Comments on the Paper by Satya Poddar and Morley D. English

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This important paper identifies many significant aspects of the personal income tax (PIT) system that we need to think about over the course of the next year or two, during which I expect there will be a thorough re-evaluation and re-examination of the Canadian tax system. Before such a thorough study it would be premature to make a whole raft of recommendations. In their paper, Poddar and English confine themselves to a relatively small number of carefully considered recommendations that are attractive and sensible.

First, I summarize briefly some of the most important insights from the paper. Then I take the basic approach, which attempts to *understand* why our tax system is as it is before trying to reform it, and I pursue it further in certain directions. The paper point outs, as others have before, that our tax system is a hybrid, combining elements of both consumption and income tax. Its first contribution is to quantify where we are on the continuum of consumption versus income tax. This is important. On the one hand, the striking result is that our PIT is about three-quarters of the way from the income tax to the consumption tax pole. On the other hand, as the paper points out, reliance on corporate income tax (CIT) revenues is increasing. Thus, unlike the situation in Europe, for example, where taxation of capital income is generally falling, we are not moving further in the consumption tax direction. In fact we may well be doing the opposite.

Poddar and English point out that our tax system is quite uneven in its taxation of personal investment income. They stress that in some areas we have treatment that is *more* generous than a consumption tax would be. This is true in the case of labour-sponsored venture funds, home buyer plans, lifelong learning plans under registered retirement savings plans (RRSPs), and the 20 percent education savings grant under registered education savings plans (RESPs). These features reduce the effective marginal tax rates on some forms of investment income below zero. The paper identifies areas, however, where we go to the other extreme and depart strikingly from the consumption tax philosophy. Surprisingly, many of the most mobile assets do not get consumption tax treatment. One might begin to wonder if the reason for having consumption tax elements

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in our system lies in a concern about incentive effects. The increasing reliance on the CIT, noted above, deepens the puzzle. The paper reports that we are giving up about $25 billion in revenue by not having comprehensive taxation of investment income under the PIT. But in 1998-99 we collected a similar amount—about $22 billion—via the CIT, which goes a long way toward cancelling out the light treatment of investment income under the PIT. So while, on the personal side, the Canadian tax system looks more like a consumption tax than an income tax, the overall picture is much less clear-cut.

The main recommendations that I take from this paper are that the high tax rates on large non-manufacturing corporations should be reduced; that we should not reduce the burden on capital income so much that we go *beyond* consumption tax treatment; and that we should convert the lifetime capital gains exemption to additional comparable RRSP room. These are all sensible and attractive recommendations.

Now, why is the tax system the way it is, and what does that imply about directions for reform? This paper talks about the possibility that social policy considerations may have an impact on the design of the tax system, but it largely discounts this influence. It talks about the PIT and CIT rates being constrained by international considerations in order to preserve revenue and to protect investment capital in Canada. I would like to add, first, the observation that there are different approaches that tend to be grouped under the heading of "consumption taxation," and they are not identical. There are important differences between what are referred to as type 1 and type 2 consumption tax approaches in this paper. It is important to ask why we have in Canada the particular mix we do of type 1 and type 2 approaches. Second, many of these consumption tax aspects are inframarginal—that is, they reduce the average tax rate on investment income but not the marginal rate. If this reflects a lack of public concern about marginal saving incentives, are there *other* underlying reasons for the broad implicit support for the consumption tax approach in Canada? Could there simply be a desire to reward people for showing thrift and self-reliance? My personal view is that such feelings likely have a lot to do with why we have the tax system we do. The fact that such feelings are non-economic does not mean that they are necessarily unimportant. We should probably keep them in mind when thinking about tax reform. Also, there are underlying equity concerns that constrain the degree to which a consumption tax approach is used.

The authors' type 1 consumption tax is essentially what we see in RRSPs—that is, pure consumption tax treatment. Type 2 is obtained when labour earnings are taxed but no deduction is given for savings; the subsequently accruing investment income is not taxed. The latter system, strictly speaking, is a wage tax rather than a consumption tax. Under certain conditions, consumption taxes and wage taxes are equivalent, but those conditions really are quite narrow. The consequences of these two different approaches may differ considerably. This is worth thinking about when designing the tax system.

Consumption tax and wage tax approaches produce the same present value of lifetime tax burdens if (1) taxes are proportional rather than progressive, (2) capital markets are perfect, and (3) there are no bequests or inheritances. Even then, the timing of tax payments over the life cycle differs between the approaches, so that while the taxpayer may be indifferent between them, the exchequer is not necessarily indifferent. A move toward the pure consumption tax and away from the wage tax—via an increase in RRSP contribution limits, for example—will tend to postpone taxes and to cause short-run revenue loss.

