Critical Limits to Taxation

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PRÉCIS

Les hausses considérables dans les dépenses gouvernementales au Canada, au cours des dernières quarante années, ont nécessité des augmentations importantes en matières d'impôts. En effet, les revenus gouvernementaux, en termes de pourcentage du produit intérieur brut, sont passés de 24 pour cent en 1950 à près de 43 pour cent en 1990. Durant cette même période les impôts sur le revenu des particuliers sont passés de 6 pour cent du revenu personnel à 22 pour cent. Certaines tendances semblent toutefois indiquer que la tolérance des contribuables envers les augmentations d'impôts est sur le point de s'épuiser. Même s'il n'est pas possible de déterminer empiriquement quelle est la limite supérieure pour les impôts, certains événements récents laissent présager que toute tentative d'augmenter les impôts de façon significative ne seraient pas viable que ce soit sur le plan économique ou politique. Parmi ces événements on note une opposition plus ouverte envers les impôts, une succession de déficits budgétaires élevés, des réductions des dépenses gouvernementales pour les services essentiels comme les soins de santé et l'éducation, des limites aux dépenses imposées par voie législative, et un recours de plus en plus grand aux frais payables par les usagers et à des sources de recettes non fiscales inaccoutumées comme les jeux de hasard. Une analyse de ces faits suggère que le Canada approche la limite critique de l'imposition, et qu'il est même possible que cette limite soit déjà atteinte.

ABSTRACT

Rising government expenditures in Canada over the past 40 years have necessitated important tax increases. As a result, government revenues as a percentage of gross domestic product increased from 24 percent in 1950 to almost 43 percent by 1990. In the same period, direct personal taxes rose from 6 percent of personal income to 22 percent. There are signs, however, that taxpayers' tolerance of tax increases is nearing exhaustion. Although a statistical upper limit to taxation cannot be determined, certain recent events may be interpreted as indicators that further significant tax increases would not be viable either economically or politically. These events include more open opposition to taxes expressed in a variety of forms; successive large budgetary deficits; government cutbacks in such essential services as health and education; legislation-mandated expenditure limits; and an increasing reliance on user charges and unconventional non-tax revenue sources such as gambling. An analysis of these developments suggests that Canada is approaching, or perhaps has already reached, a critical limit to taxation.

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INTRODUCTION

Public opposition to high, unjust, or oppressive taxes is as old as taxation itself. Few would deny that there exist limits to taxation. The limits may be reflected in alleged adverse effects on the economy, political repercussions, and public hostility or open revolts as taxes approach or exceed the tolerance level of taxpayers.

In the taxation literature, considerable attention has been devoted to studies on the shifting and incidence of various taxes and to the effects of taxes on the economy. Of particular interest have been the effects on incentives to work, invest, and save, and the effects on prices, consumption, productivity, efficiency, and economic growth. Keynesian economics assigned taxes a significant role in economic stabilization policy; higher taxes, it was argued, dampened aggregate demand and lower taxes stimulated economic activity. Later came supply-side economics, which emphasized lower taxes as a means of stimulating productivity and output. The Laffer hypothesis, a component of supply-side theory, contended that raising taxes would eventually reduce, not increase, revenue yield; it was hypothesized that high tax rates would reduce incentives, productivity, efficiency, and output and result in lower incomes and profits, and would therefore yield less tax revenue. And in 1945 Colin Clark attempted to develop a general theory that defined a statistical, critical limit to taxation that could be universally applied. Clark's theory, however, was badly flawed both theoretically and statistically and was very quickly dismissed by economists of the day.[1]

In addition to the economic effects of taxes, there are also social and political considerations that legislators take into account when imposing taxes and tax rates. It appears that there exists an inherent public hostility to taxes that becomes more open in periods of rising tax burdens. This mounting hostility is manifested in a variety of forms, including public discontent with governments. Feedback through by-elections, public opinion polls, and the media causes governments to reflect on this discontent and to contemplate alternative courses of action that could either reduce taxes or at least check their upward spiralling. Such political behaviour has to a degree been explored in public choice theories, which examine gov-

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[1] Clark theorized that inflationary pressures would begin to build when the tax burden exceeded 25 percent of national income. At this level of taxation, governments would be less reluctant to accept inflationary means of finance; work incentives and employers' resistance to wage demands would weaken; and the combination of these forces would produce rising prices that could only be brought under control by a reduction in taxes. Clark used some selective countries to try statistically to prove his hypothesis. It was shown, however, that although inflationary forces developed in some countries when taxation reached 25 percent of national income, in a number of other countries inflation did not occur even when the tax burden was well in excess of 25 percent. See Colin Clark, "Public Finance and Changes in the Value of Money" (December 1945), 55 *The Economic Journal* 371-89; Joseph A. Pechman and Thomas Mayer, "Mr. Colin Clark on the Limits of Taxation" (August 1952), 34 *Review of Economics and Statistics* 232-42; and Dan Throop Smith, "Note on Inflationary Consequences of High Taxation" (August 1952), 34 *Review of Economics and Statistics* 243-47.

