Base Reforms and Rate Cuts for a Revitalized Personal Tax

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ABSTRACT

Growing calls for cuts in Canadian personal income taxes have focused on tax rates but neglected a deeper analysis of the most urgent needs for fairness and growth. Moreover, proposals to provide tax relief in the form of special tax incentives for particular sectors—such as tax exemptions for the share options of high-tech workers and managers—would create new inequities and distortions rather than a broader, fairer, and more efficient tax system. An economic analysis can show the way to a revitalized personal tax, one that augments the economy's efficiency, growth, and productivity, while simultaneously improving the system's fairness across individuals in differing circumstances. Such a tax will require a carefully designed combination of base reforms and rate cuts.

At the lowest income levels, the priority is to raise the taxable threshold, at least into the $9,000 to $10,000 range. Cuts in the effective marginal tax rates at lower income levels should focus on reforms to the tax and transfer clawback and phaseout provisions rather than on a reduction in the statutory tax rate. At middle and upper-middle income levels, the tax cuts should focus on substantially increased bracket thresholds, and perhaps a modest cut in the middle-bracket tax rate. At high income levels, the most urgent need is a major shift in the tax base toward consumption rather than sharp cuts in statutory federal tax rates, though provincial surtax rate cuts would also be desirable. Key means of expanding consumption-base treatment would be large increases in the limits for contributions to registered pension plans and registered retirement savings plans and a cut in the tax inclusion rate for capital gains. These changes would extend to upper-income taxpayers the consumption-base treatment currently afforded to low- and middle-income taxpayers by the Canadian personal tax, with concomitant gains in horizontal equity, efficiency, incentives, and growth. They would also make the Canadian personal tax more competitive with US provisions without debasing the system or abandoning vertical equity.

Other base reforms would also improve both efficiency and equity while providing the revenues for further rate cuts beyond those that can

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be financed by the growing fiscal surplus. For example, the personal tax base could be expanded to include employer-paid health benefits, strike pay, and additional public transfer benefits. There are grounds for eliminating or reducing the age and pension credits, the $500,000 lifetime capital gains exemptions, and tax credits for labour-sponsored venture capital corporations. Deductions for interest expense could be limited to the filer's taxable investment income, and a corporate distribution tax could be instituted to stem the revenue cost associated with dividend tax credits. Some of these changes would be partially offset by the increased taxable threshold and the enhanced savings, capital gains, and investment income provisions that would be provided to all taxpayers. Moreover, converting tax credit items such as medical expenses and social insurance premiums to deductible treatment would improve horizontal equity and, in some cases, efficiency. Conversely, child-care expenses might be converted from deductions to tax credits for social policy reasons.

INTRODUCTION

There is a growing clamour in Canada to cut taxes, particularly personal income taxes, based on the simple desire for tax relief in an era of fiscal surpluses, as well as on more sophisticated arguments related to incentives, efficiency, and economic growth. Most of these proposals, however, focus on cuts in the statutory tax rates rather than on reforms of the personal tax base.[1] In fact, some base reforms may better serve the fundamental goals of tax policy than rate cuts. Indeed, some reforms to the tax base are equivalent to cuts in effective marginal tax rates as well as average tax rates. What matters for the economy's performance is not just the total individual tax burden, but the way in which those taxes are structured and applied. The policy goal for personal taxes in Canada must be to identify the best mix of cuts in statutory rates and reforms to the personal tax base.[2]

Traditionally, when one talks about the tax mix, one is referring to the mix of revenues that a government derives from various types of taxes, such as personal income tax, corporate income tax, payroll taxes, and sales taxes. It is often overlooked that a personal tax can employ a base that is a hybrid of the forms used for other tax revenue sources—total income, capital income, labour income, or consumption. A direct tax on individuals is habitually referred to as a personal *income* tax, but in many

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[1] For a recent study that considers base reforms along with rate cuts, and reaches some conclusions similar to ones presented here, see 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).

[2] For a much shorter, lay-oriented version of this study, see Jonathan R. Kesselman, "Tax Cuts for Growth *and* Fairness" (December 1998), 19 *Policy Options* 13-16.

countries, including Canada, it is much closer to being a personal *consumption* tax for all taxpayers except the wealthiest. (This is a result of the tax provisions for retirement savings and the tax exclusion for capital gains on owner-occupied homes.) The policy issues examined in this paper are the best mix of rate cuts and base reforms of the personal tax and the optimal nature of those reforms.

It is useful to consider two distinct types of reforms to the personal tax base. First are the kind of changes most commonly found in proposals for comprehensive tax reform—reforms that enlarge the base and thereby allow for greater cuts to statutory tax rates. Second are desirable base reforms that reduce the taxable base. Although these changes limit the scope for cuts to the statutory rates, in some cases they can still reduce effective marginal tax rates affecting important decisions, such as savings, investment, and entrepreneurship. Moreover, the perspective taken on the revenue costs of alternative rate cuts and base reforms needs to be long run and dynamic, not the impact analysis used in making budgets or even the short-run behavioural responses often used in forecasting models. If the tax reforms can stimulate long-run growth of productivity, real wages, and profits, more revenues can be collected in future years, even at lower rates of tax.

In addition to the fundamental criteria of efficiency and vertical equity, two relatively neglected objectives—horizontal equity and tax simplicity—should also play a central role in any redesign of the personal tax system. Horizontal equity is an elemental condition for tax fairness—the equal treatment of "equals"—yet it is often overshadowed by its twin, vertical equity, in tax reform debate. Horizontal inequities cannot be remedied by rate cuts (though the cuts can moderate them) but only by pertinent reforms to the tax base. Tax simplicity involves both administration and compliance, but emphasis should be placed on individuals' and businesses' ease and costs of complying with the tax system. Simplicity hinges on the basic design of the tax system, which relates more to the tax base than to the rate schedule, as well as on operational factors. Greater simplicity also augments horizontal equity because it allows the various tax provisions to be applied in a more uniform fashion.

PERSONAL TAX PRINCIPLES

The design of the personal tax system will be guided by the four key policy criteria: economic efficiency and growth, vertical equity (distribution of the tax burden by income class), horizontal equity, and simplicity (and related operational considerations). These criteria will have implications for both the tax base and the structure of tax rates. Most of the tax base issues affecting taxpayers at low to middle income levels differ fundamentally from those affecting taxpayers at high income levels. The reason is that Canadian taxpayers at low to middle income levels, and those who are non-taxable, are already effectively taxed on a consumption basis rather than an income basis. For taxpayers at high income levels, the most critical base issue for personal taxation is to shift more of

them from an income base to a consumption base.[3] Hence, while the base issues for high-income taxpayers relate to matters of efficiency/growth and horizontal equity, they need to be treated separately from the base issues that are paramount for low- to middle-income taxpayers.

Average and Marginal Tax Rates

Personal tax reductions can be implemented through any combination of rate cuts and base reforms. It is useful to distinguish between the effects of these changes on average tax rates (ATRs) and marginal tax rates (MTRs). Any change that reduces the net tax liability at a given level of income will reduce the ATR. Reductions in ATRs reflect pure tax relief, which is often emphasized by proponents of demand-side stimulus to the economy. Most cuts to rates and some base reforms will also reduce MTRs at various income levels, but some base reforms can produce opposite effects on ATRs and MTRs. MTR reductions are most often emphasized by analysts concerned with supply-side responses relating to the efficiency, incentives, and long-run growth of the economy. In addition, different tax bases cause the distorting effects of tax rates to act upon different margins of economic behaviour. Shifting the tax base from income toward consumption, for example, will raise the MTR on labour earnings while reducing the MTR on capital incomes.

The vertical equity goal is often expressed as progressivity of the tax system, which means that ATRs rise with taxpayers' incomes. However, the repeated pursuit of incremental progressivity over many federal and provincial budgets, until some of the most recent ones, has distorted the tax structure in ways adverse to savings, entrepreneurship, and growth. High total MTRs are applied at income levels that are quite modest by international standards. Concerns over vertical equity have also led to the deficient design of many tax and transfer provisions. At high income levels, the main effect has been to limit access to registered pension plans (RPPs) and registered retirement savings plans (RRSPs), thus denying to higher income earners the consumption-base treatment that is granted to low and middle income earners.

Base Reforms at Low to Middle Income Levels

Most deficiencies of the Canadian personal tax base that arise at low to middle income levels also result from the misapplication of vertical equity concerns. First, some income items have been left non-taxable because they are received disproportionately by those at low and middle income levels. Examples are public transfer payments, employer-paid health benefits, and strike pay. Second, some expense items that should be tax-deductible for horizontal equity across taxpayers were converted to

[3] For a sweeping and insightful analysis of the issues related to Canadian personal taxation of savings and investment income, and the use of consumption base devices, see Satya Poddar and Morley D. English, "Canadian Taxation of Personal Investment Income," *Canadian Tax Journal* (forthcoming). See also Jack M. Mintz, "Is There a Future for Capital Income Taxation?" (1994), vol. 42, no. 6 *Canadian Tax Journal* 1469-1503.

tax credits in the 1987 reforms, based on a seeming confusion of vertical and horizontal equity. Examples are medical expenses and employee-paid social insurance premiums. Third, a panoply of tax and tax-based transfer provisions have been subjected to income tests and clawbacks in order to confine their benefits to those at lower income levels. The cumulative result has been very high total MTRs for taxpayers at low and middle income levels, thus undermining incentives.

These roundabout methods of augmenting vertical equity of the personal tax come at the cost of horizontal equity and/or economic efficiency. It would be preferable to define the tax base in a way that is a broad measure of economic status or tax-paying ability. On average, this will raise additional revenues in various income classes, and these funds can be returned to taxpayers in those classes through rate cuts additional to any cuts that can be afforded by the fiscal surplus. Thus, there should be no adverse distributional effects by income class, but individuals will be more accurately and fairly assessed on their ability to pay taxes relative to each other. The use of income tests and clawbacks within the personal tax system is more difficult for policy to overcome without reducing public support for the various beneficiary groups; both minor and major policy reforms will be examined.

