A Proposal for Reducing Federal Taxes

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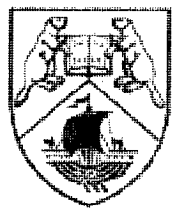

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A PROPOSAL FOR REDUCING FEDERAL TAXES

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I. Introduction

What to do with the fiscal dividend, i.e., the budget surplus that will be automatically generated by the existing federal fiscal structure, is one of the major policy issues in Canada. The federal government plans to use any surpluses for a combination of debt repayment, increased spending and income tax cuts. With respect to taxation, the federal plan calls for maintaining a surplus in the Employment Insurance (EI) account and using those funds to finance a reduction in personal income taxes (PIT) (1). The federal proposal is evaluated in this paper and is compared to an alternative package of tax cuts.

For the purpose of evaluating tax reduction options, it is important to distinguish two major aspects of the fiscal dividend. First, in the absence of adjustments to federal spending and/or taxation, the federal surplus will automatically increase year after year. The increase in the surplus will be even larger if each year the surplus is used to repay the debt because this approach would reduce federal spending by lowering interest payments on the debt. As pointed out by Ruggeri, Van Wart and Howard (1994) and Wilson, Dungan and Murphy (1998), this built-in tendency towards federal surpluses is caused by a fiscal structure that, for a given growth of GDP, generates revenues which grow at a faster rate than expenditures. Second, the excess revenues arise primarily from two sources: the surplus in the Employment Insurance (EI) fund and the high income elasticity of personal income tax (PIT) revenues. This breakdown is implicit in the analysis of Wilson, Dungan and Murphy (1998). In their base projections, they assumed that the government plans to achieve a public accounts

surplus of $6 - 10 billion. They reduced EI premiums in stages until in 2003 they reached a level that would balance aggregate contributions and benefits. As they point out, "even these substantial EI premium reductions do not use up all the room for tax cuts." (p.9). Since the remaining excess revenue is due primarily to the growth in PIT revenue, their projections include substantial reductions in personal income taxes, especially after 2003.

Let us consider first the fiscal dividend that is generated by the EI surplus. Current EI contributions can be divided into two components: the contributions that are linked to benefits and those that generate no benefits to the contributors ((see, for example, Kesselman (1998)). The first component may be viewed as a form of user fee since the contributors as a whole receive entitlements to a future benefit equal to the amount of the contributions made. The closer contributions represent a user fee, the less significant are their equity and efficiency implications. Any excess of contributions over this benefit-linked amount is a tax. Maintaining a surplus in the EI account is equivalent to the imposition of a new payroll tax with a more regressive structure than a general wage tax because of the ceiling on contributions. Using the EI surplus to reduce personal income taxes, as has been suggested by the federal Minister of Finance, involves a shift in the federal tax mix from progressive income taxation to regressive wage taxation. The relevant analysis of this component of the fiscal dividend, therefore, involves a comparison, with respect to both equity and efficiency, of a regressive wage tax and a progressive income tax.

This deliberate shift in the tax mix would not occur in the case of PIT reductions associated with the surplus that would exist after the EI fund is balanced. Lower PIT rates would prevent an automatic increase in the share of personal income taxes in the tax mix. In

this case, the proper comparison on the tax side is not between wage taxes and income taxes, but among alternative approaches to income tax reductions.

This distinction between the main sources of the federal surplus will serve as the basis for the evaluation of tax reduction options discussed in this paper. The comparison of payroll taxes and income taxes is presented in section II. Two options for reducing personal income taxes are evaluated in section III. The final section summarizes the conclusions and presents a package of tax reductions for that portion of the fiscal dividend that will be dedicated to tax cuts.

II. Payroll Tax Cuts versus PIT Cuts

This section evaluates the equity and efficiency implications of two approaches to the fiscal dividend created by the EI surplus: (a) reducing EI premiums to restore balance in the EI account and (b) using the EI surplus to finance across the board cuts in PIT rates. Before presenting the economic comparison of these two options, it is important to stress that they also have different implications for intergovernmental fiscal relations. Lowering EI premiums will improve the fiscal balances of provincial governments in two ways: it will reduce their wage bill and will increase their PIT revenue because a lower amount of EI contributions will be deducted from the PIT base. Across the board reduction in PIT rates, except for reductions in the federal surtaxes, will lower the Basic Federal Tax (BFT) for all provinces with the exception of Quebec and effectively force a tax cut by the provinces.

