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Ranking the Parties' Tax-Cut Promises

By Duanjie Chen and Jack M. Mintz

January 11, 2006

For tax-weary voters, a surprising contrast between the 2006 and 2004 elections has been the political acceptance of cutting taxes. In 2004, the debate was whether to spend money on health care or reduce taxes, with only the Conservatives proposing meaningful tax relief. In this election, the major parties have proposed a variety of cuts to taxes.

If anything, this election proves that tax cuts can be popular. However, from a long-term perspective, a key issue is whether the tax relief will substantially improve Canada's competitiveness by encouraging work and investment. None of the tax proposals in this election are brave policies that would lead to fundamental tax reform. The analysis below suggests that the broad-based income and sales tax cuts being discussed will offer minor improvements to Canada's competitive advantage in the next five years.

The expanding tax-cut menu:

The Liberals started the ball rolling with personal and corporate tax relief offered in the November mini-budget. The basic personal exemption rises by $500 and the 16 percent tax rate on the first $35,595 of income will be reduced to 15 percent effective in 2005. Within five years, the tax rate on income in the next two brackets is cut by a point each and the threshold at which the 29 percent top rate kicks in will increase from about $116,000 to $200,000. The Liberal government also proposed a Working Income Tax Benefit to reduce high marginal tax rates — 80 percent in some provinces — paid by low-income workers on employment income as a result of claw backs of income-tested benefits. The corporate tax cuts, to be implemented by 2010, include a reduction in the federal general corporate income tax rate from 21 to 19 percent and the elimination of the corporate surtax (1.12 percent of profits). The elimination of the federal capital tax on corporations will be accelerated to 2006 from 2008. Just prior to the election, the Liberals also announced a cut to dividend taxes to reduce the disparity between corporations and income trusts.

During the campaign so far, the Liberals have made only a few additional tax promises, such as increasing the lifetime capital gains exemption from $500,000 to $750,000 for property held by farmers and fishers and shares of Canadian-controlled private corporations (CCPCs).

The NDP has made a pledge not to increase taxes — any future tax relief would be made after satisfying spending priorities. Nonetheless, the NDP have signed on to Liberal mini-budget low-income personal tax cuts that immediately take effect and have proposed an increase in the child tax credit. They have indicated that they will not support other mini-budget proposals and would undoubtedly oppose the corporate tax relief. The Bloc, too, supports tax reductions for low- and middle-income earners, and has added a few proposals of its own, such as a refundable credit for families and abolishing the GST on diapers for newborns.

The most extensive — and more revenue costly — list of tax cuts is offered by the Conservatives, of which the most significant is a two-point cut in the GST rate — with one point cut in 2006 and a further point cut within five years. The Conservatives also propose several tax credits targeted to various groups, including postsecondary education students, transit riders, fishers and child-care providers. The small business corporate income tax rate would be reduced by one point on profits up to $400,000, instead of the existing $300,000 limitation. The Conservatives have indicated they will not implement the post-2005 personal income tax changes in the Liberal mini-budget although they have stated that they would adopt the corporate tax proposals.

The tax-cut quality test: Increasing Canada's competitiveness

In terms of their economic impact on competitiveness, the most important proposals are the broad-based tax reductions to the GST and income tax that have so far been announced in the campaign. We analyze the impact of Liberal and Conservative tax proposals on effective labour and capital tax rates for non-resource sectors (see table below for aggregate results).

Taxes on Labour: The effective tax rate on labour provides a summary measure of federal and provincial personal income, payroll and sales taxes net of education, health and other public subsidies as they affect employment (Chen and Mintz 2004). It is the difference between the employer's cost of hiring labour and the after-tax wage earned by an employee on the last hour worked. We calculate the average marginal tax rate by taking into account a distribution of worker earnings across industries, with a focus on Ontario, which is close to the national average.

As is shown in the table, the Conservative two-point GST cut would reduce the labour effective tax rate by 1.1 percentage points from 28.3 to 27.2 percent. This is somewhat deeper than the proposed one-point Liberal income tax cut (for low and middle income taxpayers), which results in an effective labour tax rate of 27.7 percent. Thus, the Conservative proposals would have a somewhat stronger effect in encouraging employment and labour supply.

