-oriented transfers, civil service salaries, and the Child Benefit, yet hold overall spending growth to a rate no greater than inflation and population growth.

On tax cuts and reforms, the authors argue that current federal taxes on personal and business incomes hamper growth, put Canada offside *vis-à-vis* key competitors, and create numerous inequities, with taxpayers of similar means paying different amounts of tax. Accordingly, they suggest a package of changes that, over five years, would cut personal and business tax rates at all income levels, raise personal tax thresholds by more than one-fifth, eliminate surtaxes, establish a universal credit for dependent children, and lower employment insurance premiums to a long-term sustainable level. Rather than giving in to provincial pressure for further increases in federal-provincial transfers, the authors say, Ottawa should designate some of the room created by lower tax rates as being available for provinces that need extra funds for health and education.

Robson, Mintz, and Poschmann close by emphasizing that, while the November update projected a cumulative total budget payoff of $23 billion by the fifth year, the actual payoff Canadians will enjoy depends on what each federal budget delivers during those five years. If Ottawa were to focus on areas where the benefits are relatively large and certain, and where federal action is most apt — that is, on debt paydown, selective spending increases, and sizable cuts to damaging taxes — the ultimate payoff could be $5.6 billion annually, or a cumulative $28 billion by the fifth year. Healthy surpluses and tax cuts totaling some $4.5 billion in the February 2000 budget, they conclude, would be a key step toward that goal.

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For further information, contact:

Bill Robson, Jack Mintz, Finn Poschmann
Shannon Spencer (media relations), C.D. Howe Institute
phone: (416) 865-1904; fax: (416) 865-1866;
e-mail: cdhowe@cdhowe.org; Internet: www.cdhowe.org

"Budgeting for Growth: Boosting Prosperity with Smart Fiscal Policy," *C.D. Howe Institute Commentary* 134, by William B.P. Robson, Jack M. Mintz, and Finn Poschmann (February 2000). 35 pp.; $10.00 (prepaid, plus postage & handling and GST — please contact the Institute for details). ISBN 0-88806-469-1.

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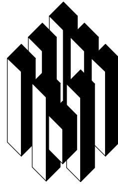

C.D. Howe Institute
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Communiqué

Embargo : à diffuser le *jeudi* 3 février 2000 à 10 h

Selon une étude de l'Institut C.D. Howe, le remboursement de la dette et des réductions d'impôts augmenteraient les gains prévus du budget fédéral

Au cours des cinq prochaines années, Ottawa devrait mettre le remboursement de la dette et les réductions d'impôt au premier plan de sa stratégie fiscale. C'est du moins ce que soutient un *Commentaire de l'Institut C.D. Howe* publié aujourd'hui. En réduisant les frais d'intérêts sur la dette et en stimulant la croissance économique, un tel programme pourrait ajouter des milliards de dollars aux gains budgétaires des cinq prochaines années décrit dans la *Mise à jour économique et financière* de 1999, qui a été publiée en novembre dernier par le ministère fédéral des Finances. Les auteurs de l'étude proposent que l'on lance le programme en appliquant l'excédent du budget fédéral de cette année au remboursement de la dette et en concentrant toute nouvelle initiative annoncée dans le budget de février sur des réductions importantes de l'impôt sur le revenu des particuliers et des entreprises.

L'étude, intitulée « Budgeting for Growth: Boosting Prosperity with Smart Fiscal Policy » (Un budget axé sur la croissance : favoriser la prospérité par des politiques financières judicieuses), est rédigée par MM. William B.P. Robson, Jack M. Mintz et Finn Poschmann de l'Institut C.D. Howe. Les auteurs fondent leurs calculs sur les projections publiées dans la *Mise à jour* de novembre; ceux-ci indiquent que, même en tenant compte de mesures de prudence pour se prémunir contre un retour des déficits, le budget fédéral a une marge d'action suffisamment importante pour se permettre des réductions d'impôt ou de nouvelles dépenses de l'ordre de 4,6 milliards de dollars pour chacune des cinq prochaines années.

Les auteurs estiment que les réductions d'impôt sur le revenu des particuliers et des entreprises pourraient stimuler la croissance économique, augmentant du coup de 0,9 milliard de dollars le gain budgétaire annuel. Une politique fédérale judicieuse axée sur ces gains améliorerait notablement le sort de la population canadienne dans les années à venir.

MM. Robson, Mintz et Poschmann estiment que la proposition du gouvernement, qui consiste à réaffecter la moitié de l'excédent projeté à de nouvelles dépenses de programme, n'est pas justifiée. Les auteurs soulignent que les projections de la *Mise à jour* de novembre prévoient une croissance des dépenses des programmes fédéraux équivalente à celle du taux d'inflation et de la croissance démographique. Les auteurs passent en revue les programmes

fédéraux pour établir la contribution probable de chacun à la prospérité future; ils établissent aussi si c'est Ottawa ou les provinces qui seraient les mieux placés pour mettre en œuvre toute mesure nécessaire. Compte tenu des hausses déjà promises des transferts aux personnes âgées et des transferts aux provinces, ils parviennent à la conclusion que le budget peut soutenir des dépenses accrues dans les secteurs suivants : la défense, plusieurs transferts axés sur la recherche-développement, les salaires des fonctionnaires et la prestation pour enfants, tout en maintenant la croissance des dépenses à un taux qui ne dépasse pas celui de l'inflation et de la croissance démographique.

Sur le plan des réductions d'impôt et des réformes, les auteurs sont d'avis que les impôts fédéraux sur le revenu des particuliers et des entreprises freinent la croissance, placent le Canada hors-jeu face à ses principaux concurrents et multiplient les inégalités, car des contribuables aux moyens similaires verseront des montants d'impôt différents. Ils proposent par conséquent un ensemble de modifications qui, sur une durée de cinq ans, réduiraient les taux d'imposition sur le revenu des particuliers et des entreprises à tous les niveaux de revenu, augmenteraient de plus d'un cinquième les seuils à partir desquels on impose les particuliers, élimineraient les surtaxes, établiraient un crédit universel pour les enfants à charge et réduiraient les cotisations d'assurance-emploi à un niveau soutenable à long terme. Plutôt que de céder aux pressions qu'exercent les provinces pour l'augmentation des transferts fédéraux-provinciaux, les auteurs soutiennent qu'Ottawa devrait attribuer une part de la marge créée par un taux d'imposition inférieur aux provinces qui ont besoin de financement accru en matière de santé et d'éducation.

En conclusion, MM. Robson, Mintz et Poschmann attirent l'attention sur le fait que même si la *Mise à jour* de novembre prévoit un gain cumulatif total de 23 milliards de dollars d'ici cinq ans, le véritable gain dont profiteront les Canadiens dépendra de ce que chaque budget fédéral offrira pendant ces cinq années. Si Ottawa mettait l'accent sur les domaines où les avantages sont relativement importants et certains, et où les mesures fédérales réussissent le mieux — c'est-à-dire le remboursement de la dette, des hausses de dépenses sélectives et une réduction importante du fardeau écrasant des impôts — le gain pourrait atteindre au bout du compte 5,6 milliards de dollars par année, soit un montant cumulatif de 28 milliards d'ici la cinquième année. De l'avis des auteurs, en produisant un excédent solide et en apportant des réductions d'impôts de l'ordre de 4,5 milliards de dollars lors du budget de février 2000, le gouvernement ferait un pas important dans la bonne direction.

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Renseignements : Bill Robson, Jack Mintz, Finn Poschmann
Shannon Spencer (relations avec les médias), Institut C.D. Howe
téléphone : (416) 865-1904; télécopieur : (416) 865-1866;
courriel : cdhowe@cdhowe.org; site Web : www.cdhowe.org

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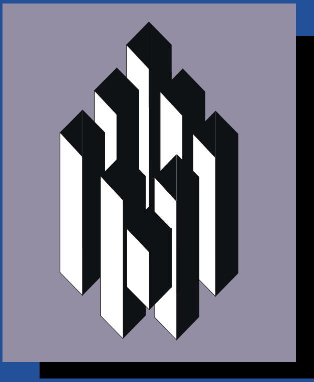

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Budgeting for Growth

Promoting Prosperity with Smart Fiscal Policy

William B.P. Robson
Jack M. Mintz
Finn Poschmann

In This Issue...

A five-year program of federal tax cuts and debt retirement offers a multi-billion dollar payoff.

The Study in Brief...

The federal government's November 1999 fiscal update showed room for $4.6 billion in new tax cuts or spending increases in each of the next five years, with no significant risk of a return to budget deficits. The February 2000 budget will show Canadians how Ottawa intends to use this fiscal room.

This study argues that smart budget choices that pay down debt and boost growth could enhance Canadians' living standards and raise the budget payoff beyond what the November update envisioned. Such a program would have three main parts.

First, unneeded budget cushions should pay down debt, lowering Ottawa's interest bill, and adding some $0.2 billion to the annual budget payoff over the next five years.

Second, Ottawa should limit spending increases to areas where benefits are relatively large and certain, and where federal — rather than provincial — action is most appropriate, thus holding spending growth to a rate no higher than population growth and inflation.

Third, the federal government should make major cuts in personal and business taxes, enhancing the rewards to work, saving and investment, and potentially adding a further $0.9 billion to the annual budget payoff.

Rather than following its previous commitment to spend half any projected surplus, Ottawa should launch a five-year program to reduce Canadian taxes and debt. Achievable goals include: lower basic federal personal tax rates (15, 23, and 28 percent, rather than today's 17, 26, and 29 percent); personal credits and thresholds up by more than one-fifth; a universal credit for dependent children; elimination of the high- income surtax; steady decreases in employment insurance premiums; and general business income tax rates that are 10 percentage points lower than they are now. These cuts would allow all unneeded contingency reserves and prudence factors to pay down debt, while leaving room for program spending to grow in line with population and prices.

Such a program would boost Canadian living standards and could raise the budget payoff to some $5.2 billion in each of the next five years. Sizable personal and business tax cuts in the February 2000 budget would start Canadians on a course to better economic and fiscal health.

The Authors of This Issue

William B.P. Robson is Director of Research at the C.D. Howe Institute. *Jack M. Mintz* is President and Chief Executive Officer of the C.D. Howe Institute, and Arthur Andersen Professor of Taxation, Joseph L. Rotman School of Management, University of Toronto. *Finn Poschmann* is a Policy Analyst at the C.D. Howe Institute.

