Special Report, Part 1: Proceedings of a Conference on Personal Income Tax Reform— The Framework for Reform

The following papers by Robert D. Brown and Jonathan R. Kesselman and comments by Edwin C. Harris constitute the first part of the Canadian Tax Foundation's publication of the proceedings of a conference on personal income tax reform, which was held in Ottawa on April 9-10, 1999.

The conference launched the Foundation's first intensive look at comprehensive personal income tax reform—an issue that has important implications for how governments finance public services as well as for individual Canadians concerned about their tax burden. Aimed at academics, public policy analysts, and federal and provincial government officials, the conference looked first at the need for reform, the process of reform, and the relationship between personal income taxes and other federal, provincial, and local taxes. Then the focus moved to the specifics of reform: the base, the rates, indexation, and interactions with the social transfer system. The appropriate treatment of retirement savings and the broader issue of the tax treatment of savings rounded out the formal papers.

The papers presented at the conference will be published over several issues of the *Canadian Tax Journal*. In this and the next issue, the first and second parts of the special report on the proceedings deal with the framework for reform. Subsequent journals will present discussions on joint occupancy of the personal income tax field, social transfer and retirement issues, the politics of tax reform, and concluding comments.

Tax Reform and Tax Reduction: Let's Do the Job Right

Robert D. Brown*

TAX REFORM OR TAX REDUCTION

The assigned title for my talk was "Tax Reform—or Tax Reduction." In fact, tax reform and tax reduction are not alternatives but must be companions if we want to improve our tax system, our economy, and the welfare of Canadians.

Tax reform—changing the system—is an urgent necessity because some components of the present system are perverse, retarding economic growth, employment, and living standards in Canada. It is widely recognized that high marginal personal tax rates, inadequate recognition of family circumstances, and bracket creep—all of which move more and more of the income of Canadians into provincial and federal tax coffers—along with uncompetitive business taxes, are issues that we must address if our tax system is not to hold back our productivity and living standards. But arguably the biggest tax reform that we could adopt is a reduction of the overall burden of taxation in Canada, which would allow Canadians to keep more of their own money in their own pockets and at the same time help to raise our living standards.

Tax reductions will also help to smooth the course of tax reform. Making major structural changes in the tax system is never easy, because if it is done on a revenue-neutral basis, there are bound to be both winners and losers. It is axiomatic in tax policy that losers have longer memories than winners, so that redistributing the tax burden is likely to be outstandingly unpopular. Reducing the aggregate burden of taxation at the same time as structural adjustments to the system are made substantially eases the process of reform and adaptation, from both a political and an economic viewpoint.

THE FISCAL DIVIDEND

It is only in the last two years that Canadians have started talking seriously about tax reduction, because it is only within this time that we have achieved the remarkable feat of a balanced federal budget, and are close to accomplishing the same in almost all of the provinces. As government expenditures have been cut or held in check, and as government revenues

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continue to rise with an expanding economy, we have the distinct possibility of running increasing budgetary surpluses at the federal level, and in some of the provinces.

These fiscal surpluses do not, of course, have to be devoted to tax cuts. Instead, they can be used to allow for an expansion of government expenditures over and above baseline projected spending (generally assumed as constant real per capita expenditures), or they can be used to pay down our overwhelming debt load. One positive aspect of these alternatives is that, for the first time in decades, Canadians do have a real choice in how they manage their public resources. Another positive aspect is that at last the debate about these various alternatives is an honest debate, predicated on achieving and maintaining balanced budgets at both the federal and the provincial levels. There will always be those who would prefer higher government spending on new and enhanced social programs in order to improve the lot of poorer Canadians. Equally, there will always be those who would prefer a strict control on government expenditures, returning as much as possible of present tax revenues to taxpayers so as to allow them the opportunity to spend their own income. However, these opposing camps are now united, to some extent, in recognizing the necessity of maintaining the balanced budgets that we have achieved so painfully over the last five years. Accordingly, the debate is over real alternatives within a solvent and balanced fiscal regime. In the past, we have had the misfortune of the high spenders and the low taxers being in an undeclared unholy alliance, with both having their way through running horrendous government deficits.

This paper is not the place to assess the likely amount of the fiscal dividend available to Canadians, but it is important to recognize that it is certainly substantially less than the amount that would permit us to do everything we want—enhance social programs, cut taxes, and rapidly push the national debt down. In a recent paper prepared for the C.D. Howe Institute,[1] it was estimated that the available federal fiscal dividend—assuming that federal spending remains constant in real per capita terms and that we maintain not only a balanced budget but a surplus—would be growing at the rate of approximately $4.6 billion per year. Even these projections could be optimistic; among other reasons, the continuation of recent rates of economic growth may turn out to be a somewhat aggressive assumption, given the fragile state of the world economy. Further, there are likely to be some unavoidable future government spending initiatives in areas such as programs for aboriginal people, the environment, and further repairs to the health system.

[1] William B.P. Robson, *Payback Time: Assessing the Room for Federal Tax Cuts*, C.D. Howe Institute Commentary 119 (Toronto: C.D. Howe Institute, December 1998); see this paper for methodology and alternative projections. The average federal surplus predicted by a group of private sector economists mainly associated with the larger banks is around $6 billion.

Unfortunately, we also have to give attention to the need to pay down some of our gargantuan public debt. Canada's present ratio of federal debt to gross domestic product (GDP) is one of the highest among the developed countries, exposing us to financial risk in the event of major economic shocks. The 1999 federal budget projected that the ratio of federal net debt to GDP will decline to less than 62 percent by 2001, compared to the peak of 71 percent in 1995-96.[2] It is assumed that this decline will result largely from growth in GDP, not from major debt reduction.

Canada also faces adverse demographic trends—in particular, the inescapable aging of the population, which will result in more people moving out of the labour force into retirement. It may therefore be argued that our public debt needs to be paid down to much more comfortable levels before we are confronted with rapidly escalating spending on pensions and health care for the elderly.

While the present contingency reserve in the federal budget of $3 billion is earmarked for debt reduction if not needed for other purposes, the question is whether this amount of surplus is big enough and the decline in debt fast enough. The actual surplus in 1997-98 was over $3 billion. The surplus for 1998-99 could be less.

JUST HOW HIGH ARE OUR TAXES?

There is some debate about just how high taxes are in Canada in relation to other countries. What is clear is that over an extended period leading back to the 1960s, the tax burden in Canada has risen inexorably. Over this period, the appetite of Canadians for government services outstripped available revenues, and we got into the habit of running huge and increasing deficits, generating ever-higher annual interest costs to service the accumulated debt.

Some other countries had the same bad habits, although perhaps not to quite the extent that we did. In any event, the comparison between the tax burden in Canada and that in other countries depends very much on how it is made. As shown in table 1, the ratio of tax to GDP in Canada in 1976-1979 was not much different from the G7 average weighted by GDP—or, for that matter, from the OECD average. Indeed, Canada's position in later years—1992-1995—also is not much different from these two comparative measures.