The arguments in favour of reducing EI premiums can be divided into two sets. The first set includes general arguments not directly related to the comparison of payroll taxes

and personal income taxes while the second set focuses on the comparison between the two taxes. There are a number of reasons, other than equity and efficiency, for cutting EI premiums. The first argument is consistency in the treatment of social insurance programs. The federal government imposes two major payroll taxes to finance two social insurance programs: the Canada Pension Plan (CPP) and the EI program. Both programs have experienced radical reforms in recent years. It has long been known that CPP contributions are insufficient to finance current benefits indefinitely. In an effort to restore the financial viability of the program, the federal government implemented a staged increase in premiums. These increases were aimed at restoring balance between contributions and benefits for current and future workers and eliminating the unfunded liability caused by the shortfall of contributions by current CPP beneficiaries. The EI program was in deficit and the federal government implemented a major reform in 1996. Unlike the CPP, EI reform took place almost entirely on the benefit side. The net result was a reduction of benefits to pre-1971 levels coupled with minimal reductions in premium rates. This unbalanced reform has created a program that generates large surpluses. Instead of rebalancing this program by reducing premiums, the federal government wants to keep these surpluses and use them for new spending programs or income tax cuts. We have a situation where increases in contributions in one social insurance program (CPP) are justified by the need to restore balance between contributions and benefits while restoration of balance in another social insurance program (EI) through reductions in premiums is resisted for budgetary reasons.

A related argument was made by some premiers who had opposed large increases in CPP premiums. Starting from the notion that payroll taxes are killers of jobs, these premiers argued that CPP reform should be tied to a rebalancing of the EI program through reductions in premiums. In their view, the increases in CPP premiums should be matched by cuts in EI premiums so that the overall level of payroll taxes for social insurance programs remained unchanged. This balancing principle is implicit in the estimates of the room for tax cuts recently prepared by Wilson, Dungan and Murphy (1998).

The third argument relates to the original rationale for the EI reform. A major reason for reforming the EI program was the belief that its inefficiencies raised its costs and, therefore, required high premiums. These high premiums, in turn, discouraged job creation. The view of payroll taxes as job killers is stressed in the 1994 HRDC paper entitled "Improving Social Security: A Discussion Paper". According to this document "Unemployment insurance premiums are a form of payroll tax....It is widely agreed that, at least in the short run, payroll taxes discourage job creation." (P. 50). As pointed out by Nakamura and Diewert (1998), the main concern on the employment effects of payroll taxes was on the employer rather than the worker behaviour. It was believed that high payroll taxes raised the cost of labour to firms thus discouraging the hiring of new workers and encouraging the replacement of workers with machines. Within this conceptual framework and with the focus of all political parties on job creation to reduce double-digit unemployment rates, EI reform carried the implicit promise of premium reductions. As pointed out by Nakamura and Diewert (1998), the refusal by the federal government to rebalance the EI program through appropriate reductions in premiums may be viewed as a

broken promise and "a betrayal of the understanding of intent at the time when Bill C-12 was passed." (P. 39).

With respect to equity, it is important to note that the premiums which generate EI surpluses are regressive, especially at the higher end of the income scale, whether tax incidence is measured with respect to labour income or total income. Relative to labour income, the incidence of EI premiums is proportional up to the ceiling on insurable earnings (currently $39,000) and regressive thereafter because a fixed amount of premium becomes a declining proportion of wages. Relative to total income, which includes transfer payments and capital income in addition to wages, the incidence of EI premiums has an inverted U-shape ((see, for example, Ruggeri, Van Wart and Howard (1994)): the ratio of premiums to income first increases as wages become a larger share of income because of diminishing transfers and then falls as capital income becomes an increasing component of income. The regressivity of EI premiums is made worse by the fact that high-income self-employed professionals do not pay EI premiums. The personal income tax has a progressive pattern of incidence throughout the entire income range, although the degree of progressivity is higher from the low to middle income range than at high income levels. Therefore, keeping a surplus in the EI program and using these funds to finance an across the board reduction in PIT rates involves reverse redistribution whereby to a certain extent the poor are asked to subsidize the opulent. The inequity of this option is exacerbated if the PIT cut involves the elimination of the high income surtax instead of proportional across the board rate reductions.

