The Art of Tax Reform

Paul Boothe*

KEYWORDS: TAX POLICY ■ TAX RATES ■ TAX REDUCTION ■ TAX REFORM ■ TAX EQUITY ■ TAX STRUCTURE

Students of public finance in general and of taxation in particular owe Geoffrey Hale a vote of thanks for his recent book on the politics of taxation in Canada.[1] Following in the tradition of Canada's greatest tax writer, J. Harvey Perry, Hale gives us a history of Canadian taxation from the 1960s to that present that is replete with facts, figures, and a penetrating analysis of the political and institutional forces at work. From the era of Edgar Benson to the era of Paul Martin, he dissects Canada's major tax policy changes, placing them in the political and economic environment of their times, all the while explaining and illustrating how the mysterious process we call "tax reform" actually works.

However, hidden below the surface of this political history is another book, not unlike *The Art of War*, Sun Tzu's sixth-century BCE classic on military strategy.[2] This hidden book, which could be entitled *The Art of Tax Reform*, draws lessons from the successes and failures of past efforts. Just as *Getting Elected in Canada* is required reading for aspiring politicians,[3] Hale's book will someday be essential for anyone interested in confronting and overcoming the perils of major tax policy change.

The purpose of this paper is to draw out the lessons from Hale's hidden book and test them by applying them to two recent tax reform efforts with which I have personal experience.[4] The first, the introduction of the goods and services tax (GST) in 1990, was a spectacular failure, at least from a political standpoint. The second, Saskatchewan's personal tax reform of 2000, was a modest success. I will proceed first by discussing the lessons that Hale uncovers as he conducts his analysis of past tax reform efforts; I will then apply them to the two reform efforts in question.

GUIDING PRINCIPLES

Hale's analysis shows us that three overarching principles should guide tax reform efforts. The first is that tax reform is not an end in itself; it is concerned with achieving some combination of political, fiscal, and economic goals. It is possible

* Director, Institute for Public Economics, University of Alberta; EnCana Scholar in Public Policy, C.D. Howe Institute. The views expressed in this paper are my own and should not be attributed to any other individual or institution. I am grateful to Kirk McGregor for helpful discussions.

to make tradeoffs between the goals, but the capacity to substitute more of one goal for less of another is limited.

The political goal of tax reform is not to reward particular groups for past support, but to capture the hearts and minds of the ever-moving, elusive, median voters by causing them to feel that they will be made better off immediately, in the medium term, or both.

The fiscal goals of tax reform depend on the particular circumstances of the government. In some cases, reform may be needed to replace a disappearing tax base. In other cases, it may be necessary to alter the tax mix to diversify the government's revenue streams or to take advantage of a new, fast-growing base. Major tax policy changes may also be driven from the expenditure side of the budget, either to fund or to limit the size of government programs.

The economic goals of tax reform depend on the particular circumstances of the government and the economy. Changing economic conditions may require a different tax mix to encourage growth in areas of emerging strength or to support industries or regions that are experiencing difficult economic times. Changes in trading arrangements and patterns of trade may also provide an economic impetus for tax policy changes.

The second guiding principle is that tax reform is about balancing competing interests. As Hale points out, every tax system embodies a set of "property rights," or entitlements to a particular tax treatment. Tax policy changes that negatively affect these entitlements will be vigorously opposed. In addition, most taxpayers take the existing tax system as given and arrange their affairs so as to minimize its negative effects and maximize its positive ones. Thus, almost any major tax policy change will entail (at the least) transaction costs of adjusting to the new tax system for a large number of taxpayers.

Because they are designed to balance between competing interests, tax reforms usually are presented as packages. Trying to selectively implement reform measures is a bit like trying to unbake a cake. The carefully constructed compromises between competing interests are lost, and balance is often a casualty.

The third guiding principle is that tax reform is about timing. Both the external environment and the order and combination of tax reform measures are critical to success. For example, unexpected events such as economic downturns can derail tax reform efforts by putting unsustainable pressure on the treasury or masking the economic benefits that reform was expected to produce. Tax changes in other jurisdictions can render proposed policy changes inappropriate or insufficient.

Finally, getting the order and combination of policy changes right is vital. One thing that Hale's analysis shows is that the electorate's memory is short. Thus the costs of the tax policy changes should never follow the benefits, lest the benefits be forgotten by voters.

