For a book that has as one of its central themes the relatively esoteric calculation of net marginal effective tax rates on labour and capital, Jack Mintz’s recent contribution to the debate on Canada’s economic policy has achieved surprisingly wide recognition and comment. It has been frequently quoted and referred to; it was the runner-up for this year’s Donner prize for the best book on public policy; and it has been awarded the Purvis prize at the 2002 annual meeting of the Canadian Economics Association.

Of course, the book goes far beyond the calculation of marginal effective tax rates, to look at the effects of Canada’s tax system and government expenditures on our economy, and ultimately on the well-being of the Canadian public. Mintz then goes on to examine in critical detail government policies as an economic determinant of prosperity—not just through the tax system but through the mix of taxes and public expenditures. He concludes with strong recommendations for Canada to achieve a distinctive advantage through smarter spending, smarter taxes, and smarter debt management.

What distinguishes this book from other treatises that urge lower taxes, debt paydown, and less government intervention is that Mintz’s arguments are both more broadly focused, taking account of public benefits as well as costs, and solidly based on an analysis of the basic determinants of our prosperity (or the lack of it). The book stands out in its comprehensiveness and the strength of its research to support its conclusions.

Mintz begins with the familiar theme of the transformation of our economy—and our society—by the growing twin juggernauts of technological innovation and international trade and investment. The continuing decline in the costs of communications and transportation, together with the internationalization of markets in goods, services, and capital, drives countries into competition with one another to attract people, jobs, industries, and funds. Governments typically account for one-third
to one-half of the economies in developed countries, and it is the relative success of
governments in devising attractive packages of spending and taxes that will in good
part determine how well their own people will do in this competitive environment.
Mintz’s basic purpose in this book is to point out just how governments in Canada,
through their tax and spending policies, could in the future create a Canadian
advantage in this new economic order—and how poorly they have done in the
recent past.

Mintz recognizes that borders do matter in the sense that businesses and people
are still attracted to trade at home rather than in other markets. But these home-
ties are weakening as global economic integration gains further ground.

THE NEW ECONOMIC ORDER

The changes in world economies through technical innovation and its accompany-
ing internationalization have accentuated a trend to agglomeration—the gathering
of people and capital in increasingly large urban areas where close contacts offer
advantages in the supply of skilled labour, the transfer of goods and services, and
the flow of information. But as technology develops further, permitting, in par-
ticular, the rapid electronic transfer of information at greatly reduced costs, it also
becomes easier to diversify production across locations and to use a range of
smaller plants in geographically diverse regions. This is especially true in the new
“knowledge industries.” Mintz points out that these two trends—agglomeration
and diversification—are still present, but in both cases capital and technology are
more mobile than people.

THE COST OF DOING BUSINESS

Mintz weaves these basic trends into his examination of the cost of doing business
in Canada and the United States—which, he points out, is central to understanding
how a country’s public policies can affect the standard of living of its citizens. A
country’s competitive position is dependent on its comparative advantage and
productivity—in other words, on a broad definition of its relative cost of doing
business. (Mintz applies this broad approach to show how ill-conceived public tax
and spending policies—for example, encouraging cucumber growing in New-
foundland—can raise business costs through wasted spending and taxes.)

Mintz argues that, with the development of international markets and the
increased mobility of business, the economic costs of inefficient public expenditure
programs and distortionary and counterproductive taxation are becoming larger
and larger; in other words, the costs of making wrong choices are getting higher.
He concludes that governments in Canada must be sensitive to those realities that
limit our choices, or we will pay a high price in terms of employment and living
standards.

Mintz notes that being concerned with international competition does not
necessarily mean engaging in a race to the bottom, in order to achieve the lowest
tax rates and the smallest government spending. Rather, people, firms, and capital
will move to the jurisdiction that has the most desired mix of expenditure and tax policies—and low taxes by themselves, with poor government services, are not prized by most businesses or individuals.