ernment decision making in terms of voter gain or voter loss potential.[2] Tax increases represent a potential loss of votes in government elections, whereas expenditure programs that yield public benefits represent a potential gain in votes. It is difficult, however, to analyze decision making in terms of voter gain and loss, because it is difficult to measure the benefits and burdens of expenditures and taxes. It has been contended, furthermore, that voters operate in a climate of ignorance of benefits and burdens. Nevertheless, they appear to be more knowledgeable about taxes than they are about government spending programs and the corresponding benefits.[3] Tax burdens are current and fairly obvious, while to many people the benefits of programs are remote and uncertain. To the extent that this is the public attitude, governments are more likely to perceive a greater gain in votes through tax reductions than through expenditure increases, or through expenditure restraint and constant taxes than through expanded spending programs with matching tax increases. Such perceptions are likely to prevail in periods when tax burdens are already deemed to be high relative to earlier periods.

Limits to taxation may vary from country to country, from period to period, and may vary with social and economic conditions. For example, the Canadian public accepted the imposition of the new federal personal and corporation income taxes during World War I, and the imposition of relatively very high tax levels during World War II, because it recognized the demands imposed by these national emergencies. With the end of the hostilities, the burdens were eased. In normal periods, a process of gradual tax increases over time is likely to be more acceptable (as taxpayers become accustomed to the slowly increasing tax burden) than a sudden, major hike in tax rates. As Peacock and Wiseman theorized,[4] taxpayers over time build new tolerance levels to taxation. A point may be reached, however, when their tolerance is exhausted.

TRENDS IN TAXATION

Some trends in taxation in Canada are illustrated in the accompanying tables. Table 1 shows the increase from 1950 to 1990 of direct personal taxes as a percentage of personal income. Taxes increased from 6.4 to 9.3

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[2] The classic works in public choice theory include Anthony Downs, *An Economic Theory of Democracy* (New York: Harper and Row, 1957), and J.M. Buchanan and G. Tullock, *The Calculus of Consent* (Ann Arbor, Mich.: University of Michigan Press, 1962). Public choice theory provided the basis for later attempts to develop a positive theory of taxation that would explain the influences on governments in their decisions on taxes and tax systems. See, for example, Walter Hettich and Stanley L. Winer, "Economic and Political Foundations of Tax Structure" (September 1988), 78 *The American Economic Review* 701-12; and W. Irwin Gillespie, *Tax, Borrow, and Spend: Financing Federal Spending in Canada, 1867-1990* (Ottawa: Carleton University Press, 1991), chapter 2.

[3] John G. Cullis and Philip R. Jones, "Fiscal Illusion and 'Excessive' Budgets: Some Indirect Evidence" (April 1987), 15 *Public Finance Quarterly* 219-28.

[4] Alan T. Peacock and Jack Wiseman, *The Growth of Public Expenditure in the United Kingdom* (Princeton, NJ: Princeton University Press, 1961).

percent in the 1950s, and increased to 16.9 percent during the 1960s. The rate stabilized during the 1970s at between 17 and 18 percent, and then gradually began to rise during the 1980s. A similar trend is illustrated in table 2 for personal taxes and total revenues as a percentage of gross domestic product (GDP). Indirect tax revenue (from sales and excise taxes) has remained relatively constant as a percentage of GDP, while corporation tax revenue has steadily declined.

Table 3 illustrates the burden of the federal personal income tax in terms of effective tax rates (taxes paid as a percentage of total income) for income groups in 1979 and 1989. The effective tax rates for income groups

Table 1 Personal Taxes as a Percentage of Personal Income, Canada, Selected Years 1950 to 1990

Year	Personal income	Direct personal taxes	Direct personal taxes as % of personal income
	millions of dollars		*percent*
1950	14,388	915	6.4
1960	29,883	2,794	9.3
1970	68,222	11,547	16.9
1975	138,578	24,138	17.4
1980	248,890	42,803	17.2
1985	400,199	75,115	18.8
1988	506,589	107,134	21.1
1989	548,989	112,608	20.5
1990	590,168	131,982	22.4

Source: Canada, Department of Finance, *Quarterly Economic Review: Annual Reference Tables, June 1991* (Ottawa: the department, 1991), 23 and 88.

