EXECUTIVE SUMMARY

FRASER INSTITUTE

Will Cutting Income Tax Rates Create Jobs for Canadians?

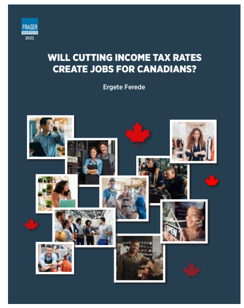
by Ergete Ferede

Job creation is often considered one of the most critical public-policy goals that governments seek to achieve. The recent significant job losses that the country has experienced during the COVID-19 pandemic have brought employment to the forefront of meaningful policy discussions and, so, some commentators and analysts suggest that policy makers should embark on tax cuts to stimulate a higher employment rate in the economy. Nevertheless, the effects of tax policy on employment have been among the most contentious issues in academic and political circles. There is also a lack of empirical evidence on this crucial issue in the Canadian setting, and results from previous studies are generally inconclusive. What are the effects of federal income taxes on employment? Can the Canadian federal government encourage private-sector job creation through cuts in the income-tax rate?

When governments face budgetary challenges and budget deficits rise, they often raise the income-tax rate on high-income earners and corporations to generate revenue. In Canada, since half of the capital gains are currently subject to income tax, any increase in the personal income-tax (PIT) rate also raises the tax burden on capital gains. However, various studies indicate that such attempts to raise tax revenue have high economic costs. An increase in the top marginal statutory PIT rate can discourage entrepreneurship, which hurts private-sector's capacity to create jobs in an economy. A higher income-tax rate reduces the after-tax wage income that individuals receive, and this adversely affects their incentives to work. Similarly, an increase in PIT that causes a rise in the capital gains taxes reduces the after-tax return for entrepreneurship and investment, ultimately hurting the economy's capacity to create jobs.

The empirical analysis of this study shows that income taxes have significant adverse effects on private-sector employment. The rates of the capital gains tax and the corporate income tax have similar negative effects on employment. The results of the study suggest that a one percentage-point cut in the federal top PIT rate leads to an increase in the private employment rate by about 0.25% in the year following the tax rate cut. In other words, if the federal government cuts the top statutory marginal PIT rate from the current 33%

to 29%—the rate prevailing before the 2016 tax-rate hike—, the private sector will create about 110 thousand jobs in the year following the tax cut. This would provide a vital boost to the economy that has suffered significant job losses as a result of the pandemic. Thus, this study's important policy implication is that, if the Canadian federal government wishes to encourage private-sector job creation, cutting the top PIT rate (and the associated capital gains tax rate), is a crucial and promising policy choice to consider. Such a policy change will also help significantly to improve Canada's overall tax competitiveness in relation to other OECD countries.



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