**A SAD RECORD**

Canada’s economic performance relative to that of the United States—and, indeed, of a number of other industrialized countries—was dismal during the 1990s and even before. Real per capita disposable income (after tax and subsidies) actually declined in Canada while it was increasing in the United States, and a period of inevitable stringency in public spending (following years of bloated deficits) savaged some of our social programs. The next few years may be brighter for Canada as we emerge from the brief recession of 2001-2, but there is no clear evidence that our economy will grow fast enough to materially reduce the performance gap between Canada and the United States, or other countries—a performance gap that makes it more difficult for Canada to attract and retain capital and employment.

**INCOME INEQUALITY AND GROWTH: WHAT IS THE CAUSE AND WHAT THE EFFECT?**

Mintz’s book is laudable in that it explicitly addresses the issue of whether the forces of globalization and competitiveness will tend to increase income inequalities in Canada. A distinguishing and vaunted feature of Canada is that income in this country has been more evenly distributed than in the United States, especially on an after-tax, after-transfer basis. A number of arguments can be made that globalization will increase income inequalities. (For example, in developed countries, skilled trades may be well paid while the unskilled lose out because of competition from cheap labour in developing countries.) There are also counterarguments that income equality supports economic growth. (For example, equality of incomes allows more individuals to invest in training and thus enables society to get the maximum out of human capital.)

Mintz’s analysis shows that over a recent 26-year period, there has been no significant relationship between before-tax income inequality in Canada and economic growth. However, the numbers show a significant negative correlation between after-tax, after-transfer inequality and economic growth; in other words, the more growth we experienced, the less after-tax inequality we had. The issue is still open, but as Mintz aptly points out, there is no clear evidence that we can trade off lower growth for less income inequality, even if we want to. Indeed, the experience of the 1990s shows that low economic growth can make it difficult for governments to maintain, let alone increase, our prized social programs.

**WHAT DO WE SPEND OUR PUBLIC MONEY ON ANYWAY?**

There are many articles that compare Canadian and US taxes, but relatively little has been written on comparative government expenditures in the two countries.
Accordingly, the detailed comparison (covering all levels of governments) in *Most Favored Nation* makes fascinating reading.

Mintz notes that in the late 1960s, total government spending in Canada, relative to the size of our economy, was about the same as that in the United States. But by the mid-1990s, government spending in Canada was some 10 percentage points of gross domestic product (GDP) higher than that in the United States—a huge gap that has also been reflected in taxation levels in the two countries. The largest single part of the gap is explained by a faster growth in interest charges in Canada, as Canadian governments—federal and provincial—incurred horrendous deficits and piled up huge debt loads. The second major factor is that public social and health spending, combined, increased faster in Canada than in the United States—by about a net 2 percent of GDP, fuelled in good part by our relatively generous old age security and employment insurance programs. (Since differences in the level of public spending on health toward the end of the period are relatively small, Canada’s health-care system does not explain our higher levels of public expenditures. In fact, public health spending in the United States over the period was rising faster than that in Canada.) The rest of the difference in spending levels is spread among a variety of programs and objectives. For example, while spending on defence and security is much heavier in the United States than in Canada, Canada tends to spend more on community development, housing, and the environment. Public spending on education is slightly higher in Canada than in the United States, and it remained relatively stable over the period.

To summarize, at the end of a 30-year period from the mid-1960s to the mid-1990s, government expenditures grew by 10 percentage points of GDP more in Canada than in the United States, and only about one-fifth of that 10 percent represented higher spending on health and social services combined. On the basis of our social program spending, Canada is indeed a kinder, gentler society—but not by much, and not by nearly enough to explain the huge imbalance over the period in the increase in government spending in Canada relative to the United States. Specifically, the growth in Canada’s spending over the period was not concentrated on education or infrastructure, which could have improved our productivity, or even on social programs. Rather, the bulk of our higher spending was directed to paying interest on our burgeoning debt, resulting from our governments’ past mismanagement of public finances, and to a wide variety of miscellaneous government programs, many of which did not help our productivity or even our social goals.

