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Backgrounder

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Debt, Taxes and Spending: Three Lessons for the Upcoming Federal Budget

by

William B.P. Robson

Canada's fiscal misadventures over the past 25 years have provided some important lessons about debt, taxes, and government programs. Canadians have learned a lot about the pain of high debts. And they are learning about the damage that high taxes can do to living standards by discouraging work and saving, and by pushing people abroad or into the underground economy. The upcoming federal budget offers an opportunity to put this hard-won knowledge to good use by adopting a fiscal plan that makes debt pay-down a priority and devotes a large share of the resulting interest savings to personal income tax cuts.

To apply the lessons of debt and taxes, however, Ottawa needs to curb its enthusiasm for new spending. To this end, it helps to contemplate a third lesson that is still under way about the unintended harm that government programs can do when they compound the discouraging effects of high taxes on work and saving. Canadians do not need new programs dealing with seniors, children and post-secondary students that add to these problems. Rather, they need a fiscal plan that promises debt pay-down and a lower tax burden in the years ahead.

A Lesson Learned: Debt

Canadians have learned a great deal about government debt over the past generation. Since the mid-1970s, federal net debt alone has grown from less than 20 percent of gross domestic product (GDP) to over 70 percent. If Ottawa's debt was the same size relative to the economy today that it was 25 years ago, its interest cost would require a family of four to pay about $1,500 more to Ottawa in taxes every year than it would get back in services and benefits. Instead, this family pays $5,500 more than it gets back.

For a while, Ottawa tried to disguise this problem by keeping taxes in line with program costs and borrowing to pay interest. But Canadians have learned a few things about that approach, too. Borrowing to pay interest is the mark of a bad credit risk, which drives up the price lenders demand. And the bigger debt is, the more increases in the cost of borrowing hurt. With the pain of reducing federal borrowing to zero still fresh in public memory, the national mood seems to have shifted toward the view that paying down debt belongs in the first rank of Ottawa's priorities over the next few years.

That makes sense. Among other things, Canada faces massive demographically driven fiscal strains in 20 years, when the baby-boomers begin collecting pensions and making heavier demands on public services such as health. The quicker Ottawa pays down its debt before then, the better shape Canada will be in to deal with those pressures — in part, if necessary, by allowing public debt to run up again to cushion the blow they would otherwise deal to the living standards of Generation X.

Paying down debt requires budget surpluses. Here, however, some of the class may be lagging behind. The Liberals' “Red Book II” commitment to spend half of any fiscal surplus has confused the issue. We cannot eat our surplus and have it too: money that is spent never appears in a surplus, and pays down no debt.

More defensible is the argument that surpluses, especially large ones, are unnecessary since growth will shrink the debt relative to the economy anyway. On a chart that compares the path of the debt-to-GDP ratio over the next few years assuming a balanced budget on the one hand and assuming surpluses of one or even two percent of GDP on the other, the two lines are pretty close together.

Canadians have heard that argument before, however — in almost every federal budget over the past 15 years — and have learned that differences in the annual bottom line as small as 1 or 2 percent of the economy add up to much more as the years go by. Lines that started close together on charts drawn in the past did not stay close together, nor will they in the future.

If we do no more than balance the federal budget over the next 20 years, for example, population growth will whittle the average family's annual $5,500 in extra taxes down somewhat, but it will still be big: over $4,000. By contrast, budget surpluses of 1 percent of GDP — about $9 billion in today's money — would cut it in half. And budget surpluses of 2 percent of GDP would eliminate it altogether.

Would several thousand dollars a year less in taxes for the average family be a good thing? The answer to that question lies in a second lesson from the past quarter century: about taxes.

A Lesson under Way: Taxes

The first part of the lesson about taxes is easy: taxes have gone up a lot over the past 25 years. Personal income taxes in particular have risen relentlessly. The amount of each dollar Canadians earn that goes to income tax is up by about one-third. And, thanks mainly to limits on indexing that have pushed Canadians with quite modest incomes into high tax brackets, the typical marginal tax rate — the share of each *additional* dollar earned taken by tax — is up by even more.

The second part of the lesson — the difference high taxes are making to Canadian living standards — is harder. On the face of it, taxes look like a transfer of purchasing power. The government takes from one person and gives to another. Assuming no violent disagreements about who should give and who should get, and how much, what is the problem?

The problem is that taxes do “collateral damage,” to borrow a military term. By reducing the rewards from work and investment, income taxes can tip people out of the labor force and discourage saving. When the rewards of escaping the taxman's grasp are high, people react by emigrating, moving into the underground economy, or shuffling their assets into less taxable forms. In short, raising a dollar in tax can impose additional costs — beyond the dollar taken out of someone's pocket — on Canadians' living standards.

