Proposal for a Debt-Reduction Tax

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PRÉCIS

La dette nationale semble pratiquement oubliée dans le débat actuel sur l'utilisation des surplus de recettes fédérales. Bien que les Canadiens attendent avec impatience le jour où ils auront le plaisir d'assister à des réductions d'impôts et à une hausse des dépenses, la dette demeure une grave menace à long terme pour le bien-être de la société canadienne et la santé de l'économie nationale. La dette est responsable des taux d'imposition élevés, de la stagnation de la productivité et de la perte d'autonomie en matière de fiscalité et d'économie. Selon les tendances démographiques, il est certain que les surplus budgétaires seront de courte durée si la dette n'est pas réduite de façon substantielle : les recettes fiscales provenant d'une population active proportionnellement moins nombreuse seront insuffisantes pour satisfaire aux besoins de la population vieillissante en matière de sécurité sociale. Il en résultera vraisemblablement une nouvelle ère de dépenses relatives aux programmes sociaux financées à même le déficit, une augmentation des impôts et une baisse du niveau de vie pour tous les Canadiens. La dette nationale soulève également la question de l'équité entre les générations : même avec la réduction de la dette, le transfert du patrimoine entre les générations causé par des années de déficit actif donnera lieu à des taux d'imposition permanents plus élevés pour les contribuables nés après la période du baby-boom qui a suivi la guerre.

L'auteur soutient que les réductions d'impôts et la hausse des dépenses devraient constituer seulement des dividendes de la réduction de la dette, et qu'une stratégie efficace de réduction de la dette devrait être mise en œuvre dès maintenant. Il propose un impôt pour la réduction de la dette affecté irrévocablement au remboursement du capital de la dette nationale. Cet impôt, qui constituerait une solution, imposée par la loi, à la politique fiscale visant à réduire la dette, permettrait d'assurer le remboursement régulier d'un montant déterminé de la dette, de sensibiliser davantage la population au besoin de réduire la dette, d'accroître la souplesse du gouvernement fédéral pour l'établissement du budget ainsi que sa responsabilisation en ce qui concerne les surplus, puis d'atténuer partiellement l'iniquité en matière de transfert du patrimoine entre les générations. Grâce à des réductions de dette importantes, le

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Canada pourra maintenir son autonomie en matière de fiscalité et d'économie, offrir aux investisseurs et aux travailleurs un régime fiscal concurrentiel à l'échelle mondiale et assurer une excellente qualité de vie à tous les citoyens.

ABSTRACT

The national debt seems all but forgotten in the current debate about the disposition of surplus federal revenues. Even as Canadians look forward to halcyon days of tax cuts and spending increases, the debt remains a serious long-term threat to the nation's economic and social well-being. The debt contributes to high tax rates, stagnant productivity, and decreased fiscal and economic sovereignty. Demographic trends ensure that budgetary surpluses will be short-lived if the debt is not substantially reduced: tax revenues from a proportionately smaller work force will be insufficient to meet the social welfare needs of an aging population. The likely result will be a new era of deficit-financed social spending, tax increases, and a lower standard of living for all. The national debt also raises the issue of intergenerational equity: even with debt reduction, intergenerational wealth transfer caused by years of deficit spending will result in higher lifetime tax rates for those born after the post-war baby boom period.

The author argues that tax cuts and spending increases should come only as dividends of debt reduction, and that an aggressive debt-reduction strategy should be implemented now. He proposes a debt-reduction tax irrevocably directed toward the repayment of the principal of our national debt. As a legislated tax policy solution to debt reduction, the tax would ensure regular and predictable debt repayment, increase public awareness of the need to reduce the debt, enhance the federal government's budgeting flexibility and accountability for surpluses, and partially redress the inequity of intergenerational wealth transfer. Meaningful debt reduction would enable Canada to maintain its fiscal and economic sovereignty, offer a globally competitive tax structure to investors and workers, and ensure a high quality of life for all citizens.

INTRODUCTION

My perspective is that of a fiscal conservative who is also a social liberal. Some would say that the two ideological perspectives cannot coexist. However, Canadians are generally comfortable with contradiction, and the duality is useful in describing what appears to be the federal government's current approach to the management of the nation's finances. Having taken measures to reduce the size of the public service, improve the efficiency of government operations, and eliminate budgetary deficits, the government seems committed to a dual agenda: getting its fiscal house in order and generating large budgetary surpluses even as it dispenses ever greater funding to provincial and federal social welfare programs.

This fiscal policy may allow the government to achieve its dual objectives in the short term: but unless structural problems connected with the management and use of federal revenues are addressed, it is not likely to be so successful in the long term. One such problem is the debt accumulated from years of deficit-financed social spending. Despite steady increases in taxation, revenues have been insufficient to meet the demands of the program spending commitments that first began to mount in the 1970s. As a result, and for the foreseeable future, a significant portion of government revenues will be required to pay the interest on years of accumulated deficits.

If the current government and its successors are to maintain health, social welfare, and education spending at the levels to which Canadians have become accustomed, a long-term debt-repayment strategy is needed. In the first part of this article I set out an argument for debt reduction and discuss some possible approaches; in the second part I propose a legislated tax policy solution that substantially addresses the concerns and issues I have identified.

THE NATIONAL DEBT

Federal debt in Canada now stands at about $580 billion and represents 66.9 percent of gross domestic product (GDP).[1] Debt charges (the interest cost of servicing the federal debt) amounted to $40.9 billion in fiscal 1997-98, or about 27 percent of $153 billion in total federal revenues.

Canada's fiscal situation used to be considerably worse. In 1995-96, debt-servicing costs were at a high of 36 percent of federal revenue, and the debt-GDP ratio was at a high of 71.6 percent. The current government, which inherited a deficit of $42 billion, has since managed to generate a budgetary surplus (the first since 1970) with the reasonable prospect of more to come. There is even a plan to pay down the debt by means of a $3 billion "contingency reserve" to be applied directly to debt repayment at the end of the fiscal year if it is not required to meet program spending commitments. In fiscal 1997-98, a budgetary surplus of $3.5 billion was applied directly to debt repayment.

