# THE "TAX DOLLARS ARE SCARCE, AND SHOULD ONLY BE SPENT ON THE MOST NEEDY" FALLACY

Nicholas Rowe

*Commentators debating what to do with the surplus spend a lot of time arguing whether to cut tax rates or increase benefit rates, apparently without realizing that what truly matters in terms of fairness and incentives is the difference between the taxes a person pays and the public benefits he or she receives. Call this difference "net taxes." A universal child benefit would have the same effect on all parents' net taxes, and it wouldn't matter whether the benefit were delivered in the form of a tax cut or a cheque from the government. Making the benefit universal would have the advantage of equalizing marginal net tax rates, and therefore minimizing the disincentives associated with net taxation.*

*Les commentateurs qui discutent la façon d'utiliser les surplus budgétaires des gouvernements se répandent en suggestions : changements à apporter aux taux d'imposition ou aux niveaux des bénéfices. Ils ne semblent pas se rendre compte de ce qui importe vraiment en matière d'équité et de stimulation de l'économie : soit la différence entre les impôts que l'on paie et les services et avantages publics que l'on reçoit. Appelons « impôt net » cette différence. Une allocation pour enfant universelle aurait le même effet sur l'« impôt net » de tous les parents peu importe qu'elle prenne la forme d'une réduction fiscale ou d'un transfert gouvernemental. Le caractère universel de la mesure aurait l'avantage d'en réduire l'effet sur l'impôt net et, par conséquent, sur la dissuasion que suscite cet impôt net.*

The Toronto *Star* editorial for July 20, 2000, which argued against making the Canada Child Tax Benefit universal, as had just been proposed in a *Choices/Choix* paper from the IRPP written by Carole Vincent and Frances Woolley, asserted that "If money were limitless, a universal benefit might make sense. But it is still scarce. Every dollar given to wealthy parents would make one less dollar available for poor parents." The next day's *National Post* agreed with the *Star*—something that does not happen often—arguing in its editorial that "throwing huge sums of money at people who clearly do not need it is no longer an acceptable government practice."

Both editorials, one from a left-wing and one from a right-wing paper, rest on a false distinction between tax policy and expenditure policy. This same false distinction underlies much of the current debate about what to do with the federal fiscal surplus, but it is particularly important for the debate on universality. Once this fallacy is cleared up, then paying "monthly allowances for millionaires" can actually be seen as good government policy—as I hope to show in what follows.

To begin with fundamentals: Governments collect taxes and use some of the proceeds to provide benefits. A tax is when I give the government money. A benefit is when the government gives me money. A tax is just a negative benefit. A benefit is a negative tax. In and of itself, the level of taxes is irrelevant. So is the level of benefits. What is relevant is *net* taxes—that is taxes minus benefits. If everyone faced a million-dollar tax increase, and also a million-dollar increase in benefits, every person's net taxes would stay the same, and nobody would be worse off, better off, or have any incentive to change their behaviour. The bottom line on everyone's tax return would stay the same.

Now it is true that taxes do usually affect people's incentives. If the tax I pay depends on how much I earn, or on how many children I have, then it may affect my decisions about whether to work overtime and how many children to have. But exactly the same is true of benefits. If the benefits I receive depend on how much I earn, or on how many children I have, then receiving benefits may also affect my decisions about whether to work overtime and how many children to have. What really affects my incentives is neither taxes, nor benefits, but the relationship between the *net* taxes I pay (taxes minus benefits) and the decisions I make. If I earn an extra dollar, and my net taxes rise by 60 cents, my reward for doing the extra work is only 40 cents. It is irrelevant to me whether I lose the 60 cents through a 60-cent increase in taxes or a 60-cent cut in benefits. The only thing that matters is my net marginal tax rate: 60 per cent.

It ought to be obvious that only net taxes matter. In introductory macroeconomics classes, we define disposable income as income minus net taxes, where net taxes in turn are defined as taxes minus transfers ("transfers" being what macroeconomists call benefits). Thereafter, we never talk about taxes and transfers separately. We only ever talk about net taxes, because only net taxes matter.

Amazingly, this obvious truth seems to be ignored in many discussions of public finance. It is not totally ignored. Some people do talk about "effective marginal tax rates," which is the change in taxes minus the change in benefits, (i.e., the change in net taxes) when you earn $1 more income. I prefer to say "net marginal tax rate" instead of "effective marginal tax rate," because net taxes clearly means net (as opposed to gross) taxes. (By contrast, "effective" taxes might mean effective as opposed to ineffective.) But enough people do ignore the obvious truth that it must be driven home with a sledgehammer.

Is government bigger or smaller than it was 20 years ago? We cannot measure the size of government just by looking at gross taxes. If the government cut everyone's taxes by $1,000, but cut everyone's benefits by $1,000 also, the Fraser Institute's "Tax Freedom Day" would come earlier in the year, and the government might claim to have downsized. The right would celebrate, the left would wear black armbands,. But nothing would really have changed: Every individual's net taxes would be exactly the same as before.

