TD Bank Financial Group

TD Economics

Topic Paper

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IN SEARCH OF WELL-BEING
Are Canadians slipping down the economic ladder?

Many Canadians feel they are not much better off today relative to previous generations or their own past situation. Yet, a number of economic and financial indicators – booming housing market, low borrowing costs, high employment levels – leave the impression that Canadians are well off and their economic status is steadily improving. In an attempt to reconcile the data with the perceptions, we found that Canadian households indeed have cause for concern – their economic well being has not advanced for many years. This adds urgency to the need to bolster Canada's lackluster productivity growth and serves as notice to Canadian governments to lighten the tax burden.

Looking beyond GDP

It is conventional to look at growth in GDP per capita as a gauge of living standards. However, this is a flawed proxy for economic well being because, when all else is equal, national income will rise when a greater portion of the population is employed, and this does not necessarily equate to greater well being. For instance, a higher incidence of double-income earners in households may come at a cost of less leisure time, less family time and more work- or home-related stress.

In Canada, the employment rate – the number of people working relative to the population over the age of 15 – has increased from only 56 per cent in the mid-1970s to nearly 63 per cent in 2004, all of which is attributed to women. Participation rates for women aged 24-54 have increased to 81 per cent from less than 60 per cent in the 1970s. Though this speaks volumes about greater job opportunities available to women, it also implies that some of the rise in nationwide income is simply a function of a larger proportion of the population in the workforce. It is estimated that over the last eight years, the simple mathematics behind a swelling workforce explains one-third of the rise in output per person. Increased work effort should not be counted as increased well being.

THE RELATIVE PERFORMANCE OF PERSONAL INCOMES AND GDP

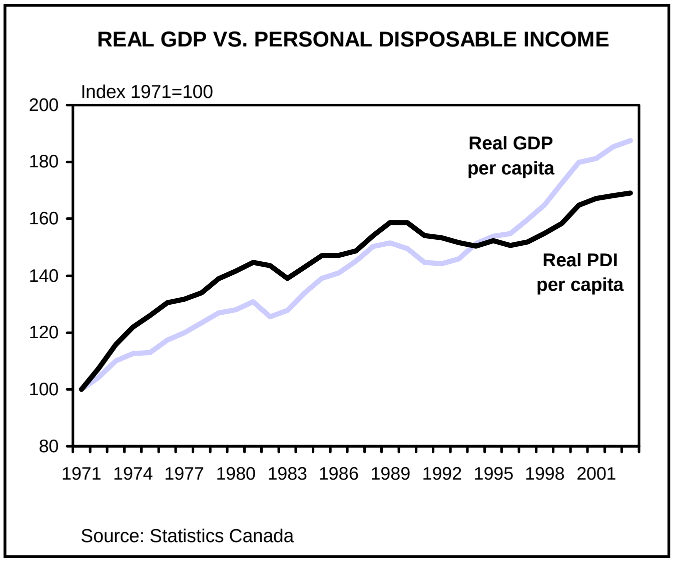
	1989-2004 Cumulative
Real GDP per capita	25.5%
Real GDP per worker	21.8%
Real after-tax income per capita	9.3%
Real after-tax income per worker	3.6%

Source: Statistics Canada

Growth in GDP per worker would bring us a little closer to how individuals judge their economic well being, but it would still be inaccurate because people would be most concerned with their after-tax personal incomes, rather than GDP which also includes corporate and government sectors. A rise in income in these sectors is unlikely to generate an equivalent feeling of personal gain.

Bringing home the (lean) bacon

So the next question is whether the take-home pay of workers has kept pace with GDP growth. And, the answer is no. Up until the early 1990s, growth in real after-tax income per person exceeded that of GDP. This relationship started to break down during the early 1990s when



the economy slid into a recession, and even though economic activity was well on the road to recovery by 1993, ongoing labour market slack and corporate restructuring initiatives kept a lid on personal income growth for three more years. Tallying it up, between 1989 and 2004, real GDP per capita rose a cumulative 26 per cent, while real incomes per capita could only muster a 9 per cent gain. The picture looks even worse if we take inflation-adjusted GDP and after-tax incomes on a per worker basis – in order to isolate work effort by individuals who generate the income. On this basis, real GDP per worker rose by 22 per cent while real after-tax incomes per worker squeaked out a cumulative 3.6 gain over the entire fifteen-year period. It's hard to make a case as to why households should be feeling better off knowing that individual after-tax incomes have not seen the gains of the economy.