Base Reforms at Upper Income Levels

Some of the tax base issues cited for taxpayers at low and middle income levels also arise at upper income levels, such as the issues of employer-paid health benefits and credit versus deduction treatment. Yet one issue that applies uniquely to taxpayers at upper income levels is whether the taxable base should be income or consumption. As has been noted, taxpayers at low to middle income levels already enjoy taxation on a consumption basis. This issue warrants detailed attention, both because of its importance for the economy's performance and because it is less familiar in tax policy debates outside of economic circles. The topic is pursued here by consideration of the empirical and theoretical evidence, the implications for tax policy, an example to illustrate the income and consumption bases, and a brief review of alternative methods of implementing a consumption-based personal tax.

Empirical and Theoretical Evidence

There is extensive empirical research on the incentive effects of various taxes, but relatively little research has been devoted to the impact of tax systems on economic growth. Contrary to the common wisdom that taxation itself is inimical to growth, the empirical evidence on this issue does not produce any strong or systematic findings. Cross-country statistical studies do not even support the hypothesis that the overall level of taxes or public spending has a significant effect on economic growth rates.[4] At

[4] Ross Levine and David Renelt, "A Sensitivity Analysis of Cross-Country Growth Regressions" (September 1992), 82 *The American Economic Review* 942-63; William Easterly

(The footnote is continued on the next page.)

the level of subnational jurisdictions, though, there is some empirical evidence that tax burdens have a negative effect on growth rates, perhaps because of the higher mobility of productive factors within a country.[5]

Many heavily taxed countries of Europe have achieved higher productivity growth rates than the Canadian and US economies. And the United States, despite its lower overall tax rates, has not displayed markedly higher productivity or real growth rates than Canada; both have been relative laggards over the last 20 years. One possible explanation is that taxes are a minor factor in an economy's performance. Another explanation, consistent with a growing body of economic theory, is that the composition rather than the level of taxes is critical for economic growth. Countries of Europe depend much more on indirect consumption taxes (value-added taxes) and payroll taxes (for social security programs) in their total tax mixes than Canada and the United States. These two countries rely more heavily on personal income taxes; in 1996, 37.7 percent of all tax revenues in Canada were derived from the personal tax, compared with 37.6 percent in the United States, proportions almost 11 percentage points above the OECD average.[6]

Considerable theoretical and quantitative analysis has been devoted to assessing the relative efficiency costs of alternative tax bases.[7] The typical findings are that taxes are more distorting and damaging in the long run when the tax base is capital income than they are when the tax base is labour income or consumption.[8] Table 1 presents the results from one

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[4] Continued . . .
and Sergio Rebelo, "Fiscal Policy and Economic Growth: An Empirical Investigation" (December 1993), 32 *Journal of Monetary Economics* 417-58.

[5] Richard K. Vedder, *State and Local Taxation and Economic Growth: Lessons for Federal Tax Reform*, report prepared for the Joint Economic Committee of the US Senate, 104th Cong., December 1995; Martin Feldstein and Marian Vaillant Wrobel, "Can State Taxes Redistribute Income?" (June 1998), 68 *Journal of Public Economics* 369-96.

[6] Organisation for Economic Co-operation and Development, *Revenue Statistics, 1965-1997* (Paris: OECD, 1998), 83. Canada also nearly matches the United States in the share of the total tax mix collected from personal and corporate income taxes combined; in 1996, Canada's share was 47.3 percent, compared with the United States' 47.2 percent, both about 11 percentage points above the OECD average. Ibid., at 81.

[7] The results cited in the text are based on a relatively non-technical review of a highly technical body of literature. See Jonathan R. Kesselman, *General Payroll Taxes: Economics, Politics, and Design*, Canadian Tax Paper no. 101 (Toronto: Canadian Tax Foundation, 1997), 42-49. Unlike the study cited in table 1, most of the economic studies do not distinguish between personal and corporate-level taxes per se, but rather examine the generic bases of consumption, labour income, capital income, and total income.

[8] One analyst reaches conclusions that depart radically from the rest of the literature. By taking a small open economy and assuming that domestic rates of return to capital are fixed internationally, he concludes that taxes on labour income are the most distorting taxes and should be given the top priority for cuts. See G.C. Ruggeri, "Employment Income Tax Cuts Key to Economic Growth and Job Creation" (February 1999), 7 *Canadian Business Economics* 21-25; G.C. Ruggeri, "The Marginal Cost of Public Funds in Closed and Small Open Economies," *Fiscal Studies* (forthcoming). However, the underlying assumption

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Table 1 Marginal Efficiency Costs of Alternative Tax Bases, US Tax Reform Act of 1986

Tax base	MEC per $1 of tax
Sales value (consumption)	0.262
Labour income	0.376
All taxes together	0.391
Capital income at corporate level	0.448
Corporate plus individual income	0.497
Individual income (labour plus capital)	0.520
All capital income	0.675
Capital income at individual level	1.017

Source: Dale W. Jorgensen and Kun-Young Yun, "The Excess Burden of Taxation in the United States" (Fall 1991), 6 *Journal of Accounting, Auditing & Finance* 487-508, at 503-4.

study; most other studies maintain the same ranking of tax bases, even if their exact numerical results differ.[9] The table shows the marginal efficiency cost (MEC) of each tax, which is the dollar-and-cents magnitude of real damage to the economy arising from the collection of an additional dollar of tax on the specified tax base. As can be seen, consumption is the least inefficient base, trailed closely by labour income and more distantly by total income (labour plus capital); capital income taxed at the individual level is by far the most inefficient base.

The figures in table 1 can be used to illustrate the potential gains to the economy that can be achieved by shifting the personal tax base toward consumption. Raising one dollar of tax revenue by taxing capital income at the individual level costs the economy $1.02 of real resources, whereas raising one dollar by taxing consumption costs only $0.26. Hence, for each dollar of personal tax revenue obtained by shifting from a capital income base to a consumption base, there will be a real economic gain of about $0.76. This is a revenue-neutral tax shift, which would likely entail a hike in the statutory MTR, and in concept it would also be a distributionally neutral change. Other studies that employ more sophisticated economic modeling show even greater divergences between the economic

[8] Continued . . .
of this work seems inconsistent with empirical findings on the link between domestic savings and investment (see Martin Feldstein and Charles Horioka, "Domestic Saving and International Capital Flows" (June 1980), 90 *The Economic Journal* 314-29; W. Jos Jansen, "Estimating Saving-Investment Correlations: Evidence for OECD Countries Based on an Error Correction Model" (October 1996), 15 *Journal of Money and Finance* 749-81) and also at odds with the divergent price-earnings ratios on Canadian and US shares for companies (particularly small and mid-cap) in the same industries. Equity capital may be much less mobile than debt capital.

[9] The tax base with the lowest MEC in the study behind table 1, at just 0.176, is property value; it is not tabulated because it does not constitute a feasible base for federal taxation.

costs of taxing consumption and those of taxing capital income, so the implied gains to the economy would be still larger.[10]

Implications for Tax Policy

The lessons from this evidence are not that Canada must drastically reduce its reliance on personal taxes in order to promote efficiency and long-run growth. Of course, that goal could be pursued through reduced personal taxes and greater reliance on the goods and services tax (GST) and/or general payroll taxes. That approach would sharply compromise the vertical equity of the overall tax system. Instead, the approach pursued here is reform of the personal tax by the shifting of its base toward consumption (and away from savings) and/or toward labour income (and away from capital income). Rate cuts will be part of the overall strategy, but at higher income levels a base shift is needed more urgently than rate cuts. Shifting the base away from savings and capital income allows the promotion of efficiency and growth without entailing sharp cuts in overall revenues or the abandonment of vertical equity.

Reducing taxes on capital income and savings by increasing the relative taxes on labour income and consumption suggests policy changes that might appear to be adverse to vertical equity. However, that outcome does not necessarily follow, particularly in the longer run. Reducing the tax rate on capital income raises the rate of capital formation, and this benefits labour in various ways. First, the construction of new plant and equipment will directly employ labour and push the economy closer to full employment. Second, the accumulation of capital over time will raise labour productivity and thereby real wage rates and living standards. Third, a recent study finds that increasing the capital stock will lift the wages of unskilled labour more than it will the wages of skilled labour, thus reducing wage inequality.[11] Finally, shifting the tax base toward consumption within a direct tax leaves open the issue of how progressive to make the tax rate schedule.

Income Versus Consumption Base

Through an extended example, one can explain in lay terms some basic properties of income and consumption bases as well as alternative ways of implementing a consumption tax base. Consider two individuals who have identical education, skills, and motivation; in fact, they work side by side at identical jobs for all of their lives and earn the same salaries in

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[10] These studies use endogenous growth models. See Robert G. King and Sergio Rebelo, "Public Policy and Economic Growth: Developing Neoclassical Implications" (October 1990), 98 *Journal of Political Economy* S126-50; Michael B. Devereux and David R.F. Love, "The Effects of Factor Taxation in a Two-Sector Model of Endogenous Growth" (August 1994), 27 *Canadian Journal of Economics* 509-36.

[11] Paul Beaudry and David Green, *What Is Driving US and Canadian Wages: Exogenous Technical Change or Endogenous Choice of Technique?* Working Paper no. 6853 (Cambridge, Mass.: National Bureau of Economic Research, December 1998).

each year. The two persons are thus fully equal in their lifetime economic opportunities to consume, but they differ in one key respect. Person A spends every dollar of his paycheque by the next payday, whereas person B saves a substantial portion of each paycheque toward her retirement. Consequently, A accumulates no savings, never receives a cent of capital income, and enters retirement with no wealth; in contrast, B earns a growing amount of capital income each year and approaches retirement with large assets.