So how *ought* we to measure the size of government? One way would be to measure government expenditure on goods and services. The government takes our taxes in cash, and gives us back benefits partly in kind, by spending on education, defence, etc., and is therefore deciding how we should spend our money. Good or bad, this does give us a measure of government size which actually means something. A second way would be to measure the amount of redistribution of net taxes. The government collects positive net taxes from some people, and negative net taxes from other people. It takes from Peter to pay Mary. The variance of net taxes across individuals would be another measure of government size that actually meant something. Looking at gross taxes, however, doesn't mean anything.

Finally, a cruder but simpler measure of the size of government in terms of redistribution is to look at net marginal tax rates on average across the population. By this measure, cutting the child benefit for rich families did not reduce government, it increased it, because it increased net marginal tax rates for families with children.

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University economics departments typically divide the study of public finance into two courses, one on taxation, the other on expenditure. This makes as much sense as dividing orthopedics into one branch for the right hand and a second branch for the left hand. (By contrast, good public policy analysts must always keep track of what both fiscal hands are doing.)

Optimal tax theory, which is used in the taxation term of the average public finance course to analyse efficient and equitable tax systems, is equally applicable to the efficient and equitable granting of benefits. In fact, let me now propose the introduction of "optimal benefit theory," which is just standard optimal tax theory with minus signs replacing plus signs and *vice versa*. Perhaps the truly useful distinction in public finance is not between taxes and expenditures, but between taxes or expenditures in cash, and taxes or expenditures in kind. (Compulsory military service is an example of taxation in kind).

In a recent paper in a C. D. Howe Institute volume on the family, Kenneth Boessenkool writes that: "...an equitable and efficient system for raising revenues (tax policy) is quite different from an equitable and efficient system for transferring money to the less well off." He is wrong. An equitable and efficient system for setting taxes is exactly the mirror image of an equitable and efficient system for setting benefits. Indeed, the only thing that really matters is that we have an equitable and efficient system for setting *net* taxes—i.e. taxes minus benefits. "Tax policy" should really be seen as "*net* tax policy."

Suppose the government wanted to encourage early marriage. It could give every young married couple a $1000 special benefit, or a $1000 special tax cut. Both policies would have exactly the same effects on the rate of early marriage, and exactly the same effects on the government's overall budget surplus. Calling it an increase in benefit merely gives it a left-wing spin. Calling it a tax cut gives it a right-wing spin. But they are really the same policy.

The left argues that the federal budget surplus should be used to increase benefits. The right argues that the government surplus should instead be used to cut taxes. (A third group wants to use the surplus to pay down the debt, but that just postpones the question of how we eventually spend the surplus). Both sides to this debate seem conceptually confused. A $100 increase in benefits is exactly the same as a $100 cut in taxes. So what are they really arguing about?

What we should be debating is not taxes vs. benefits, but the structure of net taxes. Here we really can get a meaningful debate going. The left can argue for a more steeply rising net tax structure, with higher marginal net tax rates, and the right can argue for a less steep net tax structure, with lower marginal net tax rates. Higher marginal net tax rates lead to more redistribution from rich to poor, while lower marginal net tax rates lead to better incentives to earn income and greater economic efficiency. (The debate over "flat" tax systems has nothing to do with this. A flat tax is one with a constant marginal tax rate, which can be either very high, for left-wing flat-taxers, or very low, for right-wing flat-taxers.)

Failure to recognise that a benefit is just a negative tax has plagued the debate over universality. The left are suspicious of universality because they see it as giving benefits to the rich, the right because they see it as requiring higher taxes to pay for it or spending money that could be used to cut taxes. Both sides are confused.

In Canada, the net taxes you pay depend on your income and on whether you have children. If the tax/benefit system were universal, net taxes would always be (say) $1,000 less for someone with children than for an otherwise identical person without children, regardless of income. To say the same thing a second way, if the tax/benefit system were universal, a person earning $100,000 per year would always pay (say) $20,000 more in net taxes than an otherwise identical person earning $50,000 per year, however many children they had. To say it a third way, if your taxes depended only on your income (and not on whether you had children), while your (non-taxable) benefits depended only on the number of your children (and not on your income), then that would be universality.

Universality means only that the marginal net tax rate is the same for families with and without children (for a given income). You can have a left-wing universal system, with high net marginal tax rates for both sets of families, or a right-wing universal system, with low net marginal tax rates for both sets of families. If we take the level of child benefits paid to the poor as a given, then the true conflict of interest over universality is between two sets of rich families, those with kids and those without kids. The poor aren't affected either way, except that a universal system, by creating better incentives on balance and being therefore more efficient, could yield a surplus from which many could benefit.