When the comparison is made not with international averages, but with the countries with which Canada carries on trade and investment, the story is quite different. The Canadian ratio of tax to GDP in 1976-1979 was 4 full percentage points higher than the G7 average weighted by Canadian trade. By 1992-1995, the Canadian numbers were 8.5 percentage points higher than the G7 average weighted by Canadian trade. The

[2] Canada, Department of Finance, 1999 Budget, The Budget Plan 1999, February 16, 1999, 15.

Table 1 International Comparisons of Tax-to-GDP Ratios

	Canada	US	UK	G7 average: Weighted by Canadian trade	G7 average: Weighted by GDP	OECD average
1976-1979	31.1	26.5	33.9	27.0	31.3	33.0
1984-1987	33.6	26.1	37.7	26.8	36.2	35.2
1992-1995	36.5	29.8	34.5	28.0	37.2	37.3

Source: Jack M. Mintz and Finn Poschmann, *Tax Reform, Tax Reduction: The Missing Framework*, C.D. Howe Institute Commentary 121 (Toronto: C.D. Howe Institute, February 1999), at 5, citing data from Organisation for Economic Co-operation and Development, *Revenue Statistics, 1965-1996* (Paris: OECD, 1997), at 75.

direct comparison between Canada and the United States will show that Canada was well behind the United States in 1976-1979 and fell farther behind as the years passed, until in 1992-1995 Canadian taxes were 7 percent of GDP above those in the United States—a huge differential. Even in comparison with the United Kingdom, we started out with a lower ratio of tax to GDP in 1976-1979 and wound up in 1992-1995 with a significantly higher ratio. Therefore, in relation to the countries with which international competitiveness matters most for Canada, not only are we at a competitive disadvantage through having a higher ratio of tax to GDP, but until recently we have been falling farther behind over the last three decades.

TYPICALLY CANADIAN—A COMPROMISE?

Since we are Canadians, our solution to the challenges of dealing with the fiscal dividend will likely be a compromise: it will likely combine elements of higher spending, some continued paydown in the debt, and tax reduction. However, our response should include a *significant* reduction in taxes overall, with the main emphasis on cutting and reforming personal income tax burdens.

Canadian tax burdens have gradually climbed above those in the United States over the last 30 to 40 years. It is the usual view that higher government spending as a percentage of GDP exists in Canada because Canada spends a much higher percentage of its income on social programs. While there is some truth in this, it is not the whole story, or even perhaps the main story. Canada, for example, does not spend any more (as a percentage of GDP) in public support for health than does the United States. The reasons for higher government spending and therefore higher tax burdens in Canada may include not only our willingness to support more social programs, but also a softer view of personal responsibilities and a greater acceptance of regional and personal income redistribution, along with our past willingness to run continuing massive deficits. If we had put our fiscal house in order from 1980 through to the mid-1990s, so that there were no deficits and the interest savings were passed on through lower taxes, the ratio of tax to GDP in Canada would not have changed remarkably.[3] To make the same point in a different way, the chief reason why Canadian taxes are so much higher than US taxes may not be the level of spending on social services in Canada relative to the United States, but the fact that interest on public debt takes 27 percent of total tax revenue in Canada and only about half of that percentage in the United States.

Further (as discussed below), arguably productivity, and certainly GDP growth, in Canada has lagged behind that in the United States in recent years. The United States has therefore managed to keep the ratio of taxes to GDP well below Canadian levels not necessarily by spending restraint, but by achieving faster growth in personal incomes.

Having a substantially higher ratio of taxes to GDP by comparison with our major trading partners can affect Canada's long-term productivity. While the causes of changes in productivity, and even its measurement, are matters of some controversy, it is instructive to look at long-term trends in tax burdens in Canada and the United States in relation to increases in personal income. As figure 1 shows, in the 1960s, Canadian GDP growth per capita was above that in the United States, while our tax burden was comparable; but as the tax gap between the two countries widened over the years, real incomes in Canada fell farther and farther behind.

This widening income gap is not just an issue of concern to the relatively well-to-do: figure 2 shows the close relationship of the tax gap to relative unemployment levels in the two countries.

The tax burden in Canada has steadily increased for the past 40 years. Only now, because of recent federal and provincial tax cuts, is it gradually shifting downward. Real personal income levels in Canada have been affected, and the growth of per capita pre-tax incomes—at rather anemic levels in the past 20 years—has not been sufficient to offset the rising tax burden.

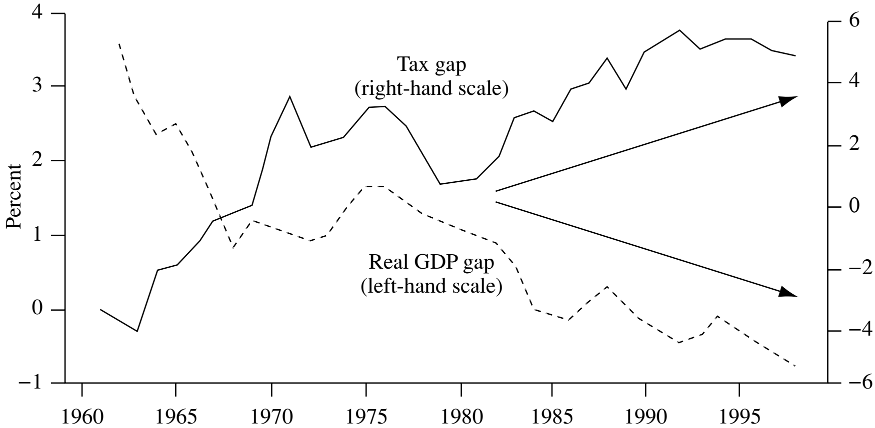
Figure 3 shows several measures of per capita income in Canada. Real disposable (after-tax) income, which is the measure that is most relevant for individual Canadians, peaked about 1990 and has since fallen steadily, through 1997. Real personal income per capita (pre-tax) fell only modestly during the early 1990s and has since recovered, but higher tax burdens pushed the after-tax figures down significantly. The result is that in real after-tax terms, Canadians have fallen behind—behind previous real income levels in Canada, and behind corresponding performance in the United States and elsewhere.

