



Counting Chickens and Unhatched Eggs: The Post-Budget Outlook for Canadian Taxes

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Introduction: Chickens and Eggs

Going into its February 2000 budget, many observers hoped the federal government would address Canada's high tax burden with tax cuts that would be supportive of economic growth and reduce the uneven burdens that face similarly situated taxpayers. The budget responded with some immediate relief, and with more ambitious plans for future cuts.

In assessing the budget's impact, I divide the tax cuts it proposed into two types. The changes that took place immediately or are scheduled for implementation during the budget's projection period from fiscal year 1999/2000 to 2001/02 might reasonably be thought of as chickens that are safe to count. By contrast, the changes promised for the budget's "out years" — the period from 2002/03 to 2004/05 — are best thought of as eggs that may or may not hatch.

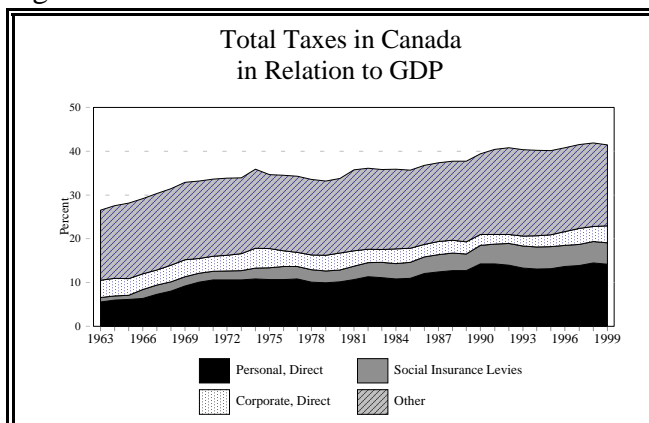
The former changes, the reasonably certain ones, are steps in the right direction, but only small ones. If fiscal policy through to 2004/05 follows the precedent of this budget and its immediate predecessors, with new spending — much of it in end-of-year binges — absorbing the bulk of discretionary fiscal room, lower marginal tax rates and greater fairness will remain largely elusive. Since this prospect is discouraging, I will close with some suggestions that might improve the changes that all the budget's eggs will produce healthy birds.

The Tax Challenge and the Budget's Response

The Challenge: Why We Needed Chickens

Although the past decade echoed with the language of government restraint, that restraint is not yet evident in Canadian taxes. Government revenues other than investment income stood at almost \$13,000 per Canadian in 1999, up almost one-fifth in real terms from a decade earlier.¹ Relative to the economy, taxes took 41.5 percent of GDP in 1999, a barely perceptible drop from their all-time peak the previous year (Figure 1).

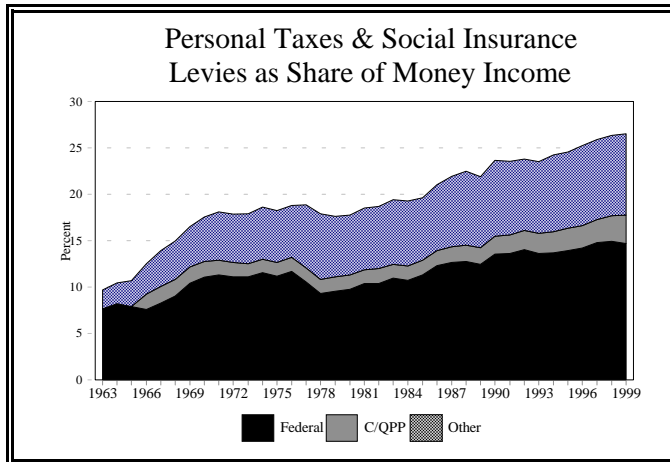
Figure 1



As a practical matter, high average rates of personal tax tend to mean very high effective marginal rates for taxpayers at some income levels, limiting the rewards from working and saving. They also tend to create major horizontal inequities, with similar discretionary family incomes attracting very different amounts of tax, depending on the number of earners and the presence of children.

¹ In this presentation, taxes are all government revenues on a national-accounts basis, less notional contributions to unfunded public-service pension plans and return on investment (the latter adjusted to remove provincial government resource royalties).