The efficiency implications of the two tax cuts are more complex. Both payroll taxes and personal income taxes distort private choices and, therefore, misallocate resources and reduce social welfare. Comparing these two taxes in terms of economic efficiency raises two major issues: (a) through which channels do these taxes distort private choice? (b) what are the relative magnitudes of the welfare losses? In addressing these questions I will first deal with general payroll and income taxes and then discuss the implications of the particular tax structures under consideration.

Payroll taxes affect economic performance by altering four private choices: (a) the hiring decisions by firms, (b) the choice between work and leisure by individuals, (c) the level of work effort and (c) the decision to acquire human capital. Economic analysis has been largely focused on the first two distortions mainly because of their potential impact on employment. Although there is no consensus on the magnitude of the employment effect of payroll taxes, there is general agreement that payroll taxes are harmful to job creation ((see, for example, Beach, Lin and Picot (1995) and Di Matteo and Shannon (1995). A payroll tax on the employer will initially raise the cost of labour to the firm and induce a reduction in the demand for labour and efforts to substitute labour with machines. Through time, some of the tax burden will be shifted to labour thus reducing the gross and net wage received by workers. The lower wage, in turn, makes leisure more attractive thus reducing the supply of labour. A payroll tax on the employee will not directly affect the demand for labour, but will have an immediate impact on the supply of labour.

When wages are flexible and workers adjust hours of work in response to after-tax wages, the traditional view of payroll taxes leads to the following three main conclusions.

First, after all adjustments have been completed, payroll taxes have the same effect on employment whether they are levied on employers or employees. Second, the magnitude of their effect depends on the elasticities of labour demand and supply. The smaller are those elasticities, the lower are the job losses. In the extreme case where the labour supply is perfectly inelastic, payroll taxes reduce wages but leave employment unchanged. Third, for a given set of elasticities, the employment effects of payroll taxes are stronger in the short-run than in the long-run, especially in the case of employer-paid taxes. These general conclusions must be adjusted when we consider the structure of EI premiums and obstacles to wage flexibility such as minimum wages. EI premiums involve a flat rate tax on wages, levied both on the employer and employee, up to a ceiling. The ceiling on taxable wages, and therefore on the amount of premium payable, ensures that, for wages in excess of the ceiling, premiums effectively become a lump-sum tax. For those wage earners, EI premiums do not affect the choice between work and leisure at the margin. As pointed out by Kesselman (1998, p. 383), this premium structure "represents a disincentive to employ lower wage, lower skill workers and an incentive to work mid- and high-income workers overtime in preference to additional hiring." Minimum wages impose a constraint on the employer's ability to pass any portion of the tax to workers, thus presenting a barrier to the employment of low skilled workers.

Payroll taxes may affect labour market behaviour in manners not involving labour market clearing mechanisms ((see, for example, Marchildon, Sargent and Ruggeri (1996)). In efficiency wage models, firms find it profitable to pay workers wages in excess of the competitive rates, for a variety of reasons ((see, for example, Shapiro and Stiglitz (1984),