Taxes on Investment: While both GST and income tax proposals will cut the effective tax rate on labour, what happens to taxes on investment? To analyze this case, we estimate the effective tax rate on capital for three types of businesses — multinational, medium-size and small-size entrepreneurial — using Canada-wide federal and provincial corporate income taxes, capital taxes and sales taxes on capital inputs. This effective tax rate is the difference between the gross and net

Table: *Effective Federal-Provincial Tax Rates on Labour and Capital for Various Proposals (in percentages) by 2010*

	Labour	Capital (Multinational)[1]	Capital (Medium-Size Entrepreneurial)[2]	Capital (Small-size Entrepreneurial)[2]
Current	28.3	39.0	52.7	42.4
Mini-budget Personal Tax Cuts	27.7	NA	NA	NA
Conservative GST Tax Cut	27.2	NA	NA	NA
Corporate Tax Cuts [3]	NA	35.2	47.4	41.7
Conservative Small Business Tax Cut	NA	NA	NA	41.2

Notes: 1. Multinational effective tax rates on capital are primarily business level taxes as it is assumed that the corporation is financing its capital from international markets so that Canadian personal tax rates are much less significant in affecting decisions.

2. Entrepreneurial effective tax rates on capital include business taxes and personal taxes on dividends and capital gains as they impact on the income earned by the entrepreneur. Entrepreneurs are assumed to earn income subject to the top personal rate.

3. Proposed in the Liberal mini-budget and subsequently endorsed by the Conservatives.

rates of return on capital where the gross rate of return is based on the income earned on the last dollar of investment sufficient to cover taxes and financing costs. The latter, of course, varies for a multinational enterprise, which obtains equity and debt financing from international markets (of which Canada is a small part), compared to an entrepreneurial business, which obtains equity financing only from Canadians. The Liberal personal income tax reductions for low- and middle-income taxpayers, while helpful to savings, do not alter much the cost of financing capital.

The Liberal mini-budget proposals for corporate tax cuts, which have been accepted by the Conservatives, would have a significant effect in reducing taxes on investments. By 2010, the effective corporate tax rate on investment for multinational businesses operating in Canada would be cut from 39 percent — currently the second highest of 36 countries — to 35.2 percent, which would help improve Canada's competitiveness. The effective tax rate on investment for a medium-size entrepreneurial firm (including business taxes and personal taxes on dividends and capital gains) would fall from 52.7 to 47.4 percent. The small entrepreneurial effective tax rate (likewise including business and personal taxes) would be reduced from 42.4 to 41.7 percent with the elimination of the corporate income surtax. The further one point reduction in the small business rate offered by the Conservatives will cut the effective tax rate on capital for small business to 41.2 percent. Thus, the Conservative tax cuts, including corporate tax relief, would have a somewhat larger impact on investment, although the small business tax cut increases the tax penalty when firms grow from small to medium size.

These estimates do not include proposed changes to the lifetime capital gains exemption by the Liberals and targetted tax reductions by the Conservatives since the provisions would have little impact on new investments and employment.

Can we do better than what has been proposed? None of the tax proposals in this election would substantially improve the efficiency and fairness of the tax system. The most important tax barriers to Canada's economic growth are related to excessively high marginal taxes that deter work effort, savings and investment. As shown in the C. D. Howe Institute's 2005 Tax Competitiveness Report, the highest marginal tax rates apply to large business investments (second highest in the world), moderate income savers (tax rates up to 80 percent) and employment income earned by moderate income workers (tax rates up to 80 percent).

To reduce these very high effective tax rates, a fundamental tax reform is needed that would lower rates and broaden tax bases to make the tax system more neutral. The Liberal and, to a somewhat greater extent, the Conservative proposals move in a direction of lowering tax rates on labour and capital but far greater effort would be needed to modernize Canada's tax system to make it as efficient and fair as possible.

Duanjie Chen is the George Weston Tax Analyst and Jack M. Mintz is President and CEO of the C. D. Howe Institute.

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Jack M. Mintz is President and CEO of the C. D. Howe Institute, at 416-865-1904, ext: 235.