Finance Minister Bill Morneau is congratulated by Prime Minister Justin Trudeau on delivering the Liberal government's first budget in the House on March 22. Adam Scotti photo

Tax Policy: Long on Re-Distribution, Short on Growth

Jack M. Mintz

The Trudeau government anointed its first budget, during the 2015 election campaign, as an engine of growth. Economist Jack Mintz analyzes the ways in which, he says, the changes to Canada's tax policy contained in the 2016 budget actually undermine that aim. Mintz decries the lack of a plan for balance, and warns that demographics will lead us into a low-productivity trap.

The 2016 federal budget can be viewed as the "Campaign Promise Implementation Act". Not that much new was in it except for breaking two important election promises: running deficits to be no more than $10 billion and balancing the budget by end of the first mandate. With a blowout in program spending, eyes in the future will turn to tax policy—will a GST rate increase be in the cards?

There is something "McGuinty-esque" about the 2016 federal budget. With

$113.2 billion in projected deficits by 2021, there is almost no plan in sight to reach a budgetary balance. In fact, the budget is not realistic with its program spending ramping-up 12.4 per cent in the first two years, followed by a lean 6.1 percent increase in the following three years.

This was the same trick played by Ontario budgets for many years. Operating and capital pending was predicted to increase very little after one or two years, promising smaller deficits and lower debt-GDP levels down the path. Meanwhile, the debt-to-GDP level kept rising over the years, eventually forcing the province to put the lid on cost increases in the past few years.

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While the federal budget is at least pessimistic on its economic assumptions, suggesting a $6 billion contingency reserve, its projection of spending is, to say the least, optimistically low. With future promises, it is hard to believe that deficits will come below $30 billion in any year, assuming the economy grows at a steady 2 percent clip after 2016, which cannot be forecasted with certainty.

This gets to the role of tax policy in the future. As dour economists like to point out, deficits today delay tax increases or spending cuts to the future. In fact, part of tax policy is to assess the economic cost of imposing taxes on future voters compared with today's generation. Optimal taxation principles include "tax smoothing" to keep tax burdens aligned today and in the future. Low taxes today coupled with high taxes in the future create more economic loss than a more even distribution of tax burdens over time.

With our aging population, pushing taxation to the future is now a more problematic issue. With more retirees relative to workers, one can easily predict a slowdown in tax revenues relative to GDP since retirees earn less income and spend less compared to workers. At the same time, federal and provincial spending on health and pensions will accelerate as more Canadians retire.

Currently, Canada's growth rate will be stuck at 2 per cent per year unless we fundamentally improve productivity. With population growth at 0.9 percent and labour productivity growth roughly 1 per cent since 1980, our normal growth rate is 2 per cent per year (15 years ago we would think that 3 per cent was the potential growth rate). With the aging population, Canada will need to eke out more output with the resources we have. The 2016 federal budget's tax policy was long on redistribution and shorter on growth.

This puts tax policy in a precarious position in the near future. If a tax hike were needed to cover spending promises, what would be the best approach to avoid harming economic growth? Even if no hike were needed, would some tax reductions be better suited to boost productivity replaced by other taxes that do less harm to the economy. The new Trudeau government will need to carefully assess tax policy in the next few years to determine the best results. Tax policy in the 2016 budget is a mixed bag, with some good and some bad measures.

To assess what is good tax policy, one has to start with some basic principles, already well-known among tax policy gurus. A tax system should be "efficient", meaning that it distorts as little as possible the best allocation of resources to maximize output over time. Taxes should be fair, meaning they are neutral among people with similar resources and rise with ability to pay. Taxes should be simple, or at

Table 1: New 2016 Federal-Ontario Marginal Tax Rates Including the Effect of Clawing Back Canada Child Benefits at the Federal Level

Income	Marginal Tax Rate- No Chldren	Marginal Tax Rate-One Child	Marginal Tax Rate-Two Children	Marginal Tax Rate-Three Children	Marginal Tax Rate-Four or More Children
$30,000-45,282	20.05	27.05	33.55	39.05	43.05
$45,283-65,000	24.15	31.15	37.65	43.15	47.15
$65,000-$73,145	29.65	32.85	35.35	37.65	39.15
$73,145-83,075	31.48	34.68	37.18	39.48	40.98
$83,075-86,176	33.79	35.99	39.49	41.79	43.29
$83,176-$90,563	37.91	41.11	43.61	45.91	47.41
$90,563-140,388	43.71	46.91	49.41	51.71	53.21

least avoid high administrative and compliance costs.