PERSONAL INCOME TAX

A major contributor to the tax burden in Canada has been the personal income tax. Canada raises a higher percentage of its taxes from personal income

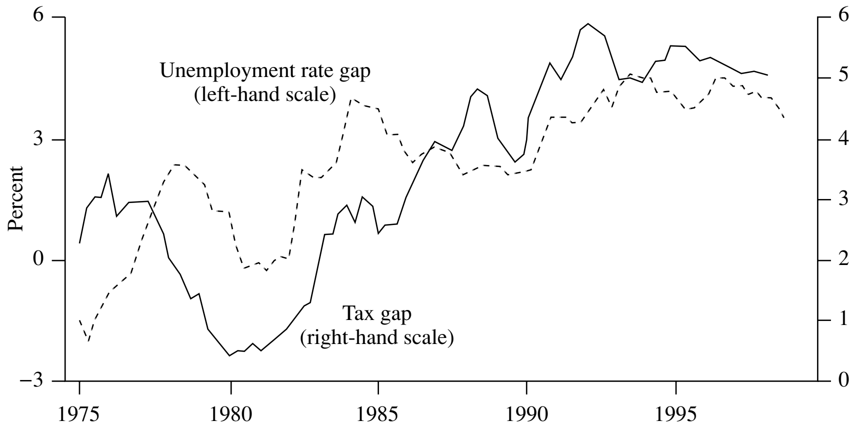
[3] Jack M. Mintz and Finn Poschmann, *Tax Reform, Tax Reduction: The Missing Framework*, C.D. Howe Institute Commentary 121 (Toronto: C.D. Howe Institute, February 1999).

Figure 1 Link Between Taxes and Personal Income, Canada Minus the United States, 1960-1998



Source: Nesbitt Burns, 1998.

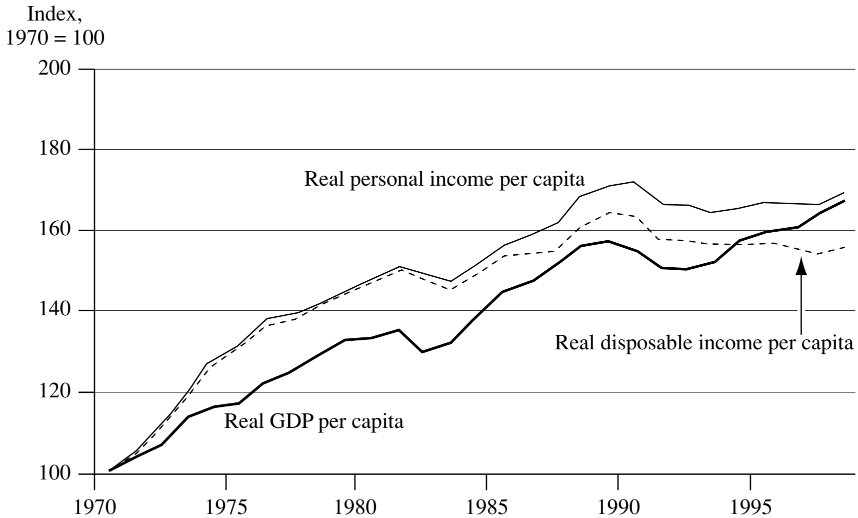
Figure 2 Link Between High Taxes and High Unemployment, Canada Minus the United States, 1975-1998



Source: Nesbitt Burns, 1998.

tax than any other country in the G7, and almost any other developed country worldwide; in fact, personal income taxes raise one-half of all federal tax revenue. It is not that other taxes in Canada are necessarily light by international standards. Rather, our highly progressive personal tax structure, along with an increasingly comprehensive tax base, and a lack of full indexation of exemptions and brackets since 1985 have meant that personal income tax is taking a higher and higher percentage of personal incomes.

Figure 3 Growth of Real Income in Canada, 1970-1998



Source: Department of Finance, 1995.

In comparing the personal income tax burden in Canada with that in other countries, it should be recognized that Canada has relatively modest payroll taxes and that, in some sense, a payroll tax can function as a crude income tax. (Payroll taxes by themselves are frequently not progressive in incidence and may not have as much effect on marginal rates as income taxes because some of them are capped. In any event, payroll taxes typically apply only to wages, and not to investment income.)

The relatively high burden of personal income taxes, together with particular features of our personal tax system such as highly compressed tax brackets and high clawback rates on targeted low-income incentives, means that Canadians are facing extraordinarily high marginal income tax rates, especially in the middle tax brackets—here, our marginal rates are the highest of the G7. These high marginal tax rates in turn tend to depress incentives and therefore productivity. The heavy burden of personal income taxes, together with high marginal rates, is also one factor contributing to the "brain drain"—the tendency of a modest but increasing number of skilled Canadians to leave this country and seek employment in the United States and elsewhere.

The causes of lower productivity and stagnant income growth in Canada are many, and high taxes are not the sole reason why Canadian incomes have been stalled in recent years. Accordingly, reducing the tax burden will not in itself be sufficient to turn around productivity in this country. However, the plain fact is that taxes carry a cost. High taxes in themselves discourage savings, by reducing both available funds and incentives; they reduce investments by cutting returns; and they reduce personal incentives, and therefore effort and initiative. All of these factors hurt productivity, and high personal income taxes are particularly damaging.[4]

THE CASE FOR PERSONAL TAX CUTS

While any tax cuts could be well received by beleaguered Canadian taxpayers, the economic effects of a tax cut depend very much on which tax is cut, and how. In general, cutting personal income taxes has a strong positive effect, particularly if it is done so as to reduce marginal income tax rates and eliminate perverse features of the present system. Cutting corporate taxes could have an even more positive economic effect; however, there are practical reasons for selecting the personal income tax as the initial focus for tax cutting.

Tax cuts in other areas, while yielding positive results, are not likely to generate as big a bang as personal and corporate tax reductions. For example, cuts in payroll taxes have no effect on marginal rates for those already at the maximum contribution level, and the lower levies are split between employers and employees with somewhat delayed effects. ("Excess" employment insurance [EI] premiums—premiums in excess of benefits—do increase marginal tax rates for many Canadians.)

Overall, therefore, most commentators—and the minister of finance—have concluded that the personal income tax is the prime candidate for tax reduction in Canada, both because of the already heavy burden it imposes and because of its key role in relation to personal rewards and productivity.

WHO WANTS TAX CUTS ANYWAY?

Ever since it appeared that the federal finance minister was going to be successful in defeating the deficit and creating a fiscal dividend, tax reduction has moved onto centre stage among current public issues. There is now a serious constituency for major tax cuts, with substantial and clearly growing support across the country.

Tax cuts as an issue, however, do not inspire in Canadians quite the passionate support and commitment that they have won from time to time in the United States. The average Canadian, according to polls, is still more interested in repairing our health system or even other social issues. Canadians need assurance that they can have their basic social safety net *and* tax reductions, before the concept of tax cuts ignites enthusiasm. Canadians are also convinced—at the federal level, at least—that we should have only the tax cuts we can afford, and we should not slip back into deficits.

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[4] Just how damaging high taxes are depends in part on what the revenues are used for. If the revenues from higher taxes are used with great wisdom by governments to provide needed improvements in infrastructure and to augment human capital, if they are not wasted on unproductive measures or on counterproductive redistributions, then the positive effects of this spending can offset in good part the negative effects of the tax burden. Given the track record of governments, it is legitimate to give this qualification by way of a footnote.

Further, there is no clear public consensus on which taxes to cut. The repeal of the 3 percent surtax on incomes over $50,000 in the 1999 budget was perceived as a negative change by some lower-income taxpayers, because of the perception that the well-to-do are already avoiding their share of the tax burden. And while lower-income groups note and respond to overly high marginal tax rates, they do not necessarily focus on this feature.

