# *Less Taxes and Better Taxes: Principles for Tax Cuts and Tax Reform*

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**ABSTRACT**

In this paper, the conditions under which Canada can have less taxes and better taxes are reviewed. First, it is argued that if we want to have less taxes, we must bring and keep the economy as close as we can to its full-employment potential, minimize the unit cost of producing public goods and services, and keep reducing the ratio of public debt to gross domestic product. Second, it is argued that if we want to have better taxes, we must strike a good compromise between fairness and economic efficiency. Fairness will be achieved if tax cuts target personal and corporate income taxation, middle-income taxpayers, and families. Economic efficiency and growth will be encouraged if tax cuts emphasize work effort, savings and investment, and international tax competitiveness. Various concrete measures to achieve these objectives are proposed. A political compromise between equity and efficiency will likely be reached only if personal and corporate taxation are reformed simultaneously.

> « L'art de taxer consiste à retirer le maximum de plumes du dos de la poule tout en provoquant le minimum de cris. »
>
> Jean-Baptiste Colbert[1]

## INTRODUCTION

I want to lead off the technical discussion by reflecting on the two principles that underlie the theme of this conference, and by deriving some first operational implications. The first principle is that we want to pay the *minimum* amount of taxes for the given level of public goods and services we choose to get. The second principle is that, once that minimum amount of taxes is set, we want the structure of taxation to be both *fair* and *growth-friendly*.

The assumption behind this discussion of principles is that we pay taxes to finance public expenditures. There is a certain amount of goods and services

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1 Quoted in J. de Mazan, *Les doctrines économiques de Colbert* (New York: B. Franklin, 1972).

that, for efficiency or distributional reasons, we want to supply through the public sector instead of the private sector. We may think that the amount of educational services supplied by the private sector acting alone will be inefficiently low and perpetuate class inequality. We may think that control over the provision of health care by a privately organized medical profession will lead to excessive spending on medical and hospital care and to a distribution of health services according to financial means instead of physical needs. We may think that private insurance and private charity are insufficient for dealing with the financial deprivation of the elderly, the unemployed, and the poor. Various decisions are reached by various countries at various times about the level of public expenditures they feel is appropriate for their tastes.

## LESS TAXES: MINIMIZING THE AMOUNT OF TAXES WE PAY

The level of public expenditures that is deemed to be appropriate can be revised over time. Different individuals, all well meaning, have diverging opinions on this issue. The political debate will never stop. But there is an aspect on which we should all agree. For any chosen target level for the provision of public goods and services, the amount of taxes collected should be as small as possible. There are two reasons for this. First, once we have decided on the amount of public services we are going to offer, we want to keep as many resources as possible for private spending and saving. Second, due to adverse incentive effects, taxation generates economic waste. This means that one dollar of additional taxation costs not only one dollar of forgone private income, but more than one dollar. How much more exactly, the empirical public finance literature gives no unique or definitive answer, but depending on the tax base considered, the forgone private income per additional dollar of taxation is estimated to range from $1.20 to $2.00. That is, one additional tax dollar induces a net loss of between 20 cents and one dollar of national income.[2]

The adverse incentives that are responsible for this economic waste are numerous. Canadian taxpayers may reduce their work effort and save less. More skilled Canadians may be tempted to emigrate, and fewer foreigners to immigrate. Firms may pursue less research and development (R & D) and invest less in plant and equipment. Fewer foreign firms may want to invest directly, and fewer Canadian firms may want to expand, in Canada. As a result, productivity and national income may grow more slowly. Moreover, the economic literature is unanimous in holding that, as the level of taxation increases, the waste rises more than proportionately. You need not be a Reagan supply-side crackpot to believe that these adverse consequences on our standard of living can be significant.