Much has changed since 1985, when the government's debt-control strategy focused solely upon "controlling the *deficit* now and reducing it in coming years."[2] At that time, the debt had grown 75 percent in three years; $20 billion had to be borrowed every year to meet debt interest charges; and interest costs amounted to almost 80 percent of revenues from personal income tax. Admittedly, the government of the day was in a difficult situation. It was committed to social program expenditures and to federal-provincial equalization payment obligations, and its tax revenues were declining because of a recession. It also

1 Canada, Department of Finance, *1998-99 Estimates: A Report on Plans and Priorities* (Ottawa: the department, 1998).

2 Canada, Department of Finance, *Securing Economic Renewal: Controlling the National Debt*, pamphlet released with the May 23, 1985 federal budget (Ottawa: the department, May 1985), 5 (emphasis added).

faced the politically unrewarding task of informing the public of the need to control debts and deficits, a task made more difficult by expectations generated by the "fiscal federalism" of the 1970s and early 1980s.[3]

The political salability of fiscal responsibility is a recent phenomenon. The inheritance of a large debt actually worked to the government's advantage: media reports of the size of the debt and the downgrading of Canadian federal debt securities by international bond-rating agencies brought the issue into the public eye, thereby making a debt-management strategy politically feasible. At the same time, because the economy was finally beginning to expand, tax revenues increased. Since the previous government had already raised tax rates, the only task left for Finance Minister Paul Martin was to make spending cuts and to ensure that his economic assumptions and fiscal targets were conservative enough to be met (unlike those of his predecessor, Michael Wilson).

It is a relief to see an improvement in federal finances, and there appears to be some reason to hope that our national economic and social agendas will not be forever crippled by the accumulated effects of past excesses. The practice of incurring program and social expenditures that exceed current tax revenue has ceased. For the first time in almost 30 years, debt principal has been paid off.

Tax and spending policy allows one generation to transfer expenditures from itself to the next. The generation that is now beginning its working life must confront economic prospects that are very different from those that faced earlier generations. Education costs are much higher than they were 20 years ago owing to reduced government funding and a move toward full cost recovery by universities and colleges. Tax rates are also significantly higher, as are the contribution rates for employment insurance and the Canada and Quebec pension plans. All levels of government have reduced programs and services, and user fees are often imposed. In real terms, after-tax income has dropped 7 percent since 1989. Somewhat more alarmingly, the decline of the Canadian dollar relative to the US dollar has led to a one-third drop in international purchasing power over the last 25 years.[4]

It seems both intuitively and logically unjust that one generation should pay for the fiscal profligacy of the preceding one. Intergenerational inequity is particularly evident in schemes such as the Canada Pension Plan (CPP), which, unlike private pension plans, is not fully funded on an actuarial basis. As a "pay

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3 Fiscal federalism is a product of the broad interpretation that courts have generally given to the federal government's power to tax and spend under section 91 of the Constitution Act, 1867. The federal government has used this power to increase its influence in the provinces (by creating national social programs) and to do indirectly what cannot be done directly, such as involving itself in education—a matter of provincial jurisdiction under section 92 of the Constitution Act.

4 "Ernst & Young's Analysis of the 1999 Federal Budget," *The Globe and Mail*, February 17, 1999.

as you go" plan, the CPP disproportionately benefits persons who are retiring now, because their contributions will not cover the cost of their pensions. The demographic shift to an older population has already caused CPP premium rates to increase; the rates will have to increase even more if the same level of benefits is to be provided to the next generation of retirees.[5] Some retirees will receive far more benefits than they paid for, while others will receive far fewer. The fiscal policy of the last 20 years is partially responsible for "a significant redistribution from 'generation X' *toward* the most fortunate generation of this century."[6]

I will address the equity issues relating to federal debt in more detail later in the article. At this point, it seems reasonable to say that it would be difficult, both from a political and a constitutional point of view, to rectify intergenerational inequity by imposing higher levels of tax upon those who presumably have benefited most from the deficit budgets of previous years. Nevertheless, the equity issues arising from deficit financing are pressing. One estimate suggests that even if budget surpluses are fully applied to debt reduction, the net tax rate for lifetime income will increase from 32 percent for persons born in 1940 to 38 percent for persons born in 1995, and that if surpluses are *not* applied to debt reduction, the lifetime tax rate for persons born in future generations could be as high as 55 percent.[7]

The national debt has led to higher taxation rates—and, it is generally agreed, high tax rates have led to lower productivity. Borrowing pressure is also a direct cause of inflation, and has made Canada vulnerable to fluctuations in international interest rates while reducing the federal government's ability to stimulate the economy in times of recession, either by tax cuts or by increased spending.

The federal government's fiscal performance has improved substantially over recent years, and the current government's debt-management strategy may well reduce the debt both in absolute terms and as a percentage of GDP. The three principal elements of the Department of Finance's debt-repayment plan are "two-year fiscal plans based upon prudent economic planning assumptions; the

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5 It should be noted that other factors contribute to the current insolvency of the CPP. The most important of these is that the CPP pays a high level of benefits, regardless of age, to persons who became disabled while contributing to the plan. A more appropriate scheme would be a long-term disability plan funded separately from the CPP. That is a topic for another paper.

6 William Scarth, *Beyond the Deficit: Generation X and Sustainable Debt*, C.D. Howe Commentary 77 (Toronto: C.D. Howe Institute, February 1996), 1 (emphasis in original).