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With its bold five-year projections, the federal government's November 1999 *Economic and Fiscal Update* (Canada 1999c; hereinafter "the update") opened a new stage in federal budgetmaking. Its key message was that, over the next five years, unchanged tax policies — combined with direct program spending growing in line with inflation and population — will produce a surplus that, even after deducting cushions for contingencies and possible economic setbacks, could grow to $23 billion in the fifth year.[1] In other words, in each of the next five years, Ottawa could introduce an average of $4.6 billion in tax cuts and spending increases, with no significant danger of putting the federal budget back in deficit. The February 2000 budget will give Canadians their first look at how the federal government intends to use this fiscal room.

At the end of those five years, Canada's economic and fiscal health will be strongly marked by the way Ottawa responds to its new fiscal flexibility — how much debt it pays down, how much and how it spends, and how and by how much it cuts taxes. With smart fiscal moves that lower its debt burden and promote economic growth, the federal government could enhance Canada's economic prospects and, in the process, enlarge the budget payoff beyond the amount shown in the update.

This *Commentary* argues that our best economic prospects lie in a conscious effort to increase the budget payoff. Each aspect of the federal budget — debt paydown, program spending, and taxes — needs close scrutiny, to determine both its impact, and the suitability of federal (as opposed to provincial) action for producing that impact. Each area has the potential to expand the budget payoff.

If the larger budget surpluses that would result from decent economic performance were used to pay down the debt, almost $1 billion might be added to the budget payoff predicted for the fifth year. And limiting spending increases to areas where payoffs are relatively large and certain would hold growth in overall program spending to a pace no faster than prices and population growth. This, in turn, would allow major cuts in personal and business taxes, which would boost economic growth and add — on middle-of-the-road assumptions — a further $4.3 billion to the budget payoff after five years.

Looking ahead over the next five years, we see no justification for dividing the projected surplus 50/50 as the government has proposed, with half going to new programs and the other half to tax cuts and debt

We are grateful to Ken McKenzie and John Richards for comments and discussion. Responsibility for the conclusions and any remaining errors rests with the authors. Most tax revenue estimates presented here were derived via Statistics Canada's Social Policy Simulation Database and Model, Release 7.0. Responsibility for the use and interpretation of these data is entirely that of the authors.

1 Much commentary on these projections has used five-year totals for the surpluses — some $70 billion for the planning surplus or roughly $100 billion before deducting the contingency reserves and prudence factors. This practice is unhelpful to understanding the impact of tax and spending changes: all references in this paper are to annual amounts.

retirement. The past few years have seen substantial increases in spending; the next few should feature a strong emphasis on lowering taxes and paying down debt. A February 2000 budget that cuts personal and business taxes by some $4.5 billion would put Canadians on course to realize the payoff foreseen in the fiscal update, and more.

The Challenge

The 1990s were not kind to Canadians economically. During that decade, Canada had one of the lowest growth rates in per capita incomes in the Organisation for Economic Co-operation and Development (OECD) (Fortin 1999). The consequences of low growth are well known: fewer jobs, meager increases in enjoyment of goods and services, fewer resources for government programs, and reduced support for such programs among voters. Canada's standard of living is lagging behind that of its most important trading partner, the United States, where national income per person is now some $12,000 higher than in Canada,[2] or nearly $50,000 per year for a family of four.

Fortunately, Canada's economic outlook looks promising. Government deficits have been virtually eliminated. The burden of total public debt, though still high at over 90 percent of gross domestic product (GDP), is declining. The economy is growing faster, following trends in the United States, and after-tax personal incomes are finally beginning to rise after ten years without growth.

"Canada's task now is to achieve sustained economic growth, a task that will present more complex challenges in the future."

Canada's task now is to achieve sustained economic growth, a task that will present more complex challenges in the future. The pace of international economic integration will quicken as new technologies take hold in telecommunications and commerce. Economic borders are disappearing as business operations become less dependent on location and more on knowledge-based assets. New forms of global business organization, including international consolidations and alliances, allow the international transfer of technology regardless of the geographic location of the underlying innovation. And as Canada's economy becomes increasingly integrated with the rest of the world, productivity and competitiveness will be critical factors in improving the opportunity for economic growth and prosperity for all Canadians.

In order to achieve sustained growth, Canadians must think strategically. Even though the size of the US market, with its large pools of financial capital and diversified labor market, makes location there attractive to businesses and individuals, there is no reason why smaller countries such as Canada cannot create economic advantages that will improve productivity and competitiveness (Harris 1999). With its abundant

2 US gross national product (GNP) per person in 1998 was US$32,400. At a Canadian/US dollar exchange rate (based on purchasing power) of 0.79, that amount equals C$41,000 — C$12,500 higher than Canada's GNP per person of C$28,500.

"Canada should be able to achieve sustained economic growth — if it has the support of smart policies on public expenditure and taxation."

natural resources, well-educated population, and economic and political stability, Canada should be able to achieve sustained economic growth — if it has the support of smart policies on public expenditure and taxation.

The Framework

For the past five years, the primary goal of federal fiscal policy has been to rein in unsustainable borrowing. Accordingly, Ottawa adopted a narrowly focused two-year time frame for budget planning, and simultaneously made pessimistic economic and fiscal assumptions in its budgets. But with the deficit crisis successfully overcome, the defects in this approach — notably its neglect of some of the longer-term implications of current budget moves, and the unreliability of the forecasts — became apparent.

The November 1999 Economic and Fiscal Update

Seeking to remedy these problems, the November 1999 fiscal update unveiled a new approach. Using an average of economic projections from numerous forecasters in the private and nonprofit sectors, the update laid out a scenario for growth, inflation, and interest rates from 2000 to 2005 (see Table 1).

Then, again drawing on the forecasters' models — under "no-policy-change" assumptions that had federal taxes essentially growing in line with the economy, and program spending growing in line with population growth and inflation — the update presented a summary of the federal government's financial transactions for fiscal years 1999/2000 to 2004/05. This summary, with some adjustments to add back expenditures that are netted against revenue in budget presentations, is shown in Table 2.

The update thus abandoned the pessimistic projections of the past. Instead, its figures allowed for economic setbacks or other unpleasant surprises both with a $3 billion annual contingency reserve similar to those in recent budgets and with a set of annual economic prudence factors. It

Table 1: ***Economic Indicators: Average of Private Sector Projections***

	1999	2000	2001	2002–05
		(percent)		
Real GDP growth	3.6	2.9	2.7	2.7
GDP inflation	1.5	1.7	1.9	1.8
Nominal GDP growth	5.1	4.6	4.6	4.5
CPI inflation	1.6	1.8	1.9	1.8
Three-month Treasury bill rate	4.8	5.1	5.1	4.9
Ten-year government bond rate	5.6	5.8	5.8	5.6

Source: Canada 1999c.

Table 2: ***Summary of Federal Government Transactions, fiscal years 1998/99 to 2004/05***

	1998/99	1999/2000	2000/01	2001/02	2002/03	2003/04	2004/05
				($ billions)			
Gross revenue	167.6	171.0	178.2	186.2	193.7	201.7	210.7
Revenue netted against spending[a]	(11.9)	(13.0)	(13.7)	(13.7)	(13.7)	(13.7)	(13.7)
Net revenue	155.7	158.0	164.5	172.5	180.0	188.0	197.0
Less net return on investments	(5.0)	(4.6)	(4.8)	(4.7)	(4.8)	(4.8)	(4.8)
Taxes and fees	150.7	153.4	159.7	167.8	175.2	183.2	192.2
Gross program spending	123.3	124.5	127.2	131.7	134.7	137.7	141.2
Revenue netted against spending	(11.9)	(13.0)	(13.7)	(13.7)	(13.7)	(13.7)	(13.7)
Net program spending	111.4	111.5	113.5	118.0	121.0	124.0	127.5
Primary balance	39.3	41.9	46.2	49.8	54.2	59.2	64.7
Less net debt charges	(36.4)	(36.9)	(36.7)	(36.3)	(35.7)	(35.2)	(34.7)
Underlying balance	2.9	5.0	9.5	13.5	18.5	24.0	30.0
Less contingency reserve		(3.0)	(3.0)	(3.0)	(3.0)	(3.0)	(3.0)
Less economic prudence factor			(1.0)	(2.0)	(3.0)	(3.5)	(4.0)
Fiscal surplus for planning	2.9	2.0	5.5	8.5	12.5	17.5	23.0
Memo item: gross debt charges	41.4	41.5	41.5	41.0	40.5	40.0	39.5

[a] Mainly the Child Benefit, the GST credit, and various fees and other charges that are netted against the expenditures of the relevant departments.

Sources: Canada 1999c; authors' estimates.

then deducted the contingency and prudence reserves from the no-policy-change balance and calculated interest costs on the assumption that the application of each year's contingency reserves against the debt would whittle interest costs down somewhat. The bottom line was that there appears to be room for extra debt paydown, spending hikes, and tax cuts rising from $2 billion in the current fiscal year to $23 billion in 2004/05. Looking ahead, then, each of the next five budgets has, on average, room for $4.6 billion in new initiatives.[3]

The Payoff

Twenty-three billion dollars sounds like a lot of money — the equivalent of about 2 percent of projected GDP in 2004, or almost $3,000 for every Canadian family of four. Yet relative to easily foreseeable demands, it is not that large: the 1990s saw rising federal debt, restrained program spending, and steadily mounting taxes, and each of these will need redress. As the

3 In other words, if $4.6 billion in program spending and incremental tax cuts is added each year for five years, there is a cumulative total of $23 billion in initiatives.

"Starting to allocate... budget room in a manner that makes both economic and political sense will be the key challenge for the February... budget."

debate over federal priorities has already revealed, debt repayment, new spending, and tax relief could possibly absorb $4.6 billion annually several times over. Starting to allocate that budget room in a manner that makes both economic and political sense will be the key challenge for the February 2000 federal budget.

One way of meeting that challenge is to rely on a simple formula — for example, committing to allocate to each major category a predetermined share of each dollar of potential payoff. Formally, the federal government is committed to this type of approach: 50 cents of each dollar of potential surplus is to be spent, and the remainder divided between tax cuts and debt retirement. Superficially, this approach is attractive: it appears easy to communicate, and it is easy to map against the results of polls in which respondents say how they would dispose of an extra federal dollar.