Table 2 Taxes as a Percentage of Gross Domestic Product, Canada, Selected Years 1950 to 1990

Year	Tax			Total revenues[a]
	Personal	Corporation	Indirect	
		percent		
1950	4.8	5.2	11.1	24.2
1960	7.1	4.0	12.4	27.1
1970	13.0	3.4	13.4	35.7
1975	14.1	4.4	12.4	37.4
1980	13.8	3.9	11.5	37.5
1985	15.7	3.3	12.3	40.0
1988	17.7	2.8	13.0	41.3
1989	17.3	2.7	13.2	41.2
1990	19.7	2.4	12.9	42.7

[a]Includes all tax revenue, Canada and Quebec pension plan contributions, and investment income.

Source: Same as table 1, at 17 and 88.

Table 3 Effective Federal Personal Income Tax Rates By Income Group, Monetary Income 1979 and 1989

Income group	1979 Average income for group	1979 Effective tax rate[a] (A)	1989 Average income for group	1989 Effective tax rate[a] (B)	Difference in tax rates (B − A)
	dollars	*percent*	*dollars*	*percent*	*percent*
9,500–10,000	9,746	5.37	9,747	3.52	−1.85
19,500–20,000	19,757	10.56	19,749	9.22	−1.34
29,000–30,000	29,488	12.69	29,495	11.16	−1.53
30,000–40,000	33,916	13.38	34,615	12.75	−0.63
40,000–50,000	44,247	14.47	44,517	14.91	0.44
50,000–100,000	65,367	16.53	63,397	16.84	0.31
100,000–200,000	129,607	19.59	132,518	19.34	−0.25
200,000 +	361,982	20.33	454,618	23.31	2.98

[a]Effective tax rates on total reported income for the tax year.

Sources: Revenue Canada, Taxation, *Taxation Statistics*, 1981 ed. (Ottawa: Supply and Services, 1981), 30 and *Taxation Statistics*, 1991 ed. (Ottawa: Supply and Services, 1991), 82.

between $30,000 and $200,000 in these two years do not significantly differ, which suggests that the personal income tax burden on these income groups did not change over the 1980s. Only at the lower and the highest income levels is the change in the tax burden noteworthy; the burden fell for the lower income groups by between 1.34 and 1.85 percent of income, and rose by 2.98 percent of income at income levels in excess of $200,000.

If income is viewed in real terms, however, the picture changes. In table 4 the average income for each group in 1989 is deflated by the consumer price index to obtain real income in 1979 dollars. The 1979 effective tax rate is then applied to these levels of real income. The results show that all income groups experienced an increase in tax burden, with the largest increases falling on the very low and the middle income groups. For example, taxpayers with 1989 income of $9,747 paid an effective tax rate of 3.52 percent in 1989. However, this income is valued at only $5,215 in 1979 dollars, and in 1979 a taxpayer with income of $5,215 paid only 0.41 percent in tax. There is, then, a difference of 3.11 percent of income. Similarly, a taxpayer with 1989 income of $44,517 paid an effective tax rate of 14.91 percent, but in 1979 dollars this income would be valued at $23,820 and taxed at a rate of 11.46 percent, which represents a difference of 3.45 percent of income. Therefore, although the effective tax rates on money income for 1979 and 1989 suggest that there has been a reduction in tax burden for lower income groups and little change in tax burden for middle income groups, there does exist a disguised tax burden increase for these groups when income is viewed in real terms. Taxpayers have experienced a decline in real after-tax purchasing power over this period.

In recent years, in both Canada and the United States, there have been a number of developments that may be interpreted as signals or indicators that society may be approaching a maximum or critical limit to the burden of taxation. These signals include: (1) social discontent and tax revolts, (2) continuous deficit financing, (3) legislated attempts to control government spending, (4) funding ceilings and cutbacks in essential social services, (5) increasing reliance on non-tax revenue sources, and (6) pressure for international tax harmonization. An analysis of each of these developments, with the focus on Canada, suggests that taxpayers are approaching a critical limit of tolerance for taxation.

SOCIAL DISCONTENT AND TAX REVOLTS

In recent years, the public has become increasingly vocal and active in its opposition to perceived high tax burdens. The United States experienced a wave of protests, known as tax revolts, that took the form of tax-limitation ballots in state elections. The protests began in California in 1978 with proposition 13, and rapidly spread to other states. Proposition 13 was a citizen tax initiative that placed on the California election ballot a proposal to reduce property taxes by 57 percent (which represented a reduction of 21 percent in total municipal revenues), and to limit future increases in

Table 4 Effective Federal Personal Income Taxes on 1989 Money and Real Income

1989				
Average income for group[a]	Effective tax rate (A)	Average 1989 real income for group (1979 dollars)[b] (B)	Effective 1979 tax rates applied to (B)[c] (C)	Difference in tax rates (A − C)
dollars	*percent*	*dollars*	*percent*	*percent*
9,747	3.52	5,215	0.41	3.11
19,749	9.22	10,567	6.38	2.84
29,495	11.16	15,782	9.17	1.99
34,615	12.75	18,522	10.26	2.49
44,517	14.91	23,820	11.46	3.45
63,397	16.84	33,923	13.38	3.46
132,518	19.34	70,909	16.53	2.81
454,618	23.31	243,260	20.33	2.98

[a]Income groups to which these averages apply are shown in table 3. [b]Average 1989 income for each income group is deflated by the consumer price index (1986 = 100). [c]Effective tax rates for each income group in 1979 are applied to the average 1989 real income for each group.