That lifetime burdens are different under pure consumption tax versus wage tax approaches is a significant point. Consumption taxes exempt the portion of lifetime wealth that is bequeathed, *B*. Wage taxes, on the other hand, exempt the part that is inherited, *I*. There is no reason that *I* has to be equal to *B*, even in present value. This means that the distribution of lifetime tax burdens under a consumption tax and a wage tax system might differ substantially. Now if people's concepts of equity are based on individuals rather than dynasties, then they are concerned about this difference. But what if we take a dynastic viewpoint? Suppose again that we are looking at proportional tax rates. From a dynastic viewpoint, the wage and consumption tax approaches are equivalent in terms of the expected tax burden (in present value). But even with this area of equivalence, there is a difference between ex ante versus ex post viewpoints. Suppose that my grandfather made a shrewd $1,000 investment in 1935, and that he prepaid the tax on that thousand dollars, as one would under the wage tax approach. Supposing, on the one hand, that the wage tax regime had been in place ever since, I might now find myself inheriting a million-dollar asset on which no tax had been paid since 1935 and on which no tax would ever be due. Under the strict consumption tax approach, on the other hand, my grandfather would have avoided tax on the original $1,000 in wage income, but would have paid tax on any portion of the accruing investment income he had consumed. Also, I would be liable for consumption tax on any portion of my million-dollar inheritance, or the returns it produced, that I eventually consumed. So the ex post tax burdens may be very different under the two approaches.

Under our hybrid PIT, we have part true consumption tax, part wage tax, and part income tax. Why don't we have just one of these three different things? Let us consider them in turn. Why not a pure income tax? Well, a pure income tax produces a savings distortion, as is well known. But what interests me more is the idea that the income tax approach may not correspond perfectly with popular ideas of equity. Views on equity are not always well formulated, but I believe people generally think in terms of a reasonably long-run view. Many thoughtful people have an intuitive appreciation of the point that double taxation of savings is horizontally inequitable. I think that this may be the most important reason why we have such strong consumption tax elements in our system.

Next we can ask, why not a *pure* consumption tax? Well, to start with, there are big transitional problems. There is a large stock of assets that are not registered. If we gave the benefit of the doubt, and assumed that tax was actually prepaid on those assets, then we would have to give people a deduction when they moved the assets to registered form. The result would be a very large short-run loss of revenue. Suppose alternatively that the tax was not really prepaid. In that case, giving a deduction for transferring into registered form would be highly inequitable.

There are other difficulties with the pure consumption tax approach. What about intergenerational equity? Suppose that I do not consume very much and am in fact quite miserly. Is everybody going to be happy if I pay almost no tax over my lifetime? It is not clear to me that this situation would generally be considered equitable. And then there is the savings distortion under a progressive consumption tax with rising marginal rates. This causes further impetus toward some element of wage tax approach.

Although the above discussion implies some reason to expect wage tax elements in our system, we can also reject 100 percent reliance on a pure wage tax. With that tax base we have a big problem of identifying income type. There is a large incentive to report labour earnings as investment income. Also, although tax may not have been prepaid in the past, under the wage tax we would treat everybody's assets as if tax had been prepaid. Finally, it is not clear that Canadians would generally agree that one not only should receive inherited wealth tax-free, but also should escape any tax on the return to that wealth over the lifetime.

I thus think that there are good reasons for not going to any of these polar systems. But is there a positive rationale for the *hybrid* system? I think that the basic intuition that many ordinary people have about equity in taxation favours a consumption tax or perhaps a lifetime income tax approach, even though this is often not made explicit. I think this is the underlying reason why we have the kind of PIT that we have. In our public discourse, we tend to use comprehensive income tax language, in part because of the influence of Carter. But in the political sphere, there is consistent support for strong consumption tax elements in our system. I believe that tells us something about true underlying popular notions of tax equity.

Now we can ask, if the basic philosophy is consumption tax, why do we see *some* aspects of the system that cannot be explained on a consumption or wage tax basis? In part they are there to prevent people avoiding tax on the return to labour by misidentifying it as investment income. Also, we need a compensatory device to deal with situations where tax was not really prepaid. Finally, we have no estate tax. Of course, many countries have very light estate taxes, but their complete absence in Canada makes us different and does have some implications. If we took a dynastic viewpoint, we would not care, but I am not sure that everybody is at that extreme. If many people desire a lifetime income tax rather than a pure consumption tax, then taxing capital income under the PIT can be regarded to some extent as mere compensation for the lack of tax on bequests or inheritances.

Finally, do I have any recommendations additional to those of Poddar and English? First of all, I would argue that we have reduced too much the use of the wage tax versus pure consumption tax in Canada. We should restore a substantial interest income deduction. On the pure consumption side, I think we should raise the dollar value of the RRSP contribution limits. Also we ought to increase the limit on the foreign content of RRSPs and RPPs. There are potentially large welfare losses from preventing people from allocating their savings efficiently, making appropriate use of both domestic and foreign instruments. Finally, we ought to proceed to a thorough re-examination of our income tax system.