But the approach has deep flaws. It neglects, for example, the fact that each year's surplus depends on the surpluses of previous years since debt paid down lowers future interest costs. The worst feature of such a simplistic budget rule is that it bypasses the continuing need to examine how Ottawa's management of debt, programs, and taxes either impedes or boosts Canadians' quest for prosperity and higher living standards.

A better way of addressing the challenge — an approach along the lines advocated by the House of Commons Standing Committee on Finance in its December 1999 report (Canada 1999e, 27–28) — is to judge each element of the federal budget on its merits, asking what impact a change in Ottawa's approach in that area will have on Canadians' future living standards. With the longer view permitted by the end of the fiscal crisis, the federal budget should be re-examined with a keen eye to boosting growth. Smart choices about debt repayment, spending, and tax cuts could make a noticeable difference to Canadian living standards, even after only five years. And given the links between economic prosperity and governments' electoral success, economically smart moves should prove politically advantageous as well.

Making the Payoff Grow

The correspondence between fiscal health and broader economic prosperity is far from exact. It is possible in principle, though in the real world it is rare, for governments to manage their budgets badly while their citizens thrive, or for sound-looking budgets to co-exist with widespread economic distress. Fiscal policy is, moreover, only one element in the policy mix that appears to be important for prosperity.

Nevertheless, there are many strong links between fiscal health and prosperity. Especially in view of the international trends just noted, Canadian governments need to keep a keen eye on their overall tax levels. Tax structure is also important: compared to other members of the Group-of-Seven (G-7) industrialized countries, Canada relies heavily on taxes that

Table 3: *The Tax Mix in G-7 Countries, 1996*

		Tax Types					
	Total Tax Receipts	Personal Income Tax	Corporate Income Tax	Employees' Social Security Contributions	Employers' Social Security Contributions	Taxes on Goods and Services	Other Taxes
				(% of GDP)			
United States	28.5	10.7	2.7	3.0	3.7	4.9	3.5
United Kingdom	36.0	9.3	3.8	2.6	3.5	12.7	4.2
Japan	28.4	5.7	4.7	4.0	5.3	4.4	4.3
Italy	43.2	10.8	4.0	2.9	10.2	11.2	4.0
Germany	38.1	9.4	1.4	6.7	7.8	10.6	2.1
France	45.7	6.4	1.7	5.9	12.2	12.5	6.9
Canada	36.8	13.9	3.3	2.0	3.9	9.2	4.6
OECD average	37.7	10.1	3.1	2.9	5.5	12.3	3.8

Sources: OECD 1999; United States 1999.

discourage work and saving — that is, personal income and business taxes (see Table 3). Studies of fiscal policy and growth in various countries tend to show that heavy reliance on these taxes is bad for growth (Kneller, Bleaney, and Gemmel 1999),[4] thus holding out promise that reducing them could improve Canada's future growth prospects beyond the projections in the fall update.

On the spending side, wise choices are no less important. Studies also show that governments can improve economic growth by investing in productive expenditures such as education and social infrastructure.[5] Canada is a large spender on education, however, and it spends about as much public money on health care as other G-7 countries, including the United States (see Table 4). The challenge in coming years will be to steer incremental new resources into areas that enhance growth, while limiting or even trimming spending in areas that do not — thus further enhancing the picture portrayed in the November update.

"The challenge in coming years will be to steer incremental new resources into areas that enhance growth."

Used with care, then, the update's estimate of $4.6 billion in annual room for action in the federal budget gives a convenient yardstick for measuring progress. In our analysis, we pay particular attention to growth-enhancing federal actions that could improve the standard of living in Canada. As an indicator of growth, we use the size of the federal surplus that is available for future debt reduction, expenditure increases, or tax cuts.

4 Those authors show that a one point increase in distortionary taxes as a percentage of GDP is associated with a decrease in growth of GDP per person of 0.3 to 0.4 of a percentage point annually. This is not a small amount: if annual growth in incomes per person had been 0.4 percent faster in the 1990s alone, the 1999 income of the average family of four would have been some $3,000 higher.

5 Kneller, Bleaney, and Gemmel (1999). A one point increase in productive government expenditures as a percentage of GDP is associated with a 0.26 percent increase in growth of GDP per person.

Table 4: *The Expenditure Mix in G-7 Countries, 1996*

	Total Current Government Expenditure	Expenditure Type			
		Education	Health	Defense	Interest on Public Debt
	(% of GDP)				
United States	34.3	5.0	6.3	3.4	3.5
United Kingdom	42.3	4.6	5.8	2.6	2.8
Japan	28.5	3.6	5.7	0.9	0.7
Italy	49.5	4.5	5.5	1.9	10.0
Germany	46.6	4.5	8.2	1.5	3.1
France	51.6	5.8	7.3	2.5	3.4
Canada	45.8	5.8	6.4	1.2	5.2

Sources: OECD 1999; United States 1999.

"With prudent management and smart budget moves, the annual budget payoff over the next five years could be greater than $4.6 billion."

As noted already, that room is what remains after a cushion against economic misfortune has been deducted: in that sense, it is a pessimistic estimate. With prudent management and smart budget moves, the annual budget payoff over the next five years could be greater than $4.6 billion. To achieve that result, the framers of the 2000 budget need to question every element of the proposed budget, to determine, first, how Canadians' incomes might be affected by the change and, second, whether the federal government is the right agency to bring about the change.

The following three sections ask those questions. We look for policies that will raise economic growth rates, yielding more tax revenues and reducing the need for expenditures on certain social programs such as employment insurance. On the other hand, policies that hamper economic growth and reduce the surpluses are undesirable. In the pages that follow, we set out our proposals for steps that the budget could take in the areas of debt repayment, spending, and taxation, to ensure that, five years from now, both the federal budget and Canadian living standards will be in even better shape than envisioned in the update.

Surpluses and Debt

Debt reduction is a central feature of a fiscal strategy that will yield payoffs greater than $4.6 billion annually over the next five years. The annual contingency reserve and any additional budget surplus generated by a cooperative economy should pay down debt.

The Benefits of Retiring the Federal Debt

The impact of applying budget surpluses against the debt is straightforward: they reduce net interest costs in every subsequent budget, so that those

budgets will be better able to cut taxes, add to programs, or yield a healthy bottom line. And, what is rare among possible budget measures, there is no uncertainty about the effect. Even if average interest rates do not drop as a result of the paydowns, lower debt will result in lower interest payments as a matter of simple arithmetic. If the average projections in the November 1999 update came to pass and all the unallocated surpluses — $2 billion in the current fiscal year and the total $13.5 billion in prudence factors over the next five years — were applied to the debt, interest costs by the end of the period would be almost $1 billion lower than shown in the update, making room for budget initiatives that would improve Canadians' disposable incomes by an average of almost $0.2 billion a year over the next five years.

Does it make sense for the federal government to take the lead in reducing public debt in Canada? Admittedly, other sectors could do more. Despite the 1998 reforms to the Canada and Quebec Pension Plans (CPP/QPP), their balance sheets will continue to deteriorate, suggesting that, over the long term, Canadian governments, in the aggregate, need to save more. In the meantime, however, the federal government has the greatest capacity to rebuild the country's public sector balance sheet before confronting the demographic squeeze that will arrive some 10 to 15 years from now.[6] Provincial governments are less heavily indebted to begin with, and they will face stronger pressure on their future surpluses from ever-expanding health budgets. To reduce the burden of paying for past consumption in order to prepare for the heavier demands that will be made by an aging population, it makes the most sense for Ottawa to get its debt down.

"[T]he federal government has the greatest capacity to rebuild the country's public sector balance sheet before confronting the demographic squeeze that will arrive some 10 to 15 years from now."

Setting a Good Precedent

The 2000 budget will do more than signal how Ottawa intends to confront its still outsized debt in the future; it will show how it has responded to better-than-expected fortune in the current fiscal year (ending March 31, 2000). The November 1999 update showed a $2 billion surplus for fiscal year 1999/2000 on top of the $3 billion contingency reserve, and recent economic news suggests that the total surplus for the year may be closer to $8 billion. In 1998/99, the government reacted to an economy that was stronger than expected with a spending overrun of almost $7 billion — part of which was due to automatic increases in equalization payments, but most of which was discretionary retrospective spending — erasing what would otherwise have been a very healthy surplus.

6 Some observers have claimed that Ottawa's debt-to-GDP ratio will not be significantly different whether the annual debt paydown is 0, $3 billion, or even $10 billion (see Mendelson 1998; Stanford 1999). The 1998 CPP/QPP reforms produced an adjustment of less than $10 billion annually in the plans' combined annual balance of contributions and benefits. Yet those reforms took plans headed for cash exhaustion, a tripling of contribution rates, and faced with serious risk of political extinction, and put them on a footing where a contribution rate under 10 percent is expected to sustain them indefinitely.

It is troubling to see unneeded prudence cushions being spent at the last minute. Naturally, if circumstances are worse than envisioned in the budget plan, the prudence cushions will be eroded — that is what the cushions are for — and the bottom line will come closer to a deficit (but, barring extraordinarily bad fortune, not all the way). By the same token, however, circumstances as good as the average projection in the update should produce surpluses equal to the prudence cushions plus the contingency reserves. And circumstances better than envisioned should produce an even healthier bottom line.

"The benefits of paying down debt are dead certain. But it is equally certain that to get those benefits the government must pay down debt."

To ensure that Canadians reap the benefits of debt reduction, Ottawa should ensure that unexpectedly good results create bigger surpluses, not higher spending. The benefits of paying down debt are dead certain. But it is equally certain that to get those benefits the government must pay down debt.

Spending

The news of $4.6 billion in annual budget room has been greeted enthusiastically by advocates of more federal spending and may, once the numbers are available, prove to have loosened budgetary discipline still more, producing a repeat of last year's $6.9 billion overrun. Before this process gets more out of hand, spending needs the same kind of scrutiny that other elements of the budget receive. The major items in federal program spending are summarized in Table 5. It is possible that Ottawa could allocate some of its budget room to expanding some of these items in ways that would boost the next five years' budget payoff. But when questions are asked about the likely impact on growth and the appropriateness of federal action, the answers are often sobering.