7 Philip Oreopoulos and François Vaillancourt, *Taxes, Transfers, and Generations in Canada: Who Gains and Who Loses from the Demographic Transition*, C.D. Howe Institute Commentary 107 (Toronto: C.D. Howe Institute, June 1998). See also Scarth, supra footnote 6, at 6. Those who entered the work force in the 1950s have enjoyed the greatest advantage. They have been "able to progress rapidly in their careers with relatively less competition, to buy houses at pre-baby-boom prices, and to draw from the [CPP] amounts far in excess of their contributions."

inclusion in the fiscal plan of an annual Contingency Reserve; and the use of the Contingency Reserve, when it is not needed, to pay down the public debt."[8]

The Department of Finance has also taken measures to "provide stable, low-cost funding for the government; and maintain and enhance a well-functioning market for Government of Canada securities."[9] These measures are designed to ensure that the national debt remains highly liquid and Canadian-owned with a broad investor base, and that interest costs remain predictable so that changes in international market interest rates will not unduly affect debt-servicing costs. For example, because the proportion of fixed-rate securities has been increased to two-thirds of market debt, a one-point rise in interest rates would now raise interest charges by less than $1 billion; in the mid-1990s, by contrast, a one-point rise would have raised interest charges by almost $2 billion.[10]

At the 1998 fiscal year-end, a contingency reserve of $3.5 billion was applied, as planned, to the repayment of the national debt. Because extremely conservative economic assumptions were used in preparing the budget, it is probable that the budgetary surplus at the end of fiscal 1999-2000 will be as much as $10 billion, or $7 billion greater than predicted.[11] At least part of this surplus probably will be applied to debt reduction, provided that the government does not undertake additional spending obligations immediately before the fiscal year-end.

The apparent success of the government's debt-management strategy raises the question of why a new debt-repayment strategy, as proposed later in this article, is necessary. Although the present debt-management strategy is a vast

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8 See Canada, Department of Finance, *Debt Management Strategy 1999-2000*, released with the February 16, 1999 federal budget (Ottawa: the department, February 1999), 7: The "contingency reserve" is the core of the current government's debt-reduction strategy. It is "included in the budget projections primarily to cover risks arising from: (i) unavoidable inaccuracies in the models used to translate economic assumptions into detailed budget forecasts, and (ii) unpredictable events. . . . The Contingency Reserve is not a source of funding for new policy initiatives." Ibid., at 18.

9 Ibid., at 5.

10 Ibid., at 11. There are two major components of the national debt. "Market debt," or interest-bearing securities held by outside parties, amounted to $467 billion at November 1998; the gross public debt was $594 billion. The difference ($127 billion) is borrowed from internal government accounts, such as the superannuation fund for federal employees and the CPP, using long-term borrowing rates. The federal superannuation fund represents the major portion of internal borrowing. Because the government can control the interest charges and does not have to fully fund current liabilities on an actuarial basis (as is done with private pension plans and some other government plans), interest rate changes pose a much lower risk for internal borrowing than for market debt: the market interest rates that must be paid are not within the control of the government. Canada, Department of Finance, *Fiscal Reference Tables: November 1998* (Ottawa: the department, November 1998), and Karin Treff and David B. Perry, *Finances of the Nation 1998* (Toronto: Canadian Tax Foundation, 1998), 16:10.

11 See Ernst & Young, supra footnote 4.

improvement over previous attempts to control debt, it is far from perfect. In some ways, the strategy's greatest strengths are also its greatest weaknesses.

First, the economic assumptions used in budget preparation are too conservative. This is not to say that Finance Minister Paul Martin was unjustified in using conservative economic assumptions in his first few budgets. The well-established tradition of using overly optimistic assumptions and the resulting failure to meet budgetary targets had eroded the ministry's credibility; by setting targets that were certain to be met, the minister was able to re-establish that credibility in the budgeting process and to reassure international financial markets of Canada's fiscal responsibility. This has almost certainly resulted in lower interest charges on the debt because of greater confidence in Canadian debt securities.

However appropriate this extreme caution may have been in the past, in the current environment of surplus revenue it may lead to wasteful spending and to a lack of confidence in the integrity of the Department of Finance and in the government. Although the contingency reserve is intended for debt reduction, and although it is reasonable to think that any surplus over and above the reserve will be so applied, at least partially, the government is not formally committed to apply *any* portion of a budgetary surplus to debt reduction. It has left itself the option to use the contingency reserve (including additional surplus) for any purpose, such as additional spending or the lowering of tax rates.

The advent of a new era of large surpluses will inevitably create political pressure to apply surplus revenue to priorities other than debt reduction, such as tax cuts, health care, low-income housing, wage increases for government workers, increased Canada Health and Social Transfer (CHST) payments to provinces, and national defence. To the extent that large surpluses put long-term debt reduction at risk in this fashion, they are a liability: "Prudence in economic assumptions is not a good idea if it merely gives the government an annual slush fund from which to dole out tax cuts and new spending."[12]

Second, because of the accounting rules under which the government currently operates, budgetary surpluses cannot be rolled from one fiscal year to the next, but must be immediately applied to debt reduction.[13] It is inherently

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12 Kenneth J. Boessenkool, *The 1998 Budget: Falling Behind on Debt Reduction*, C.D. Howe Institute Backgrounder (Toronto: C.D. Howe Institute, February 25, 1998), 2-3.

13 See section 37 of the Financial Administration Act, RSC 1985, c. F-11, as amended, which provides that "[t]he balance of an appropriation that remains unexpended at the end of a fiscal year or such longer period as may be specified in an appropriation Act or any other Act of Parliament . . . shall lapse." Lapsed amounts must be applied to offset outstanding liabilities. Because all necessary adjustments cannot be made until the actual end of the fiscal year, there is a supplementary period of 30 days after March 31 during which the government can vote to place surplus in a special fund (such as the Millennium Scholarship Fund) for spending in a subsequent year.

difficult to predict the quantum of tax revenues; decisions about how a surplus will be used must necessarily be made as the end of the fiscal year approaches, when it becomes evident that a surplus will arise. This leads to the possibility that surplus-spending decisions will be hasty and ill considered even if the goals are legitimate. Worse, there is a risk that such last-minute spending may be politically motivated, wasteful, and isolated from parliamentary debate and public consultation. If surpluses could be rolled from one year to the next, there would be less pressure on the government to make last-minute decisions and a greater opportunity for public and parliamentary scrutiny.