**AND NOW TO TAXES: WE KNOW WE PAY MORE!**

Aggregate government revenues—which naturally track to a degree aggregate government expenditures—show that the ratio of public revenues to GDP was very similar for Canada and the United States in the 1960s but that Canadian levies have since pulled steadily ahead of those in the United States. But while Canadian public revenues rose to 9 percent or so of GDP higher than those in the United States (and above the corresponding figures for Japan and even the United Kingdom), they are less than the corresponding figures for many other major developed
countries. In the OECD, Canada is at about the middle of the pack in terms of government revenues in relation to the size of the economy.

While Mintz cites these figures, his comparisons are almost exclusively with the United States. Because of the huge volume of cross-border trade and investment between the two countries, the United States does of course dominate our economy and our perceptions. But it would have been useful if the book had included some comparative analysis between Canada and other countries that have even higher levels of government spending and taxes, especially since some of these countries have reasonable records of economic performance. Of course, Mintz does recognize that it is the net balance of the benefits from government spending and the negative effects of taxes that influences the economy.

Perhaps the real tragedy of government policies in Canada over the last 30 years has been not the dramatic increase in government spending and taxation, but the fact that we have gotten so little—in either economic or social terms—from our efforts.

**IMPACT OF GOVERNMENT ON BUSINESS COSTS**

The technical heart of the book is the measurement of the impact of governments—through both taxes and subsidies—on the costs of production. Mintz adopts an innovative formula for calculating an effective excise tax rate on the costs of marginal production in Canada and the United States: if the effective net tax rate is, say, 10 percent, taxes of all kinds, net of government subsidies and assistance, add 10 percent to the cost of production. The methodology goes beyond the usual calculation of the effects of corporate income tax and other taxes on production costs, by including estimates of the effects of all taxes, net of government assistance and subsidies, on costs. Hence, it is a much more comprehensive calculation, which weighs both sides of the tax and benefit system.

The model, generally based on data for 2000, distinguishes between taxes and subsidies that affect labour costs and those that affect capital costs. Labour and capital are the two primary inputs used to produce value added in the production process.

For the computation of labour costs, which are about three-quarters of industrial value added, Mintz includes not just payroll taxes, but personal income taxes as well as consumption and sales taxes. The tax component is then reduced by subsidies for education, health, and social security, all of which can affect the supply of labour. For the calculation of capital costs, corporate income and capital taxes and sales taxes on equipment are all included in the tax figure, which is then reduced by such items as public spending on infrastructure and on research and development.

As Mintz notes, the approach he adopts does involve some uncertainties and caveats. For example, it is not always clear whether certain taxes and benefits involving labour are actually borne by or accrue to labour, or whether they are shifted forward to business as part of production costs. (Mintz provides alternative calculations on this point.) However, overall the comprehensiveness of the approach—measuring all of the effects of government tax and benefit programs—
makes it more sophisticated and useful than other ways of calculating the cost burden.

**CANADA-US COMPARISONS**

In a detailed comparison of labour costs in Canada and the United States, Mintz notes that Canadian income tax rates are significantly above US rates. Payroll-type taxes, overall, and sales taxes are also higher in Canada. In terms of benefits, the comprehensive health-care plan in Canada—despite its creaking nature—is a major advantage compared with public health services in the United States, and public support for education is also more generous in Canada (as a percentage of GDP). Overall, the calculations show that net taxes and benefits, calculated as a percentage of net-of-tax earnings, are substantially less favourable in Canada than in the United States: even taking education and health subsidies into account, the net effective tax rate on labour is 59 percent in Canada, as opposed to 43 percent in the United States. The conclusion is that despite some more generous social programs, the overall impact of governments on labour costs is very much less favourable in Canada.

A similar comparison of the cost of capital in the two countries—again for 2000—shows that Canadian corporate income and capital tax rates are significantly above those in the United States, although they are slightly offset by higher infrastructure and research support. Overall, the calculations show an effective tax rate on capital in Canada of 27 percent, as opposed to 19 percent in the United States. Cross-border comparisons by industry sector show that the Canadian disadvantage runs across all industries but is particularly large in the service sectors.