Benefits for the Elderly

It is in many ways fitting that benefits for older Canadians — Old Age Security (OAS), the Guaranteed Income Supplement (GIS), and Spouses' Allowances — appear at the top of the list of federal programs. They command widespread support and are very welcome to those who receive them, but they are not good candidates for enrichment.

What effect on Canadians' future prosperity might an expansion of elderly benefits have? The answer depends, of course, on the nature of the expansion, but a review of the recent evolution of these benefits suggests that, on the whole, it would probably not be helpful. The principal objective of these programs — to guarantee that misfortune in life would not mean that a person's final years would be spent in destitution — has been largely achieved: the incidence of low income among the elderly is below that of the rest of the population, and their ownership of assets compares favorably with that of other Canadians. That objective achieved, some worrying features of these programs are attracting attention.

Table 5: ***Federal Government Program Spending, fiscal year 1998/99***

	Gross	Adjustment	Net
		($ billions)	
Major transfers to persons			
Elderly benefits	22.3	0.5	22.8
EI benefits	11.9		11.9
Child Benefit	5.7	(5.7)	0.0
GST credit	2.9	(2.9)	0.0
Total	42.7	(8.1)	34.7
Major transfers to provinces			
CHST	16.0		16.0
Fiscal arrangements	11.6		11.6
Other, net	(2.1)		(2.1)
Total	25.5		25.5
Other subsidies and transfers	18.7		18.7
Total transfer payments	87.0		78.9
Crown corporations	5.0	(1.5)	3.5
Direct program spending			
Defense	9.1	(0.3)	8.8
Other	22.2	(2.0)	20.2
Total	31.3	(2.3)	29.0
Total program spending	123.3	(11.9)	111.4

Source: Canada 1999f.

"[Elderly] benefits probably encourage older Canadians to leave the workforce."

To begin with, these benefits probably encourage older Canadians to leave the workforce (Gruber 1997), even though many of them are still in good health and have much to offer. In part, this encouragement is simply due to the fact that the extra income makes it possible to leave what is, for many people, the tedium of daily work. With the ratio of older to prime-working-age Canadians in the population on the verge of a sharp increase, it would be foolish to strengthen this effect by enhancing these benefits. In fact, even to maintain the present benefits will raise the cost of these programs by some 0.8 of a percentage point of GDP — about $7.5 billion in today's money — by 2030 (Canada 1999d), and to trim them would be politically explosive.

Moreover — and this is even less desirable — part of the incentive to retire is due to the fact that these benefits are subject to special taxation and clawbacks, which sharply reduce the net benefit that older Canadians get from working (and from past saving). OAS payments are subject to a special taxback, and GIS payments are clawed back at a rate of 50 cents for every dollar of private income. Because these reductions may be stacked on top of regular income taxes and other clawbacks, they create effective marginal tax rates that are often much higher than the underlying income tax rates. In fact, seniors who receive the GIS can be subject to effective marginal tax

rates of 100 percent or more (Shillington 1999), thanks to the withdrawal of various provincial benefits as incomes rise.

The defunct proposal for a Seniors Benefit, which would have replaced the OAS and GIS with a payment that was slightly higher for low- and middle-income elderly while raising the effective tax rates paid by most older Canadians, illustrated the difficulty of modifying these programs without worsening the disincentives they create. Accordingly, despite the fact that the federal government clearly has primary responsibility for these transfers, they make poor candidates for discretionary increases. Over the next five years, they should simply grow in line with increases in the elderly population and their indexing provisions, which will result in a growth rate slightly faster than that of prices and the general population.

Employment Insurance Benefits

Thanks partly to the separate accounting for the inflows, outflows, and cumulative balance of employment insurance (EI) in the federal budget, and the massive surplus that has grown in the EI account since 1995, pressure to expand EI benefits has been strong. The government could respond by boosting the regular benefits provided to those who lose their jobs or the numerous ancillary transfers and services delivered under the EI umbrella or both.

What might be the consequences of expanding regular benefits? This type of program has two important effects that work in opposite directions. On the one hand, income-support transfers not only alleviate the suffering of those who lose their jobs, they also reduce the pressure to take the first thing that comes along, thus helping workers find suitable jobs and raising productivity. On the other hand, such transfers effectively compete against employers for workers, which can raise unemployment among the less skilled and in areas of the country where costs and wages are relatively low.

"[The EI] program is no longer achieving its former purpose of easing job matching."

Questions about the results of an increase in EI benefits must therefore weigh the two effects. On the whole, the second effect has probably dominated in Canada over the past 20 years, for the enrichment of the EI program in the 1970s was followed by a rise in the unemployment rate, and its curtailment in the 1990s was followed by a decline. With the proportion of the unemployed who actually receive benefits now standing below one-half nationally and about one-third in the provinces west of Quebec,[7] it may be that the program is no longer achieving its former purpose of easing job matching, so that further cuts would be unwise. On the other hand, now

7 In October 1999, there were 515,400 recipients of regular EI benefits nationwide, compared with 1,148,300 unemployed as measured by Statistics Canada's Labour Force Survey. West of Quebec, the figures were 222,400 and 670,600, respectively. Data are from Statistics Canada's Internet website: www.statcan.ca/daily/english/991220/d991220c.htm; and www.statcan.ca/english/subjects/labour/lfs-en.htm, as of January 3, 2000.

that the national unemployment rate is declining toward levels not seen since the early 1970s, it again appears unlikely that an expansion of these benefits would help economic performance. Indeed, a move to experience rating EI premiums — that is, rewarding employers who create less unemployment with lower premiums and penalizing those who create more unemployment with higher premiums — could reduce layoffs and result in even lower overall payouts of EI benefits.

The variety of other programs under the EI umbrella makes generalization difficult. Some of them — job-creation projects and training — sound good but have a disappointing record in creating lasting employment or raising their recipients' incomes (Boessenkool and Robson 1997). Others — such as parental benefits — are transfers that have no obvious connection with workforce participation.[8] On the whole, it is unlikely that increasing these amounts would enhance growth.

The aptness of increasing Ottawa's activities in those areas is doubtful. It is clear that income support and training are closely related to provincial welfare and education activities, as implicitly acknowledged in Ottawa's recent moves to give the provinces more control of training programs. And financing these programs through what is ostensibly a social insurance premium turns a large share of EI premiums into a payroll tax and raises awkward questions of accountability and even legality (a topic we return to in the next section).

"[T]he CPP/QPP premium hikes that were set in motion by the [1997] reform package...are now at their steepest rate of increase."

A final argument for restraint in this area arises from the fact that the CPP/QPP premium hikes that were set in motion by the reform package agreed to by the federal and provincial governments in 1997 are now at their steepest rate of increase: a 0.8 percent jump from 1999 to 2000 (from a 7.0 percent combined employer-employee rate to 7.8 percent) and similar jumps the year after and the year after that. Although several provinces also levy payroll taxes (other than workers' compensation premiums, which are more like insurance than a tax), the federal government is the only one that levies them at a high enough level to give it scope to offset the impact of the CPP/QPP rate hike on total payroll taxes and job creation (Dungan 1998). As we point out in the section on taxes below, a complete offsetting of the CPP/QPP increase would require cuts in EI premiums that would reduce federal revenue by more than $2.5 billion in each of the next three years. For that reason, discretionary increases in payments made under the EI umbrella seems most unwise.

In the absence of discretionary increases, the outlook for EI benefits in the coming years is that growth will be well below that of population and prices, since moderate pressure from increases in the average earnings covered by the program will be largely offset by moderate declines in the number of beneficiaries.

8 No rationale has ever been given for providing richer support to parents who were working before their children were born than to those who were not.

The Child Benefit

The Child Benefit is also a high-profile item: enrichments of this program have figured prominently in the past three budgets, and a further expansion has been promised for this year. Although the normal budget presentation leaves the Child Benefit out, treating it as a reduction in personal income taxes otherwise payable, it is in reality a sizable transfer program that — though delivered through the tax system for administrative convenience — takes considerable amounts of money from taxpayers generally and gives it to lower-income Canadians with children. It therefore deserves consideration among the other important federal transfers.

In principle, there are grounds for thinking that government support for children in low-income families can benefit the children themselves and society more broadly. Investments in health care and education for the young are potentially powerful levers for raising growth rates and quality of life. However, while extra income in the hands of less well-off families undoubtedly improves conditions for many children, money transfers are not at all the same as in-kind services such as health, education, housing, and nutrition. For families whose low income is their only difficulty, extra cash will do much good; for families whose low income is part of a bigger picture of difficulty or dysfunction, it may not — far better would be in-kind transfers and services that provinces are better positioned to provide.

To the extent that the Child Benefit serves as a kind of substitute for the recognition of child-rearing costs that the personal income tax no longer recognizes, there is a better course available. Part of the story of Canadian tax-transfer policy during the 1990s has been the attempt to use transfer payments to make up for deficiencies in the definition of the tax base. Rather than add another layer to the problem by raising child benefits for middle-income families, Ottawa should restore universal recognition of the cost of child rearing in the personal income tax, as suggested in our section on personal tax reforms below.

"Ottawa should restore universal recognition of the cost of child rearing to personal income tax."

This move would better align taxes for middle-income families with their ability to pay. And it would avoid a rise in effective marginal tax rates for families with children. The phaseout of the Child Benefit as incomes rise increases the government share of each extra dollar earned; proposals to expand the benefit tend to aggravate this problem or shift it from one income level to another, rather than reduce or eliminate it. If the treatment of families with children under the personal income tax were improved, it would be politically easier to postpone further increases in the Child Benefit over the next few years. In the absence of discretionary increases, the existing partially indexed framework and low birth rates will hold increases in this item to a rate below that of prices and population generally.

As to the difficulties posed by a system that confronts rather low-income families with effective marginal tax rates that are extraordinarily high, the resolution clearly lies in reconstructive surgery on the clawback regime, as

described in Poschmann and Richards (2000). The key to that surgery is integration with the goods and services tax (GST) credit: that credit would be subsumed within a larger income-tested benefit for families with children. Administratively, a family would be slotted into either the GST credit program or the Child Benefit program, depending on whether or not there were children under 18 in the family. The GST credit otherwise payable to the adults — $199 per parent, plus $105 in the case of a single parent — would nominally attach to the first child in the family. These amounts would be in addition to the base child benefit of $1,020 per child, plus the 1999 allotment under the supplementary child benefit ($785, $585, and $510 for the first, second, and subsequent children).