A pivotal question in the choice of a tax base is whether these illustrative individuals should be deemed to have the same ability to pay taxes over their lifetimes.[12] They earn the same stream of salaries and have identical opportunities to consume. Person B is able to consume more than person A only because B defers her consumption and thereby earns some capital income. But when their consumption streams are discounted to the same point in time, the two individuals enjoy an identical present value of lifetime consumption. An observer who believes that the two have the same lifetime utility or ability to pay taxes would opt for consumption as the appropriate base for taxation. Another observer who thinks that the individuals' tax-paying abilities should be assessed on the basis of their annual positions, despite their equal lifetime consumption options, would be partial toward an income tax base.

Consider the taxation of the two individuals, assuming for simplicity a pure flat rate of tax and varying only the base used for taxation.[13] First, if the tax base were total income (labour plus capital), person B will clearly pay more tax in every year than person A, because their labour incomes are identical but B has a growing amount of capital income, whereas A has no capital income. The present value of lifetime taxes paid by B will exceed those paid by A. Second, if the tax base each year were consumption, A will pay more tax than B in all years before retirement but none afterward, whereas B will pay less in taxes before retirement but will continue to pay taxes afterward. Yet this difference is merely a matter of timing, and the lifetime present value of taxes paid by the two will be identical under a consumption tax (assuming no bequests). Third, if the taxable base were labour income, A and B will obviously pay identical taxes each year and in total over their lifetimes, since the amounts and timing of their labour incomes are identical.

This example can be used to explore the horizontal equity and efficiency aspects of the alternative tax bases. If one deems the two individuals

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[12] Key articles arguing for the income base and the consumption base, respectively, are Richard Goode, "The Superiority of the Income Tax," in Joseph A. Pechman, ed., *What Should Be Taxed: Income or Expenditure?* (Washington, DC: Brookings Institution, 1980), 49-73, and David F. Bradford, "The Case for a Personal Consumption Tax," ibid., 75-125. Also on the consumption base, see Peter Mieszkowski, "The Advisability and Feasibility of an Expenditure Tax System," in Henry J. Aaron and Michael J. Boskin, eds., *The Economics of Taxation* (Washington, DC: Brookings Institution, 1980), 179-201.

[13] Considering a progressive rate structure would only strengthen the results in the text, but it would make the exposition more complex.

to have the same lifetime ability to pay tax, horizontal equity can be achieved with either a consumption base or a labour income base. A base of total income, in contrast, will violate horizontal equity, unless one deems the individual who chooses savings to have a greater lifetime ability to pay tax. Taxing consumption or labour income does not affect capital income, which means that the rate of return to savings is the same as the rate of return yielded by real investments. This feature means that the two tax bases do not disturb the efficiency of capital markets, savings, investment, or consumers' choices over time. In contrast, a tax on total income affects the return to capital and thereby distorts capital markets and related economic decisions. However, a tax base of total income, by including capital income, permits a lower rate of tax and thereby lesser distortion of labour market and work decisions. But, as shown in table 1, the efficiency costs of distorting the labour market are much less than those of distorting the capital market; hence, overall the income base is less efficient.

Implementing a Consumption Base

The preceding example demonstrates that a consumption base can be implemented in any of four ways, summarized in table 2.[14] First are two methods that typically are applied in indirect ways and at flat tax rates, which prevent them from using the targeted deductions and progressive rate schedules needed to achieve horizontal and vertical equity. They are a broad-based indirect tax on sales or value added, collected on the basis of each purchase, and a general payroll tax applied to all wage, salary, and self-employment earnings. Second are two methods that can be applied as direct forms of personal tax, so they can embody the deductions and progressive rates needed to achieve horizontal and vertical equity. One is a direct tax on consumption, which can be measured as the taxpayer's total income or receipts less contributions to trusteed savings plans; this is called the "registered-assets" or "cash flow" method. The other is a tax on all income except for capital income; this is called the "tax-prepayment" method, since the taxes on future consumption are prepaid when the funds are initially earned.[15]

Proposals for personal consumption taxation have a substantial history and have been given a variety of policy expressions.[16] Nicholas Kaldor

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[14] For a discussion of the characteristics of alternative forms of consumption taxes, see David F. Bradford, "What Are Consumption Taxes and Who Pays Them?" (April 18, 1988), 39 *Tax Notes* 383-91.

[15] Our example suggests intuitively why these methods are equivalent, assuming no bequests and also assuming that the rate of return on all investments is equal to the rate used for discounting future taxes. This point is demonstrated formally in Kesselman, supra footnote 7, at 269-72.

[16] For Canadian economic analysis of these issues, see Charles M. Beach, Robin W. Boadway, and Neil Bruce, *Taxation and Savings in Canada* (Ottawa: Supply and Services Canada, 1988); Robin W. Boadway, Neil Bruce, and Jack M. Mintz, *Taxes on Capital Income in Canada: Analysis and Policy*, Canadian Tax Paper no. 80 (Toronto: Canadian

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Table 2 Methods of Implementing a Consumption Tax

Flat rate, indirect taxes, with limited adjustments for horizontal or vertical equity

1) Indirect tax on individual sales/purchases
   Possible use of refundable tax credits and exemption of selected items for limited element of vertical equity
   Examples: value-added tax, goods and services tax, retail sales tax

2) General payroll tax imposed on all labour earnings, including earnings from self-employment (a form of the tax-prepayment method)
   Possible exemption on small earnings for limited element of vertical equity
   Examples: general payroll taxes of Newfoundland, Quebec, Ontario, and Manitoba (excluding earnings from self-employment)

Direct personal taxes at progressive rates, with full allowance for horizontal and vertical equity

3) Direct tax, registered-assets (or "cash flow") method
   $Y = C + \Delta W$ (Haig-Simons income definition), hence $C = Y - \Delta W$, where Y = income, C = consumption, and ΔW = net savings or change in net wealth
   Contributions deductible, investment returns tax-deferred, all withdrawals (principal and investment returns) fully taxable
   Examples: RPPs and RRSPs in Canada, IRAs in the United States

4) Direct tax, tax-prepayment method
   Tax on labour income, no tax on capital income
   Various partial devices: reduced taxation of capital gains; partial tax exclusion for interest and dividends; trusteed savings plans with non-deductible contributions, tax-free investment returns, and tax-free withdrawals
   Example: Roth IRAs in the United States

provided the original stimulus for consumption as a direct tax base in 1955, and the registered-assets method was refined by William Andrews.[17] It was further explored by the Meade committee in the United Kingdom, proposed in a US legislative bill called an unlimited savings allowance (USA) tax, and supported by the Economic Council of Canada, the Fraser Institute, and some economists.[18] In essence, it would expand the principle underlying RPPs and RRSPs—tax-deductible contributions, tax deferral on invested funds, and taxability of all withdrawals.

The tax-prepayment method of shifting the base toward consumption can be pursued by reducing the personal taxation of capital income through

[16] Continued . . .
Tax Foundation, 1987); and James B. Davies and France St-Hilaire, *Reforming Capital Income Taxation in Canada: Efficiency and Distributional Effects of Alternative Options* (Ottawa: Supply and Services Canada, 1987).

[17] Nicholas Kaldor, *An Expenditure Tax* (London: Allen and Unwin, 1955); William D. Andrews, "A Consumption-Type or Cash Flow Personal Income Tax" (April 1974), 87 *Harvard Law Review* 1113-88.

[18] The Institute for Fiscal Studies, *The Structure and Reform of Direct Taxation: Report of a Committee Chaired by Professor J.E. Meade* (London: Allen and Unwin, 1978); Economic Council of Canada, *Road Map for Tax Reform: The Taxation of Savings and Investment* (Ottawa: Supply and Services Canada, 1987).

exemptions and reduced tax rates on capital gains. Its fullest elaboration was the flat tax scheme of Robert Hall and Alvin Rabushka, embodied in a bill by US Congressman Dick Armey, and advanced in Canada by the national Reform Party.[19] The Hall-Rabushka flat tax combines tax prepayment at the individual level (no tax on any form of investment or business income) with cash flow taxation of all business earnings, all at a common tax rate.[20] David Bradford has shown how rate progressivity can be introduced into this scheme.[21]

BASE REFORMS: BROADER, FAIRER, MORE NEUTRAL

Several aspects of the personal tax base affecting mainly low- and middle-income taxpayers depart from a broad, neutral, and horizontally equitable definition of the ability of individuals to pay tax. In the area of employee benefits, these include employer-paid health benefits and strike pay. Some forms of public cash transfer benefits are not now included in the tax base. Special provision is made for age and single-parent status through extra, non-refundable tax credits in ways that do not appear to be justified. Employee premiums for social insurance and medical expenses are given credits rather than the deductions that would be warranted by horizontal equity. In addition to such equity concerns, some of the existing provisions are unnecessarily adverse to incentives and/or efficiency. Table 3 shows the estimated federal revenue impacts of most of the tax base provisions discussed in this paper.

Employee Benefits

The Canadian income tax base includes a wide range of employee benefits, with the major exclusion being employer-provided health (medical and dental) benefits. This exemption is often justified on the social policy ground that it is desirable to encourage the provision of health coverage beyond that of the public system. It is also justified on the ground that expenses incurred by households for health care are unlike ordinary consumption outlays in that they only restore a person's well-being to that of others who are not ill or injured. But that reason underlies the current allowance of tax credits for out-of-pocket health-care expenses that exceed a threshold. Therefore, for consistency, employer-provided health benefits should be included as a taxable benefit to the employee. To the extent that employer benefits plus out-of-pocket expenses exceed the

[19] Robert E. Hall and Alvin Rabushka, *The Flat Tax* (Stanford, Calif.: Hoover Institution Press, 1985); Reform Party of Canada, *A Dialogue on Income Tax Reform: Final Report of the Reform Party Taxation Task Force*, amended (January 15, 1995). Note that the flat tax is not official policy of the Reform Party.

[20] Even the Hall-Rabushka flat tax scheme, often regarded as the model for sweeping simplicity in personal and business taxation, has been found to offer new avenues for tax avoidance: see Michael Calegari, "Flat Taxes and Effective Tax Planning" (December 1998), 51 *National Tax Journal* 689-713.

[21] David F. Bradford, *Untangling the Income Tax* (Cambridge, Mass.: Harvard University Press, 1986).