Third, the failure to develop a structured approach to debt management represents a wasted opportunity. In the past, the public has had a poor understanding of the size of the national debt, the cost of servicing the debt, and even the basic relationship between the national debt and yearly deficits. The current government has been fairly successful in informing Canadians about the dangers of deficits and the importance of reducing the debt as a proportion of GDP. But unless a credible, long-term debt-repayment strategy is supported by specific legislation, there is a risk that the need for debt reduction will lose the attention of the Canadian public and be put aside by future governments, which may see their political interests as better served by the abandoning of debt reduction.

Why Reduce the Debt?

"The prospect of being hanged, Samuel Johnson observed, concentrates the mind wonderfully."[14] Metaphorically speaking, Canada faced just such a prospect in the mid-1990s, when the debt and deficits were mounting rapidly. Reductions in government spending and the restructuring of government activities, together with improvements in economic growth, were successful in controlling the deficit and stopping the growth of the national debt, and have even reversed the debt's growth as a percentage of GDP. However, much more remains to be done if we are to capitalize on improvements already made and prepare for economic downturns and increased spending obligations. The discussion below addresses the points in favour of a long-term debt-reduction strategy.

High Tax Rates

The national debt is a direct cause of high tax rates in Canada. Because almost 30 percent of federal tax revenue is spent on servicing the debt, it follows that, but for the debt, the federal government would be able to offer the current level of programs and services while delivering a 30 percent tax cut.

14 See "Matters of Special Importance—1998," in Canada, *Report of the Auditor General of Canada to the House of Commons,* vol. 3 (Ottawa: Public Works and Government Services, December 1998), 3-25, at 7.

One reason Canadians have tolerated high taxes is that the government has successfully sold the need for *deficit* reduction. However, the advent of surpluses has resulted in greater public scrutiny of tax rates: "As long as we were fighting the deficit the lid was kept on all that stuff . . . but now there are surpluses to dispose of one way or another."[15] With the deficit apparently under control, the public's focus has shifted to tax fairness and tax reductions. If taxes are seen as unfair or excessive because surpluses are large, tax compliance will decrease: "[People are] beginning to lose faith . . . in the fairness of the tax system."[16] Some general tax relief may well be necessary to maintain the credibility of the tax system: "If somebody is better off than they were before, then the suspicion that someone else is much better off doesn't bother them as much."[17]

Public scrutiny of the tax system and the pressure to lower taxes puts the government's debt-management strategy at risk: the strategy relies on generating surpluses that can be applied to debt repayment. Later in this article, I will show why it may be more appropriate to repay debt from a dedicated tax-revenue stream so that repayment does not depend upon the generating of surpluses. This strategy would allow the government greater freedom to reduce taxes in the general revenue stream when surpluses arise; moreover, it would keep the debt and the need to repay it before the public eye.

Productivity

The national debt negatively affects productivity growth because it prevents the government from delivering tax cuts. High tax rates increase the cost of doing business and reduce the incentive to earn income at higher marginal tax rates. A recent OECD report identified high tax rates as one factor responsible for Canada's lagging productivity growth in comparison with other industrialized countries. Although there is some controversy about the accuracy of the OECD report's measurement methodology, it is generally agreed that our relatively high tax rates do inhibit productivity growth and lead to the flight of skilled professionals to lower-rate jurisdictions: "The harsh reality is that Canada is in an international race. And we're falling behind our major trading partners. . . . The major obstacle is the lack of an internationally competitive tax system."[18]

15 Quoted in David Perry, "Tax System Vulnerable to Criticism," *National Post*, March 13, 1999.

16 Ibid.

17 Ibid.

18 Statement by Nancy Hughes Anthony, president of the Canadian Chamber of Commerce, quoted in "Growth in Productivity Outpaces U.S.: Statscan's Findings Differ from Recent OECD Report," *The Globe and Mail*, March 24, 1999.

Demographic Trends

Long-term fiscal planning and debt reduction are necessary for another important reason. As the population ages and fewer people (as a percentage of total population) work, the government will incur higher social welfare costs to support and care for the non-working population. By 2030, the elderly in Canada will comprise 22 percent of the population rather than the current 12 percent. In underscoring the need for a "long-term fiscal framework," the auditor general's 1998 report makes special note of the spending increases that are likely to be required to maintain current service levels: "Our debt and tax burdens remain high, and current demographic trends suggest additional fiscal pressures ahead."[19]

A lower debt, or at least a lower debt-to-GDP ratio, will enable the government to respond to the needs of an aging population with additional social program spending. At the current Treasury bill rate of 5.1 percent, a $1 billion reduction in the national debt will yield an annual saving of $51 million in interest charges—an amount that becomes available in perpetuity for additional spending.

Fiscal and Economic Sovereignty

A high level of debt compromises the government's freedom to set an independent fiscal and economic course. Further, it contributes to inflation by reducing the available money supply, which in turn can result in higher domestic interest rates. Because of dependence on international borrowing, the debt thus increases Canada's risk exposure to fluctuations in world interest rates and impedes the government's ability to stimulate the economy in times of recession by increasing spending or reducing taxes. To the extent that it has resulted in high taxes, stagnant productivity growth, and the downgraded risk ratings for Canadian debt securities as described earlier, the debt has also contributed to the decreasing value of the Canadian dollar over the last 25 years.

Summary

The preceding discussion illustrates some of the probable effects of a failure to reduce the national debt, which is much higher than the OECD average.[20] The high personal, corporate, and payroll tax rates required to support the debt are a disincentive to productivity, investment, and hiring. Projected demographic trends will trigger future spending obligations; if the debt is not controlled, the government's ability to meet those obligations will be compromised, as will its ability to chart an independent fiscal and economic course.

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19 Supra footnote 14, at 7.

20 Organisation for Economic Co-operation and Development, *Economic Survey of Canada, November 1998* (Paris: OECD, 1998).