A reduction in payments by 7.5 percent of income above the family net income threshold[9] in the case of a one-child family (rather than by the current 11.0 percent), and by 10.0 percent for all other families (rather than by the current 19.7 or 27.6 percent) would streamline the clawback structure and sharply lower the effective tax rates for most families in the $20,000–36,000 range. Second, benefits paid to families with incomes above $36,000 would be reduced at 2.5 or 5.0 percent of income, depending on whether there were one or more children, as is currently the case. The cost of this reform, with revised income thresholds, would be about $0.8 billion, not far off the cost of earlier recommendations from the Department of Finance for expanding spending under this program.

The GST Credit

"The GST credit [is] a transfer payment disguised as a tax rebate."

The GST credit resembles the Child Benefit in being a transfer payment disguised as a tax rebate (a disguise that is very imperfect, since there is no direct link between actual GST expenditures and the amount rebated). Also like the Child Benefit, its goal of putting extra purchasing power in the hands of lower-income people is accomplished at the cost of imposing higher effective marginal tax rates than those created by income taxes alone on them as workers seek to improve their financial situation.

To the extent that the GST credit is actually a federal welfare program, there are the same objections to it as those just expressed with regard to the Child Benefit. Low incomes are often only one facet of the situation of the families that welfare programs are designed to help; moreover, the GST credit can be poorly targeted (it is available, for example, to students who may be supported by high-income parents). On the whole, it makes more

9 The current benefit is a multi-tiered scheme in which benefits are reduced at a steep rate above a family net income threshold of $21,000 and at a lower rate for family incomes of more than about $30,000. Operating this scheme alongside a $2,000 credit for dependent children, as described below, makes attractive the option (costed here) of lowering the turndown threshold to $16,921; this would substantially lower the net cost of the proposal without leaving any families worse off on balance.

sense for the provinces to provide in-kind transfers and services to families in difficulty than for the federal government to provide cash.

The case for expanding the GST credit seems weak, then — indeed, a case can be made for reducing or even eliminating it. With rising incomes and partial indexation of the GST credit, it seems reasonable to project growth in this benefit at a rate well below that of population and prices.

Transfers to the Provinces

Perhaps the highest-profile demands for more federal spending concern transfers to the provinces: higher payments under the Canada Health and Social Transfer (CHST) and the Equalization program. Provincial governments are major spenders on health, education, and infrastructure — all areas that cross-country comparisons suggest can be important in supporting economic growth. But it is an open question whether new money, on top of the sizable amounts Canada already spends in these areas, would do as much good as money spent in other countries starting from much lower levels. Research on the link between quantity of inputs and quality of outputs in education, for example, shows little consistent link once inputs rise above a certain minimum standard. Nevertheless, it is reasonable to expect that wisely directed resources in these areas could leave Canadians appreciably better off in five years' time.

When it comes to the aptness of federal action, however, there is a serious caveat. It is possible that higher federal transfers will increase the total amounts being spent in these areas, but it is by no means certain, since funds transferred under the CHST and Equalization are not tied to specific provincial spending. What is certain is that higher federal transfers will increase the proportion of Canadians' tax dollars that pass through Ottawa before being routed back to the provinces where they are spent. But there is no reason to think that the resources committed by provincial governments to health, education, and infrastructure will be invested more wisely when more of the money is routed through Ottawa than when it is raised directly from provincial taxpayers.

"[H]igher federal transfers will increase the proportion of Canadians' tax dollars that pass through Ottawa before being routed back to the provinces where they are spent."

The recent baseless fuss over the possibility that new surgical procedures will be delivered privately in Alberta — as though privately delivered services were not already ubiquitous in Canada's health system[10] — illustrates how political grandstanding can impede debate about how best to secure high-quality treatment at reasonable cost. It is no accident that federations around the world give primary if not exclusive power over health and education to subnational governments, which are better positioned to respond to the differing wants and needs of citizens in

10 The vast majority of physicians are self-employed; many medical services, such as pharmacological and laboratory services, are almost completely private; and many surgical procedures are already performed in private facilities.

different regions. In order to align the incentives facing provincial policymakers more completely with the desires of their own voters and taxpayers, it makes sense to increase, not decrease, the share of provincial programs covered by provincial taxes.

We therefore recommend that Ottawa not increase transfers to the provinces beyond the already substantial amounts scheduled under the new Equalization formula and the planned increase in the CHST to $15 billion by fiscal year 2002/03. Rather, as we propose in our discussion of taxes below, Ottawa could explicitly identify part of the tax room it creates as personal income taxes come down as creating space for provinces that need additional revenue to fund their own programs. Under this scenario, overall growth in these transfers would exceed the pace set by prices and population until 2002/03, and then fall behind it; over the full five-year period, it would run ahead by about one percentage point annually.

Other Subsidies and Transfers

The list of other federal transfer payments, which totaled almost $19 billion in fiscal year 1998/99, is extremely varied. Its largest elements are payments to aboriginals, industrial and regional subsidies, and foreign aid, but there are a host of other payments, of which some are straightforward income support, others are intended to stimulate research and regional development, and still others have no public interest justification whatever.

There is little doubt that, in principle, government investments in, and subsidization of, research, infrastructure, and information systems can raise economic growth rates. Increased funding of health information systems holds the promise of bringing medical practice in Canada more in line with what research shows to be effective. Judicious spending on infrastructure — some directly and some through partnerships — could help fill important gaps in Canada's transportation system. Support for research at universities could alleviate Canada's academic "brain drain." At the same time, however, some of the biggest dollar increases in the past fiscal year — in *ad hoc* income supports and grants — were not obviously driven by considerations of broad public interest or longer-term growth. The problem with industrial policy in Canada has generally not been inadequate funding, but inadequate management.

"Whether Ottawa is the right place to look to for more subsidies and transfers depends on how well the money is directed."

Whether Ottawa is the right place to look to for more subsidies and transfers depends on how well the money is directed. Regional economic development is, almost by definition, likely to respond more successfully to regional needs when carried out by regional governments: the fact that Ottawa alone can present part of the bill to taxpayers in regions other than those receiving the funds is, if anything, a reason to avoid such activity at the federal level. Subsidies to research and development, on the other hand, are more plausible candidates for federal provision, since the benefits of success are likelier to flow to the country as a whole — provided, that is,

that the overall tax and transfer system facing business does not, as at present, stimulate research in Canada but encourage development and production in lower-tax jurisdictions abroad. The mix of activities and justifications in this area suggests that simply holding the line on areas where the results are doubtful or Ottawa's role is unclear — including financial support for Crown corporations, housing subsidies, several aboriginal programs, and transfers to special-interest organizations (particularly those that depend on Ottawa for the bulk of their funding) — would accommodate new programs to support research, development, and investments in infrastructure while holding overall growth in this category to a rate well below that of prices and population.

Defense

When Canadians are polled about priorities for spending increases, defense ranks low. But its importance to the country is considerably greater than its standing in the polls, and the federal government's unique capacity in this area is obvious. Canada's defense spending is the same in nominal dollars as it was 15 years ago — which was not high to begin with — and recent difficulty in deploying even token peacekeeping forces in the former Yugoslavia and in Indonesia have highlighted the inadequacy of the resources provided to Canada's armed forces.

"Canada's defense spending is the same in nominal dollars as it was 15 years ago."

There are few direct links between defense spending and enhanced productivity and growth — the best that can be said about defense spending as a species of industrial policy is that much of it focuses on leading-edge technologies, and the standards for judging success or failure tend to be higher and clearer than those in other industrial subsidies. If one takes physical security seriously as an element in any development strategy, however, the deterioration of Canada's military preparedness has to be a concern. Its implications go well beyond the embarrassment of recent equipment failures and the danger they present to their operators. As advances in military technology bring more powerful weapons and delivery systems into the arsenals of larger numbers of countries, the decline in Canada's ability to guarantee the security of its own waters and airspace and to participate in cooperative defense is going to become an increasing concern for its allies, particularly the United States.

If the Americans feel that Canadians are leaving serious gaps in North American defense, they will fill them. This consideration alone argues in favor of spending increases in several areas of defense in the next few years. Although the evolution of the entire defense budget should properly await a comprehensive review of Canada's foreign policy commitments, we are inclined to advocate at least maintaining defense spending at its current share of GDP and allowing it to expand considerably faster than population and prices over the next five years.

Operating Expenses

The remaining category of federal program spending, which amounts to more than $22 billion, is direct operating costs. By far the biggest share of this money, more than $16 billion, pays federal employees. In an important sense, there is still room for savings in this area. Pork barreling with public service jobs, which is made worse by quotas for employment by race, sex, and other personal characteristics, and the bureaucratic tendency to equate success with number of employees, exist in Canada as they do everywhere. Nevertheless, like defense, this area has been subject to considerable restraint over the past decade, and the prospect of more restraint along the same lines is worrying.

"The federal government's attempts to control its personnel costs have resulted in a growing gap between the salaries of top public servants and those of holders of comparable private sector jobs."

The federal government's attempts to control its personnel costs have resulted in a growing gap between the salaries of top public servants and those of holders of comparable private sector jobs. Inadequate compensation at the top poses obvious risks when it comes to the government's ability to generate and implement good policy. It may also mean that the resulting poor management worsens the overall tendency of the public sector to overstaff and overcompensate (which could also be said of inadequate current compensation for Members of Parliament).

A comprehensive review of spending would point to efficiencies that would save on payroll costs. In an ideal world, reallocations within the compensation budget and savings from more efficient operating practices would free up resources to pay high-ranking public servants at rates that would allow Ottawa to keep and attract more top-quality people. In the absence of genuine crises, however, public-service restraint in practice seems to sacrifice quality at the top for the sake of jobs and wages elsewhere. In view of this constraint, it makes sense to contemplate increases in this area, likely in line with growth in population and prices.