Table 3 Federal Revenue Costs of Selected Personal Tax Provisions, 1999 (Projected)

Provision	$ millions
Employee benefits	
Non-taxation of business-paid health and dental benefits	1,650
Non-taxation of strike pay	[a]
Public transfer benefits	
Non-taxation of GIS and spouse's allowance	305
Non-taxation of social assistance benefits	595
Non-taxation of workers' compensation benefits	625
Lower-income taxpayers and dependants	
Basic personal credit	19,395
Supplementary low-income credit[b]	300
Age credit	1,445
Spousal credit	1,215
Equivalent-to-spouse credit	470
Child tax benefit	6,000
Credit and deduction items	
Political contribution credit	10
Charitable donation credit	1,105
Medical expense credit	450
Employment insurance	
Employment insurance contribution credit	1,325
Non-taxation of employer-paid premiums	2,725
Canada and Quebec pension plans	
CPP/QPP credits	1,755
Non-taxation of employer-paid premiums	1,940
Child-care expense deduction	525
Registered savings items	
Registered retirement savings plans	
Deduction for contributions	7,745
Non-taxation of investment income	5,445
Taxation of withdrawals	−2,420
Registered pension plans	
Deduction for contributions	5,540
Non-taxation of investment income	10,655
Taxation of withdrawals	−6,015
Capital gain items	
Partial inclusion of capital gains (75% versus full inclusion)	345
Non-taxation of capital gains on principal residences (versus full inclusion)	1,930
$500,000 lifetime capital gains exemption for farm property	295
$500,000 lifetime capital gains exemption for small business shares	620
Capital income items	
Deduction of carrying charges incurred to earn income	590
Dividend gross-up and credit	995
Pension income credit	385
LSVCC credit	85

Note: Some of these items are identified by the Department of Finance as tax expenditures (departures from an income base), whereas others are designated simply as "memorandum items."

[a] Statistics Canada no longer collects data on strike pay. [b] The 1999 federal budget increases this supplementary credit and folds it into the basic personal credit.

Source: Canada, Department of Finance, *Government of Canada Tax Expenditures 1998* (Ottawa: the department 1998), 10-17.

threshold, both of them should receive tax recognition; it is argued below that the appropriate tax treatment should be deductibility, not a credit.[22]

Other basic taxation criteria also support the inclusion of employer-provided health benefits. At any given level of income some workers receive benefits that others do not, so horizontal equity demands that these benefits be included along with other taxable fringe benefits. Because health benefits are provided with greater frequency and value at higher earnings levels, their taxability would also increase the tax system's vertical equity. The non-taxability of these benefits decreases effective MTRs on earnings, assuming that benefits grow with a worker's earnings, although this effect likely attenuates above middle earnings levels. But by making the benefits taxable, a cut in MTRs can be financed for all taxpayers. Another advantage of taxing these benefits is that doing so restores neutrality and efficiency in the non-public supply of health-care services. The current treatment biases supply toward employer-based schemes.

Strike pay received by employees who are union members is ordinarily not subject to personal tax. This treatment is based on the absence of explicit legislative direction, along with court decisions that have held that strike pay is not "income from a source." Yet not only is strike pay a receipt indirectly related to employment services, it is also financed out of employees' tax-deductible union dues. Hence, it is inconsistent with both horizontal equity and the tax deductibility of union dues to omit strike pay from taxable income. Broadening the tax base to include strike pay would also tend to reduce the incentive for unions to strike or to prolong strikes; whether this is a positive or negative effect hinges on judgments that go beyond the ordinary criteria for tax policy.

Public Transfer Benefits

Large exclusions from the tax base are made in the area of public cash transfer benefits—namely, social assistance, workers' compensation, and the guaranteed income supplement (GIS).[23] This treatment is in contrast with the taxability of transfer benefits such as old age security, employment insurance (EI), and the Canada Pension Plan (CPP) and Quebec Pension Plan (QPP). All of the excluded public transfer programs, except workers' compensation, are income-tested to ensure that only persons at lower income levels receive transfers. Hence, it might be argued that little purpose would be served by taxing the benefits—their inclusion would add little or nothing to the tax liabilities of individuals mostly below the taxable threshold. However, this is not the case for workers' compensation, which is paid out irrespective of other income that the beneficiary receives. Moreover, for individuals who move between employment

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[22] In addition to the non-refundable credits for medical expenses, a refundable credit for medical expenses is available for tax filers at lower levels of earned income.

[23] Technically, all of these items are included in income subject to tax but then can be deducted to arrive at taxable income. This procedure is intended to count the non-taxable benefits for determining income-tested benefits such as the child tax benefit and the GST credit.

and claimant status within a tax year, total income including benefits usually rises into the taxable range. In addition, about one-third of all GIS recipients are already taxable on account of incomes received from taxable sources.

Taxation criteria suggest that most or all of the excluded transfer benefits should be added to the taxable base. This is a simple matter of horizontal equity between individuals whose total income is the same but derived from different sources.[24] Adding income-tested benefits to taxable income would not subject to tax people who are fully dependent on these benefits for the full tax year, because the benefits typically fall short of the taxable threshold. But for those who combine transfers with other income, some additional taxes might be due. Adding income-tested benefits to taxable income would also reduce effective total MTRs on earnings for those who are already above the taxable threshold.[25] This would reduce work disincentives and the efficiency costs of taxation. Claimants who become taxable when their benefits are made taxable would, of course, face increased total effective MTRs as the income tax rate is added to the benefit clawback rate. This problem would be most severe for GIS recipients, which fact may argue against making GIS benefits taxable.

Taxing these transfer benefits would be consistent with the tax treatment of benefits from social insurance programs (EI and CPP/QPP) and private insurance for accident, sickness, and disability. Private insurance benefits are taxable if the employer paid the premiums (which are non-taxable to the employees); if the premiums are fully paid by the employees, then any benefits from the scheme are non-taxable receipts. Perhaps the closest analogy to this arises with workers' compensation programs. The premiums are paid fully by the employer and are non-taxable benefits to the employees, yet program benefits are received on a non-taxable basis. For consistency as well as horizontal equity, workers' compensation benefits should be made taxable. This change may require some upward adjustment of the gross benefit rates to maintain the program's income-replacement objective.

Age and Dependent Status

Since the move to partial indexation of the personal tax in 1986, the basic taxable threshold has been declining in real terms. As a result, many poor

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[24] Some observers might object that the change would be adverse to vertical equity, but this need not be the case; the incremental tax revenues could be returned to taxpayers at lower income levels by raising the taxable threshold or lowering the bottom-bracket tax rate. In essence, this change is a horizontal equity issue.

[25] The situation can be summarized using t as the individual's marginal tax rate, c as the clawback rate in the benefit program, and EMTR as the effective marginal tax rate. For a beneficiary with total income below the taxable threshold, EMTR = c; for a beneficiary who is above the threshold but with non-taxable program benefits, EMTR = $c + t$; and for a beneficiary above the threshold with taxable benefits, EMTR = $c + t - ct$, which is less than the rate when the benefits are non-taxable in the case where the individual would still be taxable on earnings.

individuals and households have become subject to increasing amounts of income tax. The 1998 federal budget began a partial reversal of this situation by offering a supplementary low-income credit, which was phased out at higher income levels. This device denied the benefits of an increased taxable threshold to filers at higher income levels, but it also raised the total effective MTRs for lower-income taxpayers. The 1999 budget has raised the taxable threshold further and removed the phaseout, which reversed the previous year's hike in effective MTRs at lower income levels. Still, the increased threshold of $7,131 leaves the poor subject to tax and should be a priority for substantial further expansion.

Elderly taxpayers have enjoyed a higher taxable threshold than other taxpayers through an age credit, but in 1995 the credit was subjected to a phaseout to restrict its benefits to lower- and moderate-income taxpayers. This credit raises the taxable threshold for senior filers by $3,482 and disappears at incomes just over $49,000. Yet there is no justification in horizontal equity for an additional credit simply by virtue of a taxpayer's being elderly. In fact, budget studies suggest that the elderly require fewer outlays to attain the same standard of living than working-age individuals. The age credit should therefore be eliminated or, if that is politically difficult, trimmed dollar for dollar with any future hikes in the basic threshold. Removal of the age credit would also simplify the tax system and reduce the effective MTR by nearly 4 percentage points for moderate-income seniors.[26]

The personal tax provides a spousal credit that can be claimed by a taxpayer when his or her partner has little or no taxable income. This provision reflects the fact that two adults incur greater expenses to attain a given standard of living than a single adult; hence, it implements horizontal equity in a tax system that is otherwise based on the individual as the taxable unit. Yet the presence of dependent children also affects tax-paying ability and, aside from the child tax benefit, receives no recognition in the personal tax. Child tax benefits are paid at rates that decline with family income and vanish entirely at upper-middle income levels. That is, the Canadian income tax does not make any provision for the presence or number of children in its measure of tax-paying ability at upper income levels. This has led to proposals to reintroduce child tax credits or exemptions or to extend the child tax benefits to higher-income families.[27] In addition, the provision of equivalent-to-spouse credits for children of single parents without any phaseout at higher income levels is inconsistent with the tax and benefit treatment of dependent children for two-parent families at higher income levels.

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[26] This is the total effect for net incomes between $25,921 and $49,134, where the phaseout applies, and includes a typical provincial tax rate of around 50 percent of the basic federal tax. Note that eliminating the age credit would also subject more lower-income GIS recipients to taxable status, thus raising their MTRs.

[27] See, for example, Kenneth J. Boessenkool and James B. Davies, *Giving Mom and Dad a Break: Returning Fairness to Families in Canada's Tax and Transfer System*, C.D. Howe Institute Commentary 117 (Toronto: C.D. Howe Institute, November 1998).