Pissarides (1990) and Phelps (1994)). Higher wages may attract better applicants, may reduce an employee's incentives to quit, and may strengthen the employee's loyalty to the firm. As a result, overall wage rates are higher than those needed for full employment thus generating structural unemployment. Payroll taxes, levied either on the employer or the employee, will increase efficiency wages thus raising production costs, reduce the level of employment and raise the level of structural unemployment both in the short- and long-run. The ceiling on contributions does not have the same effect as in market clearing models. In efficiency wage models, workers do not make marginal decisions about hours of work, but decisions on how to behave in a job, given the hours of work. Therefore, what matters for workers' decisions are average rather than marginal tax rates. The ceiling ensures a regressive pattern of average tax rates and involves a smaller response as a worker's income increases. If firms are unable to identify the responses of different groups of workers, their decisions may be based on expected workers' responses to the average tax bill. In this case, the limit may have no effect on efficiency wages, employment and structural unemployment. Minimum wages may have the same effect for both types of models, but for different reasons. In market clearing models, employers cannot pass the payroll tax onto lower wages. In efficiency wage models, employers may not be willing to reduce efficiency wages to the minimum wage level for fear that they may not be able to attract and retain even workers with minimum skills.

A general payroll tax would have a direct negative effect on human capital because it would lower the net rate of return on that investment. The ceiling on EI contributions may weaken this effect. Those workers who expect to have labour earnings above the ceiling for

most of their working lives will not be deterred from acquiring human capital by the payment of a wage tax. The negative effect of EI premiums on human capital, therefore, are likely to be confined to workers who expect to earn less than the contribution limit for most of their working years.

The personal income tax has a wider base than a payroll tax, therefore, it may affect private decisions in a variety of ways. In analyzing the efficiency effects of the PIT, it is useful to separate the PIT base into five major components: (a) labour income, including all labour compensation by employees and the self-employed, (b) business income which includes farm and fishing income, rental income and other income, (c) taxable returns on investment such as interest, dividends and capital gains, (d) private pensions, annuities and other income from tax-sheltered saving plans and (e) transfer payments and public pensions.

Taxable transfer payments and public pensions include EI benefits and OAS plus CPP pensions. In 1996, these items represented about 9% of gross income subject to taxation. There is no evidence that lower tax rates on these benefits will have a beneficial effect on personal savings or labour market behaviour. For EI recipients it would represent a partial and indirect restoration of some of the benefit cuts implemented in 1996 as the net value of an unchanged gross benefit would rise. For contributors, these potentially higher benefits are offset by higher effective premiums as the value of the associated non-refundable PIT credit is reduced. Recipients of public pensions are generally out of the labour force, therefore, the tax cut would not affect their labour supply. However, it may have a negative effect on savings. There is substantial evidence that public pensions tend to reduce private savings ((for a recent survey see Gale (1995)). Since the tax cut would be equivalent to an

increase in public pensions, this measure would tend to lower private savings. It would also aggravate the intergenerational inequities incorporated in the CPP. The CPP reform maintained the large subsidy to existing beneficiaries by imposing excessive taxes on the wages of current workers. If the PIT cut is financed by the EI surplus, young workers would be asked to pay even higher taxes in order to pay for a larger subsidy because their payroll tax burden would be further increased by the reduction in the PIT credit resulting from lower PIT rates.

Private pensions, primarily in the form of RPPs and RRSPs, represented 6% of gross income in 1994. The value recorded in Revenue Canada's Taxation Statistics, however, understates their potential magnitude. In mature tax-assisted saving plans, such as RPPs, annual contributions are approximately equal to annual withdrawals (or pensions). RRSPs have not yet reached the mature state, therefore, withdrawals are still a portion of contributions. Under equality of contributions and withdrawals, the share of private pensions in gross income would increase to 9%. Lower PIT rates would produce a windfall gain to recipients of RPP pensions, but would reduce the benefits to current contributors because it would lower the tax advantage over non-sheltered savings. The lower incentive should reduce the amount of savings in RPPs. However, since these plans are under the control of employers and form part of the total compensation package, it is likely that RPP savings will be unaffected. Therefore, for RPPs the PIT reduction would amount to a lump-sum transfer payment, i.e., a transfer that would not affect economic behaviour. This may not be the case for RRSPs because they involve voluntary participation by individuals. The issue of whether tax-assisted saving plans such as RRSPs stimulate private savings has yet to be resolved.

