Chapter 7

Budget 1995 as the Foundation for Personal Income and Capital Gains Tax Relief

By Jason Clemens, Milagros Palacios, Jake Fuss, and Tegan Hill*

Introduction

The 1995 federal budget, which worked to rein in spending and balance the budget two years later, set the stage for meaningful tax relief. The small surplus recorded in 1997-98 was the first in nearly three decades and began a process of reducing the nominal value of the federal government’s debt. Overall between 1996-97 and 2007-08, net debt (total debt minus financial assets) fell by almost $100 billion, or 15.2 percent (Clemens et al., 2017).

The decline in the nominal debt, coupled with generally declining interest rates, meant large-scale savings in federal government interest costs. Part of these savings was used to reduce taxes. Specifically, Ottawa went from spending more than one out of every three dollars of revenue on interest costs (35.2 percent) in 1995-96 to spending less than one in every seven (13.6 percent) by 2007-08 (see figure 1). In nominal dollar terms, annual interest payments declined from $49.4 billion to $33.3 billion over this period.

The reduction in interest payments and shift toward surpluses enabled the federal government to turn its attention to other policy priorities, such as tax relief. Finance Minister Paul Martin noted in his 1997 budget speech that his government was now able to address tax competitiveness only because of the “progress we have made in reducing the deficit and restoring responsible financial management” (Canada, 1997: 26).

* Endnotes, references and the authors’ biographies can be found at the end of this document.
Over the next decade, the federal government implemented a series of important tax relief measures that improved Canada’s economic competitiveness. These measures could not have been introduced without the foundation for a balanced budget that the government began to build in 1995.

**Personal income tax (PIT) reform**

A key component of tax relief was a reduction in personal income taxes, including reduced income tax rates and full indexation of the personal income tax system. According to the government, these reforms represented almost $40 billion in personal income tax relief\(^1\) over the five years from 2000-01 to 2004-05 (Canada, 2000a: 84).\(^2\)

One of the government’s first tax-cutting actions, begun in *Budget 1998*, was the gradual elimination of the 3 percent surtax that applied to all taxpayers and which had effectively increased statutory tax rates. In 1998 it was eliminated for taxpayers with incomes up to $50,000 and then, in *Budget 1999*, for all remaining taxpayers.
Table 1: Personal Income Tax Rate Reductions

<table>
<thead>
<tr>
<th>Tax Bracket*</th>
<th>2000</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>30,754 or less</td>
<td>17%</td>
<td>16%</td>
</tr>
<tr>
<td>30,755 to 61,509</td>
<td>25%</td>
<td>22%</td>
</tr>
<tr>
<td>61,510 to 100,000</td>
<td>29%</td>
<td>26%</td>
</tr>
<tr>
<td>Over 100,000</td>
<td>29%</td>
<td></td>
</tr>
<tr>
<td>Surtax (base amount)</td>
<td></td>
<td>5%</td>
</tr>
<tr>
<td>15,500</td>
<td></td>
<td>—</td>
</tr>
</tbody>
</table>

* Thresholds are for the 2001 tax year.

* The 3 percent surtax was eliminated in 1999 so is not included in this table.

Note: New tax bracket marked in grey.

The first major tax reform was the full indexation of personal income tax rates in 2000. By tying both the basic personal exemption and all bracket thresholds to the price level (i.e., adjusting for inflation), this policy ended automatic increases in the tax burden caused by inflation, a process known as bracket creep, in which taxpayers had faced higher income tax rates simply because their incomes had increased in nominal, though not necessarily in real terms. The introduction of a fully indexed system in which all thresholds are automatically increased each year to offset inflation eliminated bracket creep.

The federal government also implemented several personal income tax rate reductions in Budget 2001 (see table 1 and figure 2). The rate reductions applied across all income levels. The bottom tax rate, for income below $30,755, was cut from 17 to 16 percent. The rate for those above $30,755 up to $61,509 fell from 25 to 22 percent. Between $61,510 and $100,000 the rate was reduced from 29 to 26 percent. Finally, a new threshold was added at $100,000, maintaining the top rate of 29 percent.