Assuming that public goods and services are provided at just about the right level in Canada, how do we make sure we pay the minimum amount of taxes for

2 Jonathan R. Kesselman, *General Payroll Taxes: Economics, Politics, and Design*, Canadian Tax Paper no. 101 (Toronto: Canadian Tax Foundation, 1997).

them? The answer is, by pursuing three objectives: full employment, minimum unit cost, and minimum debt. First, the closer we can bring and keep our economy to the minimum non-inflationary unemployment rate, the smaller our overall rate of taxation needs to be in order to achieve any given target we set for tax revenue. This means that the quality of macroeconomic management is key to getting and keeping tax rates low. In fact, much of the reduction in the US fiscal deficit in recent years is the result of the shrewd employment recovery strategy put in place by Alan Greenspan, chair of the US Federal Reserve. He has reminded everyone that Keynesian full employment can work marvels to keep taxes low. The rule of thumb here is that every percentage point reduction in the national unemployment rate, such as a reduction in Canada's unemployment rate from 7.5 percent to 6.5 percent, can shave the equivalent of about 1 percentage point of gross domestic product (GDP) off the overall rate of taxation—a not insignificant $8 billion fiscal dividend.[3]

The second tax-minimizing objective we should pursue is minimizing the unit cost of supplying public goods and services. This is a very tall order, one that other countries are doing much better at meeting than Canada, except perhaps in a few provinces. Not surprisingly, these provinces have lately been rewarded by tax cuts. A cost-minimizing strategy involves adopting state-of-the-art technologies and work organization in health, education, defence, social services, and so on; attracting skilled public employees with competitive working conditions; setting the right timing for repairs and expansion of public infrastructures; keeping the maximum amount of flexibility for internal resource reallocation; establishing incentive-pay schemes and robust accountability practices for public sector managers; developing partnerships with the private sector; and setting incentives for citizens to avoid wasteful consumption of public services.

The third tax-minimizing objective we should pursue is reducing the size of the public debt as a fraction of national income. A large public debt is morally unacceptable. It means that current generations are forcing future generations to pay for past excessive consumption. A large debt is also bad for economic growth. The room it occupies in private portfolios reduces the domestic financing available for productivity-enhancing investment, and increases our dependency on foreign borrowing. The resulting large interest payments on the debt exacerbate the financial vulnerability of governments to the slightest increase in interest rates. Most crucially, if governments want to stay out of the vicious circle of rising debt and deficits, those high interest payments on the debt have to be paid for by high taxes. So, reducing the public debt not only is morally,

3 A standard macroeconomic relationship called Okun's law says that every decline of a percentage point in the national unemployment rate makes GDP 2 percent higher. If total tax revenue rises proportionately, the $400 billion currently collected in taxes in Canada would then also increase by 2 percent—that is, by $8 billion.

economically, and financially sound, it also mechanically allows for continued reduction in the overall rate of taxation through continued reduction in the fraction of national income represented by government debt service. The explicit or implicit zero-deficit rules recently adopted by Ottawa and the provinces are doing exactly that job. Being frozen in current dollar terms, the public debt keeps declining as a percentage of our growing national income. At the federal level, the debt-to-GDP ratio currently declines by about 3 percentage points per year. This allows for a quasi-automatic federal tax reduction of about $2 billion annually.[4] Note further that the level of program spending itself is not affected at all by this joint debt service and tax reduction operation. These tax cuts can be made without program spending cuts.

How has Canada fared in achieving full employment, minimizing unit costs, and minimizing debt? Since the fall of 1996, the national unemployment rate has belatedly, but finally, declined from 10 percent to under 7 percent. Although nobody knows for sure at what point inflationary pressure will reappear, we are clearly heading in the right direction. Moreover, the debt reduction consequences of zero deficits are in full swing. It remains to be seen how much of the fiscal dividend from high employment and debt reduction will actually be returned to taxpayers by future budgets.