The taxman cometh

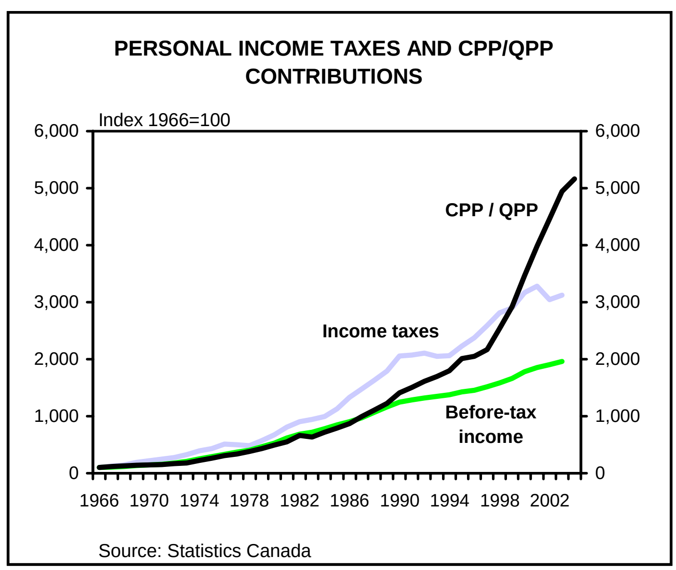
Income growth would have fared far better were it not for rising tax burdens, which went from trimming back incomes in the 1970s to giving them a brush-cut thereafter. From 1971 to 1982, taxes grew in sync with incomes, thereby allowing for a 44 per cent rise in real per capita after-tax incomes over that period. But following that decade, the rate of growth in taxes became considerably faster, capping after-tax income growth.

What was behind the rapid rise in taxes? One cause was a phenomenon called bracket creep. Over time, wages and salaries tend to rise with inflation to maintain the purchasing power of income. If tax brackets don't also rise with inflation, individuals get pushed into higher tax brackets. Up until the mid-1980s, the federal government fully indexed tax brackets, but then opted for a looser interpretation from 1986 to 2000, applying indexation only to the portion of inflation that was above 3 per cent. Unfortunately, bracket creep still occurs in low inflation environments, especially if sustained over time. This is exactly what happened to an increasing proportion of Canadian workers from 1992 to 2000 when inflation was contained to a 1-to-2.5 per cent range year after year.

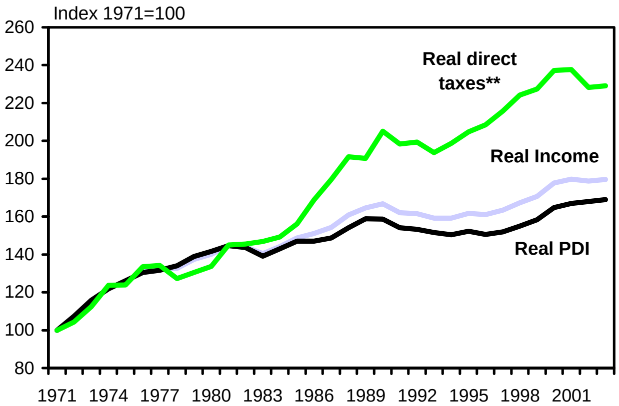
A second hit to incomes came from a rise in the premiums paid into the Canadian and Quebec Pension Plans (CPP and QPP). In order to address a huge funding shortfall for future pension payouts, employee-employer CPP premiums were hiked from 3.6 per cent in 1986 to 9.9 per cent by 2003. The sharp hike in premiums not only bit deeper into the incomes of all workers, but it also imposed an intergenerational inequity that left younger workers worse off than older workers. On a market value basis, the value of the Canadian Pension Plan is about $5.5 per $100 of income. This implies that the payrolls of younger workers are contributing $4.4 per $100 of income more than they will receive in retirement. Meanwhile, older workers, on average, will receive more in pension benefits than they would have contributed.

Payback time

Normally a rise in the tax burden would not automatically be associated with reduced economic well being if it were used to finance more current services or to invest in



PERSONAL INCOME* PER CAPITA



* Measured as wages, salaries and supplementary income
** Personal income taxes, CPP/QPP contributions and emp't insurance
Source: Statistics Canada

the future. But this is not the case here. The rise in the tax burden is the price society is now paying for past government deficits and policy shortcomings. Between 1975 and 1996, the consolidated government (federal, provincial and municipal) consistently ran deficits, swelling to as much as 8 per cent of GDP in 1992 and 1993. In that two-decade span, Canadians enjoyed $0.90 to $0.97 in program spending (total spending minus interest on public debt) for every dollar of revenue that was put into government coffers. Not so anymore. Only $0.76 to $0.84 of every dollar goes to program spending, with the rest of the money going towards interest costs and relatively modest payments against the accumulated debt.

Wealth vs. debt

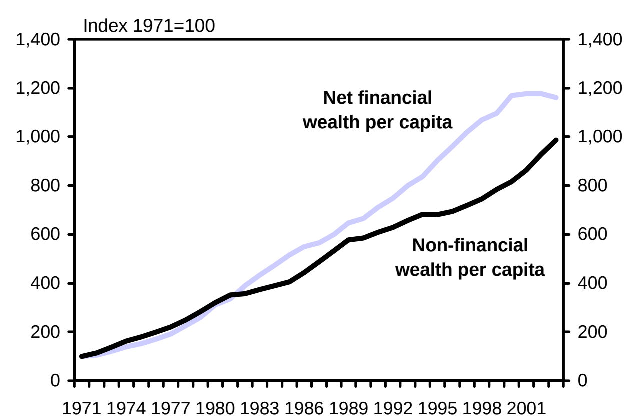
The high and growing debt burden of Canadian households is often cited as a factor leading to a feeling of deteriorating well being. Yet, household assets have been growing even faster, such that net worth (assets less debt) has never lost a step in its advances despite a flattening in after-tax incomes. Both financial and non-financial assets have grown steadily, with particularly large gains in the value of land, homes and pension plans. The rise in net worth should give households a feeling of greater well being, but perhaps there is an asymmetry in how people view their assets and debt. For instance, a paper gain in the value of one's home might not seem as tangible as hard debt – amounting to an unprecedented 120 per cent of after-tax incomes – that must be financed, even if it's at low interest rates.