What killed universality was an unholy alliance between right and left around the argument that "tax dollars are scarce, and should therefore only be spent on the most needy." This argument appealed to the right because it emphasised the scarcity of tax dollars and the efficiency cost of high taxation. And it appealed to the left because it emphasised equity and the concern to distribute benefits to the most needy. But the argument is nonsense. It assesses the cost of taxation on efficiency grounds, and assesses the gains from providing benefits on equity grounds. But since a benefit is just a negative tax, and a tax is just a negative benefit, any change to the tax system or benefit system will generally have both efficiency and distributional effects.

High marginal tax rates do not cause disincentives. High *net* marginal tax rates do. Raising benefits for rich families with children is exactly the same policy as cutting taxes for rich families with children. Both reduce the net marginal tax rate for such families, increase their incentive to earn income, and promote economic efficiency.

Tax revenue is not scarce! An increase in taxes, coupled with a corresponding increase in benefits, makes nobody worse off, and creates no disincentives. It is *net* tax revenue (taxes minus benefits) that is scarce, and positive net marginal tax rates that create disincentives and inefficiency. But just because net tax revenue *is* scarce does not mean any windfall increases in it should necessarily be spent reducing net taxes for the most needy. Any system of net taxes faces a trade-off between the twin goals of equity and efficiency. It would be equally valid to argue that "(net) tax revenue is scarce, and should therefore only be spent where it can most promote efficiency."

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Here is a short quiz, to illustrate what's wrong with the commonplace fallacy:

Suppose you are in sole charge of designing Canada's tax and benefit system. You know that high net marginal tax rates are good for redistributing income from rich to poor, but bad because they create disincentives. Carefully balancing the twin goals of efficiency and vertical equity, you decide exactly how much money to redistribute from rich to poor. But just before you announce your new tax/benefit system, you discover one extra dollar in the government's purse. When you redesign your tax/benefit system so as to spend this unexpected surplus, do you:

A) give the extra dollar to the poor?

B) give the extra dollar to the rich?

C) feel indifferent between A and B?

Final answer?

If you answered A, you are more left-wing than you think, or you have been fooled by the argument that "tax dollars are scarce, and therefore should only be spent on the most needy." If you answered B, you are more right-wing than you think, or you have been fooled by the argument that "tax dollars are scarce, and should therefore only be spent where they can most improve efficiency." In fact, the correct answer is C.

The reason is that since you designed the tax/benefit system yourself, you had already balanced the competing claims of rich and poor. You had already decided that the marginal benefit of disposable income of the rich, taking into account both equity and efficiency, was exactly equal to the marginal benefit of disposable income to the poor. If you had not decided this, you would already have planned to transfer either more or less money from one group to the other. So when an extra dollar suddenly appears in the budget, you find the marginal benefit of giving it to any one citizen/taxpayer to be the same as giving it to any other citizen/taxpayer. True, giving it to the poor would give them more utility from the additional consumption than would giving it to the rich. But giving it to the poor increases the net marginal tax rate, and weakens their incentive to earn income, while giving it to the rich does the opposite.

People to the left of you *would* want you to do A, because they want a more progressive tax/benefit system with higher net marginal tax rates than you do. They prefer to redistribute more money from rich to poor than you planned. But if you answer A yourself, you are being inconsistent. Similarly, people to the right of you would want you to do B, because they want a less progressive tax/benefit system with lower net marginal tax rates than you do. They want to redistribute less money from rich to poor than you planned. But if you answer B yourself, you are being inconsistent.

Universalists are in a quandary. We don't like the current tax/benefit system because it is not universal, but there are many ways to implement universality. A net-revenue-neutral way to do it that is also neutral in terms of the right-left debate over net marginal tax rates would be to increase net taxes on rich families without children, and reduce net taxes on rich families with children. The average net taxes for the rich (and the poor) would stay the same, and so would the net marginal tax rate, on average, but families with children would face lower net marginal tax rates, and families without children would face higher net marginal tax rates.

We could then leave left and right to fight it out over whether any government surplus should be used to cut net taxes only for the rich (with and without children), or only for the poor (with and without children). We could also leave the natalists (for want of a better word) and their opponents (anti-natalists?) to fight it out over whether any government surplus should be spent on reducing net taxes only for families with children (both rich and poor) or only on families without children (both rich and poor).

The higher is the existing net marginal tax rate, the greater the extra efficiency loss per dollar of net tax revenue raised, until at the top of the Laffer curve, an increase in the net marginal tax rate yields no extra net tax revenue, and the marginal cost of net public funds becomes infinite. Other things being equal (supply and demand elasticities, for instance), it then makes sense to reduce marginal net tax rates where they are high (as they are for families with children), and to raise them where they are low (as for families without children). The efficiency gains in the former case are bigger than the efficiency losses in the latter case, creating a net overall gain in efficiency. And, since rich families with children need more money than rich families without children, there is an equity gain as well.

Opposition to universality is based on the fallacious argument that "tax dollars are scarce, and should only be spend on the most needy." And this fallacy in turn is based on a false dichotomy between taxes and benefits. If we want to think clearly about reforming Canada's tax and benefit systems, we should stop talking about taxes and benefits separately. Net taxes are what we should be talking about.

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