Mintz notes that while Canada has a moderately more generous program of public support for research than the United States, aggregate private research spending in the United States is markedly above that in Canada. He concludes that the reason is that high effective tax rates reduce the incentive to adopt innovations in Canada, thereby in effect reducing the demand for research.

**ADVANTAGE—THE UNITED STATES**

Putting it all together, Mintz presents overall effective tax rates, net of subsidies, for Canada and the United States, broken down into main industry sectors. His calculations show that for both countries, effective tax burdens vary substantially by industry, with the resource sector being favour ed. For both countries, these perverse variations in effective rates across industry sectors reduce productivity.

In the traditional two-handed manner of economists, Mintz presents a range of results, depending on the assumption made regarding the incidence of net taxes on labour—are labour taxes shifted forward as a cost to business or backward as a reduction of labour income? (The latter assumption naturally produces larger net business tax costs, and a larger difference in those costs between Canada and the United States, than the former: however, the former assumption implies that labour earnings in Canada take a big hit because of the backward shifting.)
Regardless of the assumption used, Mintz concludes that Canada’s higher subsidies and benefits in some areas are not enough to offset higher net taxes generally, and that the cost of doing business in Canada has been increased because of government taxes and programs by far more than in the United States. The latter conclusion is not surprising, given that a large part of higher government spending in Canada is directed to non-productive purposes (such as payment of interest on the public debt, regional industry subsidies, and employment insurance). Of course, the exchange rate between the US and Canadian dollars is also relevant to competitiveness, but Mintz notes that it is the level of costs and productivity that determines the exchange rate, not the other way around.

Both the Canadian federal and provincial governments are committed to significant corporate and personal tax reductions in the years to 2005, and the United States also has some personal tax cuts scheduled for this period. Mintz reran his calculations to reflect these anticipated lower tax rates for 2005. The calculations show that, with the tax cuts, the difference in net costs between Canada and the United States would narrow but would still remain substantial. In other words, Canada’s projected tax reductions, including a major corporate tax decrease, would still leave Canadian business at a significant disadvantage.

CAN WE ACHIEVE A CANADIAN ADVANTAGE?

Mintz, as well as many other commentators, argues that Canada’s policies should reflect the growing globalization and competition that confronts all countries. But Mintz is more articulate than most in urging that we create a distinct Canadian advantage through innovative government policies, rather than simply copying others or adopting a laissez-faire position. Governments in Canada—Mintz is careful not to single out either federal or provincial governments—are creating disadvantages through inefficient public expenditures and high taxes that compromise comparative advantage, productivity, competitiveness, and standards of living.

Before outlining a detailed agenda for change, Mintz discusses the question of how much government Canada needs. There are some excellent insights in this section, and certainly it is not a polemic in favour of smaller governments at any cost. After reviewing the rationale for government intervention and spending, Mintz points out the dangers that flow from government intervention, including the fact that the costs associated with even successful social programs must be met from taxes that themselves have a cost in terms of work, savings, and investment. There is no free lunch. Mintz also makes the valid point that demographics—an aging population—could push us toward a public sector deficit of over 9 percent of GDP within 50 years without any new government spending programs. We therefore need to be careful that we do not put our programs and finances in a non-sustainable position. (The United States will face the same demographic issues, but their effect will be perhaps half that anticipated in Canada.) Mintz does not deal as fully as he might have with the non-economic reasons that can support new spending, or with the inevitable task of making tradeoffs.
A STRATEGY FOR THE FUTURE

Mintz argues convincingly that one of the best ways to shrink tax burdens and prepare for the coming demographic crunch is to reduce present public debt levels. Cutting government interest expense—which is currently almost 9 percent of GDP—would allow us, in the long run, to painlessly cut taxes or offset future spending hikes attributable to the aging population. But it would carry the cost of some near-term restraint in order to achieve surpluses that would be allocated to paying down debt.

