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Backgrounder

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Nice Tax Cuts — Shame about the Spending

by

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In the run-up to the February 2000 federal budget, hopes ran high. The five-year projections in the Finance Department's November 1999 *Fiscal and Economic Update* had prepared the ground for a more farsighted approach to addressing fiscal challenges. Revenue growth was fast outpacing program spending, giving Ottawa an opportunity to pay down debt and cut future interest payments and to encourage work and investment in Canada with broad-based cuts to personal and business taxes.

At first sight, the budget actually delivered on February 28 fulfills those hopes. The immediate reindexation of personal income taxes, the imminent reduction in the middle personal tax rate, and the improvements to capital gains taxation are all key steps forward. And the promised reductions in personal surtaxes and business taxes point tantalizingly toward a more dynamic, entrepreneurial Canada in the future.

Looking beyond those steps, however, the budget contains so much new spending that serious doubts arise about Canada's ability to reach that future. Revising the five-year projections in the November update to take account of new information presented in the budget suggests that, rather than dividing the projected surplus roughly equally among debt paydown, tax cuts, and new spending, as envisioned in the update, Ottawa will spend far more than half the total. Fresh effort to hold the line on spending is needed if the promise of lower debt and taxes is to become a reality.

Nice Tax Cuts

Turning first to the good news, the most surprising and significant move in the budget is the reindexation of personal income tax thresholds. There is no need to repeat here the economic and political reasons for disliking unindexed taxes: it is enough to note that Canadians will no longer be subject to pervasive, unlegislated tax hikes by wage increases that merely match inflation. Advocates of reindexation were discouraged by polls apparently showing that Canadians generally accorded this step a low priority, and the federal government deserves high praise for having looked past that obstacle and done the right thing.

The early move to a lower middle personal income tax rate is also highly commendable. Again, the reasons for disliking the existing regime, where Canadians encounter rapidly escalating marginal tax rates at relatively modest income levels, have been well aired. For taking a major step toward lower average tax rates for middle-class Canadians and for reducing somewhat the damage done by the stacking of income-tax rates and social-benefit clawbacks, Ottawa deserves recognition.

A third set of tax changes that stands out for its positive implications for future growth is the capital gains taxation package. A lower inclusion rate and the modifications to stock-option and rollover treatments lessen a particularly growth-inhibiting burden, and Ottawa's willingness to proceed with those steps shows a commendable concern for future prosperity.

The budget promises other tax changes that would help still further. The reduction and elimination of the high-income surtax would cut tax rates for many of Canada's most talented and hardest-working citizens to levels more consistent with the benefits they provide the country, and more competitive with rates elsewhere. Perhaps most significant over the long haul is the promised reduction of general business tax rates: business taxes are almost uniquely damaging to long-term prosperity, and Canada's general rates of corporate income tax are now well out of line internationally. Unlike the other tax changes announced in the budget, however, full implementation of these measures will not occur until well after the end of the budget's two-year planning horizon.

The Not-So-Nice Fiscal Framework

When the focus shifts from near-term tax changes to the longer-term fiscal plan, the overall sense of a good-news budget begins to fade. Whether Ottawa actually delivers on some of these promises or follows them with bolder moves to relieve Canadians of a still-punishing tax burden depends on the size and disposition of future projected surpluses. And the February budget not only cuts deeply into the surpluses projected in the November update, it appears to signal that debt paydown and tax cuts will get a much smaller proportion of those surpluses than the update projected.

As followers of federal fiscal policy know well, the November update projected that, even after allowing for spending to rise in line with population growth and inflation, the surplus (with no policy changes) would amount to $30 billion by fiscal year 2004/05, or a cumulative $100.5 billion from the current fiscal year until then. After allowing for an annual contingency reserve and prudence cushions against economic setbacks, the update identified the surplus available for new initiatives as $23 billion in 2004/05, or a cumulative $69 billion over the six-year period. Table 1 shows the key numbers, after adjustments to add back into revenue and spending a number of items that the budgetary presentation nets out (a topic explored further below).

