Intelligence MEMOS

From: Peter van Dijk and Glen Hodgson

To: Canadians Concerned about Government Debt

Date: August 17, 2020

Re: **Addressing Canada's COVID-19-induced Public Debt Ailment**

Last month's federal fiscal snapshot projects a pandemic-induced deficit of $343 billion and a debt-to-GDP ratio jumping from 30 to 49 percent this fiscal year. Don't forget provincial debt, too.

An Ontarian's combined government debt-to-GDP ratio will push toward 100 percent of GDP and beyond. Such a high debt burden is an ailment that will become threatening when the economy returns to normal operating and interest rates rise. Just as we have done with the pandemic, we should be proactive and address this ailment head-on. Fortunately, there is an evidence-based treatment plan.

The least painful treatment is to rely on economic growth to reduce our debt burden. However, it is risky to rely on economic growth alone when interest rates will eventually rise. Our second option is to control future spending once our economy returns to more normal conditions. However, with an aging population, the unrelenting growth in healthcare spending and major climate change challenges, containing spending growth will be challenging. Our third and most painful treatment is for governments to find more revenue.

If Canada has to raise additional taxes, we should be mindful as we go about it. Not all taxes are created equal and some taxes have a significantly more negative impact on our economy than other taxes. Relying on taxes that are a drag on growth creates a vicious cycle and further impairs our ability to manage our debt burden. More painful remedies would be required, such as squeezing spending and further increasing taxes.

So, what are the most – and least – harmful taxes from an economic perspective?

Personal and corporate income taxes are generally very inefficient ways of raising tax revenues. Although often attractive politically, further increases to personal and corporate income tax rates should be avoided since that would exacerbate investment disincentives. Moreover, recent research suggests that reducing high marginal personal and corporate income tax rates in Canada could actually result in higher personal and corporate income tax revenues.

Some politicians market high progressive income tax rates as a tool to reduce income inequality in Canada. At best, this only addresses a symptom of income inequality, not the root causes, such as access to education and healthcare, and an open and flexible labour market. As an alternative, gradually increasing the tax rate on income from capital and capital gains could be used to address inequality in income and wealth.

Recently, we have heard calls for a wealth tax in Canada to raise revenue and rein in income inequality. Many countries – notably in Europe – have tried to introduce a wealth tax and largely abandoned it. Their experience has been that wealth taxes do not raise significant revenue, are difficult and expensive to administer, and ultimately harm economic growth.

Consumption taxes, such as the GST or HST, are better choices for raising additional revenue while limiting the negative effect on economic activity. We recognize this is a populist flashpoint, but appropriately designed, consumption taxes can be progressive. Therefore, increasing consumption taxes should be the main source for raising additional tax revenues.

Taxing the digital economy is another option. The OECD's efforts to create an international digital taxation framework are on life support, so Canada should examine how to tax the digital economy. Following Quebec's lead to subject e-commerce businesses located outside Quebec to its consumption tax is a start. It can generate significant revenue and level the playing field with conventional businesses.

Finally, governments worldwide are making significant efforts to ensure the economic recovery is a "green economic recovery." Further increases to carbon taxes would make a positive contribution and can provide more revenues for managing our debt.

We have listened to our public health experts in dealing with the medical aspects of COVID-19. We should now draw on economic and fiscal expertise in ensuring our economic recovery from COVID-19 is successful and robust.

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