Summary

Looking at federal spending as a whole, it is hard to find many areas where there is both a reliable promise of higher living standards and a compelling case for federal action. In fact, even after years of restraint, there are many areas where tighter analysis of benefits and more emphasis on efficiency could save hundreds of millions, if not billions, of dollars. Ideally, the federal government would undertake another round of program review, subjecting each line in the budget to fresh scrutiny for its likely impact on future living standards. Unfortunately, the return of federal fiscal health appears to have inspired a strong urge in Ottawa to spend, raising the possibility that another round of program review, even if one could be arranged, would have negligible or even perverse results. Under those circumstances, simply preventing ill-conceived programs from expanding further will be a major accomplishment.

Summing up, this review of major budget items has revealed three areas where the average pace of increase over the next five years can be expected to exceed that of prices and the general population: elderly benefits, transfers to the provinces, and defense. In four other cases — EI benefits, the Child Benefit, the GST credit, and other subsidies — increases ought to fall short of growth in prices and population. And with one item, operating costs, increases ought to be roughly in line with prices and population. If we add them all up, they amount to an overall rate of growth for program spending that is less than growth in prices and population (see Table 6). Even allowing for some overruns and additional discretionary increases, then, both the assumption in the November update and the course advocated by the House of Commons Standing Committee on Finance (that overall program spending will grow at a pace similar to those of prices and population) seem reasonable.

Taxes

The choice of priorities for tax reduction among the federal government's main revenue sources — personal and corporate income taxes, the GST, and EI premiums (see Table 7) — should, as with spending, be guided by the economic bang for the buck that each dollar of tax reduction delivers and the appropriateness of federal action in the area concerned.

Personal Income Taxes

"[Personal income tax] is one of the areas in which Canada's practice is both out of line with international norms and potentially damaging to long-term growth."

Personal income taxes are the largest revenue source for both the federal and provincial governments. This is one of the areas in which Canada's practice is both out of line with international norms and potentially damaging to long-term growth. Granted, Canada's personal income taxes have positive features: relatively efficient administration; a high level of federal-provincial coordination in the definition of taxable income; and a reasonably broad base. But the rates are high and the income levels at which they kick in are low; moreover, the delivery through the tax system of benefits such as the Child Benefit and GST credit and a variety of provincial credits or other measures, which are clawed back as incomes rise, imposes very high effective tax rates on modest-income earners. Finally, because of the current system of credits, people whose discretionary incomes are similar often pay quite different amounts of tax.

Two useful reforms would be an increase in exemptions and lower marginal tax rates for all taxpayers. If one looks ahead over the entire five-year period in the update, the following elements seem especially desirable.

- *Increased personal amounts.* The personal amounts recognize that, in order to survive, individuals and families have a certain level of

Table 6: *Federal Government Program Spending, fiscal years 1998/99 to 2004/05*

	1998/99	1999/2000	2004/05	Annualized Change 1999/2000 to 2004/05
		($ billions)		*(percent)*
Major transfers to persons				
Elderly benefits	22.3	22.8	26.5	3.0
EI benefits	11.9	12.3	13.0	1.1
Child Benefit and GST credit	8.6	8.9	10.5	3.3
Total	42.7	44.1	50.0	2.6
Total major transfers to provinces[a]	25.5	21.8	25.8	3.4
Other subsidies and transfers	18.7	18.9	19.8	1.0
Total transfer payments	87.0	84.8	95.7	2.4
Crown corporations	5.0	5.0	5.0	0.0
Direct program spending				
Defense	9.1	9.8	11.8	3.8
Other	22.2	23.5	27.1	2.9
Total	31.3	33.3	38.8	3.1
Total gross program spending	123.3	123.1	139.5	2.5
Adjustments	(11.9)	(12.2)	(13.8)	
Total net program spending	111.4	110.8	125.7	2.6

[a] The 1998/99 figure includes a one-time retroactively booked payment of $3.5 billion.

Sources: Canada 1999c; authors' estimates.

nondiscretionary expenses and that the income covering these expenses ought not to be taxed. Since partial indexation took effect in 1986, basic personal amounts for the taxpayer and spouse have stagnated, and the increases in the 1999 budget rectified only the shrinkage in real values after 1992. Rather than the current $7,131 for the taxpayer's personal amount and $6,055 for a spouse, the personal and spousal amounts should be gradually raised by more than the rate of inflation, so that they reflect better the minimum levels of income that should be exempt from tax.

Amounts for dependent children. The unavoidable costs of raising children are also nondiscretionary expenditures. Recognition of this fact in the personal income tax would ideally involve a deduction for dependants; but even the reintroduction of a broad-based credit for dependants, especially if accompanied by a flatter rate structure, would be a great improvement. We recommend (as in Boessenkool and Davies 1998) allowing all taxpayers a generous amount — such as $2,000 per child — to be included in the calculation of nonrefundable credits. A similar

Table 7: ***Federal Government Tax and Fee Revenue, fiscal year 1998/99***

	Gross	Adjustment	Net
		($ billions)	
Income tax			
Personal	77.7	(5.2)	72.5
Corporate	21.6		21.6
Other	2.9		2.9
Total	102.2	(5.2)	97.0
EI premiums	19.4		19.4
Consumption taxes			
GST	23.5	(2.9)	20.7
Import duties and excise taxes	10.7		10.7
Total	34.2	(2.9)	31.4
Fees and other revenue	6.7	(3.7)	3.0
Total taxes and fees	162.5	(11.8)	150.7
Memo item: return on investments	5.1	(0.1)	5.0

Source: Canada 1999f.

feature is found in Quebec's income tax, and Saskatchewan's Personal Income Tax Review Committee recently recommended just such a measure.

Indexation. Incomplete indexation of the personal income tax structure since 1985 has raised Canadians' tax bills even as their real incomes stagnated; it has raised average marginal tax rates — thus discouraging work and saving; and it has raised the federal personal income tax take by about $10 billion above what it would have been with complete indexing. A return to full annual indexation of credits and rate thresholds would end the annual, silent tax increases and prevent governments from raising effective tax rates each year without new legislative authority. Boosting the personal amounts as suggested above would partially redress the wrongs committed in the era of partial indexation. Pending a return of full indexation, tax rate thresholds should be raised in line with proposed increases in the personal amounts.

"A return to full annual indexation of credits and rate thresholds would end... annual, silent tax increases."

Retirement plans. The current tax treatment of retirement plans allows contributions (within limits) to be deducted from income, exempts earnings on plan assets, and taxes withdrawals, which must begin at age 69. Private saving should gradually be made easier, by increasing the amount that can be sheltered in registered retirement savings plans (RRSPs), in accordance with long-delayed federal plans. The increase in the maximum RRSP annual contribution to $15,500 — now scheduled

for 2005 — should take effect in 2000, and this limit should be indexed to inflation, with limits on registered pension plan contributions adjusted accordingly.[11]

- *Investment income.* Although these rate cuts and threshold increases would help, Canada's effective tax rates on investment income would still be high by international standards, especially compared with those of the United States and especially for capital gains. Two current measures lighten tax on some investment income: only 75 percent of realized capital gains are included in taxable income; and dividends from taxable Canadian corporations generate a credit that reduces tax otherwise payable by about a quarter. Since businesses can choose to distribute income as capital gains or dividends, there should be a rough balance between tax rates on these two types of income. Yet typical combined federal and provincial income taxes yield an effective tax rate on capital gains that is several percentage points higher than that on dividend income; see Mintz and Wilson (2000) for details. Accordingly, given the Canadian personal income tax rate structure as it now stands, the share of income from capital gains included in taxable income should be reduced from three-quarters to two-thirds. Furthermore, because of the importance of retained earnings in building small businesses and family farms, rollover provisions should be changed so that capital gains on their sale could be brought untaxed into RRSPs. This would allow the lifetime exemption on capital gains on disposition of those assets to be eliminated without undue harm to the families and assets that the exemption is intended to shelter. But even after these charges, taxes on savings would still be too high. To reduce them, further desirable measures would be improvements in the dividend tax credit and more sheltering from tax of saving for purposes other than retirement.

"[T]he share of income from capital gains included in taxable income should be reduced."

- *Tuition costs.* Taxpayers now receive a nonrefundable credit for most postsecondary tuition costs. This credit provides relief only at a rate about equal to the tax rate on the lowest income bracket, rather than through a deduction that would give relief at the taxpayer's actual marginal tax rate (and would correspond more closely to the tax rates that the student will pay when he or she is working). Treating tuition fees as an investment in human capital would parallel the tax treatment

11 Further reforms to pension policy should also be considered. Currently, Canadians aged 65 or over are entitled to include in their tax calculation an amount up to $1,000 in pension income, multiplied by the nonrefundable tax credit rate (17 percent) and taken against basic federal tax otherwise payable. This concession applies only to pension income, and it has no economic justification. In addition, taxpayers aged 65 and over have available an age amount of $3,822 (also used in calculating nonrefundable credits), but it is reduced at a relatively steep rate of 15 percent of net income above $25,921. The justification for the age credit is that the cost of living for the elderly is greater than for other Canadians, which is not obviously true, and would not, in any event, justify a clawed-back credit. The phased elimination of both these provisions would make the personal income tax base broader and would reduce an inequity between older and younger Canadians.

given to retirement savings; a deduction — rather than a credit — would remove the tax bias against human capital investments. This is particularly important for workers who pay out of their own pockets for mid-career training.

- *Marginal rates*. In the range of incomes from $20,000 to $60,0000, the rate structure of Canadian personal taxes is too steeply graduated.[12] Recent federal and provincial budgets have made this problem worse by giving most of their tax relief only to very low-income Canadians, and often clawing it back as incomes increase. One improvement would be to raise the threshold above which the 26 percent middle rate kicks in; another would be to lower the middle rate itself to 23 percent. But that alone would still leave marginal rates very high. The temporary 5 percent "deficit reduction" surtax, which has plainly outlasted its justification, is notable for imposing especially high economic costs (Dahlby 1994). And at the other end of the spectrum, a bottom rate of 17 percent is too high — a perverse reward for lower skilled Canadian entering the workforce — and also should be reduced.

