What Is the Room for Tax Cuts? An Analysis of the Potential Fiscal Dividend and Its Allocation

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ABSTRACT

This paper reviews the estimates of the potential fiscal surplus (or "fiscal dividend") presented by Finance Canada in *The Economic and Fiscal Update*. It then presents a further updated projection of the fiscal dividend that incorporates more recent information. These projections cover the six-year period from fiscal 1999-2000 to fiscal 2004-5.

The fiscal dividend can be allocated to additional spending, tax cuts, or debt reduction. The authors argue that debt reduction should have highest priority in the short term, with tax reductions a high priority over the medium term. Over the five fiscal years from 2000-1 to 2004-5 as a whole, the authors recommend approximately a 25:50:25 split for spending increases, tax cuts, and debt reduction, respectively.

The authors develop a model simulation of the economic and fiscal effects of such a fiscal program. The results show favourable supply effects on productivity, and output and employment growth. Because of these favourable economic developments, the model predicts a higher potential fiscal surplus, providing additional room for further initiatives in the later years.

Recently, Finance Canada engaged four forecasting organizations to develop estimates of the potential surplus (or "fiscal dividend") that would be generated over the next five fiscal years (2000-1 through 2004-5). These estimates were developed on the basis of a common set of economic projections—the so-called consensus or average of forecasts of private sector firms and organizations—and a common set of fiscal assumptions (called here the "September fiscal assumptions"). Beyond the fiscal measures already put in place by past budgets, these estimates entail no change in basic tax rates, and—other than payments for

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employment insurance (EI) and for old age security and guaranteed income supplement—they hold program spending constant in real per capita terms.

The average results of this exercise (called here the "four-model average") were published by Finance in *The Economic and Fiscal Update*.[1] We reproduce the average projected potential surpluses in the first line of table 1. It shows that the fiscal dividend steadily increases, reaching a level of $30 billion in 2004-5.

The Policy and Economic Analysis Program (PEAP) at the University of Toronto was one of the four forecasting and modelling organizations involved. We show the potential surpluses that PEAP projected for this exercise (called "September PEAP estimate") in the second line of table 1. Although these near-term estimates are close to the four-model average, in the later years the PEAP model generates a larger fiscal dividend, reaching $33 billion in 2004-5. This result reflects the more buoyant corporate tax revenues, somewhat higher EI revenues, and lower EI payouts projected in PEAP's analysis.

Although these projections were published in November 1999, they were based on the information available in September. The economic outlook has improved significantly in recent months, as reflected in forecasts published by *Consensus Economics* and in various statements published in the financial press.

PEAP's latest long-term economic forecast, released on November 10, 1999, incorporates new information.[2] Using the FOCUS macro-econometric model, we have reconstructed the fiscal dividend projection, using this latest economic projection, but maintaining the same fiscal assumptions as in the September 1999 exercise. We show these results in the third line of table 1. The potential surplus over the first three years is increased by $1 billion, to $1.5 billion per year. But in the final two years (2003-4 and 2004-5) there is little difference between the new and the original estimates.

A key assumption in the construction of these potential surplus estimates—the four-model average as well as the two PEAP estimates discussed above—was that debt reduction would be $3 billion per year. Debt reduction obviously affects the magnitude of potential surpluses in the later years by reducing the future interest payments for servicing the debt.

The current (December 1999) PEAP base forecast, however, allows for larger debt paydowns, particularly in the early years. As a result, the potential surplus

1 Canada, Department of Finance, *The Economic and Fiscal Update* (Ottawa: the department, November 2, 1999), at 80.

2 This update was based on information available in November 1999. More recent information, provided in the 2000 federal budget documents, suggests that, because of the stronger-than-anticipated growth of the economy, the potential surplus over the next two fiscal years would grow by about $0.8 and $2.3 billion. See Canada, Department of Finance, The Budget Plan 2000, February 28, 2000, table 3.4, at 59.

Table 1 Total Fiscal Dividend

	Fiscal years					
	1999-2000	2000-1	2001-2	2002-3	2003-4	2004-5
	$ billions					
Based on September 1999 fiscal assumptions						
Four-model average[a]	5.6	9.9	13.6	18.5	24.4	30.1
September PEAP estimate[b]	5.5	10.3	14.5	20.4	26.8	33.0
November PEAP forecast[b]	6.6	11.5	16.0	21.2	26.5	33.1
Based on assumptions of larger debt paydown						
December 1999 PEAP forecast[b]	6.7	11.7	16.3	21.7	27.1	33.7

[a] Canada, Department of Finance, *The Economic and Fiscal Update* (Ottawa: the department, November 2, 1999), at 80. [b] Calculations by the authors.

generated within the current PEAP forecast (shown in the fourth line of table 1) is somewhat larger in 2004-5, at $33.7 billion—that is, about $0.6 billion higher than with the steady $3 billion debt paydown per year assumed in the other three projections shown in table 1.