Overall, Canadians do feel that they are heavily taxed, particularly since the social safety net that taxes are supposed to support seems to have some holes in it. Accordingly, they are receptive to arguments favouring tax reduction. Of course, the 1998 and 1999 budgets did cut taxes—by about $7 billion a year when fully effective—and these reductions may have whetted the appetite for more.

I predict that support for further, major tax cuts will continue to increase but that, in a typically Canadian fashion, there will continue to be less passion in this drive than has occurred in the United States.

PERSONAL INCOME TAX: CANDIDATE FOR REFORM *AND* REDUCTION

The personal income tax arguably needs reform as well as reduction, and the introduction of tax cuts provides an opportunity to implement needed reforms at the same time.

Rather surprisingly, there is a growing consensus among a range of commentators as to the direction of the needed reforms. Given the long and acrimonious history of the debate over taxes in Canada, it is remarkable that a significant body of informed opinion is agreed on the main elements of the needed changes. Those groups supporting, in broad terms, the changes noted below include the finance committee of the House of Commons (in its 1998 report),[5] several recent publications of the C.D. Howe Institute,[6] the Canadian Chamber of Commerce, the Business Council on National Issues, and a number of economists.

The general changes on which there might be this limited and partial consensus include

• lower marginal income tax rates, particularly for middle-bracket Canadians, and a repeal of surtaxes;

• broader income brackets, primarily again to give tax relief to middle-income Canadians;

• the reintroduction of full indexing of the tax system, so that inflation itself does not continue as a stealth tax on Canadians;

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[5] Canada, House of Commons, *Facing the Future: Challenges and Choices for a New Era*, Eleventh Report of the Standing Committee on Finance (Ottawa: Public Works and Government Services, December 1998), 41-47.

[6] Most notably Mintz and Poschmann, supra footnote 3.

• some improvement in the recognition of family issues (although there is diversity of opinion as to how in fact this should be achieved); and

• lower income-tax burdens generally with, if necessary, a shift to other taxes.

An important issue that has not been widely debated is the fact that Canada imposes a particularly heavy tax burden on "capital income"—income from investments. To build long-term growth, it may be necessary or desirable to lower taxes on returns from savings and investment. This is therefore another possible change that needs to be debated.

One should, of course, not overstate the consensus noted above. The agreement is only partial, and there are other groups in society who have a somewhat different emphasis. Arguments have been put forward, for example, for adopting either of the following alternative prescriptions:

• Bringing in major new incentives for saving and investment, including lower capital gains tax rates, much higher limits on sheltering of retirement savings, and significantly lower top marginal rates, as well as major and immediate overall cuts, financed if necessary by tough spending limits. Some proponents of this approach also favour a flat tax—the same tax rate to be applied to all income after enhanced exemptions.

• Focusing on substantial new targeted support for low-income Canadians, particularly children, frequently accompanied by new spending programs to deal with homelessness and other social issues, with tax cuts being very much a lower priority (or no priority at all).

Flaws in the Personal Income Tax System

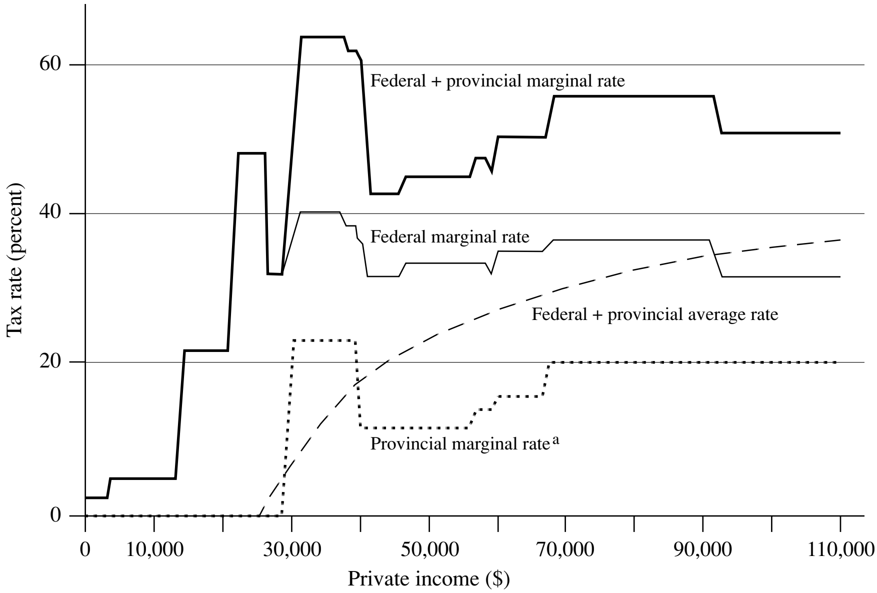
Canada's personal income tax system does contain some positive elements. We have a relatively comprehensive tax base; we have achieved a high degree of coordination between the federal government and the provinces on the definition and allocation of income; and tax administration, by international standards, is relatively effective. There are, however, some perceived deficiencies in the present structure, and these are examined below.

Marginal Tax Rates

In tax policy terms, it is both average tax rates and marginal tax rates—the rates that apply on each additional dollar of income—that are important. In Canada, we have not only high average rates, but also high marginal tax rates over the lower-income to upper middle-income brackets. Combined federal and provincial marginal rates can exceed 40 percent at $20,000 of income, and spike up to 60 percent or even much higher at not much more than $30,000. Indeed, our marginal income tax rates on taxpayers in the low- to middle-income brackets are consistently the highest among the G7 countries.[7] (The calculations shown in figure 4 include

[7] High social security taxes in Europe—assuming that they are passed on to employees—can drive up marginal tax rates on wage income.

Figure 4 1998 Marginal and Average Tax Rates for a Single-Earner Family with Three Children Living in Ontario



[a] Including Canada Pension Plan and employment insurance premiums, and allowing for goods and services tax, child tax benefit, and refundable credits, and the Ontario tax reduction and sales tax credit.

Canada Pension Plan [CPP] and EI premiums, refundable credits, and the Ontario tax reduction and sales tax credit.)

The steepness of the rate structure reflects all of the following:

• There have been only modest increases in the basic personal exemption (basic personal amount) over the last 12 years, and in real terms the exemption has been historically low.

• The system contains a number of refundable credits, including the child tax benefit, the goods and services tax (GST) credit, and the senior's credit, as well as various other low-income provincial credits. These credits are targeted at the low-income taxpayer and are recovered by being taxed back as income increases, thus contributing to very high overall marginal effective rates.