STRATEGY

According to Hale, building consensus about tax reform requires support from a combination of three groups: tax experts, stakeholders, and the general public. In a federal system like Canada's, stakeholders may include other levels of government. Hale argues that for reform to be successful, it is necessary to have the support of both of the first two groups or one of the first two plus the general public.

As in any successful policy reform process, coalitions of supporters must be created and coalitions of opponents divided. Hale's approaches to building consensus can be classified under three headings: consultation, communication, and compensation. I will look at each one in turn.

Consultation

If the reform being considered is essentially technical (that is, if it will not have a significant impact on the general public), then it is sufficient to consult only tax experts and stakeholders. Consultations help policy makers understand both the nature and the intensity of the groups' views so that proposals can be fine-tuned to deal with unforeseen impacts. In addition, potential coalitions of supporters and opponents can be identified.

If the government is not yet firmly committed to reform, consultation may help policy makers gauge public opinion and ultimately decide whether the expected benefits of reform are worth the risk. Finally, if the reforms have significant implications for the general public, the consultation process can be used both for the reasons discussed above and to begin the larger process of communicating reform.

Communication

Successful tax reform cannot come as a surprise to the affected parties. Effective communication is the key to building support among all three groups by letting them know (1) why reform is needed, (2) what options are available, and (3) why government is proposing one option or another. In other words, the government must describe the benefits and costs and how they will be distributed.

Effective communication is also needed to deal with issues raised in the course of consultations to help limit the formation of opposing coalitions. Such coalitions are dealt with either by modifying the proposed changes to deal with the issues raised by opponents or by presenting convincing counter-arguments. Sometimes it is sufficient to make clear to the general public that the concerns raised are related to a group's special tax preferences embodied in the current system.

Communication is also an ongoing process that continues through the implementation of the reform. Such communication is designed to help individuals and businesses understand how reforms will affect them and to remind them of the progress that is being made in achieving the reform's stated goals.

Compensation

Because all systems of taxation confer "property rights" in tax preferences, tax reform inevitably creates some "losers"—at least in the relative sense of one group's not gaining as much as other "winners." For example, much of the negative discussion that occurred in connection with the recent Alberta income tax reform focused on whether the middle-income taxpayers were losers—where being a loser was defined as receiving a smaller proportional tax *reduction* than other income groups.

One important way of achieving balance in tax reform (and dividing or limiting coalitions of opponents) is to compensate the losers. Usually this is done indirectly by means of some offsetting change elsewhere in the system. Offsetting changes may be used to achieve balance within groups (higher- versus lower-income taxpayers, large versus small businesses) or across groups (individuals versus businesses). Compensation is sometimes beneficial, and not only because it eliminates opposition from groups that would otherwise be disadvantaged. It may also improve support from winners if they feel that compensation enhances the overall fairness of a reform proposal.

APPLYING THE LESSONS

The Introduction of the GST (1990)

In 1990, the federal government replaced the manufacturer's sales tax (MST) with a 7 percent broad-based, value-added tax. The reform was necessary for both fiscal and economic reasons. On the fiscal side, businesses were rearranging their affairs to minimize tax, thereby causing the MST base (and government revenues) to shrink. This led the government to increase the MST rates, which in turn led to further business reaction and base shrinkage.

On the economic side, the MST was not compatible with the recently negotiated free trade agreement with the United States. The tax was unevenly applied and contained numerous exemptions, which led to cascading through the value chain and put Canadian exporters trading at world prices at a competitive disadvantage.

One can ask whether the GST was a success or a failure.[5] Although it did accomplish its fiscal and economic goals by providing stable revenue to government and improving the competitiveness of Canadian exporters, those goals were attained at great political cost. The GST is widely viewed as one of the important contributing factors to the annihilation of the Conservative government in the next general election.