We believe that a strong case can be made for larger debt paydowns in the early years. As shown in table 2, the current PEAP projection has a debt reduction of about $7 billion per year over the next three years. At a minimum we would recommend that the minister of finance add the economic prudence factors to his commitment to allocate the contingency reserve to debt reduction. This would entail a planned debt reduction of about $5 billion per year (if the private sector average forecast is realized).

We view debt reduction, particularly in the early years, as important for the following reasons:

• A larger debt reduction will generate higher national savings and lower interest rates, both of which are conducive to long-term growth.

• A larger budget surplus will reduce the burden on the Bank of Canada to control inflation.

• Given the government's determination to avoid deficits, a larger planned surplus provides a more adequate cushion against perverse fiscal policies in the event of a recession.

On balance, we view the debt reduction in the current PEAP base case as appropriate, and therefore must subtract these amounts from the projected fiscal dividend of the base case. As noted above, the larger debt paydown in the early years provides more room to manoeuvre in the later years because of reduced debt-servicing costs.

After subtracting the planned debt reduction from the fiscal dividend, we arrive at the amounts available for tax reduction or spending increases. As a base

Table 2 Derivation of Room for Tax Reductions: Current (December 1999) PEAP Base Case

	Fiscal years						Cumulative five-year totals	
	1999-2000	2000-1	2001-2	2002-3	2003-4	2004-5		
	$ billions							*percent*
Total fiscal dividend . . .	6.7	11.7	16.4	21.7	27.1	33.7	110.6	100
Amount generated by additional debt reduction[a]	0.1	0.3	0.4	0.5	0.6	0.6	2.4	na
Debt paydown	5.8	7.5	7.2	6.5	3.7	3.7	28.6	26
Additional program spending	0.9	2.5	3.8	5.6	7.9	10.4	30.2	27
Room for tax reduction	0.0	1.8	5.4	9.6	15.5	19.5	51.8	47

na not applicable (this is part of the total fiscal dividend).

[a] Over $3 billion per annum.

Source: Calculations by the authors.

case, we assume that there will be some additional program spending, similar to the recommendations contained in the majority report of the House of Commons Finance Committee.[3] These expenditures would likely focus on education, defence, health, and infrastructure.

The December 1999 PEAP base case projects a net increase in federal government spending (relative to the constant real per capita benchmark) of about $10 billion by the fifth year.[4] We view this projected increase as a reasonable forecast,[5] although it may well be that program spending will grow less than we project.[6] We note that, if spending growth were limited to population growth plus inflation, there would be considerably more room for tax reductions over the projection period.

3 Canada, House of Commons, *Budget 2000: New Era . . . New Plan*, Report of the Standing Committee on Finance (Ottawa: Queen's Printer, December 1999).

4 Note that, because our model is on a National Accounts basis, increases in the child tax credit (or reductions in clawback rates) are treated as transfer payment increases rather than net tax reductions.

5 This is a predictive, not a normative, statement. Given the priority we attach to debt repayment and tax reduction, we would view this increase as the upper limit of the appropriate spending growth.

6 Many will argue that this spending increase is insufficient to meet worthwhile objectives. In many areas, however, more efficient delivery of public services would permit greater real improvements than the spending increases suggest. And in some cases (for example, infrastructure and education), users may contribute more than in the past, reducing the burden on general revenues.

When we subtract the planned spending increases and planned debt paydowns from the fiscal dividend, we arrive at our estimates of the amount available for tax reduction. The room for tax cuts is small in 2000-1, reflecting the priority of debt repayment. But this room grows steadily over the projection, reaching $19.5 billion in 2004-5. In that year, the room for tax reduction represents almost 58 percent of the fiscal dividend, with debt reduction accounting for 11 percent and spending increases about 31 percent. Over the five-year planning period as a whole, debt reduction and expenditure increases each account for just over a quarter of the cumulative potential surplus, and tax reductions for just under a half.

A MEDIUM-TERM TAX REDUCTION PLAN

Given the foregoing projections, we believe that a medium-term tax reduction plan should be announced. Although reductions in personal income taxes will account for most of the reduction in tax revenues, it is important that the tax reduction plan include reductions in business taxes and payroll taxes. As noted earlier, these are the taxes that most strongly affect efficiency and growth.

Reductions in EI payroll taxes will help to offset the adverse transitional effects that payroll tax increases for Canada Pension Plan and Quebec Pension Plan (CPP/QPP) have on employment. We have therefore allowed for three successive, annual 20-cent reductions in the employee contribution rate, starting in January 2001. When fully in effect, this measure will cost about $4.5 billion a year.