Figure 2



On the business side, high tax rates undercut Canada’s attractiveness as a place to produce goods and services. They also tend to amplify — indeed, they foster the creation of — differentials in the tax treatment of various sectors, a kind of industrial policy that, in Canada’s case, tends to tilt against higher-tech, service-oriented businesses that many Canadians look to for a richer, cleaner future.

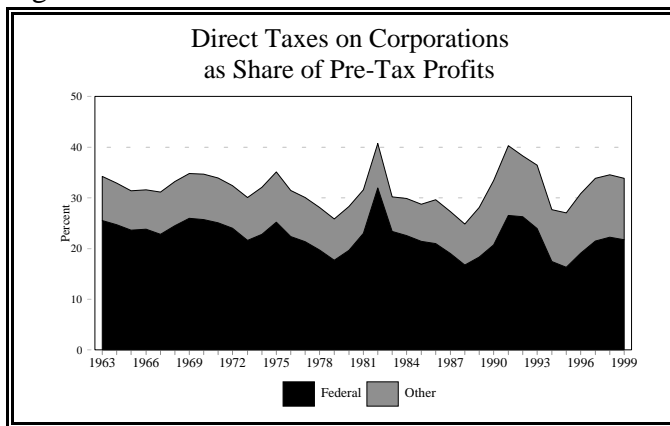
Although there is more than one layer of government in Canada, it seems fair to say that federal activity makes a key contribution to these problems. Looking at

the share of personal money incomes taken by direct taxes, which is now over one-quarter on average, federal levies loom very large (Figure 2).²

With business taxes, matters are more complicated. There is no pronounced upward trend in the bite of direct taxes into the relevant base as there is on the personal side, and the federal share of the burden has declined somewhat (Figure 3), although the share of profits taxed is strikingly high for the boom phase of the business cycle. Moreover, direct taxes as measured in the national accounts

are only part of the story — they include federal capital taxes, but not provincial capital taxes or property taxes. Also important is that the business tax base is likely becoming more elastic, as the relative costs of transportation and communication shrink, the lure of the United States grows, and the number of jurisdictions that compete with Canada for investment increases. Last but certainly not least, the almost uniquely damaging effects of business taxes on incomes and growth make Ottawa’s role in this area worthy of scrutiny as well.

Figure 3



What the Budget Produced

In the run-up to the budget, many commentators, including some at the C.D. Howe Institute (Robson,

² Money income is total income of the personal and unincorporated business sectors, less imputed rent on owner-occupied housing.

Mintz and Poschmann 2000), urged Ottawa to address this situation. The case for federal action to cut taxes had three parts: Ottawa's turnaround from unsustainable deficits to large incipient surpluses; the inevitability of higher CPP/QPP levies following the much-needed 1998 reforms; and the fact that many provinces are already cutting taxes, but face pressure for health-care spending that make further sizeable, permanent cuts in their taxes unlikely. So we had a compelling combination of motive and opportunity in the pre-budget period, and the budget responded in a number of ways.

On the personal side, the budget promised to re-index personal income-tax thresholds to inflation, cut the middle rate from 26-percent to an effective 25-percent in 2000, and a promised 23-percent by 2004. It raised the threshold for the high-income surtax from \$12,500 in federal tax to an effective \$15,500 in 2000 and \$18,500 thereafter, while dropping the rate to 4-percent for 2001 and promising to eliminate the surtax by 2004. It introduced more generous rules for medical expenses and attendant care, increased child-care deduction limits for people with disabled children, and raised tax-free limits for scholarships and bursaries. It lowered the inclusion rate for taxation of capital gains from three-quarters to two-thirds and, subject to qualifications, delayed capital gains taxes on stock options until they are exercised and allowed deferral on rollovers.³

On the business side, the budget lowered the general corporate income-tax rate from 28 percent to 27 percent in 2001 — though not for resource companies or for “passive” business income — and promised to drop the rate to 21 percent by 2004. It raised the threshold for the preferential 21-percent tax rate for private Canadian-controlled corporations from \$200,000 to \$300,000 in 2001. And it increased capital-cost allowance rates and allowed for faster write-offs for certain types of producer durable equipment.