Marginal personal income tax rates for many Canadians are now so high that economists estimate this collateral damage at 40 cents or more per dollar of revenue. Worse, this damage may not just affect Canadians' living standards right now but their future growth. As lines can start out together but diverge over time, taxes that affect growth rates can impose massive losses when we look a decade or more ahead. Taxes that discourage saving and investments in education and skills training likely cause heavy collateral damage to growth, and personal income taxes score badly on both counts.

For the upcoming federal budget, the lesson on debt already learned and the lesson on taxes now under way combine to offer a key message. Ottawa's fiscal plan over the next few years should have big budget surpluses — rising above $10 billion — as its centerpiece. Once those surpluses have steered the debt ratio's path sharply downward and started whittling away that $5,500-a-year interest bill, Ottawa should pay out part of those interest savings in broad-based personal tax cuts, starting with the rates that most affect low and modest-income Canadians.

That is not, however, what Canadians are likely to see in the upcoming budget, because there is yet a third lesson — on government spending — that has only just begun.

A Lesson Still to Come: Government Spending

The lesson on government spending is perhaps the hardest of all. Like taxes, government programs tend to look like nothing more or less than a transfer of purchasing power. A dollar raised in tax ends up in the pocket of someone else. This is not the end of the story, however: like taxes, spending has important collateral effects.

Some of those effects are positive. If a dollar in tax does significant collateral damage to the economy, some of what it pays for must provide at least a few cents per dollar of additional benefit — otherwise, the economy would be disappearing into a black hole. Investments in key physical infrastructure, health and education services for the young, and basic social insurance are all uses of government money that almost certainly yield such extra returns.

Other programs are neutral. And some are negative, as when welfare benefits for employable people pay better than work — compounding the collateral damage of the taxes that pay for them. Over the next few years, disappearing deficits will give both federal and provincial spending a new lease on life, and teach Canadians a lot more about the adverse effects of some programs.

In this light, three program areas likely to get attention in the upcoming budget pose problems: elderly benefits; the child tax benefit; and support for post-secondary education. By providing benefits that are clawed back as income rises, programs in these areas subject low- and middle-income Canadians to effective marginal tax rates that are higher, and likely more damaging, than those created by ordinary taxes alone.

In the case of elderly benefits, Ottawa announced in 1996 a new seniors benefit to replace guaranteed income supplement and old age security payments in 2001. If the new benefit is enacted as proposed, with a 20-percent clawback — on top of regular personal income taxes — on other income over $26,000, many Canadians will see their effective marginal tax rates rise sharply when they turn 65: a huge disincentive to work and retirement saving. This and other criticisms seem to be prompting reconsideration of the proposal. But some obvious sweeteners — such as enriching the benefit for the worst off and extending the clawback range — could easily *increase* the number of middle-income earners subjected to 60-to-70 percent marginal tax rates after age 65. Much better would be a signal in the upcoming budget, even if only in the form of silence, that the idea is headed for oblivion.

Ongoing changes are producing a similar problem in support for low-income families with children. Proposed changes to the child tax benefit (a transfer program disguised as a tax break) would increase effective marginal tax rates by abolishing the working income supplement — which offsets some of the clawback of welfare benefits for low-income parents entering the workforce — and boosting clawback rates for many families of modest incomes. Many low and modest-income families already face marginal effective tax rates higher than those of Canada's top income earners. Future changes in the child tax benefit should ease this problem, not worsen it.

A final area likely to figure prominently in the budget is postsecondary education. Here, again, Ottawa may take steps that increase many Canadians' effective marginal tax rates. Any system that provides university students with grants geared to income or with loans on income-sensitive repayment terms will face students with yet another layer of effective taxation, discouraging work and increasing the reward for emigrating or declaring bankruptcy. Canada now has considerable experience with problems collecting federally guaranteed student loans that should guide Ottawa toward a less problematic way of demonstrating its support for postsecondary education.

Applying our Lessons

These examples only scratch the surface of a problem that Canadians are just starting to explore. To advance understanding of the effects of government programs, Ottawa must establish clear criteria for success or failure, and provide regular reports on program impacts and side-effects.

In the meantime, federal fiscal plans should give priority to paying down debt through several years of sizeable surpluses, and easing the high effective tax rates faced by modest-income Canadians by distributing a healthy share of the resulting interest savings in personal tax cuts. Canadians do not need to wait for the end of the lesson on spending to apply what they have already learned about debt and taxes.

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