As mentioned, however, the top tax rate was effectively reduced by the elimination of two surtaxes. The 3 percent general surtax that applied
to all taxpayers was eliminated in 1999, effectively reducing the rate by a little less than one percentage point. A second surtax of 5 percent, which applied to incomes above $65,000, was eliminated in 2001, effectively reducing the top tax rate on income by 1.45 percentage points.

There were other personal income tax reductions as well. For instance, in 2005 the bottom tax rate was reduced to 15 percent and the amount of money earned tax free, referred to as the “basic personal exemption,” was increased by more than the rate of inflation, meaning real tax-free income increased. Between 2004 and 2009 the basic personal exemption rose from $8,012 to $10,320, a 29 percent increase compared to inflation of just under 9 percent over those years, according to the Bank of Canada’s Inflation Calculator.

Personal income tax reform, including rate reductions and full indexation, was the first step toward improving Canada’s tax competitiveness and enhancing incentives for individuals to pursue productive

Figure 2: Federal Personal Income Tax Rates, 2000 and 2001

* Tax rate includes a 5 percent surtax.
activity. In subsequent years, the federal government recognized personal income tax relief as a crucial factor in creating the conditions for strong economic growth and job creation, stating that “personal income tax changes have increased incentives for Canadians to learn, work, save and invest” (Canada, 2004: 159). Critically, though, the federal government acknowledged that more needed to be done in reducing personal income taxes to continue improving tax competitiveness and the incentives for work, investment in human capital, entrepreneurship, and investment.⁴

**Capital gains reform**

In addition to personal income tax relief, the federal government also reduced taxes on capital gains. Capital gains occur when an individual or business sells an asset for more than its purchase price. A portion of capital gains—determined by the “inclusion” rate—is taxed at a person’s (or business’s) top marginal personal income tax rate. Because capital gains are not indexed, inflationary gains in the asset’s value end up being taxed—even though such gains do not increase the taxpayer’s purchasing power, which is what in most theories of income taxation the income tax aims to tax.

Prior to the reforms, the federal government included 75 percent of capital gains as taxable income. *Budget 2000* reduced the capital gains tax by reducing the inclusion rate to 66.7 percent. It was then further reduced that fall in the economic update to 50 percent. The adjusted inclusion rate effectively lowered the tax rate applied on capital gains. For many people, the change in the inclusion rate meant a reduction in the capital gains tax rate from 22.8 percent in early 2000 to 14.5 percent in 2001.⁵

This was an important tax cut. The capital gains tax imposes high economic costs on society because it distorts the behaviour of entrepreneurs and investors (Clemens et al., 2017). Specifically, capital gains taxes reduce the number of entrepreneurs and investors willing to finance businesses and take on risk because they reduce the expected return from engaging in such activities.

The Chrétien government evidently understood these consequences and reduced the tax on capital gains to ensure stronger competitiveness, improved economic incentives, and better integration with the rest of the tax code.⁶ Canada needed to compete in an increasingly globalized and knowledge-based economy and the government recognized that innovation would be critical in the years ahead. As it said in *Budget 2000*, the government reduced capital gains taxes in an effort to “encourage entrepreneurship and risk taking” (Canada, 2000b: 21).
The reduction in the capital gains inclusion rate, in conjunction with personal income tax relief, created an economic environment more supportive of investment and entrepreneurship and contributed to nearly a decade of economic prosperity prior to the downturn of 2008-09.

**Conclusion**

The spending reductions introduced in *Budget 1995* were crucial in eliminating deficits, lowering the federal debt, reducing interest costs, and ultimately paving the way for tax relief. In the years following that budget, the federal government was able to take the first steps toward improving Canada's tax competitiveness by reducing personal income tax rates, restoring full indexation of the personal income tax system, and lowering the effective tax rate for capital gains.

The tax relief introduced by the Chrétien government was an important step towards improving the economic incentive for individuals to work, save, invest, and engage in entrepreneurship. Ultimately, the personal income and capital gains tax relief enabled by the spending cuts made in *Budget 1995* contributed to economic prosperity and nearly a decade of robust economic growth in Canada.
2. Notes: (i) Actual Revenues come from the Public Accounts rather than Fiscal Reference Tables because of accounting changes made in 2003; (ii) Budgeted numbers in 2002 come from the 2002 Economic and Fiscal Update since there was no budget tabled that year.