• The range of incomes over which the various tax brackets apply, originally modest, has been further compressed through lack of indexing. At the federal level, the basic rate of 17 percent applies to the first $29,600 of income, followed by a 26 percent rate up to about $60,000 of income, and 29 percent for the excess. The top federal and provincial combined rate of about 50 percent in many provinces kicks in at about $60,000 of income, which is equivalent to a point at which a US married couple filing jointly would still be paying tax at the bottom federal tax rate of 15 percent (about 18 percent with state tax). Further, the top US federal rate (which, when combined with state taxes, might work out to around 43 percent) cuts in at a level of about Cdn. $415,000 for married taxpayers, as compared with the $60,000 threshold in Canada.

The effective marginal tax rates shown in figure 4 reflect no particular tax policy concept but are rather the end result of trying to graft credits targeted at low-income Canadians onto an already progressive rate structure. This, combined with our penurious vision of what constitutes being well-to-do, results in extraordinarily steep rate progressivity, which in effect becomes a poverty trap—a tax system that provides significant relief to the poor but tends to prevent them from ever moving out of a low-income situation. The overall marginal rate structure—the result of a crazy quilt of inconsistent tax and relief measures—appears to represent the application of chaos theory to tax policy.[8]

To Index or Not To Index

The decision not to fully index the personal income tax structure after 1985 has biased the Canadian tax system. The effect has been particularly adverse for low- and middle-income Canadians through the compression of the tax brackets and loss in the real value of the basic and other personal credits. If the tax exemptions, credits, and brackets had been fully indexed, even at the relatively low inflation rates that have prevailed in recent years, total federal personal income tax revenues would have been cut by about $10 billion a year currently, with perhaps an additional $3 billion in provincial taxes. At present, the failure to index results in an increase in the income tax burden of over a billion dollars a year. The reason why successive governments have failed to reintroduce full indexation is reasonably clear: in the past, it would have resulted in dangerous revenue losses, while at present, it would use up a good share of the available fiscal room in an automatic annual adjustment. Both provincial and federal governments have to date shown little enthusiasm for such a change. But the failure to index does more than drive up effective tax rates; it distorts the overall system.

Family Incomes: Defining the Problem

The treatment of family income is a more complex issue, and it is one on which there is no broad agreement. Canada's tax system provides less recognition for the children of middle- and upper-income taxpayers than is provided in any other G7 country. Essentially, there is no exemption or personal credit for having children. There is an important child tax credit system, enhanced in the 1998 and 1999 budgets, which can provide up to $2,000 a year of support (when fully effective) for each child, but the credit is recovered as family income rises above $21,000. Taxpayers with family income of $50,000 a year still get a fragment of a credit, but those

[8] Derived from remarks by Jack Mintz.

above get absolutely no recognition for children. (The clawback of the child tax benefit is one of the most important reasons for the extraordinarily high marginal rates borne by middle-income Canadians.)

The conceptual flaw in the present system is that upper-middle and upper-income Canadian families with children are taxed the same as those families without children, a clear breach of horizontal equity. Arguably, all taxpayers should receive some recognition for dependent children because they involve a reduction in available discretionary income.

There has recently been a substantial amount of controversy about the tax position of "stay-at-home moms" and the relative burden of tax on two-earner families as opposed to one-earner families. One-earner families can pay several thousand dollars more in income tax than a two-earner family with the same total income. Part of this debate reflects philosophic differences regarding the family, and these will not be easily resolved. Providing some recognition for children through all tax brackets, while not directly dealing with "stay-at-home moms," would go partway toward easing the perceived unfairness of the present structure.

The issue of how much tax a single-earner family should pay as compared with a two-earner family with the same aggregate income is difficult to deal with. On the one hand, providing some mechanism such as joint tax returns (or evenly split incomes for married couples) could be thought by some to result in improved fairness, since families with the same total income would pay the same income tax. But this family income or split income approach would be a costly measure that would inevitably shift part of the tax burden onto two-earner families. (Further, dual-earner families already pay substantially more in payroll taxes than single-earner families, as well as higher work-related costs.)

Adopting a split income or family income approach as the base of taxation would result in a sharply higher tax burden on spouses who want to return to the work force, providing a powerful disincentive for these individuals. Typical figures show that, of the additional income that a second-earner spouse in a family with children generates from working, 60 to 75 percent is now consumed in income taxes, payroll taxes, the after-tax cost of child care, and higher personal spending on clothes and transportation.

The family income issue has been made worse by the compression of our tax brackets and by our high marginal tax rates for middle incomes. With lower marginal rates and broader brackets, the so-called disincentives for "stay-at-home moms" would be reduced.

Other Tax Changes

There are some other issues associated with the present personal tax structure that might be reviewed in an effort to improve the fairness of the system and its effect on personal productivity. Investments in human capital might be more appropriately recognized by shifting tuition costs from a tax credit to a deduction in arriving at income, with the amounts available for indefinite carryforward. This would give fuller recognition to such costs, which benefit not only the individual but society as well.

With respect to burgeoning health costs, a controversial approach would be to add the amount of government payments for health care services in respect of an individual to his/her income, up to a maximum amount, to create greater sensitivity to such costs. Another area of potential improvement is the current provision of tax credits for retirement income and seniors. These could perhaps be phased out since substantial support is provided to older Canadians by other programs.

Other possible improvements to the system could come from improved access to tax-deferred retirement accounts and ultimately some more favoured treatment of the taxation of the increasingly mobile income from investments. Improving the tax treatment of the return on savings could improve the efficiency and equity of our system. In turn, some of our present personal incentives and special treatments could be considered for elimination.

Rates and Brackets: Part of the Solution

It is now widely argued that the problems associated with our present tax brackets and exemptions can be addressed as part of the tax reduction exercise, through an integrated approach that could involve reforms such as the following:

- Continued expansion of the basic exemption amounts for taxpayers.
- Substantial expansion of the range of incomes contained in the present bracket structure, so that the higher rates become applicable only at substantially increased levels of income. This broadening of the tax brackets (or transforming the present three-rate structure into a four-rate structure) could mean that the top rate would apply at some point between $150,000 and $250,000 in annual income, while rates substantially below those now in effect would apply at income levels of $30,000 and $60,000.
- Full indexing for future increases in inflation.
- The spreading out of clawback ranges so as to reduce marginal impacts, and some review of the merits of "targeted" relief.

Overall, those reforms would result in a significantly lower income-tax burden at all income levels and a modest decline in Canada's reliance on personal income taxes to generate revenues. Equally important, marginal tax rates would be substantially lowered. Taken together, these changes could provide a boost to incentive and productivity. However, they would be very costly in revenue terms, and it would take considerable time to develop and implement such reforms.

Brain Drain: Another Cost

In recent years, an increasing number of Canadians with specialized skills and advanced training have been emigrating to more favourable fiscal locations, primarily the United States. While the aggregate numbers are still modest, the quality of those leaving is high. Canadians emigrate for a number of reasons, and net income differences, rather than solely tax differences, may be the driving force. But two facts are worrisome: the relative difference between Canadian and US personal taxes is highest at the upper-middle-income level, where a large number of mobile highly trained individuals are situated; and the relative difference can be most pronounced in the case of married individuals buying a house and starting their careers. In an extreme case, a Canadian emigrating to the United States can boost after-tax income by a third or more solely because of tax differences. It can be argued that highly progressive taxes in Canada redistribute not only income, but also taxpayers.