A time for action

So now that we know there is a legitimate reason for households to feel downtrodden about their personal financial performance, what should be done about it? A necessary, but not sufficient, solution lies with stronger productivity growth. Productivity, while growing in Canada, is lagging most other industrialized nations. Since 1990, labour productivity growth has averaged 1.6 per cent annually in Canada, which not only underperforms its closest neighbor, the U.S., but is also well shy of smaller economies like Ireland, Belgium, and Finland. Put simply, Canada must do better on productivity. This would elevate real wages of workers. Government tax receipts would also rise and the funds could be returned to the public through increased services and/or tax cuts.

Government can take an active role in helping to enhance Canadian productivity. Spending and tax programs should be designed to encourage economic growth and build a strong base for the future. A sound healthcare system is an important economic policy, but it can be argued that much of the rapid growth in spending in recent years – a 70 per cent increase in total public spending over the course of 7 years – is simply financing a more costly system, not a better one. Equally important, the rising allocation of public spending on healthcare has sideswiped a lot of areas that could contribute greatly to economic growth. For instance, spending on education has often been neglected in favour of health care. In the past eight years, health care initiatives received 40 per cent of all the increase in government spending, whereas education captured just 14

NET WEALTH



Source: Statistics Canada, TD Economics

per cent and was even a victim of cut backs in 2 of those 8 years. And yet, education is instrumental to raising the standard of living and productivity in a nation. Education should remain at the forefront of policy for both the federal and provincial governments in order to deepen the country's knowledge base and worker skill sets. Infrastructure is another area in dire need of additional funding. Although it typically does not have the wide voter appeal of health care spending, it too is pivotal to productivity growth in Canada by facilitating the movement of goods and people. Much of Canada's existing infrastructure was constructed during the 1950s, 1960s and 1970s. Given that the useful life of many of these physical structures runs up in four to five decades, a significant share of these assets are ripe for extensive upgrades or replacement – not to mention that structures must also be able to accommodate future demand growth.

The tax burden on individuals must also be reduced. The top marginal federal-provincial personal income tax rates is over 45 per cent, which is nearly equivalent to sending half of a worker's earned income to the government, not to mention that it kicks in at relatively modest income levels. For instance, the top marginal combined Ontario-Federal tax rate in 2004 was 46.41 per cent and started at $113,804. However, at $70,000, workers already faced a 43.41 per cent effective tax rate. And, more modest income levels get hit with the combination of taxes and claw backs in benefit payments that can raise the effective marginal tax rate to 80 per cent. It simply does not create sufficient incentives to work, save and invest.

Lastly, even though the government has significantly whittled down debt, the related service charges are still a big constraint on spending options. Governments need to continue reducing debt burdens, knowing the reward will be lower interest and principal payments that will free up pubic money for future generations.

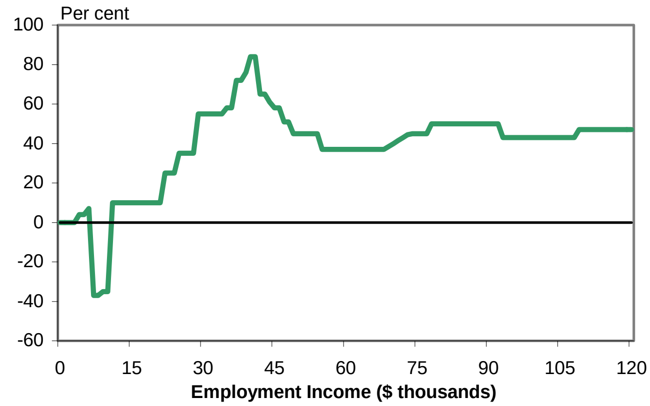
Putting it all together, debt reduction, a shift in the profile of government spending and reduced taxes would go a long way to reviving real wages and allowing Canadians to benefit from an expanding economy in a more meaningful way.

Consolidated Government
Fixed capital expenditures

	% of GDP	% of Program Spending
1960s	4.6	18.2
1970s	3.6	11.0
1980s	2.9	7.9
1990s	2.6	6.8
2000-2004	2.5	7.3

2004* = Q1 to Q3
Source: Statistics Canada

MARGINAL EFFECTIVE TAX RATES FOR A SINGLE EARNER COUPLE - ONTARIO, 2003



Source: Task force on Competitiveness, Productivity, and Economic Progress

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