Credits Versus Deductions

The 1987 personal tax reforms converted some items that had been deductions from taxable income into non-refundable tax credits.[28] The credit approach had already been in use for political contributions, with credits provided on a sliding scale to encourage modest contributions by a large number of taxpayers. Annual contributions above $1,150 do not derive any incremental credit. This structure of credits accords with the democratic ethos of encouraging widespread participation in the political process. Commencing in 1988, the tax deduction for charitable donations was replaced with a two-tier credit. The first $200 of donations now receives a credit at the lowest federal marginal tax rate (17 percent), and additional donations are credited at the highest marginal tax rate (29 percent), irrespective of the taxpayer's actual rate bracket. This credit structure is intended to encourage all taxpayers to make larger donations and avoid incentives that differ by the taxpayer's marginal rate bracket.

The 1987 reforms also converted two other types of tax deductions into credits, both at the bottom-bracket rate of 17 percent. These were the allowances for medical expenses and the employee's social insurance premiums (for EI and CPP/QPP). Unlike the other items recognized by tax credits, these expenses are not discretionary. Social insurance premiums are mandatory levies that cannot be avoided by individuals who earn income from employment (and from self-employment for CPP/QPP). Moreover, the benefits received from these programs are fully subject to tax. Most medical expenses are also non-discretionary outlays by taxpayers. Hence, all of these items should be tax-deductible, not simply creditable. The use of credits denies taxpayers in the middle and top tax brackets full recognition for their expenses and thus distorts the measure of their ability to pay taxes. This element of the reforms appears to confuse the vertical and horizontal dimensions of tax equity.[29] Reverting to tax deductibility would also reduce effective marginal tax rates for some taxpayers.[30]

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[28] The reforms also replaced the basic filer, spouse, and dependent child exemptions with non-refundable tax credits. However, these provisions do not raise the same horizontal equity issues as those in the text.

[29] See the related analysis in A. Pierre Cloutier and Bernard Fortin, "Converting Exemptions and Deductions into Credits: An Economic Assessment," in Jack Mintz and John Whalley, eds., *The Economic Impacts of Tax Reform*, Canadian Tax Paper no. 84 (Toronto: Canadian Tax Foundation, 1989), 45-73, as well as the original justification made for these changes in Canada, Department of Finance, *Tax Reform 1987: Income Tax Reform* (Ottawa: the department, June 18, 1987), 77-78. The current personal tax treatment of employee premiums is also inconsistent with the business tax treatment of employer premiums; the latter are deductible to the employer but not taxable benefits to the employee, which is analogous to making employer premiums a taxable benefit and then allowing the employee a tax deduction.

[30] This result is not solely an effect of shifting some taxpayers into lower marginal tax brackets. There are also individuals in a range of incomes above the $29,590 threshold for the middle marginal rate who face incremental social insurance premiums with additional earnings, and for them replacing the credits with deductions for their premiums lowers effective MTRs.

Deductions for child-care expenses were left untouched by the 1987 reforms, and in recent years the maximum allowable deductions have been increased. These expenses are necessary for parents to work and earn taxable employment income, and for that reason tax deductibility might be deemed appropriate. However, there is also a social policy objective in ensuring that children receive proper care when their parents work; this goal might be a greater concern for families at lower than at higher income levels. At higher income levels, there is also a possibility that some amounts claimed for child care are in fact housekeeping or other expenses. These may be grounds for converting the current child-care expense deduction into a credit allowance. Indeed, the credits could be provided at rates declining with family income, following the lead of the provisions for child-care expenses in the United States.[31]

BASE REFORMS: SHIFTING TOWARD CONSUMPTION

Individuals taxed on an income rather than a consumption basis are those whose rate of savings exceeds the allowable contribution limits to registered savings plans. Based on current provisions, this arises above $75,000 annual earnings, assuming that actual savings are at the 18 percent of earnings allowed for contributions. In 1996, tax filers with total assessed incomes above $80,000 accounted for just 3 percent of all returns but 17 percent of all labour-type incomes reported and 41 percent of all taxable capital incomes reported.[32] (The share of all wealth held by high-income groups is in fact larger, due to their holdings in tax-sheltered forms, including offshore investment vehicles and assets with accrued but unrealized capital gains.) The personal tax base could be shifted further toward consumption by raising the income level at which taxpayers could opt for consumption tax treatment.

Our strategy for reforming the Canadian personal tax base at upper income levels is not a purist one, but rather a series of incremental steps toward a consumption base. Difficulties in the arenas of politics and transition make this approach more palatable than a sweeping reform. But even this partial move should achieve much of the efficiency and growth gains of a pure consumption base. Greater weight will be placed on the registered-assets method than on the tax-prepayment method. One reason is that the registered-assets method puts fewer demands on the need to

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[31] The rates of credit on eligible child-care expenses range from 30 percent for filers with adjusted gross incomes of US$10,000 and less to 20 percent for filers with adjusted gross incomes above US$28,000. Hence, the credit rate exceeds the MTR for lower-income claimants, which provides them with an implicit subsidy.

[32] These are the author's calculations for labour income (including employment income plus net income from business, professions, farming, and fishing) and capital income (including taxable dividends, net rental income, investment income, and taxable capital gains). Net income from business and professions in fact combines returns to both labour and capital inputs. Revenue Canada, *Tax Statistics on Individuals*, 1998 Edition (Interim Statistics—Universe Data) (Ottawa: the department, 1998), 54-56.

distinguish capital and labour incomes, which can be disguised and commingled to avoid taxes. Second, the registered-assets method prevents an escape from tax on the massive capital gains that are occasionally realized in business and financial investments.[33] Third, the registered-assets method provides less tax windfall on wealth accumulated before the change in base regime.[34] For these reasons, proposed usage of tax-prepayment devices will be relatively limited.

Registered Savings Accounts

The registered-assets method of implementing a consumption tax base is already used in the Canadian personal tax. RPPs and RRSPs are central features of personal finances. Table 3 shows estimates of the federal revenue impacts of these provisions relative to a pure income tax treatment of savings.[35] For most households other than those at the lowest and the highest income levels, these "tax-sheltered" savings plans contain the bulk of financial assets. At the lowest income levels, the tax attraction of these plans is muted and savings are meagre in any event. At the highest income levels, the ceilings on contributions to RPPs and RRSPs mean that large amounts of savings are held outside the plans in taxable forms. Moreover, the failure to provide dividend tax credits and the 20 percent limit on foreign asset content in registered plans may reduce the attractions of such plans and bias their holdings toward fixed income and domestic assets. Evidence of this is the fact that few individuals currently exhaust their ability to contribute to their plans.[36]

The existing RPP/RRSP schemes serve to moderate the effective MTR on labour earnings for individuals who save out of their earnings and are not constrained by the contribution limits. For example, consider an income earner who saves the full 18 percent of earned income that is allowed as a contribution to these plans. That serves to reduce his or her effective MTR on earnings by 18 percent of the statutory MTR—a cut of about 7 percentage points for a taxpayer facing a 40 percent marginal rate, and a

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[33] The Hall-Rabushka flat tax purportedly addresses the first two concerns through its business-level tax. Capital returns from foreign sources and domestic non-business sources would remain problems.

[34] This difference also explains why a consumption base is somewhat more efficient than a labour income base. Moving quickly to the latter base would forgo tax revenues on all wealth accumulated before the regime change, thus necessitating a higher tax rate and greater distortion of labour decisions. In contrast, the use of a consumption base taxes "old" wealth as it is spent.

[35] If the reference base for personal tax were consumption rather than income, this kind of tax expenditure accounting would instead record as a "tax penalty" the failure to exempt all savings (or investment income) from tax.

[36] Only 1 in 10 taxpayers with RRSP room made the full allowable contributions in 1997; 5 in 10 taxpayers with incomes above $80,000 fully used their allowable amounts. Moreover, for the latter group, average combined RPP/RRSP contributions were $12,835, close to the maximum allowable amount of $13,500. Statistics Canada, *Retirement Savings Through RPPs and RRSPs, 1991 to 1997*, catalogue no. 74F0002XIB (Ottawa: the department, May 1999).

cut of 9 percentage points for someone facing a 50 percent marginal rate.[37] For income earners whose savings exceed the contribution ceiling, there is only a lump-sum tax cut with no cut in MTRs.[38] Hence, for higher income earners the contribution ceiling eliminates any economic benefits from reduced MTRs on incremental labour earnings and investment returns.

Taxpayers with more than $75,000 of earned income per year are constrained in their ability to contribute to RPP/RRSP schemes by the $13,500 ceiling. This limit is much less generous than the limits in US tax-sheltered savings schemes, which allow up to 25 percent of earnings and a US$30,000 annual cap. (See table 4 for a comparison of Canadian and US tax provisions.) This greatly augments the incentives of a US tax rate structure that is already well below that in Canada. To shift the Canadian personal tax further toward a consumption base, a sharp increase in the contribution limits should be a priority.[39] To address concerns over the immediate revenue impact, one could consider the Roth individual retirement account (IRA) plans introduced by the United States in 1998. These offer consumption tax treatment using the tax-prepayment method; the contributions are not tax-deductible, but all withdrawals including accumulated earnings and principal are free of tax. Some variant of a Roth IRA, with an increased total contribution limit integrated with that of the RPP/RRSP schemes, could be an attractive solution for Canada.[40]

Whether expanded or retained in their current form, registered savings plans have constraints on their holdings and operation that limit their attractions and distort the efficient allocation of capital. First, the 20 percent limit on foreign content (though it can be skirted by derivative investments) unduly constrains investment returns and risk diversification; it should be sharply increased or eliminated.[41] Second, investors in registered plans who hold Canadian equities lose the dividend tax credit;

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[37] Of course, these examples assume that the taxpayer does not take account of the taxes that will ultimately have to be paid on withdrawals from the plan, which may be several decades away. Also, allowing these tax provisions shrinks the aggregate personal tax base so that higher statutory tax rates are needed to generate a specified amount of revenue. See table 5 in the text below.

[38] This abstracts from those taxpayers whose allowable contribution deductions shift them into a lower tax bracket.

[39] The Economic Council of Canada recommended that the dollar ceiling on contributions be entirely (but gradually) removed and that the percentage limit be raised to 25 or 30 percent and be based on total income instead of earned income: supra footnote 18, at 19. However, the dollar ceiling appears to be a much greater constraint than the percentage limit, given the provision of contribution carryforward and typical savings rates.

