

Carbon Tax Could Benefit Less Wealthy

Christopher Ragan
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Now that Stéphane Dion has announced that the Liberals are promoting a federal carbon tax, this crucial issue will finally be debated seriously in the public arena. Such a debate is long overdue.

There is no longer much scientific disagreement of the close connection between the emission of greenhouse gases and the inexorable rise in the earth's temperature. Nor is there much disagreement that the burning of fossil fuels is the primary culprit. An essential part of a market-based solution must therefore involve imposing a cost on those responsible for these emissions. The result would be a greater incentive to find ways either to reduce the burning of fossil fuels altogether or to continue burning them while preventing the toxic emissions from entering the atmosphere.

The Liberal plan is based on "tax shifting". Whereas the new tax would raise the price of fossil fuels and generate tax revenue for the feds, the Liberals would then reduce personal income taxes to return this extra revenue to Canadians. Though an individual's total after-tax income may be ultimately unchanged, there would be a clear incentive to reduce spending on fossil fuels.

More is probably needed in order to battle climate change, but the carbon tax would be an excellent start. It creates the right incentives to reduce fossil-fuel use while not increasing the government's tax take. Few economists doubt that such an idea has real merit; indeed, a carbon tax recently appeared at the top of a long list of policies in a fascinating priority-setting project published recently by the Institute for Research on Public Policy.

Yet there is considerable political opposition to a carbon tax in Canada. The Conservatives argue that the Liberals wouldn't really reduce taxes on personal income, and the result would just be another Liberal tax grab. They don't yet have a complaint regarding the policy itself—just the fact that they don't believe the Liberal promise.

The NDP's criticism is more substantive. Not surprisingly, the NDP claim to really care about low-income Canadians. As usual, however, their analysis is less compelling than their rhetoric. They make two main mistakes in their criticism of the proposed carbon tax.

First, they dislike the carbon tax because it would raise the prices for gasoline, heating oil, and many other things bought by ordinary Canadians. They favour instead a cap-and-trade system imposed on large industrial polluters. They appear not to understand that a cap-and-trade system, even if it applied only to large industrial firms, would nonetheless increase the prices of most products because firms would be required to purchase costly "emissions permits", thus increasing their costs. Some of these higher costs would clearly be passed on to consumers.

The NDP also argue that the Liberal carbon tax would be especially bad for low-income households because they spend a relatively large fraction of their monthly income on gasoline and heating oil. But they miss the crucial point that higher-income households spend more—in absolute terms—on carbon-based energy than do lower-income households. The richer we are, the more cars

we own, the more air travel we do, and the more oil or electricity we use to heat our larger homes. So a carbon tax which raises the prices of these products will collect more tax revenue from high-income households than from low-income households.

With the Liberal plan, however, personal income taxes would be reduced so that total government revenue is unchanged. Here is the neat part, at least for the low-income households. The easiest way to reduce personal income taxes across the board would be to increase the basic personal exemption by the same amount for all taxpayers. If this approach were taken, the tax reduction for low-income households would be larger than the amount they paid in higher carbon taxes.

For example, imagine three income groups—low, middle, and high—and suppose that the amount of carbon tax collected annually from the three groups is \$3000, \$6000, and \$9000, respectively. If there were equal numbers of taxpayers in each group, the government would then need to reduce income taxes by \$6000 for every taxpayer. The low-income households would clearly be better off while the middle-income group would see no change in their total after-tax income. Only the higher-income households would be worse off because their income-tax reduction would be insufficient to cover their higher carbon taxes. If the NDP really thought about the Liberal plan, they would be cheering!

The numbers above are just examples, but they illustrate an important idea. Some future Liberal government could come up with all kinds of ways to reduce personal income taxes after introducing a carbon tax, but it would be far too complicated to ensure that each taxpayer is left with exactly their initial level of after-tax income. Simple approximations and averages would have to be used. As a result, any method the Liberals choose would invariably redistribute income, as in the example above, and it is a very good bet that low-income households would end up the real winners. In addition to the environment, that is!

Christopher Ragan teaches economics at McGill University and is a co-director of *A Canadian Priorities Agenda: Policy Choices to Improve Economic and Social Well-Being*, recently published by the Institute for Research on Public Policy. Christopher.ragan@mcgill.ca.