Debt-Reduction Options

There is general agreement on the need for debt reduction, but no consensus about how it should be accomplished and how quickly. In the pace and timing of debt reduction, three options are available: a back-loaded plan, a constant-surplus plan, and a front-loaded plan.[21] The back-loaded plan, which relies on debt payment from increasing surpluses, appears to be the current strategy of the federal government.[22] With the back-loaded plan, the size of budgetary surpluses and the rate of debt repayment increase with time, both in absolute terms and as a percentage of GDP. The constant-surplus plan is based upon the repayment of debt from surpluses that increase in absolute terms but remain constant as a share of GDP. Finally, the front-loaded plan emphasizes large surpluses applied early to reduce the debt as quickly as possible.

The front-loaded plan presents a number of advantages. First, because the back-loaded and constant-surplus plans depend heavily on the long-term application of a consistent debt-reduction policy, there is a risk that the policy will be derailed by changing governments, political priorities, and economic conditions. Second, the front-loaded plan is likely to result in lower short-term interest rates because reduced borrowing pressure from the government will increase the money supply, and because government debt securities will be seen as more creditworthy and can be successfully marketed at lower interest rates. Finally, the front-loaded plan allows the government more freedom to react to economic downturns with a temporary loosening of fiscal policy.

One front-loaded repayment scheme would allow the debt to be reduced from its current level to about 20 percent of GDP within 20 years.[23] In the first 6 to 7 years of the plan, a yearly budgetary surplus of about $15 billion would be applied to debt repayment. This amount is perhaps somewhat more than the budgetary surpluses that can be expected in federal budgets for the next few years, but it is within a reasonable range.[24] Assuming that the government's current performance in achieving surpluses remains constant, the yearly repayment targets of a front-loaded plan can probably be met without difficulty, particularly if the time line of the plan is extended by 5 or 10 years.

21 For a more complete discussion of these debt-reduction options, see William B.P. Robson and William M. Scarth, *Out Front on Debt Reduction: Programs and Payoffs*, C.D. Howe Institute Commentary 100 (Toronto: C.D. Howe Institute, November 1977), 3.

22 This is the "grow out of the debt" approach, which relies on reducing the debt as a proportion of GDP through economic growth. See *Debt Management Strategy*, supra footnote 8, at 7: the contingency reserve is applied to debt repayment only "when it is not needed."

23 See supra footnote 21.

24 See Ernst & Young, supra footnote 4. The budgetary surplus "could be close to $10 billion in 1999-2000, and even higher in subsequent years."

The use of the front-loaded plan described above would have a more dramatic positive effect on the economy than any other measure. The increasing yearly "fiscal dividend" realized from reduced interest charges could be applied either to spending increases or to tax reductions. It is interesting to note that when the effect of tax reductions is compared with the effect of spending increases, "[t]he comparison favours the lower-tax approach, but the difference is small relative to the overall payoff from debt reduction."[25]

Regardless of the rate of repayment, all three types of plans depend upon the application of yearly budgetary surpluses, as they materialize, to debt reduction. But debt repayment is not sexy, and political pressure to spend surpluses on other priorities is already building. Social welfare advocates want to see the federal government finance new social programs or increase funding for existing programs; business advocates are lobbying the federal government for lower taxes; and employees at various levels of government are asking for wage increases. Finally, it will become more difficult to continue to improve efficiency in government operations as surplus revenues become available to provide larger appropriations to government departments. As the auditor general has noted, an environment of surplus revenues jeopardizes "the momentum toward greater economy and efficiency in managing public funds."[26]

The current government does not have a long-term debt-repayment plan. It has based debt repayment upon two-year fiscal plans, prudent economic assumptions, and the application of a contingency reserve, when available, to debt repayment. Even if the government does choose to resist political pressure for tax cuts and spending increases and applies the contingency reserve and any other surplus to debt repayment, there is no guarantee that the next government will continue that policy.

The present debt-repayment strategy has another Achilles heel. As I pointed out earlier, excessively prudent economic assumptions may have been necessary to re-establish the Department of Finance's credibility in international bond markets. However, the minister's continuing use of conservative assumptions to generate surpluses may ultimately damage that credibility and cause suspicion among voters, who will wonder why the government is generating surpluses in excess of the contingency reserve and how it intends to use them. When large surpluses are allocated at fiscal year-end to tax cuts, new spending, or debt reduction, the public has good reason to complain: decisions about large expenditures of public funds should not be made hastily and in the absence of public consultation and debate. In his 1998 report, the auditor general expressed concern "about the government's failure to comply with PSAAB [Public Sector

25 See supra footnote 21, at 2.

26 Supra footnote 14, at 7.

Accounting and Auditing Board] standards in recording certain expenditures in the Public Accounts [including] the Canada Foundation for Innovation in 1997 and the Canada Millennium Scholarship Foundation earlier this year." He recommended that government accounts be prepared according to PSAAB standards: "[B]ecause they will not be tainted by suspicion that the method followed was chosen for political or partisan advantage, the resulting reports will have greater credibility both among citizens and in the national and international financial communities."[27]

Ideally, debt repayment should be mandated by specific legislation. A legislative approach to debt repayment has a number of advantages. It is a democratic approach that requires public consultation and parliamentary debate. It will raise the public profile of the debt, and thereby increase public commitment to the policy course set by the government. It will reduce the government's vulnerability to short-term political pressure to divert surpluses to other priorities. Finally, it will survive the current government's term of office: modification or repeal of the legislation by a succeeding government might entail political costs and in any case would require public input and parliamentary debate.

DEBT REDUCTION AS TAX POLICY

The imposition of special taxes to control deficits and debts is not new. In 1987, Alberta introduced a deficit-reduction surtax of 8 percent; today, provincial legislation requires the government to repay the province's net debt.[28] Saskatchewan also has a deficit-reduction tax, which was partially offset in 1995 by a special tax reduction because the province was in a position of budgetary surplus.[29] In the 1985-86 budget, the federal government imposed a "temporary deficit reduction surtax"; in its 1999 budget, it eliminated the 3 percent surtax as part of a package of modest tax cuts.[30]

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27 Ibid., at 16.