[40] This topic is being pursued in current research by Finn Poschmann and the author. For earners who are at a lower-income stage of their lives, and therefore in lower tax brackets, the Roth scheme would be more attractive for contributions than a registered-assets scheme.

[41] See Jason Clemens and Fazil Mihlar, *The 20% Foreign Property Rule: Increasing Risk and Decreasing Returns on RRSPs and RPPs*, Critical Issues Bulletin (Vancouver: The Fraser Institute, April 1999).

Table 4 Personal Tax Provisions for Registered Savings, Capital Gains, and Investment Incomes, Canada and United States, 1999

Provision	Canada	United States
"Registered assets" savings plans, annual limits	RPPs and RRSPs, maximum 18% of earnings or $13,500	Various schemes; for defined contribution plans, maximum 25% of earnings or US $30,000
"Tax-prepaid" savings plans, annual limits	No provision	Roth IRAs beginning in 1998, maximum US $2,000 (proposed increase to US $5,000)
Capital gains, general provisions	75% of realized gain included in tax; top effective total MTR of 39%; no distinction between short-term and long-term gains	Special tax rates on long-term gains, depending on income, federal MTR of 10% or 20%; short-term gains (assets held one year or less) taxable at regular MTR
Capital gains, special provisions	$500,000 lifetime exclusion for gains on small business or farm assets	No provision
Capital gains, owner-occupied housing	Fully tax-exempt on one principal residence	Gains up to US $250,000 (single) and US $500,000 (couple) tax-exempt
Dividend tax credit	Partial provision (full provision for small corporation tax rate)	No provision
Deduction of interest expense for financial investments	Not limited (except in relation to the lifetime capital gains exclusion)	Limited to investment income with carryover of excess

a refundable form of the credit should be extended to such investments. Third, individuals' inability to redeposit to their plans sums withdrawn for short-term needs may limit the attraction of the schemes; true consumption tax principles would allow such redeposits even if the limits on initial contributions were retained. It is worth exploring means to allow the return of withdrawn funds to plans (like existing provisions for the home buyers' plan) if the bookkeeping can be kept simple.

Taxation of Capital Gains

In addition to the Roth IRA version of the tax-prepayment method of consumption taxation, exemptions or preferential tax rates on capital incomes may also be considered. Many forms of capital such as business, professional, farming, and real property assets cannot be held within a registered plan. Hence, reduced tax rates on capital gains from non-registered assets can promote a shift toward a consumption base and greater neutrality between assets held in the expanded registered plans and other asset types. This approach would extend and modify the current Canadian provisions for capital gains taxation. From 1985 through 1994, each taxpayer enjoyed an exemption on lifetime capital gains income of $100,000. There

remains in place a $500,000 lifetime exemption for capital gains from farming property and small business shares, and ownership of home equity is fully exempt from capital gains tax. Until the 1987 tax reforms, only 50 percent of other capital gains were taxable, an inclusion rate that was raised to 75 percent for 1990 onward.

In comparison with many other countries, Canada is a relatively heavy taxer of income from capital. For example, Britain exempts the first £7,200 (about $17,000) of each taxpayer's annual capital gains; the Netherlands exempts all capital gains; and the United States has recently adopted special low rates of tax on capital gains, with a top rate of 20 percent on assets held longer than one year.[42] Some Scandinavian countries impose different rate schedules on capital and labour incomes. Sweden, for example, taxes labour income at progressive rates, rising to a top marginal rate of 51 percent, whereas capital income faces a flat tax rate of just 30 percent. These innovations reflect other nations' concerns over the international mobility of capital as well as their desire to stimulate entrepreneurial activity and spur investment and employment growth.

Reducing the tax inclusion rate for capital gains to 50 percent, where it stood from 1972 through 1987, would be an attractive policy option.[43] With this change, Canadian tax rates on capital gains would be competitive with US provisions for the highest income earners and more than competitive at upper-middle income levels, since similar taxpayers in the United States face a federal tax rate of 20 percent plus state taxes on capital gains.[44] Moreover, the Canadian treatment would avoid the US complexities of distinguishing between long-term and short-term gains. Reduced capital gains tax rates would improve Canadian competitiveness and brain-drain pressures, because stock options issued to motivate highly skilled employees and managers would be subject to the lower rates; but this would be achieved without the complexities, inequities, and industry distortions that would arise with recent proposals for special tax treatment

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[42] Long-term capital gains face a US federal tax rate of just 10 percent for taxpayers who are in the 15 percent tax bracket based on their other income; the 20 percent rate is applied for long-term gains realized by taxpayers in all the higher tax brackets. Oddly, the capital gains tax rate is determined on the basis of the level of all non-capital gains income, so that a taxpayer with US$1 million of long-term capital gains could be taxed at just 10 percent if his other income were quite low (although this circumstance would incur US alternative minimum tax).

[43] According to a report by Industry Canada, reducing the capital gains tax rate would be an effective way to induce individuals to invest in small and medium-sized enterprises: *Financing the New Economy: Towards a Positive Conspiracy* (Ottawa: the department, 1994). For a broader review of the economic evidence on capital gains taxes, see George R. Zodrow, "Economic Issues in the Taxation of Capital Gains" (November 1995), supplement, 21 *Canadian Public Policy* S27-57.

[44] US state income tax treatment of capital gains is quite varied, but most states also offer preferential treatment. For example, Massachusetts taxes capital gains at a rate of 5 percent for assets held one year; the rate declines 1 percentage point per year of the holding period, reaching zero for assets held six years or longer.

of stock options for high-tech workers. Reduced capital gains taxation should stimulate venture capital and entrepreneurial activity. It would also improve the efficient allocation of capital between the housing and business sectors and between growing new firms and established firms, and it would reduce the role of tax considerations in financial investment decisions for wealth held outside registered plans.

The revenue costs of reducing the tax inclusion rate for capital gains should not be a barrier to pursuing this base reform. As shown in table 3, the estimated federal revenue cost of the existing 25 percent exclusion is about $345 million per year. Excluding an additional 25 percent should entail less revenue cost and possibly even a rise in revenues, because a lower tax rate would induce increased realizations of accrued capital gains and may cause some taxpayers to save more outside registered plans. One could restrict the lower inclusion rate to assets purchased after the legislative change, but this would complicate the tax provision and might simply encourage individuals to retain assets already owned to await a future extension of the lower inclusion rate. In addition, lower taxation of capital gains in general would present an opportunity to phase out or abolish the $500,000 lifetime capital gains exemptions for small business and farming assets.[45] This would greatly simplify the tax system while improving horizontal equity and economic efficiency.

Taxing Investment Income

For investment income outside registered plans and other than capital gains, it is also possible to implement the tax-prepayment method of consumption taxation simply by exempting the returns from tax. Many individuals do not fully utilize their available room for contributions to registered plans for a variety of reasons. They may lack the requisite tax sophistication; they may not have enough savings to warrant the fixed costs of setting up and monitoring such a plan; and/or they may anticipate needing the funds much sooner than retirement. Accordingly, for horizontal equity and simplicity, a limited tax exemption might be instituted for interest and dividend income. This could be a restoration of the $1,000 annual exemption per taxpayer for interest and dividend receipts that was available until the 1987 tax reforms. For higher income earners, exempting a fixed proportion of interest and dividend income, such as 25 percent, would reduce the MTR on capital returns.

The preceding reforms to the personal tax base with respect to capital returns would also present an opportunity to clean up provisions that are excessively generous, even for an income base. First, the deductibility of

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[45] Note from table 3 that the $500,000 lifetime exemption is estimated to carry an annual federal revenue cost of $915 million, more than two and a half times the cost of the 25 percent capital gains exclusion. If the Mintz committee proposals were adopted, these gains could be rolled over tax-free to RRSPs rather than allowed to escape entirely from tax. See Canada, *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, April 1998).

interest charges to finance investments could be limited to the amount of taxable investment returns, with a carryover to future years of any unclaimed expense. This reform could be combined with a change to the interest allocation rules that would eliminate the need to trace individual loans and thereby greatly simplify tax compliance. Second, the existing tax credit at the bottom-bracket rate for the first $1,000 of pension income per year could be abolished, because it is unjustified on the ground of horizontal equity. Pension income could qualify for the new $1,000 interest and dividend exemption. Third, a corporate distribution tax could be implemented (following the Mintz committee's recommendation) to ensure that corporate taxes are paid where dividend tax credits are allowed.[46] Fourth, the tax credits for investing in labour-sponsored venture capital corporations (LSVCCs) could be reduced or eliminated, given our more broadly based proposals for taxing investment.[47]

Another possible reform for capital incomes would be to tax unincorporated businesses on a cash flow basis.[48] Cash flow taxation allows for immediate writeoffs of all investments but no deduction for interest expense; it is the business analogue of taxing individuals on a consumption basis. Since unincorporated businesses would not obtain any benefits from reduced capital gains taxes on shares, this reform would be economically neutral and horizontally equitable. In addition, because unincorporated businesses are not subject to the small corporate tax rate, such a move might encourage more small businesses to remain unincorporated. Finally, this reform would remove the complexities of depreciation accounting. Undoubtedly, there would be new issues arising from such a proposal that warrant close study before proceeding.

RATE CUTS: POLICY PRIORITIES

The relative priorities for various personal tax rate cuts will hinge in part on the kinds of base reforms that are simultaneously undertaken. Part of the fiscal surplus to be devoted to personal tax reduction would be applied to some base reforms, particularly at the higher incomes. The proposed reforms that broaden the base would enable larger cuts in rates. However,

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[46] Tax purists who believe that dividends and capital gains should be taxed at equivalent rates would also enrich the dividend tax credit if the capital gains inclusion rate were reduced. Note, however, that the United States provides no dividend tax credit, despite its lower tax rates than Canada on capital gains.