The brain drain is a reality, although it must be kept in mind that only part of it is directly attributable to taxation. Another contributing factor is the higher salaries and standard of living available in the United States relative to Canada. But perhaps too those higher incomes might be due in part to higher productivity achieved in the United States, where taxes are lower.

ACHIEVING EQUITY

In the tax system, equity is always of fundamental importance, in terms of both the reality and the perception of it. Unfortunately, equity does not serve to provide clear guidance in designing an improved tax system. Furthermore, equity must be modified by issues of competitiveness, growth, and productivity. There are always tradeoffs between what might be perceived to be the fairest way to tax Canadians and the reality that in a highly and increasingly competitive environment, we must have regard to outcomes as well as present perceptions. Both count in designing an acceptable system.

A solution to the inevitable conflict of equity with other objectives may lie in recognizing that real equity is dynamic, not static. Perhaps the fairest tax system is not one that exclusively concentrates on the redistribution of present incomes or wealth, but one that provides the best opportunities to all Canadians for personal growth and achievement.

It is also essential to recognize that our tax system has always been used for purposes other than the raising of revenue—in particular, to achieve social and economic objectives. The present tax system tries to redistribute incomes to achieve a perceived "fairer" result. It provides social incentives (such as credits for charitable donations), supports economic objectives (such as research and development), and aids particular economic and social groups (such as farmers). Some of these additional features are perverse and unfair, and one hopes that such special treatment and incentives can be reduced. But it is certain that we will not—and should not—totally avoid such additional purposes in our tax structure.

REFORM OF OTHER TAXES

As befits the title of this conference, we are concentrating so far on the personal income tax—the most important and the most out-of-balance part of our tax mix in Canada. But we should also make reference to the need to review other areas of the tax spectrum. The four principal sources of revenue of the federal government are personal income tax, corporate income tax, payroll taxes (essentially EI), and the GST. (CPP premiums are accounted for separately, not as part of government revenues, since they go into a separate fund.)

Business Taxes

As a member of the recent Mintz committee (the Technical Committee on Business Taxation),[9] I am hardly unbiased in the assessment of our present business tax structure, which in total drags $100 billion a year from business in Canada. (A salient feature here is that the corporate income tax, which gets most of the attention, amounts to only about one-quarter of the total taxes on business.)

The report of the Mintz committee was prepared under the constraint of revenue neutrality: tax cuts in one area had to be offset by tax increases in another. This revenue neutrality is definitely the most respectable intellectual way to examine tax reform alternatives, but it is a very poor way to implement actual changes in the real world. A little bit of the grease of tax reductions is needed to make major tax changes go down smoothly. Further, the revenue-neutral constraint did not permit the committee to examine the appropriateness of the overall level of tax on business in relation to competitiveness.

Without going into all of the issues dealt with in the Mintz report—and at a recent conference of the Canadian Tax Foundation[10]—the main issues are as follows:

• The burden of corporate income and capital taxes falls very unevenly on business activity in Canada, with the highest burden being imposed on the service sector. This happens to be the sector that is growing fastest and contributing the most to employment. A more equal and fair distribution of the corporate tax burden would improve the neutrality of the system and the efficiency of Canadian business.

• Corporate tax rates in a number of other countries have been declining. To give just two examples, the UK corporate rate is now down to 30 percent, and Australia is considering a similar level. International tax comparisons are notoriously difficult to make with any certainty, but it is likely that the aggregate tax burden on relatively favoured parts of our business sector is comparable to or a bit higher than that of our main trading partners, while taxes on the least-favoured sectors—notably services—are significantly above those elsewhere. Just as important, the

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[9] Canada, *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, April 1998) (herein referred to as "the Mintz report").

[10] *Business Tax Reform*, 1998 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1998).

statutory tax rate—the sticker price of corporate taxes—is much higher in Canada than in a number of other countries. This disparity creates an incentive to move income out of Canada and expenditures into it, with a consequent erosion of the Canadian tax base.

• The tax system for business contains a number of incentives and other features that may have a distorting effect on investment, and therefore again on efficiency.

• To be effective, tax reforms at the corporate level need to be accompanied by reforms in taxing investment at the individual level.

One very attractive feature of corporate tax reform is that while significant reductions in the personal tax burden require enormous amounts of money, the federal tax system for corporations could be positively revised at a relatively modest tax cost. Net tax cuts of $2 billion or $3 billion a year would make a substantial difference to business income tax but would make only a small dent in the personal tax sector. It is important that appropriate changes in both the tax base and the tax rates in the business sector be considered as part of an overall tax reform package, at the same time that personal income taxes are addressed. If we proceed first to implement major reductions in personal taxes, it will be extremely difficult politically at a later date to begin the task of reducing corporate taxes by themselves. It is desirable to have a balanced package of change.

Employment Insurance

At present, even with recent reductions in premiums, the EI system is generating a significant surplus—perhaps of the order of $5 billion a year—which contributes to the government's overall fiscal balance. A great deal has been written on the EI surplus accounts, and this is not the place to review those comments. Nevertheless, it is useful to note that Canada's reliance on payroll taxes is relatively low among the developed countries. In addition, since in the longer term payroll taxes tend to be passed on to employees in the form of lower wages, they do not represent a net tax on the use of labour but rather a part of the personal tax structure. Given the perceptions involved, it is inevitable that EI premiums will fall significantly over the next few years (unless we adopt the less palatable alternative of a substantial increase in EI benefits). Accordingly, a significant part of the available fiscal dividend will have to be used to cover likely decreases in EI premiums. To the extent that this occurs, less revenue will be available for personal tax cuts.

GST

Although the GST is still an unpopular tax, it is an essential component of the current tax mix. By international standards, Canada's use of consumption taxes to generate revenue is relatively low. Indeed, one could argue that Canada could improve its overall tax mix if it increased its reliance on consumption taxes and used the revenue to buy down personal tax rates. Australia has courageously just gone through such an exercise.

While an increase in the GST is simply not in the cards politically, there are important reasons for favouring a stronger emphasis on taxes on consumption, rather than on income. Taxes on consumption do not impose a double tax on savings and investment—once when the savings are made, and again when the return from the corresponding investment is earned—as personal income taxes do. However, the tax mix could be moved more toward a consumption base through increases in the available level of tax-sheltered savings, such as those for retirement.

PROVINCES

The provinces are also important users of the personal income tax system. Indeed, their influence on the structure and level of this tax is likely to be more evident in the future. The personal income tax is clearly the workhorse of both the federal and the provincial governments in terms of revenues; however, there is a suspicion that the horse has been too heavily whipped for its own good.