One way the budget claims, misleadingly, to cut taxes is by enhancing the child benefit. It also counts future increases in the child benefit and the goods and services (GST) tax credit arising from indexation of their amounts and clawback thresholds in its tax-cut total. But these are increases in transfer payments. Although Ottawa administers the child benefit and the GST credit through the tax system, that no more makes them tax cuts than delivering EI benefits through the tax system would make them a tax cut. This misleading accounting deserves emphasis because these two programs together will soon exceed \$10 billion annually (approximately equal to EI benefits), and evaluating Canadian taxes without them greatly understates both average and marginal tax rates.

Sorting the Chickens from the Eggs

How will these changes affect the overall burden of Canadian taxes, and some of the horizontal inequities and distortions I mentioned in describing the challenge? This question has a two-part answer, because the budget's proposals come in two flavours. There are the changes we can reasonably count on seeing because they are prefigured in detail in the projections for the next two years and will be part of the budget's implementing legislation: chickens we can safely count as

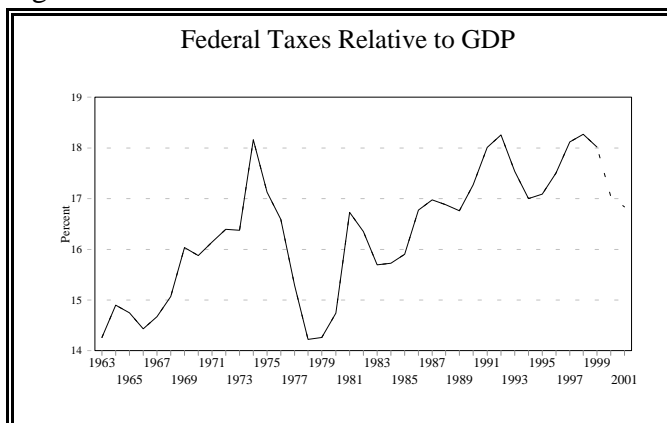
³ A significant change that does not fit easily into this list was the raising of the foreign-investment limit in registered pension plans from 20 to 30 percent.

hatched. And there are the proposals that are promised at some uncertain future date, and may not come to pass for various reasons: eggs laid by the budget that may simply stay eggs.

Chickens: The Outlook from 1999/2000 to 2001/02

For a look at the chicken-flavoured changes — those that will take effect in 2000 and 2001 — I will stay with the national-accounts-basis presentation of the previous section. National-accounts figures are easier to interpret in a national and historical context, and also better capture the total impact of federal transactions on the country, because they record total taxes and transfers, rather than netting items such as the child benefit from revenues.⁴ For projections of growth in the economy and various notional tax bases, I use forecasts for the next two years that yield nominal GDP growth similar to that in the budget projections.⁵

Figure 4



Over the next two years, the budget's changes promise an important drop in federal taxes measured against GDP (Figure 4). From 1999's near-record 18 percent, they should drop by a bit more than a percentage point by 2001. This decline would leave them at their level of the late 1980s — years that in retrospect may appear a lower-tax era than they did at the time.

Turning to personal taxes — personal income taxes and EI levies⁶ — the projected decline is less impressive (Figure

5). If money incomes grow in line with GDP over the next two years, the federal tax bite into money incomes should fall by slightly less than a percentage point. This decline seems rather small compared to the sizeable-sounding numbers trumpeted in the budget, highlighting the fact that a hefty share of the budget's "tax-relief" total arises from reindexation, which does not cut tax rates but merely stops them rising, and from increases in the child benefit, which do not reduce total

⁴ This approach has the fault of requiring conversion of the budget projections into figures consistent with a national-accounts presentation. Among other things, this introduces the possibility of error by the converter. The figures presented here have been checked against data from the Department of Finance, but responsibility for errors is mine.

⁵ I note in passing, however, that the forecasters surveyed by the Department of Finance appear to expect considerably faster growth of potential output per working-age Canadian in the future than in the recent past. They are correspondingly more optimistic about the prospects for sustained real growth faster than 2.5 percent annually, with inflation staying below 2 percent annually, than I am myself.