Sources: Revenue Canada, Taxation, *Taxation Statistics*, 1981 ed. (Ottawa: Supply and Services, 1981); Canada, Department of Finance, *Quarterly Economic Review: Annual Reference Table, June 1991* (Ottawa: the department, 1991), 80, and table 3.

local taxes to 2 percent per year.[5] Ignoring warnings by state officials of school closures and reductions in police protection and other vital services, the voters of California passed the proposal by a margin of two to one. Proposition 13 and other citizens' initiatives aimed either at rolling back taxes or at placing limits on future increases arose in response to rapidly rising state and local taxes. During the 10-year period preceding 1978, taxes paid per capita had increased 144 percent while personal income per capita had increased 125 percent. The tax cuts won through the initiatives produced a respite from rising tax burdens in the early 1980s, but by the early 1990s taxes were on the rise again. Federal tax revenue increased from 19 percent of gross national product in 1983 to 21 percent by 1990, while state and local taxes rose from 9.5 percent to over 11 percent. These recent tax increases spurred a renewed drive to roll back tax increases by ballot in 1990 and again in 1992.

In the late 1980s in Great Britain, the Conservative government of Prime Minister Thatcher replaced the general property tax with a poll tax. The rationale for the move appeared sound. The government viewed the change as a means of more closely relating taxation burdens to expenditure benefits. Under the system of property taxation, the burden of the tax fell on property owners. Benefits from expenditures, however, were much more universal in the form of various social programs. Non-property owners tended to support proposals for increased social programs because they received benefits without shouldering the burdens. The poll tax was a flat tax on everyone and, it was believed, would tend to instill in voters a greater consciousness of the costs of government programs. The poll tax proved, however, to be a social and political disaster.[6] The majority of the public was incensed at the thought that a multimillionaire would be subjected to the same flat tax as a low-income family. Non-property owners who had not been subjected to the property tax now found themselves taxed without any reference to wealth or income. In switching to the poll tax, the government had apparently stepped outside the bounds of public tolerance; that people rioted in the streets demonstrates as much. It is contended that the tax was a major factor in the replacement of Prime Minister Thatcher in the Conservative government, with the new leadership pledging a review of the tax.

In Canada, where there are no opportunities for citizen-initiated proposals on election ballots, social discontent over tax changes and tax burdens may be expressed in a variety of ways. This was seen with the

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[5] Roger S. Smith has argued that the property tax in Canada has tended to have a "reasonably good image" compared with its image in the United States and Britain because of "basic differences between the property tax scene in Canada and the situations in the United Kingdom and the United States." He concedes, however, that "these differences do not eliminate the possibility of a property tax revolt in Canada." Roger S. Smith, "Why the Canadian Property Tax(payer) Is Not Revolting" (1990), vol. 38, no. 2 *Canadian Tax Journal* 298-327, at 313.

[6] Peter Smith, "Lessons from the British Poll Tax Disaster" (December 1991), 44 *National Tax Journal* 421-36.

introduction of the goods and services tax (GST) in January 1991. The GST replaced the manufacturers' sales tax (MST), which was essentially a commodity tax on the manufacturers' selling price that was expected to be shifted to consumers. The MST was a hidden tax and many consumers most likely did not realize which commodities were taxed. The GST extended the sales tax to include a wider range of commodities and to include services, and because it used the retail price as the base, it was very visible. As a value-added tax, the GST was superior to the MST in terms of both economic and administrative efficiency. The government maintained that at the outset, at least, the GST would be revenue-neutral—that is, it would not yield more revenue than the MST had. Large segments of consumers and business, however, did not view the GST as the government did. Many viewed it as a major tax grab through increased prices, and strongly opposed the application of a sales tax to goods and services that had previously been exempt. On each taxed item purchased, they saw 7 percent added to the price.

It is unlikely that the federal government foresaw how unpopular the GST would become or anticipated the opposition that would be organized against it. Tax reform in 1988 had produced significant changes in the personal and corporation income taxes, with the personal income tax changes being expected to result in a lower tax bill for all taxpayers. Although the intention to change the sales tax was announced in 1988, the change was not introduced until 1990 and not implemented until January 1991. Perhaps if the government had implemented the GST when it changed the personal income tax and had shown that the entire package represented a tax reduction, or at least no tax increase, for the majority of taxpayers, the GST may have been better received.