To date, all of the provinces—including Quebec, which collects its own income tax—have relied very largely on the federal definition of income and taxable income, and all the provinces except Quebec have reflected the personal tax credit system of the federal government by basing their provincial income taxes on the federal basic tax. But while there has been substantial uniformity of base between the federal and provincial systems, a number of provinces have brought in a wide range of special low-income credits, high-income surtaxes, and miscellaneous (and possibly misguided) incentives, frequently with clawback features, which add to the excessive progressivity, complexity, and perversity of our overall tax structure.

The federal government has agreed to give the provinces more flexibility with respect to their use of the personal tax system, by allowing a shift in the base for provincial taxes from a tax on tax—provincial taxes as a percentage of basic federal tax—to a tax on income—provincial income taxes being levied on income determined on the federal tax base. While the federal government has taken steps to require or encourage the provinces to give continuing recognition to the federal non-refundable credits, the fact is that the provinces will have substantially more flexibility in the future.

The first major indicated provincial change is Alberta's proposal to adopt, within about a three-year time frame, a flat tax of 11 percent on taxable income in excess of an enhanced basic exemption. This measure, the implementation of which depends on Alberta's ability to accommodate the necessary revenue reductions, will represent a new and innovative feature of the Canadian tax scene. The provinces already have the ability to adjust the progressivity of their taxes in relating to the federal tax. A number of provinces, including Alberta, have effectively increased the progressivity of their taxes through low-income relief (with clawbacks as income rises) and high-income surtaxes. These have also increased overall marginal rates. What Alberta is now proposing is to reduce the progressivity of the tax system, and its marginal rates, through a flat tax.

The Alberta flat tax will reduce the maximum personal tax rate in Alberta to about 41 percent. This will clearly raise the spectre of interprovincial tax competition as chief executive officers and their head office staff contemplate the advantages of a shift to Calgary. The Alberta tax will undoubtedly be considered by other provinces, although the decline in progressivity will not appeal to some, and not many have the revenue room to impose it along with accompanying major cuts in the tax burden to give the change broader attraction.

Flat taxes have some advocates in Canada, as well as some critics. No general judgment on the concept is possible, because it depends very much on the details. There are a wide variety of flat taxes, and flatter taxes, that have been under discussion. Typically, flat taxes still involve a progressive tax burden, because the tax applies only to income over a basic exemption amount. However, the progressivity is likely less than that under our present system.

Flat taxes can improve incentives and productivity because they involve lower marginal rates. But a revenue-neutral flat tax can involve a lower tax burden on upper-income individuals, and likely on very low earners also because of higher exemption amounts. On the other hand, middle-income taxpayers can be the big losers.

If a flat tax also involves getting rid of many of our present personal credits and personal deductions, significant issues of fairness arise with respect to the distribution of the tax burden. It is often argued that a flat tax is simpler, but it is really simpler only if deductions and credits (such as those for charitable donations, child care, health costs, age, retirement savings, etc.) are removed, with consequent major shifts in the tax burden.

A flat tax is a theoretical possibility at the federal level—and no more than that. If the federal government were to raise personal amounts to the projected Alberta level and retain most personal credits and deductions, it would take a flat tax rate of 27 percent to give a revenue-neutral result—a rate on all income fairly close to the present federal top rate. The result would be heavy tax increases for middle-income Canadians.

While flat taxes may be of only limited popularity with the provinces, there will likely be substantial innovation at the provincial level in the years ahead. While some benefits may be realized through such experimentation, unfortunately it will inevitably be accompanied by increased complexity and even perversity in provincial tax structures.

DISTORTING EFFECTS OF TARGETED LOW-INCOME RELIEF

One special aspect of perceived equity merits further comment. A feature of both the federal and provincial tax credit programs has been the continual enhancement, or the introduction, of low-income benefits—benefits that are typically clawed back as taxpayer income rises in order to keep the cost of the program under control. The issue is that this growing feature of our tax system makes meaningful personal income tax reform more difficult.

If we judge proposed tax changes only by whether they deliver a greater benefit to low-income families proportionally to their tax burden than to upper-income families, we move into a system that must rely on the application of higher and higher marginal rates as income increases over a modest base level. These high marginal tax rates retard both personal incentives and savings, and arguably are one of the causes of low productivity in Canada. Making the personal tax system more and more progressive, without limits, involves expanding income redistribution, and this can ultimately be so counterproductive as to hurt all Canadians, including those with low-incomes.

It may be contended that a more rational tax system would recognize the legitimate interests of low-income Canadians through significantly higher personal exemptions, thus taking many of them right out of the personal income tax system, and through broadly based tax relief that reduces marginal tax rates across the board. Such a change could provide dynamic equity through increased entrepreneurship, investment, and employment.

THE WAY FORWARD

I now turn to a longer-term outlook on personal income tax and other tax policy issues. We live in a global village, where important changes are transforming our economy, our society, and our very lives. Frequently, a number of these trends are referred to under the heading of globalization, which is a very imprecise term and means many different things to different people.

Globalization originally referred to the increased pressures of international competitiveness. But there are many other influences that are assimilated into globalization, some of which have nothing to do with international competition. The following is a short list of major economic trends that will ultimately affect our personal tax system:

- A rise in outsourcing and an increase in the number of self-employed. This leads to important benefits in terms of labour flexibility but a relative decline in the number of employees, who are the tethered milch cows of our tax system. It can be more difficult to collect tax from the self-employed, particularly small entrepreneurs, than from employees.

- Demographic changes as our population ages. This trend raises not only the spectre of long-term increases in government spending on pensions and health, but also some intergenerational equity issues. In particular, the age groups who benefited most from high government spending in the past may be able to pass the bills on to subsequent generations.

- Growth in technology, which transforms the economy through new industries and activities, some of them not easy to contain within our present tax system. The issue of taxing international services and trade on the Internet are just two examples.

- Improved mobility of the labour force, or at least the more trained and skilled part of it. This is also accompanied by an increased mobility of capital internationally. It is a well-known and inescapable rule that taxes tend to fall more heavily on immobile, rather than mobile, factors of production. This enhanced international and even regional mobility in both labour and capital can make it increasingly difficult to maintain traditional Canadian approaches to income redistribution.

• Increasing sensitivity to high taxes and tax issues generally, as Canadians contemplate important choices in the allocation of our resources.

Globalization and all of the other things that are assimilated into it do not directly restrict our choices in tax policy, but these influences can impose penalties on us if we do not respond and adapt to them. To put it another way, "globalization" can increase the costs of being different. In a Canadian context, the costs of high taxes, high marginal tax rates, large income redistributions, and high government spending may be becoming both larger and more explicit than they have been in the past.

The issue of the pressures of global trends may ultimately cause us to re-examine our present reliance on income taxation and to move toward a system that places a stronger emphasis on consumption taxation. Such a change could result in high efficiency gains for our economy. It will be difficult to persuade Canadians of the fairness and effectiveness of such a change, but ultimately shifting more of our taxes from income to consumption could be one of the most important reforms we can undertake.