Recent studies suggest that these plans may have induced small increases in private saving and small reductions in national saving ((see, for example, Ruggeri and Fougere (1997), Engen, Gale and Scholtz (1996) and Ruggeri and Vincent (1998)). If RRSPs have no effect on private savings the tax break on these savings is strictly a transfer payment and the PIT reduction will represent a lump-sum transfer as in the case of RPPs. If RRSPs stimulate private savings, the reduction in the benefit of tax-sheltering for new contributions will reduce the incentive to save. In the case of private pensions, the PIT reduction either will act as a lump-sum transfer or reduce private saving. It should be stressed that the magnitude of the lump-sum transfer is potentially very large. If we add the amount of revenue collected from RPP pensions, as estimated by the Department of Finance's Report of Tax Expenditures (1997), to the revenue from RRSP withdrawals under a mature system, we obtain a total revenue of $15 billion in 1999. A 10% reduction in PIT rates, would produce a revenue loss equivalent to a lump-sum transfer payment of $1.5 billion per year. This amount is substantially higher than the annual revenue loss from the $100,000 lifetime capital gains exemption, except for the terminal year 1994.

The returns to unsheltered savings represented 8% of gross income in 1996. A reduction in PIT rates will provide a stimulus to this income component, but its magnitude depends on the responsiveness of saving to changes in the after-tax rate of return ((for a survey of studies see, for example, Smith (1990) and Engen and Gale (1996)). The full effect will apply to interest and dividends, but capital gains will receive only partial benefits because only 75% of their value is included in taxable income.

Business income accounts for the smallest share of gross income at about 4%. The economic activity generating this type of income should be responsive to a PIT rate cut. Given the variety of sources of this income, which includes rental income and net income from farming and fishing, it is hard to determine how significant in magnitude this effect may be.

By far the largest share of gross income is represented by labour income broadly defined to include the self-employed (73%). Income tax on this component of the PIT base is equivalent to a general payroll tax (including earnings of the self-employed) applied with a progressive rate structure. A reduction in PIT rates on the labour income component will expand the labour supply, will stimulate work effort and will provide incentives to acquire and utilize human capital.

We can now summarize the main conclusions on the comparison between reductions in EI premiums and reductions in PIT rates, starting with the efficiency implications. Reducing employer premiums will stimulate job creation, particularly in the short-run, by reducing the cost of hiring lower wage workers, lowering the incentive to use overtime for high wage workers and curtailing the rewards for substituting workers with machines. Reducing employee payroll taxes would stimulate the supply of labour by workers with earnings below the ceiling. This labour supply expansion would be more desirable if the economy were operating close to full employment than in the presence of a susbstantial output gap which characterizes the Canadian economy at present. The effects on human capital acquisition would be positive, but would not extend to the entire work force, are unknown in magnitude and would materialize in the long-run. Lower EI premiums may also

reduce efficiency wages thus stimulating employment and reducing structural unemployment. If EI cuts are applied across the board, some of the revenue loss is "wasted" on workers with earnings above the contributions limit for whom the premium reduction is equivalent to a lump-sum transfer. This "waste" can be eliminated by targeting the premium reduction on low income workers by, for example, leaving the ceiling on contributions unchanged.

A substantial portion of a PIT rate cut is also wasted as it effectively provides a windfall gain to people receiving taxable transfer payments, public and private pensions and holding financial assets, especially in tax-sheltered form such as RRSPs. The rest of the PIT cut can potentially affect both labour market behaviour and personal saving decisions. The effect on personal saving operates through a variety of channels, not all moving in the same direction. Savings in unsheltered instruments may be stimulated by the increase in the after tax rate of return. This positive effect is counteracted by the negative effect from higher public pensions and lower incentives to save in tax-sheltered forms. The possibility that the net result is an unchanged rate of personal saving cannot be dismissed a priori. Even if personal savings are raised by the PIT rate cut, this increase may have limited economic benefits in a country like Canada which may be treated as a small open economy. In this situation, domestic savings have no effect on domestic investment ((see, for example, Mintz (1994)). They increase the share of GDP used domestically and raise a person's lifetime utility, but provide no stimulus to employment or production. The foregoing discussion suggests that efficiency gains from a PIT rate cut will be generated almost entirely through the portion affecting the labour income component of the tax base. It seems that the