Despite the decline in some prices due to the removal of the 13.5 percent MST, the prices of previously untaxed goods and services rose—in some cases, by more than the amount of the GST. In addition to voicing loud complaints, the public protested in other ways.[7] It has been contended that the GST has contributed to increased consumer shopping in the United States in border areas where consumers seek cheaper-priced goods despite having to pay the GST on their importation into Canada. It has also been contended, with instances reported in the media (although this is not statistically verifiable), that the GST has fueled an underground economy, particularly for home services and repairs, in which cash without the GST is substituted for standard billing procedures. More recently, the open hostility to taxation in general has begun to manifest itself in signs that voters

[7] In September 1990, the governing council of the village of Elstow, Saskatchewan, held a referendum for its residents on the proposed federal GST. The results showed that Elstow was overwhelmingly opposed to the GST. The village residents hoped that their action would trigger similar referenda in neighbouring municipalities and begin a chain reaction across Canada to put pressure on the government to withdraw the GST. The Elstow council threatened to declare the village a GST-free zone, but adhered to the legal tax obligations following the introduction of the tax.

are shifting away from supporting spending-inclined politicians to those who favour greater fiscal responsibility.[8]

Contributing to the social discontentment with high tax burdens are the taxpayers' perceptions that they are paying more and receiving less[9] and that governments are wasteful and inefficient. A number of surveys have indicated that a large proportion of the public believes that governments could provide services more efficiently and at lower cost.[10] Each year in Canada the auditor general's report contains numerous examples of government waste. These are highlighted in the media and tend to reinforce the public's perception of government inefficiency.

BUDGET DEFICITS

Deficit financing to help bring an economy out of a recession was made acceptable by Keynesian economics. Prior to Keynes, governments sought to balance their budgets annually, and an unbalanced budget was viewed as irresponsible financial management. Keynes did not, however, abandon the notion of balanced budgets, even though he favoured the stimulation of aggregate demand by deficit financing. Instead of annually balanced budgets, Keynesian economics emphasized balancing the budget over the course of the business cycle. Deficits in periods of economic decline would be balanced by budget surpluses in periods of economic prosperity. Many governments that adopted and practised the Keynesian philosophy following World War II were reasonably successful in achieving cyclically balanced budgets. This was true of the federal government in Canada until the mid-1970s. For example, the recession of 1958-1961 resulted in relatively substantial budget deficits, which were eliminated once the economy recovered, and were followed by surpluses in the late 1960s when inflation threatened. Since 1975, however, the federal government has recorded continuous budgetary deficits. The deficit peaked with the last Liberal Trudeau government budget in fiscal 1984-85 at about $38.5 billion, or 55 percent of collected federal revenues. Elected in the fall of 1984 with a campaign commitment to balance the budget, the Conservative Mulroney government has continued to run annual deficits averaging $28 to $30 billion. Beginning in 1985, each budget speech of the minister of finance presented a five-year projection of deficits that showed a balanced budget at the end of the five-year period. Each year, the deficit remained at its high level of $28 to $30 billion, despite a relatively prosperous economy with a stable rate of inflation of 4 to 5 percent and declining unemployment from 11.5 per-

8 "Signs of Tax Revolt in Ontario Elections," *The Globe and Mail*, November 12, 1991; "Quebec Tax Hikes Spark a Revolt," *Financial Times of Canada*, April 20-26, 1992.

9 Richard M. Bird, "Closing the Scissors, or the Real Public Sector Has Two Sides" (December 1982), 35 *National Tax Journal* 477-82, at 482.

10 Paul N. Courant, Edward M. Gramlich, and Daniel L. Rubinfeld, "Why Voters Support Tax Limitation Amendments: The Michigan Case" (March 1980), 33 *National Tax Journal* 1-20; Royce Crocker, "Federal Government Spending and Public Opinion" (Autumn 1981), 1 *Public Budgeting and Finance* 25-45.

cent in 1983 to 7.5 percent in 1989. The Mulroney government was elected to power in 1984 with a huge majority and had an opportunity to use this power base to institute the tough necessary steps to reduce the deficit and bring the budget into balance. What the government lacked was the political will to institute the required tax increases or expenditure reductions, or a combination of the two, despite the announced budgetary plans and projections for deficit reduction.

The United States experienced a similar trend in continuous large budget deficits during the 1980s. Both the Reagan and the Bush administrations refused to increase taxes and unsuccessfully sought to cut the deficit through expenditure reductions, including mandated reductions through legislation, as discussed later. Deficits continued despite a relatively robust economy.