Mintz argues, however, that just paying down debt would not be enough to create a distinctive Canadian advantage, an advantage that would enable us to catch up with and surpass the United States and other countries in terms of living standards and opportunities. Rather, Mintz urges Canada to become a centre for enterprise, with distinctively Canadian policies. Copying the United States will not allow us to overcome the natural advantages, such as size, that that country possesses. For Canada to develop a unique advantage, Mintz suggests four imperatives:

1. Grow our labour force and its skills, with a concentration on education, training, and related social policies.
2. Improve productivity, in part by building capital investment.
3. Encourage innovation, with public policies that support technology and research.
4. Encourage savings and investment.

To achieve these strategic goals, Mintz puts forward a package of reforms based on smart spending, smart debt finance, and smart taxes.

Smart Spending

Increasing the effectiveness and efficiency of public programs would require considerable discipline and restraint, and a concentration on outcomes instead of inputs.

With respect to education, Mintz notes that Canada already spends a very respectable amount by international standards but perhaps without outstanding results. Further, the demand for graduates depends not only on their having the right skills, but also on having firms that have the productivity and capital to make use of these skills. Mintz recommends changes to increase the flexibility and adaptability of the education system, changing funding to base part of it on outcomes and moving more control to students. More competition for students would induce positive changes in the system, but charging tuition for primary and secondary education, as Mintz suggests, is not an idea that will—or should—be greeted with enthusiasm. Overall, however, Mintz is correct in seeking to break down the power and inertia of the existing systems and to provide more relevant education.

With regard to health care, Mintz would again concentrate on effectiveness. As compared with other countries, we already spend a relatively large amount of
public funds on health. But our system is fragmented and under strain; it lacks accountability, and information systems are weak. Some changes, such as regional health authorities, are being experimented with. Others, such as allowing private firms to provide covered services, should be introduced.

Mintz argues that more patient control, and more accountability within the health-care system, including some partial patient responsibility for health costs (but not to exceed a very modest proportion of income), would both improve the system and help to restrain demand and control costs. The issue of requiring patient contributions (“co-payments”) for even a modest level of health costs is controversial in Canada, even though the health-care systems of most other countries incorporate some patient responsibility for costs. But technology and demographic changes are driving up health costs faster than GDP, resulting in huge strains on government budgets. The system clearly requires a new look at the management of health costs, with better information systems, managed care schemes, and integrated approaches based on health outcomes.

With respect to social assistance programs too, Mintz argues for better management, and for benefits that are structured to provide support to those who need it, while still leaving them with an incentive to improve their circumstances. The present employment insurance system is an example of an unjustified subsidy to some workers and employers, and it can induce a state of almost permanent dependency. A properly managed insurance program would match employer premiums to employment experience or risk. Social welfare systems might be modified to provide some in-kind assistance (training, housing, etc.) in partial substitution for cash. As Mintz points out, the dark side of targeted social payments shows up in our tax system, where the clawback of benefits provided to low-income families can result in effective tax rates of 75 percent to over 100 percent for additional earnings or the return on savings. We pay a lot to subsidize the poor, but we tend to favour systems that keep them poor.

Smart Debt Policy

Total public debt in Canada (federal, provincial, and municipal) now runs about $800 billion. This figure does not include additional hidden liabilities for unfunded old age security, health care, and other liabilities. To cope with the burden that an aging population will place on us in the future, as well as to reduce present debt service costs, Mintz argues that we should be more active in paying down the public debt. He is not as clear in explaining how this policy might be justified to the public.

Smart Tax Policy

Most Favoured Nation questions the accepted wisdom of the Carter report\(^2\) that a broad definition of income is the suitable base for a comprehensive and progressive personal income tax. Instead, Mintz argues that our prime revenue source should be based on consumption, not income. He believes that consumption is a better tax
base than income because it does not contain a bias against savings (whereas an income tax is levied twice—first on the income from which savings are made, and then on the income from those savings). Further, in a world of increasing mobility, almost all countries are finding it more and more difficult to tax the income from capital; a few do not even try. Even in Canada, which has the illusion of a comprehensive tax base, most income from capital either is not currently taxed (because it is earned in tax-exempt entities such as pension funds) or is subject to favourable treatment (for example, as capital gains). In a period of declining savings and a perceived shortage of investment funds, there are powerful arguments for shifting our tax system toward a consumption base.

