Economics versus Politics in Canadian Payroll Tax Policies

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Payroll taxes have assumed an important role in the federal government’s financing choices in recent years. Employment Insurance (EI) premium rates have been kept well above the associated program’s expenditures to reduce the measured federal deficit. Canada Pension Plan (CPP) premiums are set to rise sharply to place that program’s financing on a sustainable basis. The government’s increasing reliance on payroll taxes displays an aversion to raising more visible levies such as the Goods and Services Tax (GST) and income taxes. Hence, payroll tax policies reflect the dominance of political considerations of public acceptance over the economic criteria of efficiency, equity, and employment.
ECONOMICS OF BENEFIT-LINKED AND GENERAL PAYROLL TAXES

An assessment of these policies hinges on the distinction between benefit-linked and general payroll taxes (see Kesselman 1997, chapters 2-3). In essence, this distinction turns on whether there exists a substantial link between the taxes paid by (or on behalf of) a worker and the worker’s expected value of future benefits. A social insurance program’s premiums can conceptually be divided into its benefit-linked and general payroll tax components.

A benefit-linked tax is much like a price charged in a private market; it imposes little if any efficiency costs. In contrast, a general payroll tax, where there is little or no effective link to benefits, creates a distortion. The relative size of the efficiency costs calculated for various taxes depends on the extent of behavioural responses and also the model assumptions used. Static analyses find that the lowest efficiency costs are associated with a broadly based indirect consumption tax, followed closely by a general payroll tax. Higher efficiency costs are associated with income taxes (including both labour and capital incomes) and still higher costs with capital income taxes. This overall pattern is confirmed in most studies that use general equilibrium methods of analysis, including endogenous growth models. The efficiency costs of a personal income tax are increased by a progressive tax rate schedule.

For a benefit-linked payroll tax, the appropriate standard for equity is “user pay.” Individual workers obtain benefits of expected value equal to the taxes they pay or that are paid on their behalf, and in this sense the tax is clearly equitable. If there is a ceiling on earnings subject to tax, these taxes can appear to be highly regressive, but if the associated benefits have similar ceilings this is not the case. The incidence of benefit-linked payroll taxes falls on the worker, either directly if the taxes are paid by the employee or indirectly — after a period of market reaction resulting in lower gross wages — when the taxes are paid by the employer. This neutrality between employer- and employee-paid payroll taxes requires significant labour market flexibility but appears to be mostly supported over the longer run by empirical studies.

A general payroll tax is appropriately judged by standards of horizontal and vertical equity, just like any other general revenue source. In a lifetime view, a payroll tax is like a consumption tax in providing horizontally equitable treatment across persons with different saving patterns. A tax on total or capital income undermines this aspect of equity. In terms of vertical equity, a general payroll tax with no ceiling on taxable earnings is proportional to labour income. Given the pattern of labour income relative to total income, that makes the tax progressive from low to middle incomes but regressive for higher incomes where capital sources predominate. This regressivity at the upper end is accentuated by the presence of a ceiling on taxable earnings.

A perfectly benefit-linked payroll tax should have no impact on employment, while a general payroll tax can affect employment if it is borne at least partially by employers. After an employer-paid tax has had time to be shifted into lower gross wages, the employment effects should dissipate. A tax initially imposed on the employee side does not require an adjustment period; it is immediately and fully borne by workers. Empirical evidence is somewhat mixed on this issue perhaps because these predictions are based on market-clearing models (Scarth 1997), but it generally supports the conclusion that any initial disemployment effects shrink over several years. Other taxes used for general revenues (including the income tax, retail sales taxes, and the GST) also involve wedges between gross and net real wages that can lead to transitory disemployment effects.

PAYROLL TAXES FOR EMPLOYMENT INSURANCE

The payroll taxes used to finance EI raise issues about the cyclical pattern of rate setting, the counting
of EI surplus funds against the federal deficit, and alternative sources of budgetary finance. The projected annual EI surplus for 1998-99 is $6 billion, which would conclude this fiscal year with an accumulated surplus of $19.6 billion. Relative to the annual rate of EI program spending ($13 billion), this cumulative surplus will be far larger than in any year since the late 1950s, when very different principles were used for setting premium rates and reserves.