Both Mulroney and Reagan won landslide election victories. Supported by growing economies, their governments were in a position to introduce the necessary measures to bring budget deficits under control. Both failed to do so. The Reagan government, following a philosophy of "the less government the better," simply refused to increase taxes. The Mulroney government showed some early signs of determination in restraining expenditure and raising revenue. Taxes were increased each year from 1985 to 1987 and, combined with increased revenues produced by a growing economy, budgetary revenues grew at an average rate of about 9 percent per year. The additional revenues, however, were absorbed in part by the high cost of servicing the public debt, which was fueled by high interest rates, and in part by increases in other expenditures. Elimination of the deficit would have required more strenuous expenditure restraint and larger tax increases. The government, however, shied away from major tax increases. The minister of finance argued that deficit reduction had to be balanced with the objective of maintaining economic growth. At the same time, however, the minister emphasized the importance of keeping inflation under control. In other words, a strong case could have been made for increasing taxes as a means of raising revenues to reduce the deficit and maintain price stability. The fact that this strategy was not adopted indicates that the government did not view substantial increases in taxes as a viable policy option. The economy was relatively strong; economic growth averaged 4 percent in real GDP per year, and probably could have absorbed higher taxes without any significant dampening economic effects. The major constraint, therefore, appears to have been fear of a political backlash from large tax increases. The government apparently viewed continuous deficits as a more politically acceptable path. This conduct may be interpreted to mean that the government was approaching what it viewed to be a limit to the level of taxation and feared serious political repercussions if it exceeded that limit. Limits to taxation can therefore be viewed in terms of the perceptions of the political costs of taxation. These perceived political costs in essence prevented the Mulroney government from making major inroads into deficit reduction.

The perceived political costs of higher taxes and expenditure restraint for the purposes of deficit reduction are evident in the Mulroney government's actions prior to the 1988 federal election. Deficit reduction was a major election commitment in 1984. Searching for more revenue, the government increased the MST from 10 to 11 percent in 1985, imposed surtaxes in the personal and corporation income taxes, and increased excise taxes on tobacco and alcohol products. In 1986 the MST moved up to 12 percent, excises on alcohol and tobacco were again increased, and indexation of the personal income tax was reduced. In 1987 there were further increases in excises on gasoline, tobacco, and alcohol, and the MST base was expanded. These tax measures worked in concert with a growing economy and with expenditure restraint to reduce the deficit. The growth of federal program expenditures (expenditures less public debt charges) fell from an average annual increase of 12 percent in the period 1974 to 1984 to 10.5 percent in the fiscal year 1984-85, fell further to −1.1 percent in fiscal 1985-86, and rose slightly to 4.6 percent in 1986-87. These slowdowns in growth helped reduce the budgetary deficit from $38.3 billion in 1984-85 to $28.1 billion in 1987-88. With the 1988 election looming, however, the government took a softer stand on deficit reduction, beginning with the 1987 budget. Indeed, instead of being reduced for 1988-89, the deficit increased. Tax reform in 1988 brought some reductions in personal income tax revenues, and the recession that began in early 1990 contributed to the maintenance of a budgetary deficit in excess of $30 billion.

LEGISLATED SPENDING CONTROL

Both Canada and the United States have attempted to mandate government spending control through legislation because of their inability or their reluctance to reduce the deficit with tax increases or expenditure restraint, or some combination of the two, through the use of normal budgetary procedures. In the United States, the Balanced Budget and Emergency Deficit Control Act of 1985[11] (the Gramm-Rudman-Hollings Act) specified targets for deficit reduction over a five-year period. If the deficit target for any particular year were not met, automatic expenditure cuts would come into play that would reduce expenditures by a certain percentage for a wide range of government programs. Only a few essential programs were made exempt from these automatic cuts. The mandated deficit reductions were not realized, however, because both the president's office and Congress found ways, including accounting gimmickry, to circumvent the legislation. Another attempt at mandated expenditure controls was introduced by the Budget Enforcement Act in 1990.[12] With the presidential election occupying the stage in late 1992, however, there appears to be little incentive for politicians either to raise taxes or to reduce expenditures, and the projected federal deficit for 1992-93 has soared to over $400 billion from about $200 billion in 1990-91.

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[11] Pub. L. no. 99-177, enacted on December 12, 1985.

[12] Title XIII of the Omnibus Budget Reconciliation Act of 1990, Pub. L. no. 101-508, enacted on November 5, 1990.

In Canada, the minister of finance introduced in his February 1991 budget a formal proposal to limit federal government expenditure over a five-year period in an attempt to reduce the deficit. The spending control act of 1991[13] specified that federal expenditure increases could not exceed an average of 3 percent per year from 1991 to 1996. If in any one year the expenditure increase did exceed 3 percent, in some other year the increase would have to be held below 3 percent. The effectiveness of the legislated controls remains to be seen, but the 6.9 percent increase in federal spending in 1991-92 and the 4.6 percent increase in 1992-93 does not bode well for this initiative. In addition, the Act leaves considerable room for circumvention through accounting gimmicks and the exclusion of certain expenditures from the Act.

