Taxation with the least pain—a new tax structure for Canada

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Canada's tax burden—total government revenues are now about 43% of GDP—is well above levels that existed in the past 50 years. It is substantially higher than that of many other countries, including Australia, Hong Kong, Iceland, Ireland, Japan, Korea, Spain, Switzerland, the United Kingdom, and the United States, to name but a few. Although this tax burden has been rightfully a subject of debate in Canada, little attention has been paid to another aspect of tax policy—the tax structure.

The tax structure is important. Taxes can significantly deter work effort, savings, risk taking, and investment, resulting in a smaller economic pie to support the population. Thus, even if one is reducing taxes, it is important to reduce them to remove the most objectionable tax distortions that impair economic growth and job creation.

In the light of the events of September 11, 2001, it is easy to dismiss the need to address issues surrounding the tax burden and tax structure. In fact, some experts have almost given up on long-term fiscal issues, arguing that we will have bigger governments and higher taxes to contend with in future years. However, I believe that the issue of tax reform—better tax levels and structure—should not be put on the back burner.

We ignore taxation and its structure to our peril. The problems facing Canada prior to September 11, 2001 have not disappeared: productivity, competitiveness, and an aging population continue to remain at the forefront.

How can we improve productivity and competitiveness through a better tax system? At the heart of the issue is the need for Canada to be an attractive place for skilled workers and jobs. With greater economic integration, particularly in North America, Canada will need to offer economic policies that will attract people and businesses here. Part of our economic plan should be to improve our tax structure.

Below, I outline a tax structure that I envision for Canada, one that would result in greater productivity and improved competitiveness in North America; a tax structure that is far better than that found in other countries, including the United States.

A tax structure for the twenty-first century

What kind of tax structure do I have in mind? In pursuit of both efficiency and fairness, the tax structure that best maximizes opportunities for growth and job creation is one that taxes people according to what they consume rather than what they produce. Thus, the best taxes are those based on consumption.

Tax research in the past several decades has recognized that the most important revenue source today—the annual personal income tax—discriminates against savers. If two people have the same lifetime earnings but one saves some earnings for future consumption, the saver pays more tax than the consumer does over a lifetime. The reason for this is that saver is taxed twice—once on earnings and a second time on income earned on saved earnings. On the other hand, the consumer is taxed only once—only when earnings are received since consumer does not save anything and, therefore, has no capital income. Thus, the annual income tax falls more heavily on those who wish to consume more in the future.

Yet, the Carter Report (Canada 1966), still the bible of Canadian tax policy at the Department of Finance and among practitioners,[1] argues that annual income—earnings plus income earned on investments—is the most efficient and fair base for taxation. However, the non-uniform taxation of consumption under the annual income tax is troubling. If a person's welfare depends on consumption of goods and services throughout all periods of life, what rationale is there for taxing future consumption more highly than current consumption? Taxing the return on investment does not seem efficient or fair.

Taxation of savings can impose high costs on the economy at the same time that it lowers our productivity. The economic cost of taxing savings can be quite significant, varying from 11 cents to one dollar on each dollar of revenue raised by governments (Bernheim 1999). In terms of economic output, in the year 2000, taxation of savings can result in a loss of GDP ranging from $15 billion to $140 billion per year or, per person, from $500 to up to $4500 per year.

However, these estimates of the economic gains resulting from eliminating taxes on savings fail to account for other pressing needs in the future: the demographic time bomb and competitiveness pressures.

Demographic impacts

The demographic picture for Canadian and other industrialized economies is well known. The population over 65 years of age will rise sharply over the next 50 years with very little growth in the population at working age from 2020 onwards. The impact of these projected changes on public resources will be significant (OECD 2001). While expenditures on education and child support will fall by 1.2 percentage points of GDP by 2050, expenditures on benefits for the elderly and health care shall rise by 9.4 percentage points. Further, with more people retired, who pay less tax, taxes, as a proportion of GDP, will decline by 1.2 percentage points. The net effect shall be a worsening of primary balances by 9.4 percentage points that can only be made up by major expenditure cuts, lower debt, or substantially higher taxes that will be felt by the working population.

The impact of these demographic changes on public expenditures and taxation is only part of the story. The current working population will need to accumulate sufficient wealth to cover significant private expenditures when they retire in later years. Further, to the extent that governments target public support to the elderly who most need it, these elderly will need greater resources after retirement. Thus, savings today will be important to cover the future needs. As the day of reckoning is not far away—only two decades from now—governments will have to plan carefully now to ensure that future needs shall not place immense burdens on the younger population.

Productivity and Competitiveness

After a decade of slow growth, Canada must do more to improve its standard of living. To achieve growth in the future, Canada will have to compete with other countries for human and capital resources. The past two decades has witnessed an explosion in cross-border financial transactions, intrafirm trade within multinational companies, and inbound and outbound investment. Although not disappearing, borders between countries are "thinning" (Helliwell 2000), especially between Canada and United States. The recent security measures adopted at the border between Canada and United States and difficulties this poses to businesses and travellers is a testament to how much trade matters between the two countries.