A number of these changes would reduce the income tax revenue of provinces that levy their personal taxes as a percentage of basic federal tax (leaving aside the offsetting impact of improved economic growth). There is, however, little justification for Ottawa to avoid these changes on that score. Several of these provinces already intend to move to personal tax systems linked to the federal base rather than federal tax payable, which would limit the impact of some of these changes on provincial revenue. More fundamentally, however, these provinces have benefited from unlegislated tax increases over the past two decades as federal thresholds have come down in real terms. If bracket creep allowed the provinces to set their tax rates lower, or spend more, than they otherwise would have, the restoration of the real value of federal thresholds ought no less logically to prod them to reverse those changes. To ease the political tension that might result if provinces raised their rates to offset a shrinking base, Ottawa could explicitly identify part of its personal income tax reductions as an effort to create room for provinces that urgently need more revenue.

"[T]he... economically damaging structure of Canadian personal income taxes justify allocating the bulk of the annual $4.6 billion in budget room to reducing them."

In our view, the weight and economically damaging structure of Canadian personal income taxes justify allocating the bulk of the annual $4.6 billion in budget room to reducing them. Estimates of the deadweight cost of these taxes on work and saving and empirical work on cross-country growth rates both give grounds for expecting that lower personal income

12 Canada's personal taxes are easily the most sharply graduated among OECD countries, as measured by the marginal rate jump as taxpayers move from two-thirds to all of the average wage (OECD 1997, table 19). Between $20,000 and $35,000, the problem is at its worst, owing to stacked clawbacks attached to federal and provincial child benefit programs, combined with targeted reduction schemes, based on family income, for provincial taxes.

taxes could boost growth. If we set aside possible stimulus to demand or confidence arising from a reversal of Canada's rising tax burden, and look at a middle-of-the-road figure derived from the cross-country correlations between distorting taxes and growth, it appears that personal tax cuts of some $4 billion annually would increase the budget payoff in the fifth year by an additional amount of perhaps $3.8 billion (a further $0.8 billion annually).[13]

Taxes on Business

The taxation of business in Canada was the subject of the comprehensive report of the Technical Committee on Business Taxation (Canada 1998). That report argued for lower rates of corporate income tax and a broader and more neutral tax base. As with the personal income tax, changes here would greatly improve efficiency and fairness throughout the economy.

"Recent business tax reforms in many countries have put Canada in a worsening position."

Recent business tax reforms in many countries have put Canada in a worsening position. Canada's general corporate income tax rate, at 43 percent (federal plus provincial), will soon be the second-highest in the developed world (see Table 8). Effective tax rates on investments in manufacturing, which are taxed at a lower rate of 35 percent, will still be higher than in Canada's main competitor countries. Equally serious, Canada's services sector taxes are high, both by international standards and compared with those in the United States. This differential is important, because some key areas of the services sector, such as business services, communications, and transportation, are becoming steadily more subject to international competition while having a relatively heavy tax burden that limits their profitability and ultimately restrains domestic investment and growth.

The ideal time to address these sectoral imbalances is when there is room, as now, to reduce the tax burden overall.[14] If corporate income tax rates were lowered moderately to below the average OECD rate of 34 percent and if some perverse incentives were reduced, there would be substantial efficiency gains to the economy. Therefore, the corporate income surtax, currently at 4 percent, should be eliminated and the general federal corporate income tax rate of 28 percent should gradually be reduced to

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13 The cumulative reduction in taxes, expressed as a proportion of GDP, amounts to about 1.8 percent; using a coefficient of –0.35 to relate the tax-to-GDP ratio to growth suggests that, by the end of the period, growth would be almost two-thirds of a percentage point higher than otherwise and GDP would be some 2 percent higher. This estimate of the growth-enhancing effects of lower tax rates may seem large, but the coefficient is derived from international averages, and Canada's reliance on distorting taxes is relatively high. Calculations of the impact of taxes on work effort, saving, and investment (deadweight losses), moreover, usually suggest that, when taxes are as high as Canada's, tax cuts can produce one-time increases in the level of output and incomes that, in the short run, are even larger (Dahlby 1994).

14 This point is where the Technical Committee was most constrained by its terms of reference, which required revenue neutrality within the business tax system and therefore made it politically difficult to act on its broad recommendations, since a reduction in the burden on overtaxed sectors would require higher taxes on others.

Table 8: ***Statutory Corporate Income Tax Rates, Selected OECD Countries, 1996 and 1999***

	Corporate Income Tax Rate			
	July 31, 1996	January 1, 1999	Direction of Change	Intention (Year)
		(percent)		
Australia	36.0	36.0	lower	30.0 (2001)
Canada	34.9/43.2	35.0/43.3	no change	
Denmark	34.0	32.0	lower	
France	41.7	36.7/40.0	lower	36.7 (2000)
Germany	56.1	51.9	lower	35.0 – 38.0 (2000)
Ireland	10.0/38.0	10.0/28.0	lower	12.5 (2003)
Italy	53.2	31.3 – 41.3	lower	
Japan	52.2	48.0	lower	
Netherlands	37.0/35.0	35.0	lower	
Norway	28.0	28.0	no change	
Poland	40.0	34.0	lower	22.0 (2004)
Sweden	28.0	28.0	no change	
Switzerland	35.5	25.1	lower	
Turkey	44.0	33.0	lower	
United Kingdom	33.0	30.0	lower	
United States	39.2	39.2	no change	

Source: Mintz 1999.

18 percent. This would be most useful in the services sector, particularly financial services, where statutory and effective rates are high by any standard. Such a change could improve Canada's growth prospects beyond the boost provided by personal tax cuts alone: the same cross-country evidence cited above (which may be conservative given the potential for more bang for the buck when reducing corporate rates) suggests that the additional growth could enlarge the cumulative budget room over the next five years by a further $0.5 billion.

EI Premiums

The EI payroll tax stands out as a target for reduction because, even with several successive years of premium cuts, the amount collected is expected to remain far more than required to fund insurance payouts. Meanwhile, as a matter of honesty in advertising and for distributional reasons, that tax is not well designed for generating general government revenue.

The 2000 employee premium is set to be $2.40 for each $100 of covered wages, plus another $3.36 to be paid by employers. The November 1999 update projected that EI revenues would exceed costs by nearly $6 billion — an amount that will grow if the unemployment rate continues its recent impressive decline. Furthermore, by the end of fiscal year 2001/02, the

surplus in the EI account (the cumulative excess of premiums over costs) will be more than $30 billion, which is far more than enough to allow premiums to remain stable when EI payouts increase in the next slump (Canada 1999b, chap. 33).

In fact, there is no actual separate EI fund; the annual excess of revenue over payouts flows directly into Ottawa's consolidated revenue fund. But if the small premium reductions of the past few years are not followed by larger ones, EI will continue to be a misleadingly marketed general payroll tax supporting government spending, rather than the self-financing program for the benefit of employers and employees it is intended to be.[15]

When it comes to tax cuts aimed at improving income growth and employment, however, it is not clear that payroll taxes should be first in line. Personal income taxes are probably more damaging to the economy. The work-discouraging effects of the personal income tax are more pervasive, since they affect people across the income scale (unlike EI premiums, which do not apply to employment incomes above $39,000). Income taxes also directly discourage saving and investment, whereas payroll taxes do not.

So the potential tradeoff is daunting. Cutting EI premiums enough to stop the account surplus from building further in 2000 and 2001 would, in revenue terms, be equivalent to cutting each of the three federal income tax rates by a full percentage point and eliminating the 5 percent federal surtax, while still leaving room to increase the basic personal amount.

"Ottawa should…commit itself to making EI more closely resemble an insurance plan."

Ottawa should, however, commit itself to making EI more closely resemble an insurance plan by 2004. This would necessitate lowering premiums to roughly balance benefits over the long run, in order to help mitigate the job-killing effects of scheduled increases in CPP/QPP contributions. As noted already, the CPP/QPP rate is scheduled to rise in 2000 by another 0.8 percent of covered earnings. In order to fully offset the increase, EI premiums would have to be cut to 5.04 percent (2.94 for employers, and 2.10 for employees, rather than 2.40), a move that would deprive the federal government of $2.5 billion in revenue annually.

If noninsurance payouts under the EI label do continue to rise, the portion of premiums not used to pay benefits to laid-off workers should be explicitly labeled as a general payroll tax. Canadians should not be led to believe that the hefty tax they pay under EI is actually tied to EI benefits. Such a change could easily allow the portion of EI premiums paid by employees to be reduced to zero (Boessenkool, Poschmann, and Robson 1998), leaving the continuing financing of EI to employers alone. This would make it easier to implement partial experience rating, so that the premiums a firm pays depend on its record as a stable employer. This combination of

15 As already noted, total payroll taxes are already scheduled to rise, thanks to the continuing hikes in CPP/QPP premiums. Since Ottawa is the only government with the capacity to offset this increase and dampen its potential impact on jobs (Dungan 1998) with a cut in its own payroll taxes, the case for its acting is clear.

measures would make the EI system more efficient, fairer, and more accountable, and less expensive, but it would not cut deeply enough into federal revenue to preclude other tax cuts.

The GST

The GST remains an unpopular tax, but it is not a good candidate for reduction. It is a reasonably efficient tax on economic grounds because it avoids the income tax bias against saving and investment. And although Canada relies far more on sales taxes than does the United States or Japan, its use of consumption taxes is low by international standards (see Duclos and Gingras 1999).

Indeed, Canada could improve its tax mix if it increased its reliance on consumption taxes and used the revenue to lower personal taxes, as Australia has recently done. A growing body of empirical evidence supports the argument that a tax mix based more on consumption, less on labor, and still less on capital leads to higher growth than any other arrangement (Xu 1997). Although these arguments would suggest that the GST should, if anything, be a more important revenue source for Ottawa — its base broadened and perhaps even its rate raised to pay for cuts in other taxes — the same shift toward a consumption-based tax system could be achieved by more generous treatment for saving under the personal income tax. Accordingly, it is perhaps best to avoid a political headache and leave the GST as it is.

Summary

"Ottawa has important opportunities to reduce several economically damaging taxes."

Surveying the tax side reveals that Ottawa has important opportunities to reduce several economically damaging taxes, with cuts to personal and corporate income tax at the top of the list. Federal leadership in this area could raise Canadian living standards appreciably by the end of the five-year period surveyed in the November 1999 update, not through their impact on aggregate demand (effects already included in the update's projections), but through greater rewards for work and saving. If we use the room for budget initiatives identified in the update as a yardstick, it is not unreasonable to imagine a payoff some $4.3 billion higher by the fifth year than without tax cuts — a further $0.9 billion annually in fiscal room beyond what the update projected.