What went wrong with the GST reform? A review of events in light of Hale's guiding principles and strategy is illuminating. Probably most important, it is clear with hindsight that the government was never able to gain the support of two of the three critical groups. The move to the GST was widely, if not unanimously, supported by tax experts, but stakeholders were divided on the issue. The general public was never supportive, and business groups were divided. Large manufacturers and exporters supported the reform because it removed taxes on business inputs and improved international competitiveness; small business opposed the reform because of the "mountains of paperwork" the new tax would create.[6]

Not surprisingly, the provinces also opposed this invasion of "their" tax field by the federal government, despite numerous efforts by Ottawa to compensate them through a range of related and unrelated measures.[7] Efforts to gain the support of the provinces were ultimately doomed for fiscal and political reasons.[8] Indeed, the Atlantic provincial governments that ultimately cooperated with the federal government in setting up a harmonized sales tax regime felt the wrath of voters in their next general elections.

Finally, the federal government was never able to gain support for this wide-ranging reform from the general public. In part, this failure was the result of conflicting messages communicated to the public by the provincial governments and by small business. However, it is not clear that the public would have supported the GST even without the opposition of some important stakeholders. Again with hindsight, it is clear that the federal government made two critical political errors. As Hale points out, the first was to provide the compensating benefits (personal tax reductions) before the costs (the introduction of the GST). Hale discusses in detail the political circumstances that led to this decision.[9] Suffice it here to say that, with a federal general election separating the two events, voters had largely forgotten the benefits of personal tax reductions by the time the GST was implemented, and they did not view the new tax as a quid pro quo for earlier income tax reductions.

The second political error was not to allow tax-inclusive pricing. This decision, which was strongly supported by tax experts, ran counter to the administration of value-added taxes in many other jurisdictions. The reasoning was that tax-exclusive pricing was better for accountability, and the government had promised that prices would not rise as a result of the GST. However, it soon became obvious that people were not happy about having to solve a mental arithmetic problem every time they made a purchase. Tax-exclusive pricing ensured that the public never forgot (or forgave) the introduction of the GST, and the decision shows why technical experts should avoid giving "political" advice.[10]

Some might argue that there was no politically feasible way of introducing what was perceived to be a new tax. However, successful implementations in Europe and more recently the Australian federation show that this is not true. I believe that Hale's lessons offer us a useful explanation of the (avoidable) political failure of Canada's GST reform.

Saskatchewan's Personal Tax Reform (2000)

In 2000, Saskatchewan took advantage of the general move of provinces to a tax-on-income system to substantially simplify its income tax regime and lower its tax rates. Over a three-year period, the province reduced rates across the board, eliminated a host of surtaxes and other ad hoc measures, and reduced the number of rates from five to three. Income tax reductions were financed in part by a broadening of the sales tax base.[11]

Personal tax reform was necessary for both economic and political reasons. On the economic side, personal tax reductions in neighbouring Alberta had created a larger gap relative to Saskatchewan's complex, high-rate system. The gap led to the widely held perception that Saskatchewan was not competitive and that out-migration was being exacerbated by declining confidence in the Saskatchewan economy.

On the political side, the government was approaching its third general election. Having raised taxes substantially to eliminate the province's substantial deficit in the early 1990s, the government was persistently criticized by the opposition for the province's perceived inability to compete economically with Alberta. In addition, voters were looking for a reward for the sacrifices that were required to eliminate the deficit.

Did personal tax reform succeed or fail in Saskatchewan? I believe that it should be judged a success—with one reservation. The government succeeded in substantially closing the income gap with Alberta so that, for the majority of Saskatchewan people, the difference in taxes was roughly equivalent to the difference in the cost of living in major centres in the two provinces. Furthermore, the government was able to counter one of the opposition's strongest criticisms and has survived (at the time of writing) three years in coalition with a handful of independent members. However, interest groups were able to thwart the government's efforts to expand the sales tax base sufficiently to lower sales tax rates as well as income taxes. This failure to reduce sales tax rates led to some public confusion about the overall goals of reform and provided an opening for the opposition to attack the government.

Once again, we can use Hale's lessons to examine what went right and what went wrong in Saskatchewan's personal tax reform. On the positive side, the government deftly handled the consultation phase of reform. Of course, Saskatchewan's relatively small and politically engaged population made consultation more manageable. However, the government's choice of three non-partisan tax experts to consult with the public and make recommendations gave the process substantial credibility and helped to win the support of both tax experts and the public for the government's tax reform agenda.