The conversion of our income tax into a consumption tax could be accomplished through the expansion of deductions for registered retirement savings plans and similar savings shelters, and through new tax-deferral schemes. It would also be assisted by new plans with non-deductible contributions and an exemption for income earned on the invested funds. Mintz points out that if the personal income tax were converted into a pure consumption tax, there would have to be a major reform of the corporate tax (and likely the introduction of some interesting new tax-avoidance rules in addition). But unfortunately, he does not describe how such a conversion could be carried out, and we are left to wonder how we get from here to there.

Mintz also raises some questions about the progressivity of the present personal tax system, pointing out that high marginal tax rates on upper-bracket individuals can harm work and investment incentives. He also notes that high progressivity is in effect a tax on education and training.

Overall, Mintz settles on four basic reforms of our tax system that would give Canada a distinct competitive edge:

1. Convert the present personal income tax into a consumption or expenditure tax.
2. Implement a dual-rate progressive tax on expenditures, presumably with a progressive rate structure for labour income and a lower tax rate on capital income (dividends, interest, capital gains, etc.).
3. Increase reliance on taxes that have less effect on competitiveness, such as payroll, property, and excise taxes, which tend to fall on immobile bases.
4. Increase user-pay levies, including some environmental taxes.

GOOD COMMUNICATION ON A TOUGH TOPIC?

Mintz’s book is a very good effort at communicating, in relatively simple and clear terms, the central issue of public priorities in a world swept by rapid changes in technology and internationalism. The book is intended to address a reasonably broad readership, and it tries to set out some of its main issues in clear and understandable terms. (An example is Mintz’s explanation of Ricardian relative advantage in trade.) Mintz is also meticulous in building his arguments on logical processes from observed facts, and not simply leaping to conclusions.
But the book is not always user-friendly. For example, the explanation of alternative business taxes suggested, and of the dual-rate personal tax, is lacking in clarity. A chart in the middle of the text that refers—without further explanation—to “Causality test (Granger), F-test values” will leave all but economists scratching their heads. And while some of the aspects of the calculation of business costs were put in an appendix, even more could have been usefully removed from the main discussion.

Possibly a more telling criticism is the less than full attention given to social and other non-economic issues. Mintz does mention a number of these—such as income inequality—but perhaps does not fully drive issues home for those who tend to think in non-economic terms. For example, he might have made more of the fact that countries that lag in growth and prosperity must in the end also lag in terms of social programs, because they will lack the means (and likely the will) to respond to the need for improvements in social policies. Canada sets a high value on its social policies, including its public support of education. But even though we spend a higher proportion of our GDP on education than does the United States, that country now spends more public funds per pupil on education than we do, because the incomes of its citizens, and therefore its GDP per capita, are so much higher.

Mintz has also not given sufficient attention to the difficulties of explaining these issues to the broad public and motivating the necessary change. A number of his recommendations will face some opposition. How can the process of moving to better policy outcomes be encouraged, and how can a constituency for change be built? What are the second-best or transitional alternatives that can still work toward better outcomes for Canadians? In a democratic society, there will always be a split between those who favour lower taxes and less government intervention, and those who want more social spending. But both have a long-term common cause in supporting more efficient government spending and less distorting taxes.

Some years ago, The Economist magazine ran a cover story on “The Puzzling Failure of Economics.” The chief complaint was really with economists. While the magazine considered that most of them were reasonably good at their work, it thought them terrible at communicating the results of that work to the public in a way that could be understood, and that would influence the public’s perception of current policy issues. As a result, the public was left to decide major questions of priorities and policies without a full understanding of the matter.

Mintz has obviously tried to respond to this criticism with a clear and well-argued review of some central public policy issues. The book is based on a first-rate assessment of the facts and is excellent and recommended reading for those who have an interest in a broad range of policy questions facing Canada today.

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