[47] For a critical analysis of LSVCCs, see Duncan Osborne and Daniel Sandler, "A Tax Expenditure Analysis of Labour-Sponsored Venture Capital Corporations" (1998), vol. 46, no. 3 *Canadian Tax Journal* 499-574. Poddar and English, supra footnote 3, call the joint use of LSVCCs and RRSPs a form of "double dipping," which yields a negative effective tax rate on investment (unlike the zero rate of a pure consumption tax). A report by Industry Canada, supra footnote 43, suggested that reduced capital gains tax rates could be offset by reduced tax credits for LSVCC investors.

[48] Such a reform might eventually be attractive for the corporate tax as well, but the transition problems should be easier for unincorporated business because of their smaller amounts of debt finance; under cash flow treatment, capital purchases can be fully expensed but interest deductions are disallowed.

the rate-cutting moves proposed here will stress widening the tax brackets rather than making major cuts in the marginal rates themselves. Widening the bracket ranges would move many taxpayers into lower rates of tax. Once the rate brackets have been increased to appropriate levels, full indexation should be restored to the system for the future.

In addition, a formal mechanism for income averaging needs to be restored to the personal tax; averaging provisions were swept aside with the 1987 reforms on the ground that they were superfluous with the flatter rate schedule. However, with the significantly progressive rate schedule that remains, base averaging over years is needed for horizontal equity between persons with the same average income but differing income variability. The lack of averaging also reduces incentives for individuals to enter into activities with variable incomes, including self-employment, business, and entrepreneurial activities.[49] One partial device to help individuals self-average would be the proposed provision to allow redeposits of amounts withdrawn from registered savings plans. In years of unusually low income, individuals could withdraw funds to sustain their consumption, and these funds could be redeposited in years when incomes rise to normal or higher levels.

Cuts at Lower Income Levels

The most important tax-cutting priority at lower income levels is a substantial further hike in the taxable threshold, as previously discussed. The goal over the next several years should be to raise the threshold from the current level of $7,100 to at least $9,000 to $10,000. The higher threshold would also help to insulate those affected by the proposed taxability of social assistance and workers' compensation benefits. In comparison, a cut in the bottom federal tax rate of 17 percent is less important. The problems of incentives and efficiency at low to lower-middle income levels do not arise so much from the ordinary tax rates as from the large additions to effective MTRs from numerous tax and transfer clawback provisions.[50] These provisions often add 5, 10, 20, or more percentage

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[49] One study found that high degrees of rate progressivity can be as damaging to the economy's efficiency and growth as using a lower-ranked tax base. Alan J. Auerbach, Laurence J. Kotlikoff, and Jonathan Skinner, "The Efficiency Gains from Dynamic Tax Reform" (February 1983), 24 *International Economic Review* 81-100. However, this is the result of variations in the tax rates faced by individuals over their lifetimes, which could be moderated even while retaining much rate progressivity through improved schemes for income averaging. Hence, there is an efficiency basis for averaging provisions, which can help to sustain higher degrees of rate progressivity.

[50] For documentation and computation of these features within the income tax, see Alan Macnaughton, Thomas Matthews, and Jeffrey Pittman, " 'Stealth Tax Rates': Effective Versus Statutory Personal Marginal Tax Rates" (1998), vol. 46, no. 5 *Canadian Tax Journal* 1029-66. For a detailed analysis of the specific provisions, see Jonathan R. Kesselman, "Income Security via the Tax System: Canadian and American Reforms," in John B. Shoven and John Whalley, eds., *Canada-US Tax Comparisons* (Chicago: University of Chicago Press, 1992), 97-150; and Jonathan R. Kesselman, "The Child Tax Credit: Simple, Fair, Responsive?" (June 1993), 19 *Canadian Public Policy* 109-32.

points to the individual's effective MTR, so if one is concerned about incentives and efficiency, it is more crucial to control these effects than to shave a percentage point or two off the basic income tax rate.

Some of these provisions have already been cited (the age credits and child tax benefits), but many others also require scrutiny. These include the income tax clawbacks on old age security and EI benefits; income tests in the GIS and spouse's allowance; phaseouts used in the transfer of tax credits to a filer's spouse; phaseout of the GST credits; provincial tax-relieving measures at low income levels; and the income tests embedded in many provincial benefit programs such as social assistance, public housing, and child-care subsidies. Most solutions would require large additional public outlays (and therefore higher general tax rates) or reduced benefit levels. The incentive effects of these tax and transfer provisions must be examined carefully as part of any strategy for cutting income tax rates.

Recent initiatives to expand the child tax benefits and to encourage the provinces to supplement the federal benefits have increased effective MTRs for households at modest income levels.[51] Since the federal government has stated that it plans to augment this scheme, as part of its attack on child poverty, these policies must be carefully examined. Not only have the direct budgetary costs of the child tax benefits been rising sharply; the hidden efficiency costs to the economy from the rising rates of phaseout have also been mounting and will rise further with planned future benefit hikes.[52] While these policies to "get the kids off welfare" have been moderating the poverty trap at the lowest income levels, they have also been raising the effective MTRs and work disincentives for a much larger group of households at moderate income levels. This is an unavoidable effect of policies with this structure of benefits and should cause us to consider alternative ways of providing support.[53]

Several alternative anti-poverty strategies that do not involve such high efficiency costs warrant review. First, instead of the refundable tax credit format of the child tax benefits, one could consider earnings subsidies or

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[51] See the description and analyses in Finn Poschmann, *Growing Child Benefits, Growing Tax Rates*, C.D. Howe Institute Backgrounder (Toronto: C.D. Howe Institute, February 1999); and Ken Battle, "Child Benefit Reform: A Case Study in Tax/Transfer Integration," *Canadian Tax Journal* (forthcoming).

[52] See the analysis and estimates in Edgar K. Browning and William R. Johnson, "The Trade-Off Between Equality and Efficiency" (April 1984), 92 *Journal of Political Economy* 175-203; and Charles L. Ballard, "The Marginal Efficiency Cost of Redistribution" (December 1988), 78 *The American Economic Review* 1019-33.

[53] The problems with this "get kids off welfare" strategy were assessed in Jonathan R. Kesselman, "Public Policies To Combat Child Poverty: Goals and Options," in Keith Banting and Ken Battle, eds., *A New Social Vision for Canada? Perspectives on the Federal Discussion Paper on Social Policy Reform* (Kingston, Ont.: Queen's University, School of Policy Studies, 1994), 73-97. See also Adil Sayeed, *Improving the National Child Benefit: Matching Deeds with Intentions*, C.D. Howe Institute Commentary 125 (Toronto: C.D. Howe Institute, May 1999).

supplements.[54] However, these supplements still require phaseout provisions with high MTRs. Second, wage-rate subsidies avoid the incentive problems of phaseouts and have been estimated to carry far lower efficiency costs than the other schemes.[55] Their main drawback is greater administrative complexity. Third, the efficiency costs of redistribution can be reduced by targeting transfers on traits other than income, such as single parenthood.[56] This approach, which draws on the traditions of categorical welfare, does not offer a comprehensive solution and may not be socially acceptable. Finally, greater reliance can be placed on the universal provision of in-kind benefits and services (for example, free school meals) where the needy will self-select to participate without the formal use of an income test.[57]

Cuts at Middle and Higher Income Levels

The proposed hike in the taxable threshold will be of modest but declining relative value for taxpayers at middle and higher income levels. Much more important for them would be adjustments to the bracket thresholds for the federal 26 and 29 percent tax rates. The 26 percent rate now applies at about $29,600 of taxable income, which should be increased to at least $40,000; this would also facilitate a remedy for the excessive total MTRs resulting from the child tax benefit phaseouts. The $59,200 taxable threshold for the 29 percent rate should be at least doubled. Upper-middle income taxpayers should not have to pay at the same top-bracket marginal rate faced by the truly wealthy. (In the US federal income tax, the top-bracket rate does not kick in until taxable income reaches US$278,000, or more than $400,000). The 5 percent federal high-income surtax could be eliminated, applied at a much higher income threshold, or blended into the new statutory top tax rate. In addition to these bracket adjustments, some priority could be given to cutting the 26 percent rate, perhaps by 2 or 3 percentage points, in line with the proposed base-broadening reforms.

Some observers argue that reducing the top federal MTR itself is a high priority. At 29 percent—or 30.5 percent if the high-income surtax is retained and merged with it—this yields a total MTR of around 45 percent when combined with a typical provincial tax rate (at least west of Quebec), excluding provincial surtax. If there is any concern over higher total MTRs

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[54] See John Richards, "The Case for Earnings Supplements: The Devil's in the Detail," in Douglas W. Allen and John Richards, eds., *It Takes Two: The Family in Law and Finance* (Toronto: C.D. Howe Institute, 1999), 170-214.

[55] See Ballard, supra footnote 52; and Jonathan R. Kesselman and W. Craig Riddell, *Assessment of Alternative Subsidy Treatments for the EIC Self-Sufficiency Project*, Research Paper R-95-5 (Ottawa: Human Resources Development Canada, 1995).

[56] George A. Akerlof, "The Economics of 'Tagging' as Applied to the Optimal Income Tax, Welfare Programs, and Manpower Planning" (March 1978), 68 *The American Economic Review* 8-19.

[57] Charles Blackorby and David Donaldson, "Cash Versus Kind, Self-Selection, and Efficient Transfers" (September 1988), 78 *The American Economic Review* 691-700.

Table 5 Illustrative Effective Marginal Tax Rates of Alternative Personal Taxes for High Earners[a]

Tax policy assumptions		Effective MTR on income from	
Total MTR	RPP/RRSP limits	Labour	Capital
45%	No change	45%	45%
50%	Increased	41%/50%[b]	0%

[a] These figures are for taxpayers with earned income above $75,000 who are constrained by the $13,500 limit on contributions to registered savings plans but are not constrained after the limit is increased. [b] Effective MTR is 50% (41%) if the individual does (not) consider the present value of future taxes to be paid when funds are withdrawn from registered savings plans (MTR at that time assumed to be 50%). The 41% figure is derived as 50%(1 − 0.18).

arising at high incomes, which result from provincial high-income surtaxes, this should be addressed through provincial changes.[58] The analysis here emphasizes the relative priority at higher incomes of shifting the tax base toward consumption rather than significant marginal rate cuts (besides those from expanding the brackets). Large hikes in allowable contributions to registered savings plans can cut effective MTRs on capital income to zero and thereby induce greater savings. Moreover, the current MTR on labour income can also be reduced for workers who save an incremental part of their earnings. Table 5 illustrates this tradeoff between larger cuts in the top MTR and moves of the base toward consumption.