⁶ Like most analysts, I assume that the incidence of EI levies is on workers' incomes. Less defensibly, in this presentation, I treat the entire levy as a tax.

Figure 5

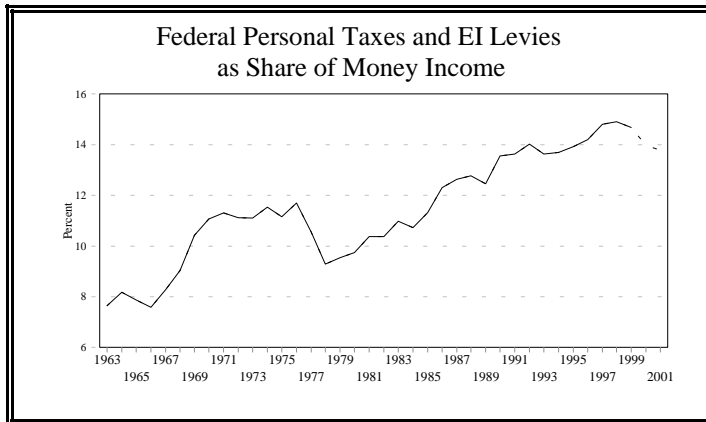
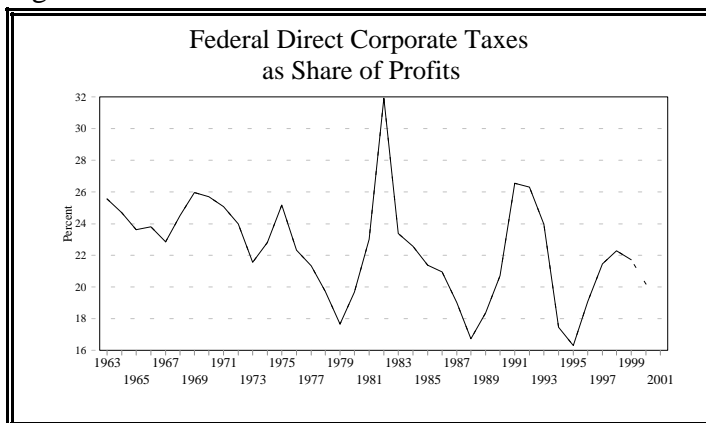


Figure 6



personal income-tax collections. From this perspective, the burden of federal taxation will still be higher in 2001 than at any time before the early-1990s recession, limiting the scope for lowering high marginal rates or lightening the load on Canadians who are disproportionately burdened.

On the business side, and assuming that corporate profits grow in line with GDP, the federal tax burden should fall by about 1.5 percentage points (Figure 6). This is a step in the right direction, but not a decisive one — the share of profits taken by federal taxes normally swings with the cycle, but the recent tax load would be more suitable to a slump than the current expansion. If by 2001 the share of profits in GDP were to decline to its average level over the 1990s, reaping the revenue anticipated by the budget would require an effective tax rate around 27 percent — higher than in any year except 1982.⁷

Scratching Away at Personal Taxes

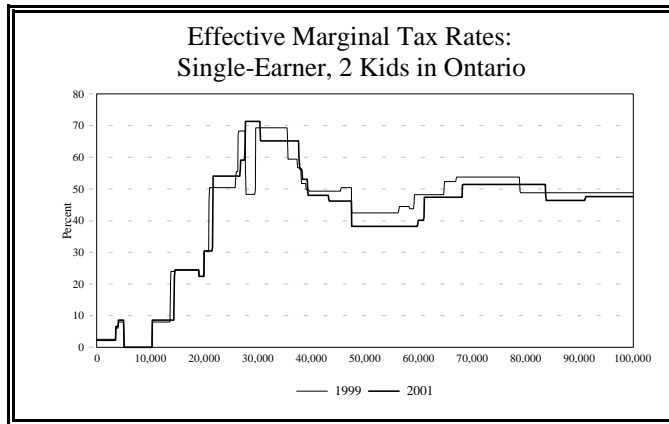
On the personal side, the relief in the 2000 budget is insufficient to produce decisive improvements in marginal tax rates facing individuals across the income scale.