> *The middle-class tax cut and Canada Child Benefit plan will see a substantial reduction in taxes paid for both low and middle-income families (although, ironically, this will be partly offset by the cancellation of the income-splitting tax credit up to $2,000 for those families with a parent staying at home to raise children).*

The two tax policy centerpieces in the budget were the middle class income tax cut and the child tax benefit plan. The middle personal income tax rate is reduced from 22 to 20.5 percent for incomes roughly between $45,000 and $90,000. The tax-exempt Canada Child Benefit replaces the old non-taxable child tax benefit and taxable Universal Child Care Benefit with new maximum annual benefits of $6,400 per child under six and $5,400 per child aged 6 through 17.

No question the middle-class tax cut and Canada Child Benefit plan will see a substantial reduction in taxes paid for both low and middle-income families (although, ironically, this will be partly offset by the cancellation of the income-splitting tax credit up to $2,000 for those families with a parent staying at home to raise children). But here is the rub. The cost of redistributive policies is raising marginal tax rates for many taxpayers, discouraging work, saving and risk-taking.

The middle-income tax cut is partly covered by hiking the top rate on growth-generating Canadians with incomes of more than $200,000, bringing Canada's federal-provincial top rate to 53 percent, one of the highest in the OECD. For working families, marginal tax rates will substantially increase since the Canada Child Benefit is clawed back at rates ranging from 3.2 to 23 percentage points, depending on income level and number of children and much higher for childless taxpayers, as illustrated by new 2016 marginal tax rates in Table 1 for Ontario.

The consequences of the new tax packages for many families are to deter work even if some short-term demand stimulus is achieved through tax reductions. With higher marginal tax rates and more household income (through the tax cut) economists would predict that people would prefer more leisure or non-taxable "home production". This is especially important with respect to secondary workers that tend to be most sensitive to taxes. For these workers, the higher child benefits and marginal tax rates will encourage mom or dad to stay home.

What about other tax policies? While I would strongly argue that the income-splitting measure brought some fairness between those families with two working and single working parents, I do think the elimination of the child fitness and arts credits was quite appropriate. These credits increase the administrative costs with unclear impacts on efficiency (one might argue fitness increases health and productivity but the credit was likely too little to matter).

More problematic was the extension of the mineral exploration tax credit for flow-through shares and the bizarre re-introduction of the Labour-Sponsored Venture Capital Corporate tax credit in those provinces with existing LLSVC entities (Ontario and Alberta do not have a venture capital credits but will now be pressured to provide one). Both credits fail efficiency and fairness tests for good tax policy.

As several recent studies have shown, flow-through and LLSVC tax credits have encouraged sub-performing investment, as taxpayers are more interested in the tax benefits rather than the economic returns from the investment. The LLSVC tax credit has not only been ineffective in spurring innovation but has harmed the venture capital market with average rates of return of 3 percent or less. No wonder that Canadian pension funds do not invest in Canadian venture capital funds when they can earn six times the returns in the US funds. We need to think of better tax policy ideas for innovation and investment.

Many other tax policy issues are raised by this budget but let me add just one more. In work done with Daria Crisan and Ken McKenzie, the current tax-transfer system is highly geared towards seniors, increasingly so through the years. Pension-income splitting (kept for seniors but not workers), pension credits, aged tax credits, Old Age Security and other various benefits have resulted in negative taxes (taxes net of transfers paid) on seniors for incomes up to $60,000. This leads to significant income redistribution from workers to retirees and is therefore a critical issue as to how to target support to help low-income seniors as the population ages. The top-up under the Guaranteed Income Supplement for single seniors to avoid poverty was a welcome change. Bigger issues lie down the road since middle-income seniors might need to bear more taxes.

Obviously, one tax that is distributed more fairly across the population is the GST. Many economists, critical of the Conservative GST cut from 7 to 5 percent, would argue that a higher GST rate would be appropriate to consider. This might be the most efficient tax increase but it will certainly hurt the very group that the government targeted to help.

It will be fascinating to watch how tax policy plays out in this government. Hopefully, it will put more focus on growth in the future than suggested by this budget. P

Jack M. Mintz is the President's Fellow, School of Public Policy, University of Calgary and Scholar-in-Residence at Columbia Law School in New York.
jackmmintz@gmail.com