During the last several years the federal government has slowly reduced EI premium rates. The decline in benefit payouts has been far faster, however, resulting in part from an improving economy but largely from legislated reductions in the benefit levels and access. The federal government has resisted repeated calls from business, labour, and provincial advocates for faster premium cuts. It has argued that only a large cushion can prevent premium rate increases during the next recession, which would aggravate the downturn.

A more likely explanation for this resistance to faster, sharper EI rate cuts lies in the contribution these revenues have made to the government’s battle against the deficit. The accumulation of massive EI balances is not necessary for a cyclically stabilizing pattern of premium rates, and there is no good reason to avoid a cumulative EI deficit during recession. All that is required is slow adjustment of rates so that EI account imbalances are not quickly reversed (Kesselman 1983, chapter 8). The federal government’s current policy appears aimed at avoiding a cumulative deficit for EI during a recession of any likely severity. In short, EI revenues have been used for reduction of the overall federal deficit (Orr 1997), and the economic effects of this approach vis-à-vis alternative tax sources need critical review.

The “excess” revenues collected under the rubric of EI premiums, but actually for purposes of fiscal balance, constitute a form of general payroll tax. These extra payments do not entitle the workers to any additional benefits. Moreover, the additional current premium payments will not reduce workers’ future payments through lower premium rates, relative to a strategy of running lower average EI balances over the long run. (Interest earned by the larger EI balances will be offset by the additional interest that workers and their employers could have earned themselves if they had retained the funds.) There are two key dimensions in comparing the “general” component of EI payroll taxes with other tax sources — the rate structure and the tax base. The economic criteria of equity, efficiency, and employment effects are all relevant.

The EI rate structure’s essential aspects are its flat rate combined with an upper ceiling on taxable (“insurable”) earnings. The current ceiling, $39,000, falls somewhat above average full-time earnings. For vertical equity, this structure is proportional (with respect to employment earnings) up to the average earnings and very regressive for higher earnings, since total premiums are capped at the ceiling level. This lump-sum aspect of the premiums for higher earners reduces the efficiency costs of the tax (Dahlby 1994). Since a large portion of EI premiums constitutes a general tax, however, it represents a disincentive to employ lower wage, lower skill workers and an incentive to work mid- and high-skill workers overtime in preference to additional hiring.
The tax base for EI premiums is all earnings from employment; this excludes both self-employment incomes and the returns to business, property, and financial investments. These exclusions from the taxable base for the general component of the levy violate both horizontal and vertical standards of equity. Excluding self-employment from coverage is both inequitable and economically inefficient. Excluding capital sources of income from the tax base promotes overall efficiency. Still, it necessitates a higher rate of tax on employment earnings, creating more distortions to the labour market and aggravating the employment effects of the taxable ceiling.

Two alternatives to using “excess” EI premiums to combat the deficit would be to raise additional revenues through the income tax or the GST. In view of the existing deficiencies of the income tax, relying on it for additional revenue would require several simultaneous reforms. For efficiency purposes, its base might be shifted more toward consumption, by raising RRSP contribution limits or restoring exemptions, removed in 1988, for limited amounts of interest and dividends. To avoid the large efficiency costs imposed by high marginal tax rates on upper-income earners, the income tax rates could be increased more at middle incomes than at upper incomes. Even this pattern would be more progressive than the current use of EI premiums with a taxable ceiling.

A different approach is to replace the “excess” EI revenues with more GST revenue; each percentage point increase in the GST rate generates about $2.7 billion per year. A simultaneous enhancement of the GST refundable tax credits would insulate those at lower incomes, some of whom would also enjoy reduced EI premiums. This approach would promote vertical and horizontal equity, and its shift from a payroll to a consumption base would yield some efficiency gains. Although the total effects on employment might be small, a less distorting pattern of employment demands would result. Of course, in political terms raising the GST would have been anathema for a government trying to disengage itself from an earlier commitment to abolish it. Politics have also stood in the way of a personal income tax hike, which is much more visible than simply failing to cut EI premium rates more quickly and sharply.