Putting It All Together

Having identified key priorities for the five-year period canvassed by in the November 1999 update, we need to work out a set of annual packages by which they could be achieved in a fiscally prudent fashion.

Framing a Fiscal Plan

To repeat, the November update envisioned an accumulation of fiscal room, without any policy changes, amounting to $23 billion in the fifth year — an annual average of $4.6 billion in initiatives. We think that using unneeded prudence factors to pay down debt and concentrating on distorting taxes in the allocation of that budget room might raise the total to over $28 billion by the fifth year — an annual average of $5.6 billion. The update, however, was determined not to count unhatched chickens, and in that spirit we restrict our recommendations to moves that can be accommodated within the update's framework of annual $4.6 billion initiatives.

We propose a package of tax changes to be implemented through federal budgets beginning in 2000. The size of the prospective cuts is predicated on economic assumptions in the November update and on program spending growing in line with prices and population, rather than on the 50/50 rule. The cuts respect the contingency reserves and prudence factors contained in the November update. The effect of our suggested changes would be to reduce the weight of personal and corporate income taxes in federal revenues.

"[O]ur...changes would...reduce the weight of personal and corporate income taxes in federal revenues."

Business tax changes should not wait for major cuts in personal income tax. A balanced program of changes in personal and business taxes, with a heavy emphasis on reductions in personal income tax, could be explained and justified to the Canadian public. But if personal tax cuts were to come first, crucial changes in business taxes would be postponed unduly. And business tax reform would also be politically less acceptable by itself, without complementary cuts to personal income tax.

Reallocations and tax reform are more difficult when there is not enough budgetary room to ensure that there are many winners and few losers. For this reason, it may be best to limit the tax rate reductions in the 2000 budget in order to ensure that the potential for rate reductions in 2001 and later is great enough to offset the impact of base-broadening measures for the majority of taxpayers. This tactic, however, is only possible if there is a firm commitment to bank the surpluses, rather than spend them. To delay tax cuts only to see the budgetary room absorbed by last-minute spending increases is a recipe for frustration and economic underperformance. In this sense, intelligent tax reform and budget surpluses larger than the $3 billion contingency reserve are complementary parts of a package.

Upcoming Budgets

For the spring 2000 budget, our first recommendation is a package of changes to the personal income tax:

- a cut in the middle rate from 26 to 25 percent;
- an increase in all thresholds and personal amounts by 2.6 percent;
- introduction of a $1,000 credit for dependents; and

- reduction of the personal surtax from 5 percentage points to 2.5 percentage points.

The combined effect of this package, after allowing for the interaction of the various elements, would be to reduce revenues by some $3.3 billion.

In addition, we recommend reducing the share of capital gains included in taxable income from three-quarters to two-thirds — a change that, after allowing for increases in capital gains realizations in the near term, might result in a revenue decline of about $0.2 billion.

On the corporate side, a 2 percentage point cut in the general business income tax rate, with some base broadening, would reduce revenues by some $0.5 billion, while a 2 percentage point reduction in the corporate surtax would result in a further tax cut of about $0.3 billion.

As for EI premiums, we recommend a further reduction in the employee share of 5 cents per $100 in covered wages beyond the amount already planned for 2000. This would further offset the CPP/QPP premium hike and also provide relief for small businesses that would gain relatively less from our proposed changes to corporate taxes. The revenue forgone as a result of this change, after allowing for increases in personal income taxes as a result of smaller credits for EI contributions, is some $0.3 billion.

"[Our] package would produce tax cuts in the February 2000 budget of some $4.5 billion."

This package would produce tax cuts in the February 2000 budget of some $4.5 billion,[16] meeting the targets and leaving aside just a little more than the contingency amounts and prudence factors for more meaningful debt reduction.

The 2001 package could complete two changes started in 2000: eliminate the personal surtax completely and raise the credit for dependants to $2,000. After allowing for a reduction in revenues from these changes of $1.1 billion, there would be room for further changes — in particular, a 1 percentage point cut in the bottom personal income tax rate, a further increase of personal amounts and tax rate thresholds by an amount roughly equal to inflation, additional cuts in EI premiums, and elimination of the corporate surtax. In this year, as in the third and fourth years, room would still be available (with some base broadening) to shave two points from the general corporate income tax rate.

By years three and four, the stage would be set for large-scale cuts in personal income tax. A reduction in the bottom rate by a further percentage point, in the middle rate by 2 percentage points, and in the top rate by 1 percentage point would move the system to a new 15, 23, 28 percent structure by year three. In addition, it would be possible in year four to undertake a sizable increase — on the order of 10 percent — in all thresholds, restoring much of the value lost in recent years owing to incomplete indexation.

16 Changes in the structure of the Child Benefit are outlined under the heading "Spending," above, and treated as expenditures in Table 6.

By making it explicit that part of this decrease had created room for provinces eager to spend more on health and education, the federal government could more easily placate provinces still linked to the "tax-on-tax" system and are worried about the impact on their revenues; it could also alleviate provincial pressure for further increases to federal-provincial transfers.

The package we have described would still allow, in the fifth year, two more points to be cut from the general corporate income tax rate as well as further, generous increases in personal amounts and thresholds. Meanwhile, the total cuts in EI premiums would bring the employee rate down to $1.90 per $100 in covered earnings, a level more financially and politically consistent with a sustainable program.

By the final year, it is probable that additional debt paydown and the impact of tax cuts on growth would have increased Ottawa's budget room to the point where the fiscal plan underlying these packages would not be ambitious enough. If so, the opportunity for further sizable rate cuts would open up, making it easier to contemplate tax reforms that would further broaden the tax base and enhance economic growth — a further virtuous circle that is encouraging to contemplate, even if it is still several years away.

The proposed tax changes are summarized in Table 9.

The February 2000 Budget

"[T]he federal government needs to take seriously the task of enhancing economic growth and boosting the budget payoff identified in the November update."

As the 2000 budget approaches, the federal government needs to take seriously the task of enhancing economic growth and boosting the budget payoff identified in the November update. Twenty-three billion dollars offers a lot of room for new budget initiatives, but the total good news over the next five years could be greater yet. Debt paydown, program spending, and taxes — each area needs close scrutiny, and hard questions need to be asked about what impact changes would have, and whether the federal government is the right government to make these changes.

In our view, the use of the unneeded prudence factors to pay down debt offers a guarantee of larger payoffs down the road — adding almost $1 billion to the five-year budget payoff identified in the update. Because of the federal government's large debt and buoyant bottom line, it is the logical government to reduce the burden of Canada's public debt. When it comes to program spending, we see plenty of room for reallocations to accommodate increased spending in areas that offer clear benefit and where federal action is most appropriate; we recommend holding total growth to a rate equal to increases in prices and population, as envisioned in the update and recommended by the House of Commons Standing Committee on Finance. As for tax cuts, the scope for moves that would enhance growth is enormous, and the case for federal action is compelling. An average of $4.6 billion in tax cuts in upcoming budgets would relieve Canadians of a

Table 9: ***A Schedule of Cuts in Personal Income Tax, Corporate Income Tax, and Employment Insurance Premiums, 2000–04***

	Cost				
Description	**2000**	**2001**	**2002**	**2003**	**2004**
			($ billions)		
Decrease middle rate 1 point	1.1	1.1	1.2	1.2	1.3
Decrease bottom rate 1 point		1.9	2.0	2.1	2.1
Shift to rates of 15, 23, and 28%			4.4	4.6	4.8
Raise rate thresholds and personal amounts					
by 2.6%	1.0	1.0	1.1	1.1	1.2
by 2.0%		0.8	0.8	0.9	0.9
by 9.9%				3.5	3.6
by 7.4%					2.6
Reduce personal surtax					
by half to 2.5%	0.3	0.3	0.3	0.3	0.4
to zero		0.3	0.3	0.3	0.4
Introduce $1,000 credit for dependants	0.8	0.8	0.9	0.9	0.9
Raise credit for dependants to $2,000		0.8	0.9	0.9	0.9
Lower capital gains inclusion rate to 66 2/3%	0.2	0.2	0.2	0.2	0.2
Lower EI premiums					
$0.05 for employees, $0.07 for employers	0.3	0.3	0.3	0.3	0.4
$0.15 for employees, $0.21 for employers		0.8	0.8	0.9	0.9
$0.05 for employees, $0.07 for employers			0.3	0.3	0.3
$0.10 for employees, $0.14 for employers				0.7	0.7
$0.15 for employees, $0.21 for employers					0.9
Lower general business income tax rate					
by 2 points	0.5	0.5	0.6	0.6	0.6
by 2 points		0.5	0.6	0.6	0.6
by 2 points			0.6	0.6	0.6
by 2 points[a]				0.8	0.8
by 2 points[a]					0.8
Lower business income surtax by 2 points	0.3	0.3	0.3	0.3	0.3
Eliminate business income surtax				0.3	0.3
Offsetting income tax base-broadening measures[b]	0.1	–0.5	–1.7	–2.8	–3.2
Total	4.5	9.1	13.8	18.4	23.0

[a] In the fourth and fifth years, the manufacturing and processing rate would also be lowered to match the general business rate.

[b] Corporate income tax rate cuts are partially offset by base-broadening measures that reduce the net revenue cost by $0.8 billion by year five; the expansion of RRSP contribution room beginning in year one is more than offset by the elimination of the lifetime capital gains exemption for farm and small business proceeds, taken together with RRSP rollover provisions (see Mintz and Poschmann 1999); and beginning in year three, employer-provided health insurance benefits would become taxable and creditable under the medical expense tax credit (see ibid.), for a net federal revenue gain of $1.5 billion.

Sources: Canada 1999c, 109–113; authors' estimates.

costly burden and could, under reasonable assumptions about the links between taxes and growth, expand the total payoff by a further $4.3 billion over five years.

In all, then, we see potential for wise moves in upcoming budgets that could raise the total payoff envisioned in the update to more than $28 billion by the fifth year — an average of some $5.6 billion annually. To reap that kind of extra benefit, without adding to the risk of slipping back into deficit, strikes us as a worthy goal for federal fiscal policy. Well-chosen tax cuts in the spring 2000 budget would move Canadians a long way toward that goal.

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