TOWARD A REVITALIZED PERSONAL TAX

Growing calls for cuts in Canadian personal income taxes have focused on tax rates but neglected a deeper analysis of the structural priorities for fairness and growth. Moreover, proposals to provide tax relief in the form of special tax incentives for particular sectors—such as tax exemptions for the share options of high-tech workers and managers—would create new inequities and distortions rather than a broader, fairer, and more efficient tax system. An economic analysis can show the way to a revitalized personal tax, one that augments the economy's efficiency, growth, and productivity, while simultaneously improving the system's fairness across individuals in differing circumstances. Such a tax will require a carefully designed package combining base reforms and rate cuts. Table 6 summarizes the base and rate changes recommended in this paper and relates them to the criteria for a good tax system.

At the lowest income levels, the priority is to raise the taxable threshold, at least to the $9,000 to $10,000 range. This change would reduce

[58] If the federal high-income surtax were merged with the federal top-bracket rate, albeit above a sharply higher threshold, this would reduce the provinces' need for their own surtaxes in order to augment tax rate progressivity; the current federal surtax is not part of the "basic federal tax" upon which provincial (other than Quebec) income tax is calculated.

Table 6 Summary of Recommended Tax Changes and Related Policy Criteria

Recommended tax change	Policy criteria[a]
Employee benefits	
Employer-paid health benefits: add to tax base	HEQ, EFG
Strike pay: add to tax base	HEQ, EFG
Public transfer benefits	
Social assistance benefits: add to tax base	HEQ, EFG
Workers' compensation benefits: add to tax base	HEQ, EFG
Lower-income taxpayers and dependants	
Basic personal credit: substantially increase	VEQ, SIM
Age credit: eliminate	HEQ, SIM
Child tax benefits: extend to higher incomes	HEQ, EFG
Or: Income-test equivalent-to-spouse credit for child	HEQ
Various clawbacks and income-tested tax provisions: moderate, eliminate, and/or rationalize	EFG, SIM
Credits versus deductions	
Medical expense credit: convert to deduction	HEQ, EFG
Social insurance contribution credit: convert to deduction	HEQ, EFG
Child-care expense deduction: possibly convert to credit	Social goals
Registered savings items	
RPPs and RRSPs: sharply increase dollar limits, allow redeposits	EFG, HEQ
And/or: Introduce tax-prepaid savings plans	EFG, HEQ
Lift foreign content limits and allow dividend tax credits	EFG
Capital gain and investment income items	
Capital gains tax inclusion: reduce from 75% to 50%	EFG, HEQ
Interest and dividend incomes: introduce partial exclusion	EFG, HEQ
Pension income credit: eliminate	HEQ, SIM
$500,000 lifetime capital gains exemptions for small business and farm assets: eliminate or allow rollover to RRSPs	HEQ, SIM, VEQ
Deductibility of investment interest expense: restrict to taxable investment income, allow carryforward of excess, abolish tracing	HEQ, VEQ, SIM
Dividend tax credit: introduce corporate distribution tax	HEQ, VEQ
LSVCC credit: reduce or eliminate	HEQ, SIM
Unincorporated business: possibly tax on cash flow basis	EFG, HEQ, SIM
Tax rate schedule	
Federal 26% tax bracket: substantially increase threshold, cut rate slightly	EFG, VEQ
Federal 29% tax bracket: sharply increase threshold	EFG
Federal high income surtax: eliminate or sharply increase threshold	EFG
Provincial high income surtaxes: eliminate or moderate	EFG
Restore full indexation and averaging provisions	EFG, HEQ

[a] The abbreviations of policy criteria are as follows: EFG—efficiency and/or growth; HEQ—horizontal equity; SIM—simplicity and/or minimizing of administrative and compliance costs; and VEQ—vertical equity.

average tax rates for taxpayers at all income levels, but in relative terms the tax relief would be greatest for those at lower income levels. However, it would do nothing to trim marginal tax rates other than those for taxpayers who are shifted to non-taxable status. Cuts in effective MTRs, which are crucial for incentives and efficiency, could best be secured for taxpayers at lower income levels by systematic reforms to the plethora of tax phaseout and transfer clawback provisions. At middle and upper-middle income levels, the reforms should focus on substantially increased bracket thresholds and a modest cut in the middle-bracket tax rate. At high income levels, the most urgent need is a major shift in the tax base toward consumption rather than sharp cuts in statutory federal tax rates, though provincial surtax rate cuts would also be desirable. Key means of expanding consumption-base treatment would be large hikes in the contribution limits for RPPs and RRSPs and a cut in the capital gains tax inclusion rate. These changes would extend to high-income taxpayers the consumption-base treatment already afforded to low- and middle-income taxpayers.

Other useful areas of base reform involve broadening to promote horizontal equity and operational simplicity. Examples would be to include in the taxable base items such as employer-paid health benefits, strike pay, and additional public transfer benefits. Others would be to eliminate or scale back the age and pension credits, the $500,000 lifetime capital gains exemptions for farm and small business assets, and tax credits for LSVCCs. Deductions for interest expense could be limited to the tax filer's taxable investment income, and a corporate distribution tax could be instituted to stem the revenue cost associated with dividend tax credits. These changes would augment total tax revenues, which could then be returned to all taxpayers at the relevant income levels through further cuts in the statutory rates. Abolition of the age and pension credits would be partially offset by the expanded taxable thresholds provided to all taxpayers. Removing the lifetime capital gains exemptions would be partially offset through enhanced savings, capital gains, and investment income provisions available to all taxpayers.

Desirable types of base reform that contract the taxable base would limit the scope for cuts in statutory tax rates, but in a number of cases they would still reduce effective MTRs and therefore improve incentives and efficiency. Reforms that move the personal tax base closer to consumption—through expanded access to registered savings and tax-prepayment devices such as lower capital gains tax rates—would reduce the MTRs on savings, investment, and capital incomes. Expanded access to registered savings plans would also serve to reduce the effective MTR on labour earnings for workers constrained by the current contribution limits. Converting tax credit items such as medical expenses and social insurance premiums back to deductible treatment would also improve horizontal equity and, in some cases, reduce individuals' effective MTRs. The tax-deductible child-care expenses, on the other hand, might be a candidate for conversion to credit treatment.

In moving toward a consumption base, the balance between using registered assets and tax-prepaid assets may be important for long-run fiscal policy. The use of registered assets (with tax-deductible contributions) carries heavier current revenue cost, but it would be reflected in larger future revenues when the savings are withdrawn and taxed. Hence, expanded contribution limits for RPPs and RRSPs constitute a special kind of tax cut, one that would reduce taxes in the short term but increase revenues in the long term as the baby-boom generation retires. This form of tax cut could provide a sustainable foundation for lower rates of personal tax well into the future, when demands on public spending will rise again. The expanded access to non-taxed forms of savings and moderation in upper MTRs should also ease the political task of dismantling assorted industry-specific tax shelters, thereby augmenting the economy's efficiency and growth.

The proposed strategy for the Canadian personal tax system would move it closer to the US system in significant respects but would leave overall taxes higher here than in the United States. Some observers argue that Canadian income tax rates must be cut to match US rates in order to retain skilled workers.[59] Yet even if the Canadian tax rate structure were reduced to US levels, Canadian personal taxes would still be higher on account of the more generous American treatment of savings, investment income, and expenses such as mortgage interest. At upper-middle and high income levels, it is more important to reduce the effective tax burden on capital than on labour income—not to compete with the United States per se, but for the efficient and productive growth of the Canadian economy. If Canadian job opportunities and real wages are not expanded over time, no feasible cuts in personal tax rates will bridge the gap in takehome pay for similar work in the United States. Moreover, the proposed cuts in capital gains tax rates and greater access to registered savings plans would reduce the average tax burdens faced by skilled workers and entrepreneurs in Canada.

Some analysts propose shifting the Canadian tax mix away from the personal tax and toward heavier reliance on payroll taxes and indirect consumption taxes.[60] This approach is typically promoted for reasons of economic efficiency, incentives, and growth. It would also follow the pattern of many European countries, which rely more heavily on payroll

[59] For critical analysis of arguments relating to taxation and the brain drain, see Jonathan R. Kesselman, "Policies To Stem the Brain Drain—Without Americanizing Canada," in Fazil Mihlar, ed., *The Brain Drain: Causes, Consequences, and Policy Impacts* (Vancouver: The Fraser Institute, forthcoming).

[60] In effect, this is the result of the current policy of relying on excessive premiums for employment insurance as a means of financing larger cuts to personal taxes; it yields a consumption-like base of labour incomes but with an extremely regressive pattern on account of the flat rate and the $39,000 earnings ceiling for premiums. See Jonathan R. Kesselman, "Economics Versus Politics in Canadian Payroll Tax Policies" (September 1998), 24 *Canadian Public Policy* 381-87.

taxes (mostly employer-paid) and value-added taxes. In contrast, this paper suggests that a shift away from the taxation of savings and capital income and toward the taxation of consumption and labour income could be achieved entirely within our personal tax. An advantage of pursuing this shift within the personal tax rather than through greater resort to payroll taxes or the GST would be the preservation of vertical equity. Unlike those types of taxes, the personal tax allows the use of a taxable threshold and progressive rate schedule. The proposed reforms would measure taxpayers' ability to pay more consistently on a consumption basis, thus promoting lifetime horizontal equity while retaining vertical equity. These reforms would also incline the economy toward sustained growth of productivity, employment, and living standards.