

CANADA'S FISCAL HYDRA: PAUL MARTIN'S FIGHT IS NOT OVER

BY WILLIAM B.P. ROBSON

Having brought down a budget that showed federal revenues and spending in balance, not only this fiscal year, but over the next two, Finance Minister Paul Martin is being hailed as the slayer of Canada's deficit dragon. Sadly, however, the Minister cannot put away his sword. The monster he has been battling is no dragon; it is a hydra that grows new heads even as it loses old ones.

As Mr. Martin struggled with mounting debt and interest payments, another threat to Canadian living standards—high taxes that discourage work and saving—arose in its place. Worse, as he turns to battle that threat, yet another—targeted transfers that, through clawbacks, compound the damage of high taxes for low and middle-income Canadians—is growing in destructive power.

The growth of Ottawa's debt burden over the past 25 years has driven a \$5,500 wedge between what a Canadian family of four pays in taxes every year and the services and benefits it gets in return.

If governments do not stop taxing and clawing back more of every additional dollar Canadians earn, the resulting erosion of work and saving may nurture a new federal deficit problem. Like Hercules fighting the hydra, Mr. Martin needs to ensure that each victory provides, not

a short respite before the next attack, but a permanent gain.

A HEAD OFF: DEBT

Growing debt was a threat Mr. Martin came to office ready to fight. The growth of Ottawa's debt burden over the past 25 years has driven a \$5,500 wedge between what a Canadian family of four pays in taxes every year and the services and benefits it gets in return.

During the 1980s, Mr. Martin's predecessors tried to play down this threat, keeping taxes in line with program costs and borrowing to pay interest. But borrowing to pay interest is the mark of a bad credit risk, which drives up the price lenders demand. And the bigger the debt is, the more increases in the cost of borrowing hurt.

So Mr. Martin picked up his sword. Now, he has not only cut federal borrowing to zero but, thanks to deliberately understated economic and fiscal assumptions, he has set the federal budget on a course to pay down debt with budget surpluses over the next few years.

A HEAD ATTACKING: TAXES

Now that the hydra's deficit head is gone, its second head, taxes, looms large. Taxes in Canada are way up over the past 25 years, and personal income taxes in particular have risen relentlessly. Average income taxes on each dollar Canadians earn are up by about one-third. And the typical marginal tax rate—the share of each *additional* dollar earned taken by tax—is up by even more.

Rather than cutting tax rates, leaving Canadians a larger share of each additional dollar they earn, the February budget introduced complex geared-to-income adjustments to the basic personal credit and the 3-percent surtax that actually increased marginal tax rates on low- and middle-income Canadians.

What makes this head a threat to living standards is that taxes do more than simply transfer purchasing power from some people to others. They also reduce the rewards from work and investment, tipping people out of the labour force and discouraging saving. When the rewards of escaping taxes are high, moreover, people emigrate, move into the underground economy, or shuffle their assets into less taxable forms. In short, raising a dollar in tax imposes additional costs, beyond the dollar taken out of someone's pocket, on living standards.

Marginal personal tax rates for many Canadians are now so high that estimates of this additional damage exceed 40 cents per dollar of revenue. Even worse, this damage may not just lower living standards now, but impair their future growth, imposing 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.

Unfortunately, Mr. Martin's initial thrusts at this threat have been off the mark. Rather than cutting tax rates, leaving Canadians a larger share of each additional dollar they earn, the February budget introduced complex geared-to-income adjustments to the basic personal credit and the 3-percent surtax that actually *increased* marginal tax rates on low- and middle-income Canadians. It is becoming common for people earning between 20,000 and 40,000 annually to lose more than half of every additional dollar to governments—marginal effective tax rates that are higher than those facing Canada's top income earners, and that send a strong negative message to younger, less skilled or less experienced workers about the merits of working, saving, and upgrading their skills.

A HEAD GROWING: PROGRAMS

Even as Mr. Martin becomes more adept in taking on taxes, he risks nurturing a third head that could yet cost him the fight. Like taxes, many government programs look at first simply like a transfer of purchasing power from one person to another. Also like taxes, however, many programs—such as welfare benefits for employable people that exceed what their recipients can make working—impose additional costs that compound the damage of the taxes that pay for them.