I have recently estimated that $30 billion of cumulative tax cuts are possible over the next 10 years as a result of achieving high employment and debt reduction.[5] But this is a conservative estimate in the sense that it assumes that nominal program spending will grow *at the same rate* as nominal GDP on average. If we begin to make better progress in the area where we have not done too well so far—namely, minimizing the unit cost of supplying any given level of public goods and services—then we can think of increasing nominal program spending *more slowly* than nominal GDP without having to reduce the growth rate of real program spending. The potential for tax cuts would increase to that extent. Of course, all those who want to downsize government program expenditures beyond what has been achieved in recent years are ready to argue in favour of even larger tax cuts. But that is a matter for political choice. What can be said is

4 In the winter quarter 2000, the net federal debt is about $575 billion and nominal annual GDP is about $980 billion, which yields a debt-to-GDP ratio of 58.7 percent. With zero deficit and nominal GDP forecast to grow by 5 percent during 2000, by the winter quarter 2001 the debt will remain unchanged at $575 billion and annual GDP will have increased to $1,030 billion. The debt-to-GDP ratio will therefore decline by about 3 points to 55.8 percent. Furthermore, if interest rates do not go wild, interest charges on the federal debt will remain about unchanged at $42 billion. As a percentage of GDP, interest charges will thus decline to 4.1 percent from 4.3 percent currently. This will make room for a $2 billion tax cut—that is, 0.2 percent of the $1,030 billion GDP.

5 Pierre Fortin, *The Canadian Standard of Living: Is There a Way Up?* Benefactors Lecture 1999 (Toronto: C.D. Howe Institute, October 19, 1999), 42-49.

that this more extreme option is clearly heading for a clash with the enormous spending pressure currently felt in the areas of health care and education.

## BETTER TAXES: MAKING THE TAX STRUCTURE FAIRER AND MORE GROWTH-FRIENDLY

So far, I have discussed only the issue of tax level: by how much the overall rate of taxation should be cut over the next decade, given our target level of publicly provided goods and services. Just as important is the twin issue of tax structure: how exactly the $30 billion (or more) of tax cuts should be implemented, given that we want to achieve both fairness and maximum economic growth.

Economic theory gives little guidance about how fairness should be incorporated into the tax and transfer system. Perceptions of fairness flow from individual and social value systems and are reflected through democratic institutions. The broad message about fairness one seems to get these days was clearly spelled out in the minister of finance's *Economic and Fiscal Update* of last November.[6] It has three dimensions. First, while most (but not all) Canadians would agree to support a somewhat larger public sector and pay more taxes than Americans do on a long-term basis, there is a widespread feeling that too much of the Canada-US tax gap is currently borne by personal and corporate income taxes. This creates frustration, independent of the economic efficiency consequences for migration and for foreign direct investment. Conversely, payroll taxes are lower in Canada than in the United States. So, the first presumption is that much of the tax reduction should be concentrated in personal and corporate income taxes, and little if any in payroll taxes. One could even think of expanding payroll taxation so as to allow larger cuts in personal and corporate income taxation.

Second, the personal income tax in Canada is much more progressive between the lower and middle income categories than it is in the United States, or in any other G7 country. Since Canada has so far done relatively more than other countries for low-income earners, the second presumption is that a substantial fraction of the personal income tax relief should be provided to middle-income taxpayers.[7]

6 Canada, Department of Finance, *The Economic and Fiscal Update* (Ottawa: the department, November 2, 1999).

7 The recent proposal put forward by the Reform Party for tax reduction and tax reform goes much further, reflecting its characteristic taste for small government and distaste for tax progressivity. Reform's tax reduction would call for significant additional downsizing of federal program spending, to 9.5 percent of GDP in 2004 from 11.8 percent in 1999-2000. Its tax reform would sharply reduce the degree of progressivity of the personal income tax schedule. Under the Reform plan, typical single taxpayers earning $30,000 and $100,000 in 2004 would pay 10.7 percent and 12.2 percent of their total incomes in federal taxes, respectively, compared with 12.3 percent and 19.4 percent in 1999. This would entail a large 37 percent federal tax cut for the $100,000 group, and a smaller 14 percent cut for the $30,000 group.

Third, compared with other G7 nations, including the United States, Canada is much less generous to taxpayers with family responsibilities. So, the third presumption is that our personal income tax system should aim for greater horizontal equity with respect to family needs.

My personal values are certainly not in disagreement with this statement of the fairness issue in the minister's update. However, as a professional economist I can be more useful in underlining the conditions that would maximize economic growth, and the potential conflicts between the fairness and growth objectives. In short, as suggested by the large economic literature on this topic, a growth-friendly tax structure will minimize waste and maximize growth by encouraging three features: work effort, savings and investment, and international tax competitiveness.