Nevertheless, the fact that both the Canadian and the US governments were forced to resort to unprecedented measures to impose some discipline upon themselves regarding expenditure restraint indicates the severity of the problem. Both attacked the deficit by concentrating on expenditure restraint rather than by relying on major tax increases, which implies that further tax increases were viewed as simply not a viable option either economically or politically. Finance officials and political leaders in both countries publicly contended that tax increases might harm the economy and cause economic decline and a recession. It should be remembered, however, that expenditure reductions also have a dampening economic effect of reducing aggregate demand and through a larger multiplier effect than tax increases. It is therefore likely that the reluctance to raise taxes stemmed more from political considerations than from economic considerations, and politicians may have feared the political fallout from raising taxes. If, indeed, politicians feared that the public would not tolerate any significant increase in tax burdens, a perceived tax limit can be said to have been reached.

LIMITING FUNDING IN ESSENTIAL SERVICES

Health, education, and social welfare have been viewed in Canada in recent decades as essential, universally provided government services. The universality principle for such programs as old age security, family allowances, medicare, and hospital care has been viewed, until recently, in the words of Prime Minister Mulroney, as "a sacred trust." That trust was breached, however, for old age security and family allowances; with the introduction of the "clawback tax" in 1989, the two payments would be repaid to government in their entirety by recipients whose income exceeded a specified level. As for health care and post-secondary education, cutbacks in federal and provincial government spending have placed strains on these systems and are having the effect of reducing the availability of services.

The federal government began to limit its contribution to the medicare shared-cost program in the mid-1970s when deficits began to appear on

[13] Government Expenditures Restraint Act, SC 1991, c. 9.

the federal budget. In 1976-77, the federal contribution was limited to an increase of 13 percent, and in 1977-78 it was limited to an increase of 10.5 percent. The 50-50 cost-sharing formula for medicare and hospital services was abandoned in 1977 with established programs financing, which replaced federal transfers with a combination of tax transfers and cash payments for hospital services, medicare, and post-secondary education. Faced with huge, continuous budgetary deficits throughout the 1980s, the federal government embarked on a program of expenditure restraint that in 1990 produced additional restrictions on Ottawa's contributions for health care and social services. The federal cash payment for health under established programs financing was frozen for the period 1990 to 1992 at the 1989 level, with growth limited to the population increase in each province, or about 1 percent nationally. The federal budget of February 1991 extended this freeze to 1994. In addition, payments to Ontario, Alberta, and British Columbia under the Canada assistance plan were restricted to an increase of 5 percent. The provincial governments, also facing major deficits, responded that they would have no choice but to scale back services in these programs. Even those provincial political parties that have traditionally favoured expanded and improved social services have been faced with the reality (when elected recently) of revenue constraints. These new governments, with their reluctance to increase tax burdens substantially or to engage in continuous high deficit finance, have begun to retrench and rationalize government programs and dampen the expectations of their supporters.[14]

RELIANCE ON NON-TAX REVENUE SOURCES

Another indicator that governments may be approaching a maximum level of traditional-type taxes is their search for new forms of revenue and their increased reliance on non-tax revenue sources.[15] Government-run lotteries have proliferated over the last decade in both Canada and the United States, and have more recently been extending to government-operated casinos. The government of Manitoba has been operating a casino since 1989, and Ontario is currently considering the possibility. Traditional monthly or weekly lottery draws have been extended to a wide variety of instant lottery games. Several US states have extended government-operated gambling systems to include coin-operated pinball games traditionally found in arcades, and are currently eyeing the lucrative sports-betting field.

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14 This has been the case for the newly elected New Democratic governments in Ontario, Saskatchewan, and British Columbia.

15 See, for example, Alice M. Rivlin, "The Continuing Search for a Popular Tax" (May 1989), 79 *The American Economic Review*, papers and proceedings, 113-17; Joseph Cordes, Jon Hakken, and Rosemarie Nielsen, "Consumption vs. Income Taxes: What Are the Comparative Advantages?" in *Proceedings of the Eighty-Third Annual Conference on Taxation*, National Tax Association and Tax Institute of America 1990 (Columbus, Ohio: NTA-TIA, 1991), 105-9; Charles E. McLure Jr., "Tax Policy Issues of the 1990s," ibid., 85-89; and Joseph A. Pechman, "The Future of the Income Tax" (March 1990), 80 *The American Economic Review* 1-20.

Governments have also recently been turning more and more to user charges and earmarked taxes to finance their operations.[16] User charges and earmarked taxes bring the costs and benefits of government closer together. A person who pays fees for recreation services, garbage collection, home care services, etc., receives direct and obvious benefits and consequently, it is contended, is more likely to accept user charges than taxes. Similarly, earmarking gasoline taxes for the construction and maintenance of roads or applying payroll taxes for unemployment insurance and old age security more closely relates cost burdens to program benefits and is likely to be more acceptable to the taxpayer than general taxes.