A higher priority, from the standpoint of economic efficiency and growth, is a reduction in business taxes. We believe that a significant reduction in corporate income tax (CIT), as well as being desirable on its own, will allow the recommendations of the Technical Committee on Business Taxation (herein called "the technical committee")[7] to be followed more easily. Our tax reduction package therefore includes a 3 percentage point reduction in the statutory rate for large firms, to be phased in over three years. This reduction is over and above the rate reductions that could be financed by base-broadening measures. Upon full implementation, the annual ex ante cost of these measures would be about $2 billion. As the technical committee notes, however, a reduction in statutory corporate rates will likely increase the corporate tax base, thereby reducing the revenue loss. In combination with the technical committee's suggested reforms, this measure would reduce the combined (federal-provincial) corporate rate to about 30 percent.

We would also recommend reducing the capital gains inclusion rate from three-quarters to two-thirds, in order to bring the typical top-bracket marginal rate on realized capital gains into line with the effective marginal rate on dividends.

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7 See Canada, *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, April 1998).

This measure should be put into effect in 2001-2. The annual net revenue costs, which would begin in fiscal year 2001-2, would be about $0.3 billion on an ex ante basis. But reducing capital gains taxes would likely stimulate realizations,[8] reducing the net revenue cost of this measure.

When the payroll, business, and capital gains tax reductions are deducted from the total tax room, we derive the amount available for personal income tax (PIT) reductions. As shown in table 3, there is considerable room for PIT reductions within the five-year fiscal plan.

A balanced PIT reduction package is presented in table 4. Its key features include

1) major reductions in rates for middle-income taxpayers; the middle bracket is reduced by 3 percentage points, bringing it to 23 percent (a point midway between the high- and low-bracket rates);

2) annual increases in the basic amount for the personal tax credit;

3) a phaseout of the 5 percent high-income surtax, which was originally justified as a deficit reduction measure;

4) increased income thresholds for the middle- and high-tax-rate brackets; and

5) increased deduction levels for registered retirement savings plan and registered pension plan contributions.

Over the first three years of the fiscal plan, the specific measures shown in table 4 would exhaust the available room for PIT reductions. In fiscal 2003-4 there would be room for additional tax reductions of $3 billion and, in fiscal 2004-5, of almost $6 billion. We have chosen not to allocate these amounts, for two reasons. First, we want to allow for the possibility that the estimated fiscal dividend may be overstated. Recall that the September PEAP projected surplus was about $3 billion above the four-model average in fiscal 2004-5. Second, there is time to consider the various alternative ways of using this additional fiscal room. High on our list of priorities would be changes to the tax treatment of children and the family, and appropriate changes to how transfer clawbacks interact with the PIT.

ALLOCATING THE FISCAL DIVIDEND: ECONOMIC EFFECTS

The current debate is about the allocation of the fiscal dividend. We have therefore chosen to model the economic effects of the particular combination of debt paydowns, spending increases, and tax reductions described above relative to an alternative allocation. In the alternative, we have limited debt reduction to $3 billion per year, and have allocated *all* the remaining potential surplus to non-taxable transfers to persons. We selected this particular alternative because it

8 Jack M. Mintz and Thomas A. Wilson, *Capitalizing on Cuts to Capital Gains Taxes*, C.D. Howe Institute Commentary no. 137 (Toronto: C.D. Howe Institute, February 2000), at 23.

Table 3 A Recommended Tax Reduction Strategy[a]

	Total tax reduction room	EI rate cuts	Capital gains and CIT cuts	Room for PIT cuts
		$ billions		
2000-1	1.8	0.4	0.0	1.4
2001-2	5.4	1.9	0.9	2.6
2002-3	9.6	3.4	1.5	4.7
2003-4	15.5	4.5	2.0	9.0
2004-5	19.5	4.5	2.0	13.0

[a] The revenue cost of these measures is based on data in Canada, Department of Finance, *The Economic and Fiscal Update* (Ottawa: the department, November 2, 1999), at 112-13.

Table 4 An Illustrative PIT Tax Reduction Package[a]

	Increase amount for basic credits by $100 p.a.	Middle-bracket rate reduction of 1 percentage point p.a. for 3 years	Widening[b] brackets by +$1K/$2K p.a. starting in 2002	Phaseout of 5% surtax starting in 2002	Increase RRSP contribution room by $1K p.a. starting in 2002	Other	Total
				$ billions			
2000-01	0.28	1.05	0.0	0.00	0.0	0.0	1.4
2001-02	0.56	2.10	0.0	0.00	0.0	0.0	2.6
2002-03	0.84	3.15	0.6	0.13	0.0	0.0	4.7
2003-04	1.12	3.15	1.2	0.26	0.2	3.1	9.0
2004-05	1.40	3.15	1.8	0.39	0.4	5.9	13.0

[a] The revenue cost of these measures is based on data in Canada, Department of Finance, *The Economic and Fiscal Update* (Ottawa: the department, November 2, 1999), at 112-13. [b] These estimates are adjusted to take into account interactions with the middle-bracket rate reduction.

represented the base case used in the original fiscal dividend exercise, but we updated it to reflect the economic outlook as in December 1999.