28 See "Surtax Must Go—Day," *Edmonton Journal*, January 23, 1999. Net debt is the debt that remains after government assets are subtracted from gross debt. The legislation expires once the net debt is repaid, but may be extended until all debt is repaid.

29 Saskatchewan Finance, 1995 Provincial Budget, February 16, 1995, 68. Support in Saskatchewan for debt reduction remains high. In "Report on the 1999-2000 Pre-Budget Consultation," in Saskatchewan Finance, 1999 Provincial Budget, March 26, 1999, 61-63, almost 72 percent of respondents responded in the affirmative when asked, "Should paying down the debt be a priority?" (The same document reported that 53.4 percent believed that the government's current emphasis on debt repayment was appropriate; 4.7 percent thought it should increase the emphasis; and 13.1 percent thought that debt repayment was a priority, but should be given somewhat less emphasis.)

30 Supra footnote 2, at 5.

These measures amounted to little more than simple tax increases that were given a special label to justify them to the taxpaying public. Typically, such taxes were not accompanied by balanced-budget or debt-reduction legislation. In a way, this is understandable. Because of weaknesses in the economy and reduced tax revenues, many governments have not been able to guarantee balanced or surplus budgets without making politically unacceptable cuts to social and other program spending.

This is no longer the case. Over the last six years, the political and fiscal maps of Canada have changed substantially. First, the nation has weathered the recession that made it difficult to control budget deficits and has moved into what is likely to be a period of sustained economic growth; government revenues have increased to the point that debt reduction is now a realistic option. Second, the federal government has streamlined service delivery, divested itself of unprofitable Crown corporations, and improved its management practices: overheads have been reduced and additional resources freed for use. Third, the general public is more aware than ever before of the costs of servicing the national debt and of the long-term costs of a failure to reduce it.

The public's awareness of deficits and debts began to grow in 1993, when New Zealand was experiencing a short-term liquidity crisis. The CBC wrongly reported that the country was on the verge of bankruptcy. Canada's debt was then at 70.1 percent of GDP, and New Zealand was held up as a warning of what happens to countries that borrow more than they can afford. Regardless of the inaccuracy of the reporting, the deficit message got through to the Canadian public on television programs such as *W5*:

> Economists are predicting that sometime in the next year, maybe two years, the deputy minister of finance is going to walk into cabinet—and it doesn't matter whose cabinet—and announce that Canada's credit has run out. Now *that* matters. Our lives will change dramatically.[31]

Given the improvements to Canada's fiscal health and the apparent political salability of debt reduction, the time may well be ripe for the federal government to bring debt-reduction legislation before Parliament. Such legislation must address a number of policy goals: It must provide credible, long-term debt reduction; it must be understood by and have the support of the Canadian public; and it must allow the government sufficient fiscal flexibility to meet program spending objectives and to respond adequately to unforeseen events, such as economic downturns. In the sections that follow, I will outline a proposal amend the Income Tax Act to create a debt-reduction tax that addresses the essential requirements of a long-term debt-reduction strategy in a transparent, cost-effective manner.

31 Quoted in Linda McQuaig, *Shooting the Hippo: Death by Deficit and Other Canadian Myths* (Toronto: Penguin Books, 1995), 3 (emphasis in original).

A Proposed Debt-Reduction Tax

To the extent that it is a tax levied as a percentage of income, the proposed debt-reduction tax (DRT) is similar to surtaxes previously imposed by the federal government for deficit reduction. However, it differs from those surtaxes in several important ways. The essential features and policy benefits of the DRT are presented below.

Broadly Applied and Highly Visible

On the basis of the accepted notion that everyone who earns income should pay tax, the DRT would be levied on all taxpayers who earned net income that exceeded the basic personal amount. This meets two important policy goals. First, it provides an easily administered and effective means of retiring the debt. A broadly applied tax is generally more fair, produces more revenue, and is easier to collect. Second, it should be highly visible, so that the debt-retirement objective is clear to the tax-paying public.

Based on Ability To Pay

The DRT rate would be progressive—that is, the rate would increase with the taxpayer's income. The idea of progressivity is well established in Canada, and is grounded in the 1972 tax reforms that were based on the report of the Carter commission. A progressive rate is appropriate for two reasons. First, it recognizes that the ability to pay tax without incurring undue hardship depends upon income, because the marginal utility of earned income decreases as income increases. In other words, those with higher income can afford to spend a higher proportion of their income on non-essential or discretionary items.

Second, a progressive rate addresses—albeit partially and imperfectly—the issue of intergenerational equity identified earlier. In general, those who earn higher incomes are older and have been in the work force longer than those who earn lower incomes. Taxpayers of whom this is true are also likely to have benefited most from the intergenerational redistribution of wealth from the current to previous generations, as discussed above.[32]

In the context of intergenerational equity, the proposed DRT is unfair to younger taxpayers who entered the work force at high salary levels. If intergenerational equity were the principal focus of a DRT, a complex scheme could be developed that would take into consideration age, years in the work force, average lifetime earnings, current salary, etc. Theoretically, a DRT scale could be established on the basis of a notional calculation of the total benefit received by an individual from his or her participation in the economy over a lifetime. Although this kind of approach might appear to redress intergenerational inequity,

32 Supra footnote 7.

it is not workable for a number of reasons, not the least of which is the administrative complexity and expense involved. Moreover, such a scheme might well be in violation of the Canadian Charter of Rights and Freedoms because it discriminates on the basis of age. It would also amount to retroactive taxation, which seems intuitively unfair and has generally been avoided in Canada. Finally, it might violate the principle that tax should be imposed on the basis of one's ability to pay: an individual might currently have few resources and a low income regardless of his or her past earnings.