A reasonably straightforward reading of the November update's figures was that the contingency reserves and prudence cushions were there to protect the budget's bottom line from unexpected setbacks. If events turned out worse than expected, those cushions would not be available for a budget surplus, but their erosion would allow the rest of the fiscal plan to stay on course. By the same token, if the economy behaved as envisioned in the update, those amounts would translate into budget surpluses that could be used to pay down debt. And if the economy turned out better than expected, the debt paydown could be larger yet. Of the $100.5 billion cumulative difference between revenue and spending, $32 billion — just shy of one-third — would, on this reading

Table 1: ***Summary of Federal Government Transactions, fiscal years 1998/99 to 2004/05, According to the November 1999 Fiscal and Economic Update***

	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	Total 1999/00 to 2004/05
				($ billions)				
Gross taxes and fees	162.6	165.6	172.7	180.9	188.4	196.5	205.5	
Less gross program spending	(123.3)	(123.7)	(126.4)	(131.2)	(134.2)	(137.3)	(140.8)	
Equals 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)	
Equals underlying balance	2.9	5.0	9.5	13.5	18.5	24.0	30.0	100.5
Less contingency reserve and prudence factors		(3.0)	(4.0)	(5.0)	(6.0)	(6.5)	(7.0)	(31.5)
Equals fiscal surplus for planning		2.0	5.5	8.5	12.5	17.5	23.0	69.0

of numbers be allocated to potential debt reduction.

Turning to the $69 billion left for discretionary action, Ottawa has long maintained that its policy is to spend half of any projected surplus. This crude rule of thumb has been much criticized — not least by the House of Commons Standing Committee on Finance, which recommended greater emphasis on tax cuts — but never abandoned. The November update's projections seemed to suggest that, of the $69 billion in cumulative discretionary room, one-half would be spent and one-half devoted to a like amount in tax cuts. Overall, therefore, the update outlined a split of almost exactly one-third to each of debt paydown, tax cuts, and new spending.

In the wake of the February budget, however, things look quite different. To begin with, the budget projects sizable increases in nearly every category of spending, from transfers to the provinces to subsidies to business, and in nearly every government department, from National Defence to Human Resources Development. At least as disconcerting, moreover, the budget shows that the federal government is determined to dispose of unexpected surpluses, not by paying down debt but by billions of dollars of last-minute spending. In a now-familiar tactic, much of this spending is packaged as one-time transfers to arm's-length bodies. As the budget's fresh infusion of money to the Canada Foundation for Innovation — an entity created by post-year-end spending in fiscal year 1996/97 — illustrates, however, last-minute splurges in one year tend to become ongoing commitments in later years.

In order to put the budget's changes into the familiar five-year framework used in the November update, Table 2 reconciles the figures presented in Table 1 with new information presented in the budget. Aside from plugging in new revenue and spending numbers for fiscal years 1999/2000 through 2001/02, the reconciliation involves three operations.

First, Table 2 adds to the budget's revenue and spending numbers several spending items that are netted against revenue in the budget presentation. This adjustment corrects an artificial diminution in the apparent size of the federal government's operations in all years. It also accounts — which the spending numbers in the budget do not — for the new money for the Child Benefit. The budget treats this

Table 2: ***Summary of Federal Government Transactions, fiscal years 1998/99 to 2004/05, According to the February 2000 Budget***

	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	Total 1999/00 to 2004/05
					($ billions)			
Gross taxes and fees	162.6	167.6	170.7	177.5	184.1	191.4	199.2	
Less gross program spending	(123.3)	(127.7)	(130.4)	(137.7)	(142.2)	(146.4)	(150.5)	
Equals primary balance	39.3	39.9	40.2	39.8	41.9	45.1	48.7	
Less net debt charges	(36.4)	(36.9)	(37.2)	(36.8)	(36.2)	(35.7)	(35.2)	
Equals underlying balance	2.9	3.0	3.0	3.0	5.7	9.4	13.4	37.5
Less contingency reserve		(3.0)	(3.0)	(3.0)	(3.0)	(3.0)	(3.0)	(18.0)
Equals fiscal surplus for planning		0.0	0.0	0.0	2.7	6.4	10.4	19.5
Changes since November Fiscal and Economic Update								
Gross taxes and fees collected		2.0	(2.0)	(3.4)	(4.3)	(5.0)	(6.3)	(19.1)
Gross program spending		4.0	4.0	6.6	8.0	9.1	9.7	41.4
Primary balance		(2.0)	(6.0)	(10.0)	(12.3)	(14.1)	(16.1)	(60.5)
Net debt charges		0.0	0.5	0.5	0.5	0.5	0.5	2.5
Underlying balance		(2.0)	(6.5)	(10.5)	(12.8)	(14.6)	(16.6)	(63.0)