Take, for example, a single-earner family with two children under the age of seven in Ontario. In 1999, the share of each additional dollar of earned income taken by governments through various levies and clawbacks rose rapidly as earnings approached the \$30,000 mark, getting close to 70 percent at around \$26,500 and again from \$30,000 to \$35,000 (Figure 7).⁸ These marginal rates present a low-income person contemplating more or better-paid work to raise her/his living standards with a pretty powerful headwind. Provincial taxes and clawbacks are part of the problem, but Ottawa

⁷ Since federal corporate income-tax revenue is a function of profits, this is an illustration, not a forecast. The budget's projections of rich collections from this source do raise questions about the wisdom of eliminating the economic prudence factors included in the November Economic and Fiscal Update from the budget projections to 2001/02.

⁸ These rates are calculated over \$100 increments of earned income. I am grateful to Finn Poschmann for his indispensable collaboration in producing these figures.

Figure 7



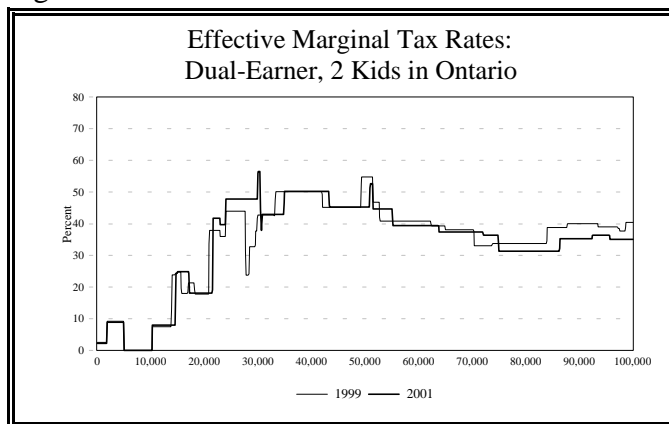
is the principal culprit, with clawbacks of the basic personal amount, the GST credit, the child-benefit supplement and the child benefit stacking on top of regular income-tax rates.

For such families with earnings higher than about \$40,000, the 2000 budget represents part of a general pattern of improvement.⁹ Lowering the middle rate reduces the government’s share of each additional dollar earned through much of the relevant zone, and the 1999 budget’s extension of the higher personal amount throughout the

income scale also helps (as, for Ontario families, does the planned lowering of Ontario taxes).

For families with earnings from the low-to-mid \$20,000s to the high \$30,000s, however, the 2000 budget’s impact is not uniformly helpful. Focusing on the most problematic area, the more rapid clawback of a richer child-benefit supplement pushes the federal effective marginal tax rate up by at least 4 percentage points in the range above \$22,000, and by considerably more than that in the range above \$27,000, where it overlaps with the clawback of the GST credit: adding provincial taxes and clawbacks would push the total effective marginal rate in this range over 70 percent in Ontario, which is not the worst province in this regard.

Figure 8



Two-earner couples are harder to describe, because producing a marginal-rate-progression schedule requires simplifying assumptions about the split of earnings that are open to objections. A simple before-and-after snapshot of a family with two children in Ontario whose earnings are split 60:40 nevertheless reveals a similar type of problem (Figure 8).

At higher income levels, the two-earner couple enjoys lower marginal rates, but the overlap of taxes and clawbacks means that, even with lower provincial taxes and EI premiums, marginal rates for these couples will be no lower, and sometimes appreciably higher, over

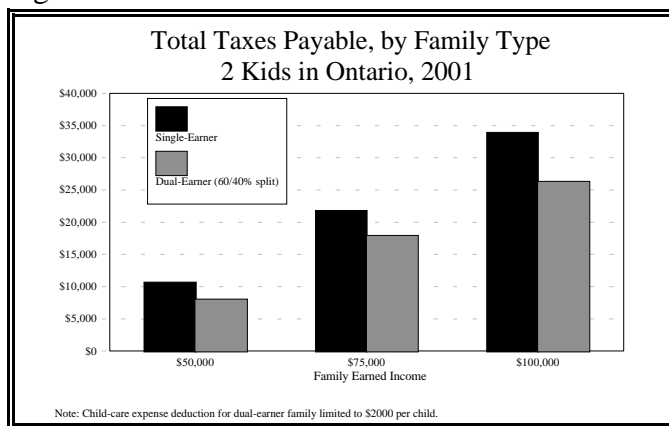
income scale also helps (as, for Ontario families, does the planned lowering of Ontario taxes).

