Tax Cuts Must Focus on Incentives

by Jason Clemens, Niels Veldhuis, & Milagros Palacios

Over the last year or so, we have written a number of articles explaining why tax relief must focus on enhancing the incentives for work, savings, investment, and entrepreneurship (for example, see Clemens and Veldhuis, 2005). Earlier in this issue of *Fraser Forum*, John Williamson of the Canadian Taxpayers Federation offers a persuasive argument for targeting tax relief at lower-income Canadians. This article counters by reiterating the beneficial effects of incentive-based tax relief.

Need for tax relief

As Williamson (2006) rightly points out, Ottawa has increased spending significantly in recent years while maintaining sizable surpluses. The Organization for Economic Cooperation and Development (OECD) expects Canadian governments to extract 40.6 percent of the economy this year in government revenues (OECD, 2005). This is above the OECD average (37.6 percent), and only slightly less than Canada's all-time high recorded in 1998 (44.9 percent). In addition, Statistics Canada (2006) recently reported that in 2005-06, all governments in Canada (federal, provincial, and local) recorded the second largest surplus ($26.0 billion) in the last 20 years. Canadian governments are clearly in a position to offer significant tax relief.

Broad-based tax relief and low-income earners

At the heart of Williamson's argument is the need for broad-based tax relief (usually defined as tax relief that benefits all taxpayers) that is particularly focused on delivering benefits to lower income earners. His suggested tax cuts would occur in a tax environment in which we already require higher earners to pay a disproportionate share of the total tax bill. According to Veldhuis and Palacios (2006), the top 30 percent of families earned 59.1 percent of all income in Canada in 2006 but paid 65.9 percent of all taxes. The bottom 30 percent, meanwhile, earned 9.4 percent of all income and paid 4.7 percent of all taxes. The type of tax cuts Williamson advocates will only increase the propor-



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Table 1: Welfare Gains from Tax Reductions[a]

Capital Cost Allowance	$1.40[b]
Sales Tax on Capital Goods	$1.30
Personal Capital Income Tax	$1.30
Capital Tax	$0.90
Corporate Income Tax	$0.40
Average Personal Income Tax	$0.30
Wage Tax	$0.20
Consumption Tax	$0.10

[a]Revenue loss is assumed to be recovered through "lump-sum" taxation. Welfare gains are calculated as the gain in economic well-being per dollar of tax reduction.

[b]The estimate for an increase in capital cost allowances (CCA) is for new capital only. Increasing CCA is not a tax reduction *per se* but rather an increase in a deduction against corporate income taxes.

Source: Baylor and Beauséjour, 2004.

tion of the total tax bill carried by the top 30 percent.

Increasing the number of *net* beneficiaries of government

By reducing the GST as the government did, or increasing the basic exemption as Williamson proposes, more Canadians become net beneficiaries of government. Increasing the basic personal exemption without changing any of the spending programs that the government undertakes results in more Canadians receiving benefits from the government in the form of program spending and income transfers than they pay into the system. In Mr. Williamson's own words, some 1.7 million Canadians would be removed from the income taxes rolls by 2010. Ultimately, increasing the proportion of net beneficiaries to net contributors provides the foundation for increasing demands for *more* government programs and services—services that are largely paid for by the top 30 percent.

This dynamic is not just theoretical. The US experience with the Earned Income Tax Credit (EITC) provides corroboration. As low income families in the US have become increasingly sheltered from the costs of the programs they consume, they have demanded more of government in the form of both more programs and larger income transfers. According to Chris Edwards of the Washington DC-based Cato Institute, some 42 percent of US households now do not pay any income tax as a result of the EITC, which reduces personal income taxes and potentially mitigates the effects of payroll taxes for low-income workers (Edwards, 2005). Fewer and fewer individuals paying income tax has led to demands for more government programs.

Getting Friedman right

Nobel Laureate Milton Friedman famously stated that he was in favour of tax cuts "whenever, wherever, and however." Underlying Friedman's analysis was a view, proven entirely correct, that the strongest constraint on government spending is a lack of resources. The debate in Canada, however, has not been about the need for tax relief, for which there was consensus.[1] Rather, the debate centred on what type of tax relief should be implemented. Another quote from Friedman on this issue is instructive. Friedman stated that "some tax cuts are better than others." He was referring to the different incentive effects of different types of tax relief.

Are all tax cuts created equal?

So the question is not whether Canadians need tax cuts, but rather, which ones Canadians should get. This point is critical. We have argued repeatedly that the best types of tax cuts are those that improve our economy. In his analysis of tax relief, John Williamson fails to even mention incentives or the need for Canada's economy to improve.

Incentive-based tax relief is designed to enhance the incentives for working, saving, investing, and acting entrepreneurially. For example, a reduction in marginal personal income tax rates and increases in the income thresholds at which the different rates apply, particularly for middle and upper-income earners, increases the benefits of undertaking positive activities such as saving, investing, and starting a business. Similarly, declines in the effective tax rates on capital, including reductions in corporate income tax rates and the outright elimination of corporate capital taxes, creates stronger incentives for people and firms to invest.

A 2004 working paper by Maximilian Baylor and Louis Beauséjour for the federal Department of Finance summarized the incentive effects of different types of tax cuts. Specifically, they found that reductions in

- taxes on investment (interest, dividends, and capital gains) lead to increased savings by increasing the returns available to these activities. The increased savings lowers the cost of capital, which results in increased investment;
- taxes on capital (corporate income taxes and capital taxes) also results in an increased after-tax rate of return, which increases incentives

- for savings by increasing the returns available to such activity and lowers the cost of capital for firms, which spurs investment;
- consumption taxes decrease the cost of consumption and thus encourage more of it at the expense of savings.

The importance to society of savings and investment is critical. Savings lead to investment, which finances the purchase of machinery, equipment, and research and development. These types of investments make workers more productive and result in higher wages.

Baylor and Beauséjour (2004) also estimated the benefits of different types of tax cuts and found that reductions in taxes on capital and investment yielded the largest benefits while reductions on consumption taxes yielded the smallest. Specifically, they estimated that a $1.00 tax cut in the form of a reduction in consumption taxes yields a $0.10 benefit (see table 1). On the other hand, reductions in business taxes, broadly speaking, yield significantly larger benefits ranging from $0.40 for corporate income taxes to $1.40 for changes to depreciation expenses.[2]

Conclusion

There is no doubt that Canadians would benefit significantly from tax relief. However, we disagree strongly with those, including John Williamson, who advocate for politically expedient tax relief that does not improve economic incentives. We argue for a stronger and more robust Canada with higher incomes for workers, lower unemployment, higher job growth throughout the nation, and opportunities for all those who seek them. Such an invigorated Canada must be based on a stronger economy, which in part will be delivered through better incentives.

Note

[1]In the last election campaign, the then-governing Liberals offered tax relief centered on personal income tax cuts while the Conservatives focused on reducing the GST. The NDP, too, accepted the need for some, albeit limited tax relief.

[2]Baylor and Beauséjour's analysis is supported by a large body of economic research dating back to the early 1970s. See Veldhuis and Clemens (2006) for an extensive review of the existing research investigating the relationship between taxes and behaviour along with a summary of the research on the economic costs of different taxes.

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