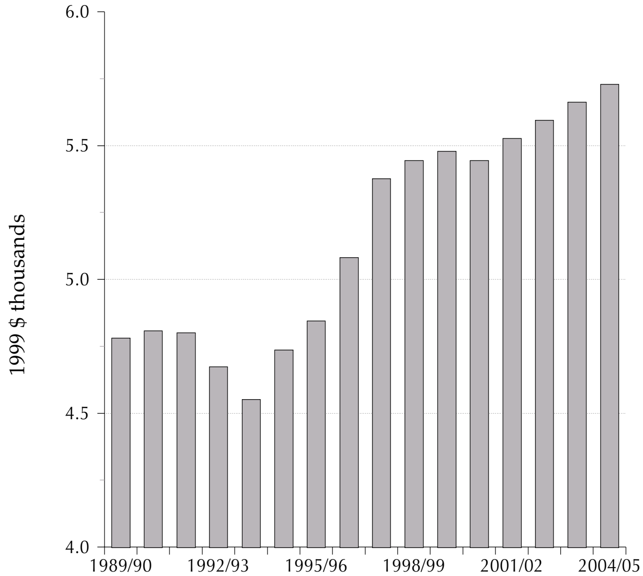
spending as a reduction in personal income tax revenue on the grounds that the program is administered through the personal income tax system. In reality, the program provides transfer payments to one group of citizens that are financed by higher-than-otherwise taxes on others: it is the gross size of government taxes and spending that matters, not just the difference between them.

Second, Table 2 projects forward from 2001/02, using the same growth rates for revenue and spending after that year that were assumed in the November update, save for downward adjustments to revenue to account for the impact of indexation.

The final adjustment reflects a lesson from recent budgets about what happens to surpluses beyond the $3 billion contingency reserve. The February budget is the fifth in a row in which unanticipated revenues were spent in an end-of-year binge, making it clear that the forward-looking case for debt paydown cannot compete with the instant political gratification from more spending. Accordingly, Table 2 rolls future prudence cushions into spending, on the grounds that this annual "March burn-off" will continue.

These reconciliations reduce the cumulative surplus through to fiscal year 2004/05 from $100.5 billion to $37.5 billion. The $63 billion difference is the result of a small $2.5 billion cumulative rise in debt-servicing costs, a modest $19.1 billion cumulative reduction in taxes, and a far less modest $41.4 increase in program spending. If this budget anticipates realistically the fiscal plans of the next five

Figure 1: *Real Gross Federal Taxes per Person, fiscal years 1989/90 to 2004/05*



years, the chances for further significant progress in reducing federal debt and taxes look less than robust.

The Bottom Line

It would be a shame if federal fiscal policy gave as short shrift to debt paydown and meaningful tax cuts as projections based on the February 2000 budget suggest. Adjusted for population growth and inflation, federal taxes have never been as heavy as they are now, and even the relief the budget offers will barely lighten the burden. Unless more substantial cuts follow the budget's near-term tax measures, the burden of federal taxes will shortly resume its record-setting upward march (see Figure 1). To prevent that result, Ottawa needs to make fresh efforts to get its debt down and hold the line on spending.

The February 2000 budget is an important and welcome step. Reindexation, the middle-rate cut, and the changes to capital gains taxation all move Canadians toward a less taxed, more prosperous future. If promises of further growth-stimulating cuts in surtaxes and business tax rates — let alone further broad-based relief for Canadians at all income levels — are to be fulfilled, however, federal debt-paydown and spending restraint must be considerably more vigorous than the budget suggests.

As the federal government shifts its attention to the 2001 budget, it needs to look hard at the way it sets spending priorities and the *ad hoc* manner in which it allocates increases. Better judgment and discipline on spending would ensure that future budgets leave more room for action on debt and taxes. Only by getting interest payments down and controlling spending can Ottawa guarantee delivery of the future tax cuts outlined in the February budget. And only then can the promise of a more lightly taxed and prosperous Canada become a reality.

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