⁹ This illustration overstates the improvement slightly by using nominal dollars to compare 1999 with 2001 on the horizontal scale. Much of the movement of steps to the right simply reflects indexation.

the range from the high \$20,000s all the way to the mid-\$70,000s.¹⁰

Comparing the marginal-rate progressions for one-earner and two-earner couples reveals an important contrast. Marginal rates for one-earner couples are, almost without exception,¹¹ higher than for two-earner couples until the two-earner couple hits its top marginal rate — which, for the 60:40 couple shown here, occurs at family income around \$230,000 in 2001 (too far along the horizontal axis to be displayed in Figures 7 and 8 without losing interesting detail). This contrast means that one-earner couples pay more tax than two-earner couples with similar discretionary money incomes, and that the gap between the two family types rises with income (Figure 9).¹²

Figure 9



This discrepancy is usually justified, when it is justified at all, as an offset to the implicit income generated by a spouse in the home. In the absence of any consensus that the state should redistribute implicit income generated by living arrangements, however — let alone any accepted method for calculating such income — it seems regrettable that the unevenness in treatment of money incomes of different families will remain so stark in the budget's wake.

Flying in the Face of Business Tax Imperatives

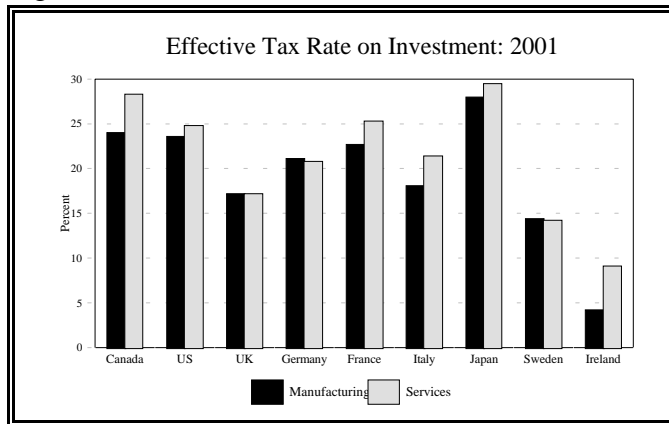
On the business side, the tax changes over the next two years are also helpful but hardly decisive. Thanks to business tax reforms in other developed countries, Canada's business tax rates now stand out as relatively unattractive. Even the full general CIT rate cuts promised in the budget by 2004 would leave Canada's general rates above the current OECD average (Mintz 2000), let alone the lower OECD average likely to prevail in several years.

¹⁰ To facilitate comparison with the one-earner couple, the two earner couple is assumed to deduct child-care expenses of \$2000 per child, this being the level that several commentators (Boessenkool 1999; Poschmann and Richards 2000) have suggested for universal child deductions or credits.

¹¹ In the 60:40 case, there is a span around \$50,000 of family income where the two-earner couple faces the higher rate.

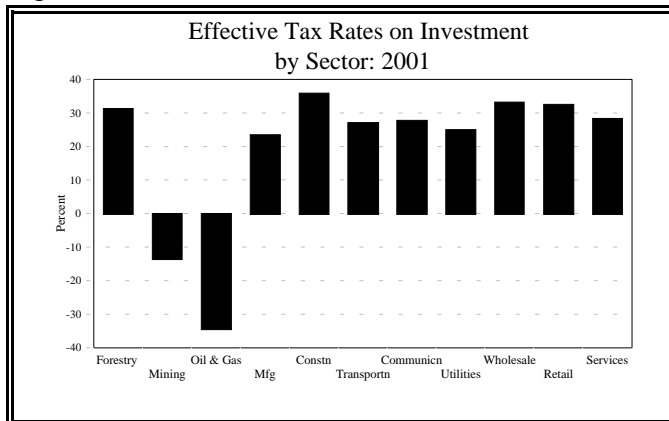
¹² As noted already, the two-earner couple's child-care expenses are capped at \$2000 per child in this illustration, to avoid exaggerating the contrast in discretionary income.