The three-person tax review committee developed a bold proposal to address the issue of competitiveness by financing substantial income tax reduction through sales tax base expansion—to the point that the sales tax rate could also be lowered.[12] The proposal to lower both income and sales tax rates was designed to help win public support for base expansion and to isolate the government's opponents. The pace of tax reform was carefully timed to match the initial benefits of income tax reductions with the costs of sales tax base expansion. Finally, the reform was phased in over three years, and the base expansion was complete within the first six months. Thus, the government was able to deliver sustained income tax reduction over the life of its mandate.

Despite its overall success, however, the government was not able to deliver the full reform and reduce sales tax rates as well as income taxes. In hindsight, it is clear that the government waited too long after the release of the commission's report to show its support. In part, this caution can be attributed to the realities of the coalition government's razor-thin majority in the legislature. Whatever the reason, it allowed interest groups not currently subject to sales tax (primarily restaurant owners) to launch an aggressive public campaign to defend their tax preference.[13] In the face of this vigorous opposition, the government decided not to expand the sales tax base to include restaurant meals. The forgone revenue was sufficient to preclude a reduction in the sales tax rate and allowed the opposition to focus its criticism on base expansion.

CONCLUSION

Although tax reform has fiscal and economic elements, it is important to remember that it is ultimately a political exercise. This is one of the key messages of Hale's work. Only in considering the political forces as well as the fiscal and economic ones can we fully understand the tax reform process. As we have seen, the lessons Hale draws regarding both the guiding principles and strategy of tax reform provide a useful framework for examining two recent Canadian tax reform efforts: the 1990 introduction of the GST by the federal government and Saskatchewan's 2000 personal tax reform. As a tax reform survivor, I recommend this book be required reading for all finance ministers and deputy ministers who are contemplating the perils of tax policy change.

NOTES

1 Geoffrey Hale, *The Politics of Taxation in Canada* (Peterborough, ON: Broadview Press, 2002).

2 See Stephen F. Kaufman, *The Art of War: The Definitive Interpretation of Sun Tzu's Classic Book of Strategy for the Martial Artist* (Boston: Charles E. Tuttle, 1996).

3 Tom Brook, *Getting Elected in Canada* (Stratford, ON: Mercury Press, 1991).

4 In 1990, I served as adviser to the deputy provincial treasurer of Alberta. In 2000, I served as deputy minister of finance for Saskatchewan.

5 For a full account of the reform, see Neil Brooks, *The Canadian Goods and Services Tax: History, Policy, and Politics*, Australian Tax Research Foundation Research Study no. 16, Public Sector Management Institute (Sydney: Australian Tax Research Foundation, 1992).

6 See, for example, the discussion in Alberta, Office of the Premier, *Protecting Alberta's Future . . . Why We Oppose the Federal Goods and Services Tax (GST)* (Edmonton: Office of the Premier, 1989), 16.

7 It was a common occurrence during the negotiations for federal officials to offer side deals to individual provinces to gain their support. These deals rarely survived the provincial finance minister's next trip to his riding to hear his constituents' views on the proposed GST.

8 Dahlby and Wilson discuss the negative vertical externalities that can occur when tax fields are jointly occupied without some explicit sharing agreement. See Bev Dahlby and L.S. Wilson, "Tax Assignment and Fiscal Externalities in a Federal State," in Paul Boothe, ed., *Reforming Fiscal Federalism for Global Competition: A Canada-Australia Comparison* (Edmonton: University of Alberta Press, 1996), 87-107.

9 Supra note 1, at 214.

10 As Hale reports, ibid., at 219, polling conducted in 1994 showed that fully 74 percent of the public supported the GST's inclusion in prices.

11 Saskatchewan, Department of Finance, Taxation and Intergovernmental Affairs Branch, *A Plan for Growth and Opportunity: Personal Tax Reform in Saskatchewan* (Regina: Department of Finance, 2000), released with the March 29, 2000 Saskatchewan budget.

12 Saskatchewan, *Final Report and Recommendations of the Saskatchewan Personal Tax Review Committee* (Regina: Department of Finance, November 1999).

13 Full-page ads in daily newspapers showed a young girl imploring Premier Romanow not to tax her lunch. How many schoolchildren regularly purchased their lunches in restaurants was never made clear. Senior executives from national fast-food chains flew to Saskatchewan for private meetings with the premier.