Several federal transfers, such as the Child Tax Benefit and transfers to the elderly, already contain clawbacks that increase the effective marginal tax rates faced by low- and middle-income Canadians, cutting the share of every addi-

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tional dollar earned that they keep. And as the government looks for new politically popular spending programs and for new ways to save money on old ones, the number of such transfers is growing.

Canadians cannot look forward either to continued increases in living standards or to continued fiscal balance, if government policy is tilted so strongly against work and saving.

The most ominous prospect on this front is the Seniors Benefit that is due to replace existing elderly benefits in 2001. As proposed, this program will impose a 20-percent clawback—over and above regular income taxes—on other income over \$26,000, sharply increasing many Canadians' effective marginal tax rates when they turn 65. The result will be less work, as more people retire early, and less saving, thanks to lower earnings and punitive tax rates on retirement income. The proposal is unpopular and may yet change. But some obvious sweeteners—enriching the benefit for the worst off or extending the clawback range—could increase the number of people facing 60-percent-plus effective marginal tax rates after age 65.

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saving.

A LABOUR OF HERCULES

Vanquishing a hydra requires more than cutting off one head after another. As Hercules discovered, it requires making sure that heads, once removed, do not grow back.

By balancing the budget, Mr. Martin has cut off one head of the hydra. Two other heads, however, taxes and clawed-back transfers, have gained strength and are on the attack. The growing hostility of Canada's tax and transfer system to work and saving threatens to further erode Ottawa's tax base and boost demand for its transfer payments. If it does, the old threat of deficits and mounting debt may yet return.

Only by leaving more of each additional dollar earned in the hands of those who earned it can Mr. Martin defeat the fiscal hydra, and finally earn the right to put away his sword.



William B.P. Robson is a Senior Policy Analyst with the C.D. Howe Institute.

TOWARDS A REALISTIC TAX POLICY

BY JONATHAN R. KESSELMAN

The 1998 federal budget cut income tax rates for all taxpayers except those at upper incomes. In excluding higher earners from the tax cuts, the Finance Minister stated that the priority must be relief for middle- and low-income Canadians. As a result, the high-income surtax was left in place, and abolition of the general surtax was phased out between incomes of \$50,000 to \$65,000 so as to yield no cuts at higher incomes.

Cutting tax rates for upper earners poses obvious political difficulties, even for right-of-centre parties.

One could argue that cuts in the top marginal tax rate are a priority for the next federal budget. Such cuts can be justified to improve incentives, enhance economic efficiency, and augment job creation. While this change is not the end-all for tax reform, it is a pressing need that can be achieved at modest, if any, revenue cost.

Top-bracket taxpayers are relatively small as a group but are highly influential in the economy's overall performance. They face marginal tax rates exceeding 50 percent in all provinces except Alberta, which has a top rate of 46 percent. B.C. has the highest combined federal-provincial top marginal tax rate, at 54 percent.

Cutting tax rates for upper earners poses obvious political difficulties, even for right-of-centre parties. In the last

B.C. election campaign, the Liberals proposed a 15-percent cut in provincial income taxes but, remarkably, they would have left the top marginal tax rate unchanged. Ontario's Tory income tax cuts are being offset in part by a new surcharge on those at higher incomes, which will still leave the top marginal rate at nearly 50 percent when fully implemented.

Economic analysis for Canada and the U.S. has found the costs of imposing high marginal tax rates to be large. With B.C.'s surtaxes, for example, the loss of valued economic activity has been estimated at \$65 for each extra dollar of tax revenue; for Quebec's surtax the figure is over \$70. Using plausible assumptions about behaviour, total tax revenues might actually be increased by cuts in the top-bracket marginal rates.

These strong results can be explained by individuals' actions to curtail their taxable incomes when confronted with high tax rates. They will reduce their work effort, substitute untaxed production of home services for taxed market work, take more compensation in untaxed fringe benefits, decline promotions, postpone the sale of appreciated assets, invest in legal tax shelters (including home equity), and find ways to evade taxes.

Clearly, no one benefits if tax rates are set so high that revenue is actually decreased. Even short of such rates, the cost to the economy in reduced supply of productive labour and capital services and entrepreneurial activity is high. Employment is reduced for other individuals at more modest wage and skill levels,