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1. There is some debate about the total value of personal income tax relief included in Budget 2000. Some measures, such as the increase to the Canada Child Tax Benefit (CCTB), were counted as tax relief when some observers argued it should have been included as additional spending. The CCTB was a direct benefit provided to eligible families with children. The estimated cost of the increase in the CCTB for 2004-05 was $2.5 billion. See Section 4 of Budget 2000: https://www.budget.gc.ca/pdfarch/budget00/pdf/bpe.pdf.

2. Indeed, the breakdown on page 84 of Budget 2000 indicated a total tax relief package of $58.3 billion over five years including personal income tax relief ($39.5 billion), business income tax reductions ($4.0 billion), and reductions in Employment Insurance ($14.8 billion). See https://www.budget.gc.ca/pdfarch/budget00/pdf/bpe.pdf.


4. For more on the relationship between taxes and economic growth see Murphy, Clemens, and Veldhuis (2013).

5. The federal surtax of 5 percent on high income earners was eliminated in 2001.

6. The Fraser Institute was particularly influential in the government’s decision to provide capital gains tax relief. A 2000 study by Herbert Grubel encouraged the Chrétien government to return the capital gains inclusion rate to its original level of 50 percent as one potential policy option (Grubel, 2000). Grubel emphasized that this reduction would provide greater incentives for entrepreneurship, risk-taking, investment, and job creation—all of which spur economic growth.
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CHAPTER 8: Corporate Tax Reform Since 2000 and its Aftermath
by Jack Mintz


About the Authors

**Jason Clemens** is Executive Vice President of the Fraser Institute and President of the Fraser Institute Foundation. He has an Honours Bachelors Degree of Commerce and a Master’s Degree in Business Administration from the University of Windsor as well as a Post Baccalaureate Degree in Economics from Simon Fraser University. He has published over 70 major studies on a wide range of topics, including taxation, government spending, labour market regulation, productivity, and entrepreneurship, and over 300 shorter articles that have appeared in national and international newspapers.

**Livio Di Matteo** is a Senior Fellow at the Fraser Institute and Professor of Economics at Lakehead University in Thunder Bay, Ontario, where he specializes in public policy, health economics, public finance, and economic history. His recent work examines health-care spending and its sustainability. As well, he conducts research on the historical evolution of economic inequality. Di Matteo is a member of the CIHI National Health Expenditure Advisory Panel, the Evidence Network (EvidenceNetwork.ca), and is a contributor to the economics blog, Worthwhile Canadian Initiative. He has been listed in Canadian Who’s Who since 1995 and holds a PhD from McMaster University, an MA from the University of Western Ontario, and a BA from Lakehead University.

**Don Drummond** is the Stauffer-Dunning Fellow and Adjunct Professor at the School of Policy Studies at Queen’s University. In 2011-12, he served as Chair for the Commission on the Reform of Ontario’s Public Services. Mr. Drummond spent almost 23 years with Finance Canada where he served as Assistant Deputy Minister of Fiscal Policy and Economic Analysis, Senior Assistant Deputy Minister of Tax Policy & Legislation, and most recently, Associate Deputy Minister. In the latter position he was responsible for economic analysis, fiscal policy, tax policy, social policy and federal-provincial relations and coordinated the planning of the annual federal budgets. Mr. Drummond subsequently was Senior Vice President and Chief Economist for the TD Bank (2000-2010), where he took the lead with TD Economics’ work in analyzing and forecasting economic performance in Canada and abroad. He is a graduate of the University of Victoria and holds an MA (Economics) from Queen’s University. He has honorary doctorates from Queen’s and the University of Victoria and is a member of the Order of Ontario.
Jake Fuss is an Economist at the Fraser Institute. He holds a Bachelor of Commerce and a Master's Degree in Public Policy from the University of Calgary. Mr. Fuss has written commentaries appearing in major Canadian newspapers including the National Post, the Globe and Mail, and the Toronto Sun. His research covers a wide range of policy issues including government spending, debt, taxation, labour policy, and charitable giving.