For the portion of EI premiums that do not exceed the program’s long-run average financial needs, the tax-benefit links could be strengthened by experience-rating the premium rates, at least on the employer side (Kesselman 1983, chapter 9; Beauséjour, Sheikh and Williams 1998). With a tighter benefit link, premiums become more like a user charge. Numerous distortions of the current program across various industries, occupations, and regions would vanish, as would distortions to employers’ hiring, layoff, and hours-versus-workers choices. This change would also restore the program’s horizontal equity with respect to different kinds of workers. As with the “general” portion of EI premiums, the explanation for why governments have not pursued economically preferable policies lies in the realm of politics. Experience-rating is opposed by industries that are regionally concentrated and therefore politically effective.

Payroll Taxes for the Canada Pension Plan

While there are some similarities between the payroll taxes used to finance EI and the CPP, there are differences as well. For one thing, because the CPP’s finances are not consolidated with the rest of the federal budget, its surpluses or deficits cannot be manipulated to affect the reported budgetary balance, although money in transit can affect federal financial requirements. Yet even though CPP surpluses cannot be used to offset the federal deficit, raising CPP premium rates may reduce the need for heavier reliance on other taxation sources to meet public policy objectives. (For related analyses of the CPP, see Pesando 1997 and Robson 1997.)
The central issue confronting policymakers for the CPP in recent years was how to keep the program financially sustainable over the long term. The CPP premium rates set in earlier years were inadequate to cover the program’s future benefit liabilities for a number of reasons: slow real wage growth, growing longevity, and shorter average time spent working on account of earlier retirement and higher unemployment. In 1997, the federal government announced a series of annual premium rate increases for CPP, arguing that a rapid increase soon would allow rates to be capped at a lower level later on. It further argued that raising premium rates more quickly will help to address generational equity issues by making older workers pay more of the total costs of financing their own benefits prior to retirement. Still, these rate increases will not impinge on currently retired beneficiaries, and workers approaching retirement will still enjoy large net gains from being relatively early participants in the program.

Conceptually, the rate and financing arrangements needed to make CPP sustainable over the long term are divisible into two components. First is the rate needed to finance the program over the long run for all current and future workers. Adopting this rate for CPP premiums will yield a relatively tight tax-benefit link for workers; this is the benefit-linked portion of the payroll tax. Second is the balance of the financing requirements for the program, needed to cover the excess value of benefits over contributions (with interest earnings) for the first generation of beneficiaries. This component of the CPP premium rate is clearly a general payroll tax. It is imposed on current and future workers without any associated benefit entitlements for them.

Of course, there is no necessity to raise the second portion of CPP financial needs through the program’s payroll tax. Based on economic criteria of equity, efficiency, and employment effects, other sources of finance would likely be preferable, as argued in the previous section on EI. In particular, financing the CPP bonus for the current old through a payroll tax (with its insurable ceiling) raises similar issues of vertical inequity and adverse employment effects (see Dungan 1998 for estimates). There is also a violation of horizontal equity in financing the bonus from workers but not from those reliant on capital incomes. The Reform Party’s proposal to privatize the CPP recognized the need to finance the bonus portion for the older generation and suggested using general revenues rather than a payroll tax. This point is equally valid for any scheme to sustain the CPP as a public program, and the financing options include an expanded but reformed income tax and the GST.

It might also be appropriate to consider new tax provisions to partially correct the horizontal inequities across generations that result from the CPP bonus. This could be financed in part by the generation that is gaining from it — for example, by a supplementary income tax rate applied to all tax-sheltered dissavings and payments that had benefited from preferential tax treatment for retirement savings. This special tax could be applied above an exemption level, and phased down over the next 20 years as the bonus element of CPP dissipates. This tax is a back-door way of recapturing part of the bonus; a more direct method would be a partial clawback on CPP benefits for the bonus generation, clearly a political nightmare.

Regardless of the means used to finance the CPP bonus, there might be resistance to injecting other tax revenues into the program on the grounds that doing so would compromise the program’s integrity. Yet supplemental funding in social insurance programs has been common when special benefits unrelated to workers’ earnings or payroll tax payments are involved. For example, at various times in the 1970s and early 1980s, the UI program drew upon general revenues to cover employment services, benefits for self-employed fishermen, benefits in the initial phases that were attributable to higher unemployment rates, regional benefits in the extended phases, and extended benefits to claimants in training. The proper use of general revenues
allows a closer link between premiums and earnings-entitled benefits, strengthening the program’s social insurance basis.