Figure 10



In the spirit of counting only chickens whose hatching we can confidently foretell, Figure 10 shows the marginal effective tax rates expected to prevail in 2001 on incremental capital investment by large, tax-paying firms in manufacturing and services respectively in the G7 countries, Sweden and Ireland.¹³ In neither case does Canada stand out as particularly hospitable to new investment, and in services, the relative unattractiveness of Canada as a destination for new investment will still be stark.

Figure 11



At least as important as average effective tax rates on new investment are the differences among the tax rates in different sectors (Figure 11). The budget promises to even out these differences, but they will remain substantial in 2001. Canada’s tax system will still deviate markedly from the neutral treatment most economists would favour and, moreover, will not do so in the pro-“new economy” fashion that might find favour among advocates of growth-oriented industrial policy.

Will the Eggs Hatch?

To summarize to this point, the chickens we can confidently count following the 2000 budget are welcome, but they are outnumbered by unhatched eggs. What are the chances that some of the tax changes the budget promised but deferred for later — the reduction of the middle rate to 23 percent, the complete elimination of the personal surtax, and the lowering of general corporate tax rates — will actually come to pass? And can anything be done to improve these eggs’ chances of hatching?

Hazards of a Long Incubation

To answer those questions, it helps to step back to the longer-term projections of the November 1999 Economic and Fiscal Update (Canada 1999b), and see how the room for fiscal manoeuvre outlined in that document looks in the budget’s wake.

¹³ Source: International Taxation Program, University of Toronto. Figures for Canada are all-province averages. I thank Duanjie Chen and Jack Mintz for making these figures available to me.

The November Update took average economic and fiscal projections from private-sector forecasters and, assuming no policy changes, projected an “underlying surplus” adding up to \$100.5 billion over the six years from fiscal 1999/2000 through to 2004/05. Of this amount, \$72.5 billion arose during the second three years from 2002/03 to 2004/05, the Budget’s “out-years.” The relevant numbers, and the revenue and spending projections underlying them, are shown in the top panel of Table 1.¹⁴

Table 1

Summary of Federal Government Transactions, 1999/00 to 2004/05									
	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	1999/00- 2001/02	2002/03- 2004/05	1999/00- 2004/05
	<i>\$ billions</i>								
November 1999 Fiscal Update									
Gross Taxes and Fees	165.6	172.7	180.9	188.4	196.5	205.5	519.2	590.4	1,109.6
Less Gross Program Spending	(123.7)	(126.4)	(131.2)	(134.2)	(137.3)	(140.8)	(381.4)	(412.2)	(793.6)
Less Net Debt Charges	(36.9)	(36.7)	(36.3)	(35.7)	(35.2)	(34.7)	(109.8)	(105.7)	(215.5)
Equals Underlying Balance	5.0	9.5	13.5	18.5	24.0	30.0	28.0	72.5	100.5
February 2000 Budget									
Gross Taxes and Fees	167.7	170.7	177.5	184.0	191.3	199.6	515.9	574.9	1,090.7
Less Gross Program Spending	(127.8)	(130.5)	(137.7)	(142.1)	(146.2)	(150.9)	(396.0)	(439.2)	(835.2)
Less Net Debt Charges	(36.9)	(37.2)	(36.8)	(36.2)	(35.7)	(35.2)	(110.8)	(107.2)	(218.0)
Equals Underlying Balance	3.0	3.0	3.0	5.7	9.4	13.4	9.0	28.5	37.5
Change from 1999 Update to 2000 Budget									
Gross Taxes and Fees	2.1	(2.0)	(3.4)	(4.4)	(5.1)	(5.9)	(3.3)	(15.5)	(18.9)
Gross Program Spending	4.1	4.0	6.6	7.8	9.0	10.1	14.7	27.0	41.6
Net Debt Charges	0.0	0.5	0.5	0.5	0.5	0.5	1.0	1.5	2.5
Underlying Balance	(2.0)	(6.5)	(10.5)	(12.8)	(14.6)	(16.6)	(19.0)	(44.0)	(63.0)

