TD Bank Financial Group

TD Economics

Briefing Note

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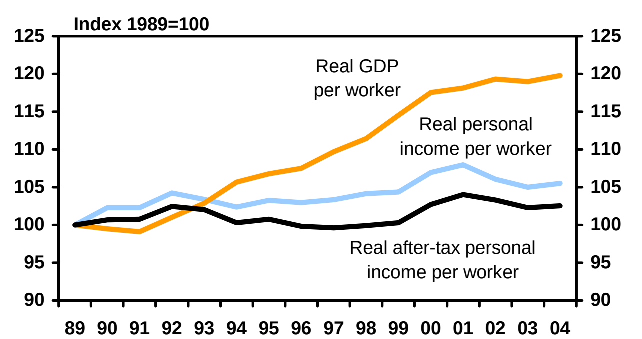
RISING TAX BURDEN NOT THE ONLY EXPLANATION OF STAGNATING "ECONOMIC WELL-BEING"

On January 18th, TD Economics released a topic paper entitled, "In Search of Well-being: Are Canadians slipping down the economic ladder?" The purpose of this report was to investigate why many Canadians seem pessimistic about the performance of their personal finances in recent years. Our analysis highlighted two explanations. First, real after-tax personal income did not keep pace with the expansion of the economy. Second, a good portion of the increase in national income was due to a greater proportion of Canadians working. This does not necessarily equal increased well being, as more double-income earner households comes at a cost of more work-related stress, less time for leisure and family and higher expenses. Specifically, real GDP per worker rose by 20 per cent between 1989 and 2004, but real after-tax income per worker was virtually stagnant. The above table presents these data. It differs slightly from the original report to reflect recently released income and employment data. The updated analysis paints an even bleaker picture.

THE RELATIVE PERFORMANCE OF PERSONAL INCOMES & GDP 1989-2004 cumulative (%)	
Real GDP per capita	25.5
Real GDP per worker	19.8
Real personal income per capita	10.5
Real personal income per worker	5.5
Real after-tax personal income per capita	7.4
Real after-tax personal income per worker	2.6
Source: Statistics Canada	

Some commentaries on the TD Economics report have placed the emphasis on the role of taxes. While this was a contributing factor, it was not the sole or primary explanation. Taxes account for about 3 percentage points of the 17-percentage point difference in the growth between real GDP per worker and real disposable income per worker. Income taxes detracted from growth until 1996 and bolstered it thereafter, while CPP/QPP premiums squeezed income growth the whole time.

GROWTH IN GDP vs. INCOME



Source: Statistics Canada; 2004 = average Q1 to Q3

With taxes explaining only part of the story, what accounts for the significant underperformance of personal income relative to GDP? For one, corporate incomes rose to a record high share of GDP. This occurred for many reasons that will be addressed in an upcoming topic paper on the changes in corporate balance sheets.

Another key contributing factor was a reduction in government interest payments to the personal sector in relation to a low inflation/low interest rate environment. While this dampened income growth, the reduction in debt-service payments also freed up government resources for tax cuts and/or increased goods and services. More recently, the emphasis has been squarely on the latter option.

For the purpose of explaining economic well being, the focus should remain on the stagnation in real after-tax incomes over the past 15 years. Although taxes are only one part of the story, the dismal performance in income growth has policy implications. Canadian tax burdens need to be reduced and the structure needs to be shifted away from income and capital. But this is only part of the solution, which is why we stressed in the report the need for stronger productivity growth. Here too, governments can play a role by redistributing spending initiatives toward areas that enhance productivity, like education and infrastructure.

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