



# TD Economics

## Special Report

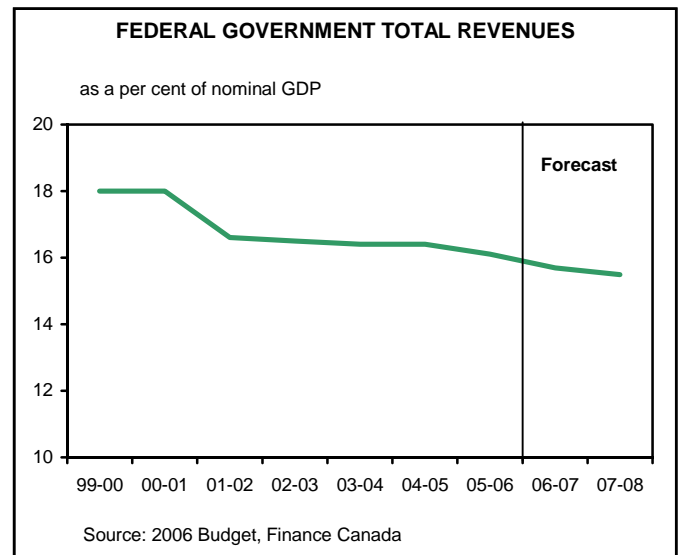
June 7, 2006

### SORTING OUT THE SPIN ON TAX CUTS IN THE 2006 FEDERAL BUDGET

Global Insight (Canada) Limited recently wrote a note arguing that the May 2, 2006 Budget offered “much less tax relief than advertised”. The note itself is very clearly written and with one exception its analysis is sound. However, in questions that have been put to us following media coverage of the Global Insight note it is clear that its key point has been lost in translation. That should not be surprising because Global Insight’s note was all about the nature of budget spin and cutting through that can lead to dizziness. The purposes of this brief note are to draw attention back to the main premise of Global Insight’s argument, show that the one questionable assumption they make weakens their case and argue that to cut through the spin we should focus on the overall tax burden, which is coming down. In other words, we should let the numbers speak for themselves.

#### The magnitude of tax cuts all depends upon the choice of benchmark

Global Insight’s main premise is that the Conservative’s Budget of May 2, 2006 measured tax relief not from the intentions pronounced by the Liberals last fall and implemented by the Canada Revenue Agency, but rather from what sits in legislation. For example, the Liberals introduced a Ways & Means motion cutting the lowest marginal tax rate from 16 to 15 per cent effective January 1, 2005. But the change was not passed into legislation as an election was called shortly after. The Conservatives set the lowest tax rate at 15.5 per cent from July 1, 2006 onward. Is this a tax cut of one-half a percentage point or an equivalent tax increase? It all depends upon what benchmark you choose. The Conservatives billed it as tax relief because they chose the benchmark tax system as that speci-



fied in legislation. On the other hand, Global Insight claims the budget move represents a tax increase because their benchmark is the tax rate in the Ways & Means motion that was implemented by the Canada Revenue Agency. Both positions are correct. The distinction is really just spin. The rate is what it is – 15.5 per cent. It is lower than it was previously but not as low as had been reflected in people’s tax-home pay. The exact same issue is at play in the Global Insight analysis of the budget’s change to the basic personal amount. Again it represents a tax cut relative to the amount set in legislation but an increase relative to the Liberals’ Ways & Means motion and the practice of the Canada Revenue Agency. Along the same lines, Global Insight claims that the Conservatives’ cut to dividend taxation should not count at all because the Liberals squeaked in a Ways & Means motion with the same meas-

ure days before their government fell. In this case the Canada Revenue Agency has not yet incorporated the change into actual practice.

### The Conservatives' choice of benchmark is appropriate

In total, by choosing a different benchmark, Global Insight claims that the Budget only cut taxes half as much as the Conservatives claim and that the cumulative value of tax cuts is 1.4 times the value of spending increase compared to the budget's claim of 2 to 1. We could just leave this as a difference of opinion as to the appropriate base if it were not for one problematic assumption made by Global Insight. The assumption is that the personal income tax rates set by the Liberals through Ways & Means motions would have "stayed in effect right through to March 2008, the end of the period covered by Budget 2006". Implementing the tax measures from the Liberals' Ways & Means motions was already questionable judgment on the part of the Canada Revenue Agency. Their role is to enforce tax legislation. There is a protocol to act on the basis of Ways & Means motions, but only when there is certainty that the supporting legislation will be introduced and passed in a timely manner. These conditions are typically only considered to be satisfied when there is a majority in Parliament and an election is not in near sight. That was hardly the case when the Liberals introduced the Ways & Means motions in the Fall 2005 Update and definitely not the situation with the cuts to dividend taxation which came just days before the government fell. Any armchair political observer knew there was a high probability of an election coming soon and another Liberal majority was far from a sure thing. It could be countered that lots of legislation does not get passed for years after Ways & Means motions have been introduced. Regrettably this is true, but the Canada Revenue Agency would not continue to enforce the parameters of the Ways & Means motion if the governing party was giving signals it was not going to continue with the policy.

### Without legislation the Canada Revenue Agency could not have continued enforcing the Liberals' personal income tax cuts

The Conservatives were very clear in their election party platform that they were not going to continue with aspects of the Liberals' personal income tax cuts and instead put much of the emphasis on GST rate cuts. In such

Federal Budgetary Revenues (as a per cent of GDP)				
	04-05	05-06	06-07	07-08
Personal income tax	7.6	7.5	7.5	7.6
Corporate income tax	2.3	2.5	2.4	2.4
Goods and services tax	2.3	2.3	2.1	2
Other excise taxes/duties	1.0	1.0	0.9	0.9
<b>Total tax revenues</b>	<b>13.6</b>	<b>13.7</b>	<b>13.3</b>	<b>13.2</b>
Employment insurance premium revenues	1.3	1.2	1.1	1.1
Other revenues	1.5	1.2	1.3	1.3
<b>Total</b>	<b>16.4</b>	<b>16.1</b>	<b>15.7</b>	<b>15.5</b>
Source: 2006 Budget, Finance Canada				

a situation it would have been illegal for the Canada Revenue Agency to continue enforcing the Liberals' personal income tax changes when no legislative support had a hope of appearing. The Conservatives no doubt concluded it was to their political advantage to ignore the Liberals' tax cuts in calculating the value of the measures introduced in their budget. But in fairness, their choice of going back to legislated tax parameters does seem appropriate considering legal jurisprudence. We will leave it to others to judge whether all ambiguities considered, the Conservatives could have provided more of an explanation as to why they chose to measure tax cuts this way .

### The budget numbers show the tax burden coming down

At any rate, enough on spin. Let the numbers speak for themselves. The tax-cutting budget of 2000 sliced the tax burden - as measured by the ratio of budgetary revenues to nominal GDP - from 18 per cent to 16.6 per cent by 2001-02 and then it slightly slipped to 16.4 per cent by 2004-05. The Conservatives 2006 Budget gets the tax burden moving down again to a projected 15.5 per cent by 2007-08. This is what should matter. It is not surprising that half the reduction in the tax burden over the next few years comes from the GST. Despite the personal income tax cuts the ratio of personal income tax revenues to GDP remains unchanged in the budget projection for 2007-08 at the actual figure for 2004-05.

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