efficiency comparison of cuts in EI premiums and the PIT is ultimately reduced to a comparison between two payroll taxes: one with proportional rates, a ceiling and collections from both employer and employees and the other with a progressive rate structure, no ceiling, and collections from employees only. For the same dollar reduction in taxes, the PIT version would generate larger efficiency gains because it would stimulate the labour supply and work effort of all workers. It would also provide a strong stimulus to human capital accumulation by providing more than proportional tax breaks at the high end of the wage scale. This potential advantage of PIT rate cuts is reduced if the comparison is made with respect to an EI premium cut targeted to low income workers. When EI premium cuts are targeted, there is no "waste" of revenue on lump-sum transfers as in the case of general reduction in PIT rates. It is not known a priori whether the stronger efficiency effect per dollar of revenue is sufficient to offset the lower amount of revenue dedicated to efficiency-enhancing behaviour.

Even if a cut in EI premiums generated lower efficiency gains than a similar cut in PIT rates, it may still be the preferable option when equity and other considerations are taken into account. As discussed earlier, reductions in EI premiums would improve the fairness of the tax system, would maintain consistency in the treatment of different social insurance programs such as the CPP, would provide an offset to the payroll tax increase for the CPP, and would uphold a promise of lower premiums incorporated in the EI reform process. When all factors are taken into consideration, I believe that there is a strong case for reducing EI premiums rather than keeping a surplus in the program and using the funds to finance PIT cuts which will produce large windfall gains to high income Canadians.

Of the two components of EI premiums, I would argue that preference should be given to lowering employer contributions. With a substantial output gap and high unemployment rates , cutting employer premiums would have a stronger short-run effect on job creation. A proposal for selective cuts in employer EI premiums has also been presented by Scarth(1997). Scarth distinguishes between high income and low income workers. In accordance with empirical evidence, he assigns lower labour supply and demand elasticities to the former and higher elasticities to the latter. He also recognizes the floor to wages imposed by minimum wages and assumes that increases in overall wage rates lead to higher minimum wages. He expects little employment stimulus from lowering employee payroll taxes. Such a tax cut would have little effect on their labour supply of high income workers because of their low labour supply elasticity. It will also have little effect on employment for low income workers because they cannot reduce their wage claims below the minimum wage. Scarth favours cuts in the employer payroll tax for low income workers. He argues that the increase in the wages of high income workers would have little or no effect on employment, but would give an upward push to minimum wages by raising average wage rates. Higher minimum wages would depress employment among low income workers and the net effect of the tax cut for high income workers would be lower employment. A similar tax cut for low income workers may not raise wage levels if there are unemployed workers who would be willing to work at the minimum wage but could not because of the lack of job opportunities. Therefore, it would have a positive effect on employment.

III. Alternative Approaches to PIT Cuts

The fiscal dividend in excess of the EI surplus is generated largely by the PIT and its potential to produce revenue growth in excess of personal income growth. It would seem logical, therefore, that part of this component of the fiscal dividend be used for PIT reductions. Discussions about PIT cuts usually center around across the board, though not necessarily proportional, reductions in statutory rates. As the previous discussion indicates, this may not be the best option from both an equity and an efficiency perspective. With respect to equity, a proportional cut in rates will reduce the redistributional impact of the PIT, the only progressive tax in the Canadian fiscal system. In absolute dollar amounts, it will offer much larger benefits to high than to low income Canadians. On the efficiency side, the main shortcoming of this option is the "waste" of a large portion of the revenue loss for what amount to lump-sum transfers to selected groups of Canadians. As in the case of reductions in EI premiums, a stronger bang for the buck can be achieved through selective PIT cuts. It was shown in the previous section that the major area where we can expect a PIT cut to have significant economic impact is labour market behaviour. Therefore, the impact of a PIT tax cut would be strengthened by limiting its scope to labour income broadly defined to include income from self-employment. Mechanically, this option can be easily implemented through an employment tax credit calculated as a percentage of taxable labour earnings.