First, to encourage work effort we need to shift personal income taxation to a lower and smoother marginal tax rate schedule in the low to middle income classes. Over the years, the lack of indexing and the accumulation of refundable credits that have to be recovered as income rises have caused the marginal rate structure to spike to more than 60 percent (and, in some extreme cases, more than 100 percent) around income levels slightly above $30,000. As Robert Brown recently quipped, this is the equivalent of chaos theory applied to tax policy.[8] Although precise estimates of work disincentives are always difficult to obtain, it is a matter of sheer common sense that beyond *some* marginal tax rate the incentive to improve the quantity and quality of work effort is destroyed. It is entirely possible that this threshold has been reached in Canada in those income brackets. The mechanisms by which we deliver income relief to low-wage workers are in need of major rethinking and overhaul, beginning with a significant increase in the basic tax exemption.

Second, concerning savings and investment, we need to make progress in exempting savings from personal taxation, and business investment from corporate taxation. Savings and investment are the fulcrum of economic growth, but Canada ranks next to last among G7 countries in this respect.[9] Our savings rate is terrible! It needs to be jumpstarted. While most people think of a consumption tax as proportional or regressive, it must be understood that removing savings from taxable personal income retains progressivity. It amounts to transforming

8 Robert D. Brown, "Tax Reform and Tax Reduction: Let's Do the Job Right" (1999), vol. 47, no. 2 *Canadian Tax Journal* 182-205, at 193.

9 In its *National Accounts, Main Aggregates 1960-1997*, vol. 1 (Paris: OECD, 1999), the Organisation for Economic Co-operation and Development estimates that the net national savings rate for 1997 was 17.7 percent in Japan, 9.5 percent in Italy, 9.0 percent in Germany, 8.5 percent in France, 7.4 percent in the United States, 6.2 percent in Canada, and 5.3 percent in Britain.

the progressive personal income tax into a progressive consumption tax.[10] This need not involve sweeping changes in the tax code either. We could simply expand the current registered pension plan (RPP) and registered retirement savings plan (RRSP) rules to include a larger percentage of earnings than the current 18 percent, raise the cap above the current $13,500, and introduce various other changes (such as removing the 20 percent limit on foreign asset content) to make them more attractive. Do we need to be reminded that the role of RPPs and RRSPs is not to exempt saved income from taxation, but only to postpone taxation until the savings cease to contribute to growth and are withdrawn for consumption? Also, as many have recently suggested, some of the double taxation affecting savings outside of registered plans could be corrected by simple measures like reinstating the old $1,000 tax exemption for interest and dividend income, and returning the rate of inclusion of capital gains in taxable income to its pre-1987 level of 50 percent from the current 75 percent.

Furthermore, all capital investment should be income-tax-deductible at the time the outlays are made. Business investment in training, R & D, plant, and equipment should be subtracted from taxable corporate income, and personal investment in education and training should be deducted from taxable personal income, both with unlimited carryforward. These measures would introduce consistency between the treatment of investment and that of savings. Again, the principle is that the fraction of business and personal income that is re-spent to expand physical and human productive capacity and contributes to growth should be entirely removed from taxable business and personal income until it is later returned into the consumption flow. The corporate income tax should to that extent be brought closer to a cash flow basis. A complementary measure would end the mindless discrimination of corporate taxation against the service sectors and against larger firms.

Third, the international competitiveness of our tax system should be a crucial concern. Over the years factors of production such as business capital and highly skilled labour services have become increasingly mobile internationally. A growth-friendly tax system must not only encourage domestic firms to invest more, but also induce them *and* foreign firms to invest more *in Canada*. It must not only encourage our young people to develop their skills through education, but also induce them *and* skilled foreigners to work *in Canada*. There is mounting evidence that foreign direct investment does respond swiftly to international tax differentials—Ireland, with its very low effective rate on business capital,