A wealth tax earmarked for debt repayment could also address the issue of intergenerational inequity. Although such a tax would respect the ability-to-pay principle and would be relatively easy to administer, it would have to be imposed at a high rate to have any significant impact on the debt. Further, it would create strong incentives to conceal wealth or to move it offshore; it would compromise the credibility of the tax system by encouraging tax evasion; and it would reduce investment in Canada.

Revenue-Neutral

The DRT should not result in any significant net increase or decrease in tax revenue, though the application of the ability-to-pay principle in determining the applicable rates might result in a change in the total amount of tax payable by a particular individual. The imposition of the DRT should therefore be accompanied by a corresponding reduction in the rates of non-DRT personal income tax.

Although revenue-neutrality is not an essential component of the DRT, it is a desirable one for at least two reasons. First, given that many people believe that there is an "urgent need for substantial tax reductions,"[33] it seems certain that any new tax will be viewed with suspicion. Unless the DRT is shown to be revenue-neutral, it is unlikely to receive wide political support. Second, current estimates of the surpluses that are likely to be generated from existing tax revenues suggest that increased revenue should not be required for the government to achieve meaningful debt repayment. Conversely, tax reductions should not accompany introduction of the DRT because, based on current estimates of projected surpluses, there would then be insufficient revenue to support a front-loaded debt repayment plan.

Separate Revenue Stream

The DRT would be a directed tax, with revenues kept separate from all other streams and applied solely to the reduction of the principal of the national debt. The creation of a debt-reduction holding fund would allow the government the flexibility necessary to apply DRT revenues to debt repayment when long-term

33 See Ernst & Young, supra footnote 4.

debt securities mature or when Treasury bills or Canada savings bonds are redeemed.

A separate revenue stream is an essential feature of the DRT. Debt reduction would no longer depend upon surpluses being applied to debt repayment at the government's discretion. Repayments would be regular and predictable, and would be unconnected with any other tax or spending decisions. The government would be relieved of political pressure to spend surpluses on priorities other than debt reduction, and would be free to allocate surpluses arising from non-DRT revenue to any priority it chose.

Applied to Debt Principal Only

DRT revenues would be directed solely to debt repayment. Interest charges on the national debt would continue to be paid from general, non-DRT government revenues. This feature of the DRT is necessary to ensure that debt repayment actually occurs. If interest charges were paid from DRT revenues, a significant portion of the revenues would be consumed, with little remaining for reductions to the debt principal. This would eventually lead to the very problem the DRT is intended to address: large non-DRT budgetary surpluses, which the government might be pressured to apply to tax cuts and spending increases rather than to debt reduction. Furthermore, if the DRT is to be easily understandable and politically salable, taxpayers must see tangible reductions to the debt principal. Using DRT revenues to pay interest charges would confuse taxpayers and make the calculation of the debt-amortization period more complicated.

Greater Budgeting Flexibility

The introduction of the DRT should be accompanied by an amendment to the Financial Administration Act to permit the federal government to carry surplus appropriations from one fiscal year to the next. This feature too is essential. The government would be relieved of the legislated requirement to apply surpluses (arising from non-DRT revenues) accumulated at fiscal year-end to repayment of the debt. As described above, this would allow it complete flexibility to allocate surpluses in any other manner it chose. This flexibility would remove the need to make last-minute spending decisions at fiscal year-end, with the probable result that the use of non-DRT surplus revenues would be more closely scrutinized by the public and Parliament.

BALANCED-BUDGET LEGISLATION

Balanced-budget legislation should be introduced in conjunction with the DRT so that the federal government would not be permitted to incur a deficit except in limited circumstances (such as natural disasters, war, or recession, which could be defined as two consecutive quarters of negative economic growth as determined by Statistics Canada). This feature of the proposed DRT, though not essential, is very desirable. Without balanced-budget legislation, a government might, for political or ideological reasons, return to deficit-financed spending or tax cuts. This could occur explicitly, by way of planned deficits, or indirectly, by way of spending based on overly optimistic economic forecasts and revenue projections.

Deficit spending would either partially or completely negate the DRT's policy objective by allowing a government indirect access to DRT revenues intended to be applied to debt reduction. In periods of economic growth, and absent the need for emergency spending, there should be no need for deficit-financed spending because growth would ensure continued increases in government revenues. Moreover, the government would be at liberty to raise non-DRT tax rates if necessary to meet its spending requirements.

The greatest challenge in the design of balanced-budget legislation is determining what penalty should apply when a deficit arises that does not meet a specific exception in the legislation. Provincial balanced-budget legislation has included sanctions such as salary cuts for elected officials who have presided over a deficit budget. Another possible sanction is the triggering of a general election within 90 days of the end of a fiscal year in which a deficit was incurred. Such legislation could easily be amended or repealed by the government, of course, but that action might entail undesirable political costs.

Yearly Rate Calculation

The DRT rate should be actuarially recalculated each year, using a predetermined amortization period (for example, 30 years) and taking into account all relevant assumptions, including projections of GDP growth, long-term interest rates, productivity, economic cycles, and government revenues. This is a purely technical feature of the DRT proposal, but it is necessary to ensure that the DRT rate is adjusted as necessary to achieve debt repayment within the planned debt-amortization period.[34] A disadvantage of yearly recalculation of the DRT rate is that a taxpayer will not know from one year to the next what his or her tax rate will be; this makes tax planning and predictability difficult. Therefore, it may be appropriate to limit the frequency of DRT rate adjustments to a maximum of one change every three years. This would have the added benefit of reducing the DRT's administrative costs.

Information to Taxpayers

Information about the DRT—including the current total debt, interest charges, the current year's surplus or deficit, DRT revenues, the estimated time to full

34 See supra footnote 7. According to the front-loaded strategy discussed above, the 20-year target is to reduce the total debt to 20 percent of GDP. I have generally presented the objective as being debt repayment in full. The DRT proposal should work equally well in a front-loaded debt-reduction model.

debt repayment, and the DRT rate for the following year—should be provided each year to every taxpayer. Ideally, the information should be printed on the notice of assessment that is sent to each taxpayer after a T1 individual tax return is processed. However, personal income taxes are levied on a calendar-year basis and the government fiscal year-end is March 31; a separate mailing may thus be necessary, because the information will not be available when many returns are processed.