To attract investment and jobs, countries have been looking towards improving the quality of their skilled labour, infrastructure, and other factors that improve the business environment. Canada will have to make changes in these fields, just to keep up with international rivals. Coupled with the demographic changes discussed above, capital investment is critical for improvements in productivity.

Seen in this light, savings and investment play an important role in creating a better environment for economic growth. Some recent theories suggest that savings can also reduce income inequality. With additional resources, lower-income households can benefit from increased investments in capital, including the acquisition of skills and training, and reduced levels of unemployment.

Further, given the difficulties being encountered at the international level to tax income from savings, the administrative and compliance problems of levying income taxes are becoming more troublesome. I have argued elsewhere (Mintz and Chen 2000) that the corporate income tax, as we know it today, could wither in the next two decades given the problems involved with levying corporate taxes on income that can be easily shifted from one jurisdiction to another.

A dramatic departure—replace income taxes with an expenditure tax

A dramatic move that would substantially improve Canada's standard of living is to adopt a new tax structure that would replace the income taxes with expenditure taxes. This type of approach has already been proposed in the United States but, even if not adopted there, Canada could achieve a significant economic advantage by adopting a consumption tax.

Canada already has some forms of consumption taxation so it would not be difficult to expand on what is already in place. The types of consumption taxes we have at present include the following:

- federal and provincial sales and excise taxes on consumption goods
- taxes and fees that are related to the consumption of public services
- some use of the expenditure base for the personal "income" tax.

The latter type of consumption taxation—an expenditure tax for personal taxation—requires some elaboration. Under a personal expenditure tax, once a person receives earnings, the same amount of tax is paid on a present-value basis no matter whether the earnings are consumed immediately or deferred until a later time for consumption. Two approaches can be used for consumption taxation (Institute for Fiscal Studies 1978).

First, taxes could be levied on expenditure measured as the difference between earnings and savings. This type of approach is used for the tax treatment of registered pension (RPP) and retirement savings (RRSP) plans, whereby a person can deduct contributions to these plans from their base and pay tax on withdrawals of the principal and accumulated income at a later time. Thus, for a full expenditure tax, no limitations would be placed on contributions made to registered plans.

Second, consumption taxes could be imposed by simply exempting interest, dividends and capital gains earned by taxpayers (as discussed below a parallel business tax would be needed with this approach). This latter approach is referred to as the exempt-yield approach and it has been largely followed in Hong Kong, for example (see Mintz and Richardson 2002).

In Canada, we have used the expenditure approach to tax owner-occupied investments in housing. Taxpayers cannot deduct contributions to housing investments nor are they taxed on the sale of their house or on any "imputed rent" that they receive by effectively renting the house to themselves as owners.

Under the expenditure tax, deductions and credits to recognize families of different sizes, disability costs, medical costs, and so on could continue. The schedule for tax rates could be flat (same rate for all levels of income) or rising with income. Both the registered asset and exempt-yield approaches to expenditure taxes would allow taxpayers to smooth out their expenditure base over time. Such self-averaging could avoid the impact upon taxpayers who now high tax rates in some years and low rates in other years.

Business taxation is a significant issue for a regime of expenditure taxation. If there were no business tax, individuals could avoid taxes by withdrawing their earnings from businesses in the form of dividends or other forms of capital income that might escape tax under the exempt-yield approach. A business-value tax could therefore be levied, the base defined as the difference between revenues and current and capital costs. Effectively, the business-value tax would eliminate the business tax on marginal investment projects and encourage productivity and job creation.

A full-fledged approach to expenditure taxation in Canada would therefore result in the following improvements upon the current income tax:

- taxpayers would be able to deduct contributions to RRSPs and pension plans without limit

- taxpayers would be able to invest in other forms of savings without paying tax on dividends, capital gains or interest income

- corporate income and capital taxes would be replaced by business-value taxes.

The economic gains from moving to an expenditure tax approach have already been stated. One could argue that fairness is also improved by taxing savers and consumers on the same basis. Further, it would make it easier to administer taxation and would encourage compliance. Levying annual income taxes raises many problems since it is so difficult to measure components of income properly. Income should be indexed for inflation. Depreciation of assets should be based on true economic lives and obsolescence. Capital gains should be taxed on an accrued, not a realized, basis. The latter is especially difficult since accrual taxation requires periodic valuation of assets, some of which are not frequently traded, and taxes have to be assessed even if the asset is not sold (thereby raising issues of liquidity). Expenditure taxes avoid all these problems of measurement and are thus easier for taxpayers to comply with and for governments to administer.