We then implemented our recommended package of debt reduction, spending increase, and tax reduction, reducing non-taxable transfer payments dollar for dollar to finance those initiatives. We set monetary policy to maintain the price level approximately unchanged when we introduced our fiscal dividend allocation package.

The results, presented in table 5, show that the package affects employment, productivity, and real output favourably. It shifts the composition of demand from consumption to investment, net exports, and real government purchases of goods and services. As the package exerts a deflationary impact on prices, monetary policy is eased, with lower interest rates and a lower exchange rate. With investment stronger, the capital stock gradually increases. The federal government surplus rises, both directly as a result of our higher debt reduction targets, and indirectly because of lower interest rates and stronger economic

Table 5 Economic and Fiscal Effects of Implementing the Proposed Fiscal Plan

	Fiscal years				
	2000-1	2001-2	2002-3	2003-4	2004-5
Economic: growth in			*percent*		
Real GDP	0.2	0.4	0.4	0.5	0.7
Machinery and equipment	0.7	2.5	3.5	2.4	1.2
Labour productivity	0.2	0.2	0.1	0.2	0.3
Employment	0.1	0.2	0.3	0.3	0.4
Capital stock	—	0.2	0.5	0.8	0.9
			$ billions		
Current account balance	1.9	3.8	4.1	4.5	5.2
Fiscal: growth in					
Federal surplus	5.6	6.7	6.4	3.8	5.3
			percentage points		
Federal debt to GDP ratio	−0.4	−1.1	−1.6	−2.0	−2.4

— nil.

Source: Calculations by the authors.

growth. In the final year of the analysis, the federal debt to GDP ratio drops by 2.4 percentage points relative to the alternative allocation.

These economic and fiscal results are due to three of the measures in our package:

1) higher debt paydowns, which provide more room for monetary easing;

2) business tax reductions, which stimulate investment; and

3) payroll tax cuts, which put downward pressure on unit costs (that is, they are like a favourable supply price shock), permitting stronger growth without inflation.

The other components of the package—PIT cuts and increased government spending on goods and services—have aggregate effects similar to those of non-taxable transfers. These results therefore underline the importance of debt reduction and cuts in business taxes and payroll taxes if economic growth and productivity are to be enhanced.

Table 6 shows the additional fiscal surplus generated by this fiscal package. By fiscal year 2004-5, the federal surplus would have grown by about $4.5 billion. These additions to the surplus provide some insurance that debt reduction targets will be met. Alternatively, they can be viewed as providing opportunities for additional fiscal initiatives in the later years of the projection.

The bulk of the unallocated portion of the PIT reductions ($5.9 billion in the fifth year) combined with part of the additional fiscal dividend ($4.6 billion) generated by the favourable supply-side effects would be sufficient to finance major changes to the PIT system.

Table 6 The Impact of the Fiscal Package on the Budget Surplus

Fiscal year	Debt reduction target[a]	Debt reduction result[b]	Additional fiscal surplus
		$ billions	
2000-1	7.5	8.6	0.9
2001-2	7.2	9.7	1.5
2002-3	6.5	9.4	2.9
2003-4	3.7	6.8	3.1
2004-5	3.7	8.3	4.6

[a] From table 2, line 3. [b] The federal surplus reported in table 5, plus the $3 billion contingency reserve.

Such large amounts should not be dribbled away through piecemeal changes. Rather they should be used to finance significant reforms to the PIT system. Although the large potential surplus has focused public attention on tax reductions, meaningful tax reform could also entail significant base broadening,[9] which could finance even larger reductions in tax rates, or additional measures to improve equity and efficiency.

SUMMARY

In this paper we make five main points:

1) The federal government should adopt a medium-term fiscal plan to allocate the potential surplus.

2) In the near term, the highest priority should be given to debt reduction.

3) In the later years, the priority should shift to tax reduction.

4) Although personal income tax cuts will take up most of the room for tax reduction, it is important to reduce payroll and business taxes as well.

5) Using the FOCUS macro-econometric model for our calculations, we propose a fiscal package that would involve significant debt reduction, modest spending increases, and reductions in personal, business, and payroll taxes. The results indicate that this fiscal package would have favourable supply-side effects on output, employment, and productivity over the medium term. These favourable economic effects would further increase future potential fiscal surpluses.

9 Examples of possible base-broadening measures include replacing the $500,000 exemption for farmers and Canadian-controlled private corporations with expanded access to RRSPs, taxing certain employee benefits, eliminating age and pension credits, and taxing lottery and gambling winnings.