The provision of information to taxpayers in an easily understood format is a key feature of the proposed DRT. Such disclosure would enhance public awareness of the debt and show that debt repayment is achievable; most important, taxpayers would see that DRT revenues were actually being applied to debt repayment. Although the public's understanding of federal finances in Canada has probably improved over the last few years, still more improvement is needed. If taxpayers are given regular and reliable information about the debt, awareness of and support for the DRT's policy objectives are likely to remain high, and demands for increased spending or tax cuts are likely to decrease.

Table 1 shows how a typical annual statement might look. (All figures used are approximate.)

Example of a Progressive-Rate DRT

The current federal rate structure uses three basic marginal rates; table 2 illustrates a more progressive tax, with marginal rates increasing on seven increments of $30,000. (The basic personal amount—$6,794 for 1999—is excluded from the calculation of tax.)

DRT Policy Benefits

The DRT proposal outlined above addresses many of the shortfalls of the government's current debt-management strategy. The DRT is a long-term debt-management approach that offers the possibility of predictable and reliable debt repayment. As a sharply progressive tax, it partially addresses the issue of intergenerational inequity by imposing more tax on those who are likely to have extracted (and who are likely to continue to extract) higher levels of benefits from the Canadian economy.

Like the goods and services tax (GST), the DRT probably will not be easily repealed once implemented: the public's more accurate understanding of the size and cost of the national debt will lead to a general acceptance of the need to control and reduce it. But even if this assumption is flawed—if the Canadian public chooses not to support debt reduction after having gained a good understanding of the debt and the long-term implications of not repaying it—at least the choice will be an informed one.

In sum, the proposed DRT would increase the government's accountability for tax and spending decisions, both by making debt costs more generally

Table 1 Debt Reduction Tax (DRT) Annual Statement

Debt interest charges, 2000-01[a]	$ 35,000,000,000
Total debt at March 31, 2000	$650,000,000,000
Less DRT Revenues, 2000-01	−$ 15,000,000,000
Total debt at March 31, 2001	$635,000,000,000
Interest savings from debt reduction	$ 765,000,000
Projected year of full debt repayment	2031

[a] Debt interest.

Table 2 A Progressive-Rate DRT

Income range	Marginal rate (%)	Marginal tax	Applied DRT (at top of income range)
$6,794-$30,000	3	$696.18	$696.18
$30,000-$60,000	6	$1,800.00	$2,496.18
$60,000-$90,000	9	$2,700.00	$5,196.18
$90,000-$120,000	12	$3,600.00	$8,796.18
$120,000-$150,000	15	$4,500.00	$13,296.18
$150,000-$180,000	18	$5,400.00	$18,696.18
$180,000-$210,000	21	$6,300.00	$24,996.18
$210,000 and above	21	—	—

known and by virtue of the accompanying balanced-budget proposal. It would also enhance the government's fiscal flexibility by permitting it to carry over surpluses from one year to the next, and allowing it the freedom to stimulate the economy in times of recession. It might be argued that the ability to carry over surpluses would have the effect of reducing accountability, but in fact it would reduce the need for hasty end-of-year spending decisions and lead to greater parliamentary and public debate on those decisions. The proposed DRT also offers the reasonable prospect of a more sovereign fiscal policy in Canada. By reducing debt interest charges, the DRT would mitigate the effect of world interest rate fluctuations on government finances. Reduced total debt loads would inevitably result in better risk ratings from international credit agencies, which in turn would further reduce the federal government's cost of borrowing. Finally, the value of the Canadian dollar is likely to increase when the debt-to-GDP ratio decreases, and because tax cuts made possible by debt repayment will contribute to higher levels of productivity and investment.

CONCLUSION

A number of important issues remain to be addressed, and much more work is necessary to bring the proposed DRT up to the standard of credible tax policy. Because of my personal limitations in the fields of accounting, actuarial science, and statistics, I have made no attempt to present a detailed framework for the DRT. Such a framework should necessarily include a workable sample rate structure showing actual DRT revenue projections and the proportion of DRT to non-DRT revenues, with examples of how the progressive effect of the DRT would change tax burdens for each class of taxpayer. It should also include projections of various debt-amortization periods with estimates of the revenue required in each year to meet payment schedules (taking into account appropriate assumptions regarding long-term interest rates, economic cycles, etc.).

I have discussed the DRT only with reference to personal income tax (T1), which is only one of several sources of federal tax revenue. It may be appropriate to apply a DRT to other sources, particularly corporate (T2) and trust (T3) revenues. The question whether a portion of GST and Customs and Excise revenues should be allocated to debt reduction must also be addressed.

Because the proposed DRT is a revenue-neutral tax that amounts to no more than a reapportionment of existing revenues to debt repayment, it may not matter whether the DRT net is cast narrowly and applied only to T1 revenues or broadly and applied also to T2 and T3 revenues. Broad application would render the DRT more visible and would increase the public's sense of responsibility for the national debt. A narrow application to T1 revenue would result in administrative simplicity.

The proposed DRT is one structured approach to debt repayment. Other approaches may well achieve the same objective. Regardless of the method chosen, repayment of the national debt—or, at the very least, substantial reduction of the debt-to-GDP ratio—is a necessity. With the advent of globalization, the world is becoming more competitive. The lion's share of profits from international competition will probably go to economies that encourage investment and foster the development of competitive industries in a deregulated environment, all within a fiscal policy regime that is perceived as stable and responsible. The profits are likely to be greatest in countries that can achieve market-economy efficiencies while maintaining adequate levels of spending on health, social welfare, and education. If we are to achieve this objective, we must rid ourselves of the albatross of debt that jeopardizes the quality of life and social stability that Canadians have come to expect and will continue to want in the future.