10 For an exposition of the progressive consumption tax, including a summary of the evidence that exempting savings from taxable personal income would raise the savings rate, see Laurence S. Seidman, *The USA Tax: A Progressive Consumption Tax* (Cambridge, MA: MIT Press, 1997).

being the case in point.[11] The responsiveness of migration to international after-tax wage differentials (which depend on both tax rate and before-tax wage differentials) is also well documented. Studies find that migration typically responds less to differences in wages than to differences in employment opportunities, and that the highly skilled are much more mobile than are those with less education.[12] It is not clear yet whether the net migration of skilled Canadians to the United States in recent years really deserves to be called a "brain drain," not to mention whether the tax factor has played a decisive role.[13] Nevertheless, economic prudence seems to dictate that our effective rate of taxation of business capital should not exceed the OECD average, and that our effective rate of personal taxation for the highly skilled should not be excessively out of line with that of our main competitor, the United States.

Concrete measures to achieve these objectives can be proposed. In the case of taxes on business capital, it would be desirable to cut the current effective rate of 31 percent to below the G7 median of 22 percent.[14] In the case of personal taxes for the highly skilled, we could cut the middle bracket rate (currently 26 percent at the federal level) and extend the bracket to income levels much higher than the current $60,000 threshold. In both proposals there is an immediate perceived conflict between the requirements of international tax competitiveness and domestic tax progressivity. The first asks for tax cuts among middle- and high-income earners, while the second requires that higher-income earners pay proportionately more taxes than lower-income earners. The only way to resolve this conflict is to have its terms clearly and honestly spelled out by policy authorities, and to negotiate a social contract based on political compromise. An important requirement for striking such a deal is that personal and corporate taxation be reformed *simultaneously*.

However, I would like to point out that the conflict between growth and fairness may actually be less acute than it seems. Ireland, after reducing its effective

11 Two papers presented at this conference are relevant. The paper by Steven Clark summarizes the evidence on the impact of taxation on foreign direct investment, and that by Brendan Walsh reports on the Irish experience. See (2000), vol. 48, no. 3 *Canadian Tax Journal* (forthcoming).

12 See John F. Helliwell, *How Much Do National Borders Matter?* (Washington, DC: Brookings Institution Press, 1998). This book reviews the international evidence and presents new evidence on Canada-US migration.

13 The most comprehensive study is by John F. Helliwell, *Checking the Brain Drain: Evidence and Implications*, Policy Study no. 99-3 (Toronto: Policy and Economic Analysis Program, University of Toronto, June 1999). Helliwell concludes that the migration flows of the 1990s from Canada to the United States were modest from a historical perspective.

14 These numbers are calculated as weighted averages of the manufacturing and service sectors' effective tax rates on capital investment, as reported in the paper presented by Jack Mintz at this conference. See (2000), vol. 48, no. 3 *Canadian Tax Journal* (forthcoming).

tax rate on business capital to around 10 percent, has experienced no loss in tax revenue and a startling boom in foreign direct investment and national income that has seen its unemployment rate fall from 17 percent to 5 percent in 12 years. And the Netherlands, after eliminating its capital gains taxation entirely, is currently enjoying an unemployment rate below 3 percent, the lowest among OECD countries. While simple correlations do not establish causality, the experiences of these two countries are at least suggestive that the much-feared conflict between efficiency and equity could be exaggerated.

## CONCLUSION

My basic message is quite simple. First, if we want to have *less* taxes, we must bring and keep the economy as close as we can to its full-employment potential, minimize the unit cost of producing public goods and services, and keep reducing the public debt-to-GDP ratio. Second, if we want to have *better* taxes, we must strike a good compromise between fairness and economic efficiency. Fairness will be achieved if tax cuts target personal and corporate income taxation, middle-income taxpayers, and families. Economic efficiency and growth will be encouraged if tax cuts emphasize work effort, savings and investment, and international tax competitiveness. I have tried to explain and justify these principles and derive some first operational implications.

Canada has the very rare opportunity of overhauling its tax system over the next decade, because the large tax cuts to come will allow governments to make long-awaited structural changes without having to play the impossible game of pitting winners against losers. It is crucial that we do not miss this once-in-a-lifetime opportunity.