An employment tax credit has a number of advantages over an overall reduction in PIT rates. It concentrates its impact on the area of market behaviour that may be most responsive to higher returns to factor income. It is an effective complement to the reduction

in the employer EI premiums and economically a more powerful substitute for reductions in employee -paid EI premiums. It will provide incentives to acquire human capital by raising the returns to this type of investment for all Canadians. As a federal employment tax credit it does not affect the calculation of Basic Federal Tax and, therefore has no impact on provincial revenues. Although a combined federal-provincial tax credit would enhance its economic impact, a federal only credit can be implemented unilaterally. Finally, this credit would address directly an issue of international migration that is becoming an increasing concern of economists and politicians, namely the brain drain to the US. It should be stressed that there is no empirical evidence that the observed flow of skilled workers to our southern neighbour is motivated by tax considerations. Other factors are involved in this migration, such as a much lower unemployment rate, higher before tax wages, a low Canadian dollar which adds 50 cents to each dollar saved in US dollars, and the surplus of Canadian skilled workers produced by fiscal restraint in a number of provinces. Since the brain drain involves a change of residence in order to take up new employment, to the extent that it is tax motivated the relevant tax is that on employment earnings. The most direct attack on this problem is a reduction in the taxation of labour income. The employment tax credit suggested in this paper is a more powerful instrument than an across the board PIT rate reduction because it does not waste part of the tax ammunition on factors irrelevant to the issue.

IV. Conclusions

This paper suggests that the increasing fiscal dividend arising from the existing federal fiscal structure can be divided into two components: the part created by the EI surplus and the rest, which results primarily from the high income elasticity of the PIT. For the first component, it compares reductions in EI premiums and PIT rates. It concludes that, when all factors are taken into consideration, the preferable option is a reduction in employer EI premiums. For the second component, the paper compares an across the board cut in PIT rates with a proportional reduction in PIT rates on labour income only implemented through an employment tax credit. Although the analysis in the text suggests a sequential implementation of the two tax reductions, in practice both tax reductions could be introduced simultaneously. The targeted PIT rate cuts would serve as an effective complement to the reductions in the employer-paid EI premiums.

The proposed package of tax reductions strikes a balance between equity and efficiency and between short-term job creation and long-term growth potential. The reduction in employer EI premiums will eliminate the inequity of raising payroll taxes on low income workers and will provide a stimulus to job creation in the short term, especially if the reduction is targeted to low income workers. This employment stimulus is particularly welcome at a time when there exists a substantial output gap which may increase if the economy fails to grow at its potential. The selective reduction in PIT rates through an employment tax credit will stimulate the labour supply and the acquisition of human capital thus raising the long term growth potential. Both measures will stimulate aggregate demand thus helping reduce the current slack in the economy.

ENDNOTES

(1) The rationale for this option, which follows OECD reports, is based on the view that Canadian payroll taxes are lower than in other OECD countries and that payroll taxes are less distortionary than personal income taxes. This view is questionable. Payroll taxes are used primarily to finance social insurance programs. These taxes are lower in Canada because the benefits they finance are lower. Current comparisons are also misleading because they do not include the scheduled increases in CPP premiums. When these increases are added, payroll taxes will be higher in Canada than in the US. The high payroll taxes in European countries are generally considered a major cause of their high unemployment rates. Canada's international competitiveness will not be enhanced by following the inefficient tax policies of other countries. With respect to the efficiency arguments, the following points need to be stressed. First, efficiency is measured by tax-induced changes in in utility and not real output, as is done in the OECD reports. Second, the comparison of taxes is usually based on closed economies where changes in domestic savings automatically result in changes in domestic investment, a connection which is severed in small open economies. Third, what is being modelled in those studies is a general PIT rather than the existing PIT with the preferences for personal savings which makes it a hybrid income-consumption tax. Ruggeri (1999) shows that, when the current PIT is incorporated into a model which treats Canada as a small open economy, a change in the PIT is less distortionary than an equal-revenue change in a general payroll tax with the same rate structure as the PIT.

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