I predict, rather optimistically, that all of these trends will lead in the long term to some easing of the tax burden in Canada as the costs of maintaining present policies become more evident. Even though the reduction in the tax burden is likely to be slow, it will still be good news for Canadians, and it will not necessarily be bad news for those who favour strong and improved social security systems. The decline in the tax burden on Canadians can come not from cutting support for the poor, but from other sources such as the following:

• Lower interest on government debt, through debt paydowns.

• Increased efficiency in government operations and fewer counterproductive government programs that seek futilely to protect Canadians from change, rather than helping them adapt to it. (The horrendous increase in our tax burden over the past 30 years has resulted not only from new social programs, but from a misapplication of public resources and massive deficits that have run up our interest costs.)

• Improved private sector performance and hence an expanded tax base.

INCOME INEQUALITY

I have said that equity is always important in tax policy, regardless of the fact that it is difficult to measure. I believe our perception of equity will be strained in the long run because of another long-term trend in Canada and elsewhere.

In Canada, as in other countries, there is a trend to increasing inequality in pre-tax income distribution. In a high tech, knowledge-based economy, the incomes of those who have skills and knowledge are increasing, while those who do not possess these advantages are falling farther and farther behind.[11] This trend is most evident in the United States, but it is apparent in many other countries as well. In Canada, the before-tax effect shown in figure 5 has been ameliorated to a great extent by our combined social welfare and tax system, resulting in substantial redistributions of income. But as the trend continues, and as we inevitably face pressures for lower taxes on mobile factors, our willingness to continue this pattern of income redistribution may be challenged.

The same issue of increasing dispersion of incomes can also be seen regionally. The favoured regions in Canada are moving ahead, while those less fortunate are falling behind. Again, the fundamental issue may be whether we should be adapting our tax and other policies not so as to reverse these trends, but to adjust to them. We need to examine the extent to which direct redistribution of present income levels, primarily through the personal income tax system, is capable of doing the job of achieving a really fair system—one that provides expanding opportunities and income for all Canadians. We may have to examine some new issues, including

- improved support for education, in order to build personal intellectual capital and skills that will help achieve a more equal distribution of income;
- reduction of the poverty trap in the present tax and welfare systems by the provision of real incentives for personal advancement; and
- encouragement of labour flexibility and mobility.

We must always be concerned with equity, but it may wear a different hat in the future.

NEXT TO THE LAST WORD

In my paper, I have necessarily dealt with some of the problems in our existing system, and I have noted some very cogent reasons why some of these problems are not likely to be fixed in the near term. But I do not mean to seem quite as critical of tax policy formulation as I might appear.

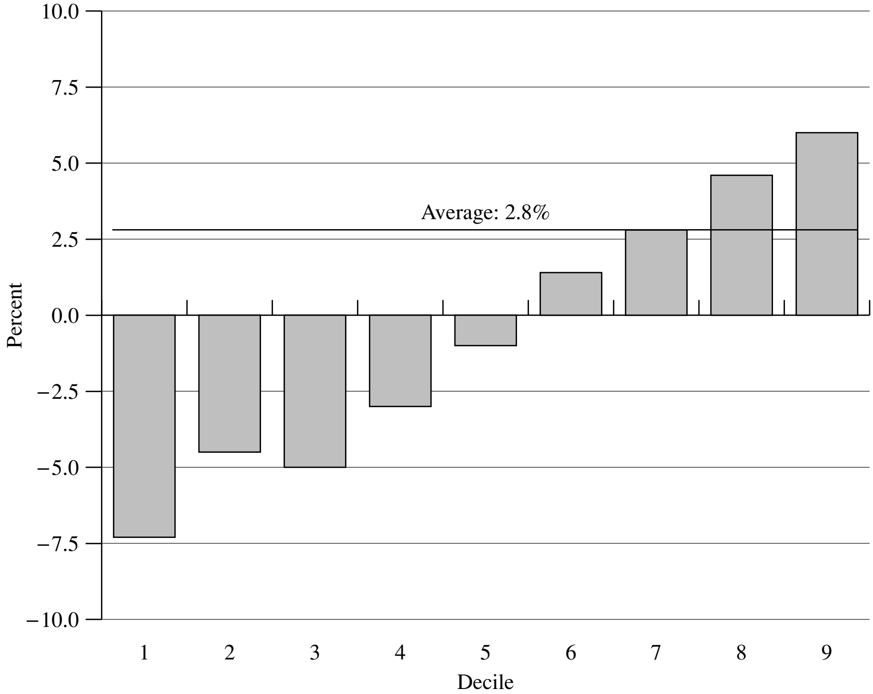
To paraphrase Johnson's remark about a dog walking on its hind legs or a woman preaching, the wonder is not that tax policy is not done well, but that it is done at all.

TAX STRATEGY ON TAX AD HOCERY

To sum up this discussion on tax reform and tax reduction, there is a substantial likelihood of achieving significant and growing "fiscal room" in Canada over the next five years. Even allowing for some modest increases in government spending and an equally modest decline in the national debt, there will be possible room for significant tax cuts over those five years—and the $7 billion in total annual cuts in the 1998 and 1999 budget are only a downpayment on this. However, achieving not only significant

[11] The increasing breakdown of families and the rise of single-parent family units also contribute to greater income disparities.

Figure 5 Growth of Average Real Family Income Before Taxes, by Income Decile, 1980-1995



Note: Income is before taxes but includes government transfer payments.

tax cuts, but also meaningful tax reform—reform that will improve the efficiency and productivity of our economy—will require something more.

First of all, it will require us collectively to exercise strong discipline in respect of government spending—discipline that would not prevent the introduction of needed new programs but would require them to be financed in larger part through a reallocation of existing expenditures. Prudence and the ultimate threat of adverse demographic shifts should also motivate us to achieve an appreciable amount of debt paydown, to put our fiscal house in order and to prepare for the day when the demands of an aging population will require attention.

This strategy will still leave some substantial fiscal room for tax cuts. Given the competing calls for the funding of new programs, these available tax reductions are not likely to be realized unless Canadians are prepared to focus on the advantages of reducing our tax burden. Further, any tax reductions that may be achieved are not likely to be accompanied by a meaningful improvement in the negative features of the present system unless we also commit to a long-term plan of tax reform.

To achieve both objectives—tax cuts and tax reform—requires the articulation of a long-term overall fiscal plan. This plan will have to be flexible. Future revenues cannot be estimated with precision in an uncertain world economy, and we do not want to step back into tolerating "temporary" major deficits. However, the plan must also be sufficiently concrete to set out a meaningful goal of tax reductions within a framework of structural tax changes, with the variable being whether it will take (say) four years or five to attain them. The federal government cannot be expected to present such a plan to Canadians unless the twin objectives of tax reduction and tax reform have substantial political support.

Setting out, and then achieving, a meaningful policy framework involving both tax reform and tax reduction would work to repair and improve productivity—and therefore living standards—for all Canadians. It is a worthy aim for the discussions at this conference.