**Politics versus Economics in Policy**

Payroll taxes are politically appealing because they are imposed on employers as well as the more numerous workers, who also wear hats as voters. It is not commonly understood that the ultimate burden of the employers’ share falls ultimately on workers through lower gross wages. Raising the same revenues through increased reliance on income taxes or GST would be much more transparent as a tax increase. The political preference for payroll taxes is consistent with the theory of political economy (Hettich and Winer 1997) and case-based and empirical studies (Gillespie 1991; Landon and Ryan 1997). Benefit-linked payroll taxes have further political appeal. Charges are confined to those who will be entitled to benefits, and voters can see the link to program benefits. But these attractive aspects may tempt policymakers to use the guise of “premiums” or “contributions” to provide superficial appeal to what are often, in fact, increases in general payroll taxes.

The political barriers to rational economic policy for federal payroll taxes are illustrated in recent comments by the finance minister to the parliamentary finance committee (28 May 1998):

> [I]f we’re in competition with the United States and our payroll taxes are lower than theirs, and our personal income taxes are higher, are our payroll taxes the first thing we should be looking at, or should we not be looking at the greater weight being put on personal income taxes? ... It would be our view that the first priority ought to be a reduction in personal income taxes.

These remarks are a tacit admission that social insurance premiums are being used for general revenue purposes. They also evince a concern over high income taxes but do not explain whether this stems from efficiency aspects, the tax base or its rate schedule, or simply a vague unease over not being “competitive” with the US.

In economic terms, the concern over high income taxes and the willingness to accept heavier use of general payroll taxes with taxable ceilings could relate to the comparative bases and/or the rate schedules. A payroll tax avoids the problems and distortions of measuring and taxing capital incomes. Its application of a flat rate on insurable earnings up to a taxable ceiling avoids the additional distortions of the progressive rate structure used by the income tax. Of course, if economics were the only concern, then federal tax policy could proceed by other means than greater reliance on payroll taxes. Expanded use of the GST or of a reformed income tax system based on consumption principles would satisfy the economic criteria more closely. Those changes would approach the kinds of flatter-rate and consumption-based taxes that economic analysis is increasingly favouring for efficiency and growth objectives (see the studies in Aaron and Gale 1996 and Boskin 1996).

The federal government’s payroll tax policies in recent years could be viewed as pure political optimization with little regard for the economic attributes of the outcomes. Yet paradoxically, these policy choices could instead be viewed as economically optimal subject to the political constraints of public acceptance. If it is felt that the public would not accept increased rates of income tax, reduced progressivity of income tax rates, enhanced preferences for savings or capital incomes shifting the income tax base closer to consumption, or higher rates and base-broadening of GST, then heavier reliance on general payroll taxes may have been the only feasible way to achieve the economic goals. While this perspective has not been articulated by policymakers, it may be roughly embodied in official statements that Canadian tax policy must be competitive with that of our major trading partners.
Increased federal reliance on payroll tax revenues has been mirrored in the general payroll taxes of four provinces (two instituted in 1990; see Kesselman 1997, chapters 5 and 7). These are employer-only levies with no ceilings on the taxable payroll. All four provinces label their levies for health care and/or postsecondary education purposes, but three put the revenues directly into their consolidated revenue funds. None of these levies has any link between the taxes paid on behalf of a worker and benefit entitlements. Provinces have been constrained in their use of other taxes, because most do not have control over the income tax base and most rely on retail sales taxes that distort business input choices rather than a neutral GST. The only one with a harmonized sales tax, Newfoundland, cannot vary its tax rate; and Quebec would need to hike its sales tax by more than four percentage points to replace its payroll tax revenues. Hence, reduced provincial reliance on payroll taxes may have to await federal tax initiatives.

In conclusion, political forces have dominated economic considerations in key public policy choices over the use of payroll taxes in recent years. If governments had been less concerned with public acceptance and the visibility of the total tax burden, they might have paid greater heed to the criteria of equity, efficiency, and employment. It may be understandable that governments acted in this manner when budgetary pressures and already high tax burdens made it politically difficult to raise more revenues from highly visible sources. The emerging budgetary surpluses may provide governments with the political lubricants needed to reduce their reliance on payroll taxes and shift more to taxes suitably reformed to maximize the economic benefits.

REFERENCES