How do we get from here to there?

Given these gains in efficiency, equity and compliance, why are Canadian governments not jumping at the opportunity of adopting an expenditure tax? Three issues are critical but none are insurmountable.

Equity

The usual argument against expenditure taxes is that they are not fair. Since savings are a larger proportion of annual income for upper-income taxpayers, critics of consumption taxes suggest that the exemption of savings results in a regressive tax (regressivity implies that taxes proportionally decline in relation to the base). Advocates of a consumption tax argue, however, that expenditure taxes can be made progressive if desired.

The reply to the argument that consumption taxes are unfair notes that savings simply defer taxes on consumption to future years. Therefore, one should calculate the present value of taxes paid on savings and add this value to current taxes to measure the total amount of taxes paid by individuals on their earnings. Calculated in this manner, a consumption tax levied at a flat rate is at least proportional to earnings, once taking into account deferred taxes on savings.

Further, the argument rests on the implementation of expenditure taxes. If a refundable tax credit or a rising rate schedule is provided, the expenditure tax is made progressive in the sense that the average tax rate rises with consumption levels (income-testing the credit will surely make the expenditure tax more progressive).

Concerns about the accumulation of wealth

Since the accumulation of savings is equal to the stock of wealth held by people, proponents of annual income taxes argue that savings should be subject to tax. Wealth provides opportunities for people to enjoy more untaxed consumption goods including leisure (the landlord's son who does not work) and political power. Therefore, it is appropriate to tax savings for these two reasons. The first argument—the consumption tax is applied on a narrower base compared to an income tax—is an important criticism since an equal-yield expenditure tax as a replacement for the income tax would result in a heavier tax on labour earnings. However, the argument does not provide a basis for an annual income tax; it is not a foregone conclusion that the return on savings should be taxed at the same rate as labour earnings.

The second argument made against consumption taxation is that the accumulation of wealth provides political power. Little research has modeled wealth as a source of political power and therefore providing special gains to certain individuals. One would need to provide an explicit model of political decision-making to understand the role of wealth, an area that should be open to greater analysis with new models of political economy that are now fashionable. Not all forms of wealth leads to greater political power: housing and retirement assets, the most significant forms of wealth for many people, unlikely play an important role in political influence. Instead, a tax on the very wealthy might be appropriate in principle, as some consumption advocates have argued. However, the wealth tax has provided very little revenue to governments since so many forms of wealth, such as housing, farming and small business investments, have been exempted .

Transition problems

Although there might be good arguments for the adoption of any major change to the tax system, any change could flounder in the midst of transition problems. By shifting from an income to consumption tax, old assets and accumulated wealth of the elderly would be subject to new levies and there would be a desire to provide some tax relief for low-income individuals. Transitional relief that would make it more politically acceptable to adopt a new form of taxation could possibly reduce some of the efficiency gains from adopting a consumption tax as a replacement for the income tax.

One very recent study (Altig et al. 2001) has modeled transitional measures for the adoption of a flat tax on consumption in the United States and found that most efficiency gains would be lost from adopting a consumption tax that provides offsets for low-income and elderly taxpayers. However, this study is based on the assumption that a move to an expenditure tax would raise the same revenue as the existing income tax. If governments are cutting taxes while changing the tax structure, it is possible to move to the desired tax base without hurting some taxpayers. Thus, for example, an expenditure tax could be easily adopted in Canada by expanding RRSP limits and introducing the exempt-yield approach over time.

The above arguments explain much of the public's ambivalence towards the full adoption of expenditure taxation in Canada. Although several points may be raised against the adoption of an expenditure tax, advocates of the expenditure tax can easily refute most of the arguments. The economic case for expenditure taxation is, therefore, pretty strong. But, in the end, political perception plays an important role in determining tax policy.

Conclusion: potential Canadian tax reforms

Given demographic pressures and increased economic integration, especially with the United States, Canada could sharply increase its standard of living and productivity by replacing the income tax with an expenditure tax. Several policies that would not be difficult to achieve include:

- a sharp increase in sales tax revenues (sales and excise) to reduce income taxes

- a major expansion of RRSP and pension limits to allow for greater accumulation of wealth to meet future contingencies of various sorts

- the introduction of an exempt-yield tax saving plan (with restrictions on contributed amounts) that would encourage saving by individuals expecting increases in future tax rates.

The adoption of an expenditure tax would certainly set Canada apart from other countries, including the United States. However, such a reform would require a careful consideration of implementation issues, including distributive impacts, transition and business level taxation. As has been recorded in studies found in the past literature, the technical issues are not insurmountable. The primary issue is to improve the tax structure to remove taxes on savings and investments and so create greater opportunities for economic growth and job creation.

Note

1 Even the tax expenditure accounts, often cited in the press and expert analysis, rely on annual income as the benchmark for evaluating the value of such expenditures.

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