INTERNATIONAL TAX HARMONIZATION

With an approaching global economy, countries are becoming increasingly conscious of economic conditions and the business environment of their neighbours, particularly those countries that are major trading partners. Tax structures and levels of taxation are an important part of this equation. Canada has recognized that it cannot afford to have a tax structure vastly different from that of the United States, its major trading partner.[17] This factor has become more prominent with the implementation of the free trade agreement between the two countries in 1989. Moreover, not only are the barriers for commodities being eliminated, but in the process the mobility of resources and business establishments has increased. There have been reports of numerous Canadian firms pulling up stakes and re-establishing in the United States since the introduction of the free trade agreement. A variety of factors are reported to have influenced this movement, including non-unionized labour, lower wages, incentives from state governments competing for new businesses, and lower taxes. Some US states do not levy a corporation income tax, and property taxes, particularly in the southern states, tend to be lower than in Canada.

There is ample evidence that the Canadian government considers US taxation in its own tax policies. For example, US tax reform in 1986 was followed by tax reform in Canada in 1988 in which a number of parallel tax changes can be observed. The US government reduced its upper marginal personal income tax rates (lowering the maximum marginal rate from 50 to 33 percent) and reduced the number of tax brackets to three. Canada followed suit, reducing the number of its tax brackets from 10 to 3 and lowering the rate in the top bracket from 34 to 29 percent. The United States reduced the maximum corporation income tax rate from 46 to 34 percent, and Canada followed with a reduction of its maximum rate from 36 to 28 percent. The pressure for international tax harmonization was made clear when, introducing the tax reform package, the minister of

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[16] For trends in municipal user charges, see Mark Sproule-Jones and John White, "The Scope and Application of User Charges in Municipal Governments" (1989), vol. 37, no. 6 *Canadian Tax Journal* 1476-85, at 1480.

[17] John Whalley, "Recent Tax Reform in Canada: Policy Responses to Global and Domestic Pressures," in Michael J. Boskin and Charles E. McLure Jr., eds., *World Tax Reform: Case Studies of Developed and Developing Countries* (San Francisco: ICS Press, 1990), chapter 5.

finance stated that "[i]t is important that our tax system not place Canadians at a competitive disadvantage in domestic and international markets" and that Canada must "recognize the competitive reality of tax systems in other countries."[18]

CONCLUSION

It is readily apparent that taxpayers' pockets are not bottomless and that there is a limit to continuous tax increases that the public is prepared to tolerate. Claims that tax increases are required to meet society's demands for more and better public services are frequently met with skepticism by taxpayers when they already feel overburdened with taxes, when they perceive waste and inefficiency in government, and when they view the benefits of various government programs as uncertain and remote. It appears also that the federal and provincial governments have become increasingly conscious of the hostility of the public to high tax burdens and have realized that they cannot continue to tap taxpayer resources to finance an ever-increasing public sector. In an effort to curb expenditures, governments have begun cutting back on even essential public services such as health care and education. Cutbacks, however, are difficult to implement successfully, particularly when the effects are directly felt in such terms as crowded classrooms, hospital bed closings, lengthy waiting periods for physicians' services, and deteriorating roads and streets. During the 1980s, governments to a degree tended to postpone expenditure constraint by meeting revenue shortfalls through deficit financing. The result has been the accumulation of huge public debts by both federal and provincial governments. The interest payments alone on these debts are huge and are absorbing an increasing proportion of government budgetary revenue. Currently, 34 cents of each dollar collected by the federal government in taxes goes to pay interest on the public debt, while an average of roughly 12 cents of each dollar in taxes collected by the provinces is allocated to debt services charges. The rising debt places pressure on future taxes to meet interest charges, or alternatively reduces the proportion of budgetary revenues that can be allocated to other government-provided goods and services.

The continuous deficit run by the federal government over the last decade indicates that the government has been reluctant, for economic or political reasons or both, to raise taxes sufficiently to meet its expenditures. That reluctance serves as an indicator of a recognition of limits to taxation. The need to harmonize Canadian taxation with international taxation to prevent Canadians from being placed in a competitive disadvantage in the global economy has also served to influence levels of taxation, as acknowledged by the minister of finance. When the reluctance to raise taxes causes a retrenchment in expenditures for essential services, forces cost consciousness and greater operating efficiency in government programs, tempers political election promises for new or expanded programs, and causes gov-

[18] Canada, Department of Finance, *The White Paper: Tax Reform 1987* (Ottawa: the department, June 18, 1987), 4.

ernments to turn to previously avoided activities such as gambling, and when existing tax burdens sharpen the awareness of society to the costs of government-provided services and heighten the hostility of taxpayers to the point of tax revolts in one form or another, it may be contended that Canada is approaching, or perhaps has already reached, an upper limit to taxation.