David R. Henderson is an emeritus professor of economics with the Naval Postgraduate School in Monterey, California, a research fellow with the Hoover Institution, and a senior fellow of the Fraser Institute. He is a widely respected public policy expert and educator. He is also the editor of The Concise Encyclopedia of Economics, a comprehensive but accessible summary of economics.

Born and raised in Canada, Professor Henderson earned a BSc degree in mathematics from the University of Winnipeg before heading south to complete his PhD in economics at the University of California, Los Angeles.

He is a frequent contributor to The Wall Street Journal and was previously a frequent contributor to Fortune. He has also written scholarly articles for the Journal of Policy Analysis and Management, Journal of Monetary Economics, Cato Journal, Regulation, Contemporary Policy Issues, and Energy Journal.

Professor Henderson served as a senior economist on President Reagan’s Council of Economic Advisers from 1982 to 1984, specializing in energy and health policy.

Tegan Hill is an Economist at the Fraser Institute. She holds a Bachelor of Economics and a Master's Degree in Public Policy from the University of Calgary. She specializes in government spending, taxation, and debt.

Ron Kneebone is Scientific Director of the Social Policy & Health research division in the School of Public Policy at the University of Calgary. His published research has dealt with issues of government financing, deficits and debt reduction but he has more recently focused on issues of social assistance, poverty reduction, income inequality, and the economics of homelessness.

Lydia Miljan is an Associate Professor of Political Science at the University of Windsor and a Fraser Institute Senior Fellow. She was Director of the Fraser Institute’s Alberta Policy Research Centre and from 1988 to 2001 was the Chair of the National Media Archive. She holds a PhD in Political Science from the University of Calgary specializing in political communication. Prof. Miljan teaches in the areas of Canadian public policy, research methodology, and politics and the media. Her main research interests include how journalist’s personal views are reflected in news content and public opinion formation. In addition to peer-reviewed papers, she is the author of three books: Public Policy in Canada, Hidden Agendas: How Journalists Influence the News, and Cross-Media Ownership and Democratic Practice in
Can *Hidden Agendas* was short-listed for the Donner Prize for the best book in public policy, 2003/04.

**Mark Milke**, PhD, is a public policy analyst, keynote speaker, author, and columnist with six books and dozens of studies published across Canada and internationally in the last two decades. He is Executive Director, Research for the Canadian Energy Centre Ltd. Mark’s work has been published by think tanks in Canada, the United States, and Europe, including the Fraser Institute, the Montreal Economic Institute, the American Enterprise Institute, the Heritage Foundation, and the Brussels-based Centre for European Studies. In 2019 he was the lead architect of the United Conservative Party election platform and principal policy advisor to UCP leader Jason Kenney. A regular columnist, his commentaries have appeared in the *Globe and Mail*, the *National Post*, and *Maclean’s*.

**Jack M. Mintz**, PhD, is the President’s Fellow of the School of Public Policy at the University of Calgary after serving as the Palmer Chair and founding Director from January 1, 2008 to June 30, 2015.

Dr. Mintz held the position of Professor of Business Economics at the Rotman School of Business from 1989-2007 and Department of Economics at Queen’s University, Kingston, 1978-89. He was a Visiting Professor, New York University Law School, 2007; President and CEO of the CD Howe Institute from 1999-2006; Clifford Clark Visiting Economist at the Department of Finance, Ottawa; and Associate Dean (Academic) of the Faculty of Management, University of Toronto, 1993–1995. He was founding Editor-in-Chief of *International Tax and Public Finance*, published by Kluwer Academic Publishers, from 1994–2001.

He chaired the federal government’s Technical Committee on Business Taxation in 1996 and 1997 that led to corporate tax reform in Canada since 2000. He has also served on numerous panels and boards at the federal and provincial levels including vice-president and chair of the Social Sciences and Humanities Research Council 2012-2018.

**Milagros Palacios** is Associate Director for the Addington Centre for Measurement at the Fraser Institute. She holds a BS in Industrial Engineering from the Pontifical Catholic University of Peru and an MSc in Economics from the University of Concepcion, Chile. Ms. Palacios has studied public policy involving taxation, government finances, investment, productivity, labour markets, and charitable giving, for over 15 years. Since joining the Institute, Ms. Palacios has authored or coauthored over 100 comprehensive research studies, 150 commentaries, and four books.