Updating those projections in the budget’s wake involves three steps. First, I insert the budget’s detailed projections for 2000/01 and 2001/02. Second, I project revenue and spending forward for the remaining years on the same basis as used in the Update, but with slightly lower revenue growth to account for reindexation. Third, I assume that unneeded economic prudence cushions will continue to be spent, since the 2000 budget continued the pattern of last-minute spending established by its predecessors.

The resulting new projections, shown in the middle panel of Table 1, give an underlying surplus for the 2002/03-2004/05 period of \$28.5 billion. After deducting three years’ worth of contingency reserves, or \$9 billion, this leaves \$19.5 billion in discretionary room — a much diminished pot in which to find money both for further tax cuts and new spending.

The prospect that the government will actually use this fiscal room for tax cuts looks bleaker, moreover, in light of the outcome of the struggle between tax cuts and new spending that occurred

¹⁴ The figures in Table 1 are on a public-accounts basis. They consistent with those in the November update, but show gross revenue and expenditure, rather than the net figures which, as discussed earlier understate the true impact of federal fiscal policy on Canadians. (Robson et al. 2000, 6).

after the publication of the November Update and the delivery of the 2000 budget. The first three years of the Update's projections, the years shown in detail in the budget, contained the other \$28 billion of the \$100.5 billion surplus projected over the full six years. In the budget's wake, the surplus over the first three years has dwindled to \$9 billion — the total of the three years' contingency reserves.

The bottom panel of Table 1 reconciles the Update's projections with the post-budget outlook, and shows what happened to the \$19 billion difference. Higher debt-service charges took \$1 billion: about one twentieth. Lower revenue accounts for \$3.3 billion: less than one-fifth. And higher program spending accounts for the remaining \$14.7 billion: more than three quarters of the difference. If tax cuts get a comparably small share of the surpluses from 2002/03 to 2004/05, most of the 2000 Budget's remaining chickens will never see the light of day.

Helping the Chicks Emerge

It would be a shame if so many of the chickens promised in the 2000 Budget remained just eggs. But there are steps that might improve their chances of hatching.

In my judgement, their chances would improve if Ottawa stopped highlighting net rather than gross tax and spending numbers in the public accounts. The growing importance of federal income support administered through the personal tax system makes the net numbers increasingly poor measures of the full scope and impact of Ottawa's activity. The Auditor General has called this presentation "incomplete financial disclosure,"¹⁵ and the government's response that this presentation "is consistent with the way Parliament appropriates funds" (Canada 2000) is, in my view, hollow — Parliament only appropriate funds that way because the government present the figures that way.

This debate matters for future tax relief: netting not only shrinks the apparent size of the federal tax burden at a point in time, it also lowers its apparent growth over time. Netting thus helps advocates of higher taxes and more spending argue that the federal government is shrinking to insignificance, an impression strikingly at odds with the reality facing most taxpayers.

A reinvigorated debate over tax reform could also help the chickens hatch. Personal taxes that are friendlier toward work and saving, and treat families with similar discretionary wealth more fairly, are worthy objectives. So are business taxes that enhance Canada's attractiveness as a place to invest, and treat different sectors more evenhandedly. Achieving these objectives is easier when governments can give up some revenue, making winners many and their winnings large, while keeping losers few and their losses small. Explicit commitments to lower personal tax rates and reduced inequities among families, and to a more attractive and less distorting investment climate, would hold out hope for higher living standards, and reinforce the will to preserve room for tax cuts in future budgets.

¹⁵ Canada 1999a, 1.37. The Department of Finance deserves commendation for having included this discussion in the Budget documents, despite its unsatisfactory response.

A Final Peep

In my view, the tax changes in the 2000 Budget were steps in the right direction, but small ones. The chickens we can count are very welcome. But if Canadian taxes are to be more supportive of growth and fairer by 2004, we need to make sure that the rest of the budget's chickens make it out of their shells.

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