



The Repair of Taxation

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About the Author

Tom Kent is one of the chief architects of postwar Canadian social policy. He played a key role in shaping the policies of the Liberal party during its 1957-63 opposition years and, as Policy Secretary to the Prime Minister and a Deputy Minister, was equally active in the implementation of those policies – including medicare – by the Pearson government.

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Discussions of public policy commonly conclude with the right question in the wrong form. The right question is: Can we afford it? The wrong form is to take it for granted that affordability means “with the present tax system.”

Today the public good of Canada requires, above all, a better tax system. What we have hampers the efficiency of the economy. It blocks progress to a more just society. Short-sighted politics have allowed it to become not only too unfair but too slack to command public respect. More and more people are in a position to dodge tax. More and more do.

Already the consequence of bad taxation has been to paralyse social progress for a generation. How we came to this situation will be summarised later. Change for the better will not come easily. In federal politics the simplistic advocates of lower rates for present taxes still have some wind in their sails. They want government to recede; corporations and their executives should be taxed less in order that the globalised market economy may work its magic.

In truth the future of the market depends on more government. Globalisation is the economists’ take on the intensifying interdependence to which technology increasingly drives all our activities. One failed switch can darken half a continent. One bright youth can create a computer virus that crashes world-wide systems of communication. A small band can destroy the towers of Manhattan. One traveller can carry a virus that throws a country’s hospitals into confusion. One sick cow can impoverish hundreds of farmers. A handful of cheating executives can wreak ruin on thousands of employees and pensioners. Such globalisation makes closer regulation, not less, the contemporary impera-

tive. New technologies make new public infrastructures the rising price for a livable planet. The responses may be various, some perhaps perverse. The United States, seeing interdependence as threatening its security, may wage foreign wars and aspire to put weapons in space. That it can do so while cutting taxes is a brief illusion. The role of government is not going to diminish. The future does not lie with the tax-cutters.

But nor does it lie easily with their opponents. They also have their illusion. For generations a greater role for government has been identified, at least in democratic countries, with a more just society. We are learning that the relation is not automatic. Government expenditures in reaction to interdependence may not often be as regressive as some aspects of the “war on terror,” but many are in themselves socially neutral. Today’s sick are not cured, today’s poor are not fed in body or mind, by stopping the degradation of the environment. What we owe to the future is the price of past improvidence, but today it competes for resources with present ills. The combination already presses the limits of public tolerance for existing taxes.

Serious reformers cannot shrug off tax discontent. It is not that most people want lower taxes rather than medicare. It is the widespread feeling, not less strong for being unconfessed to pollsters, that present taxes are unfair enough to be dodged with an easy conscience. That sentiment is the mounting impediment to the betterment we need, in health and education and much else. Betterment will not be achieved by talking about improved programs when the tax base for them is eroding. The reform that social reformers now need first is tax reform.

We can't stay put

Politicians have understandably little stomach for doing much to taxes except cut them. Any significant change in the system antagonises interests powerful enough to stir deep political trouble. To attempt it is to risk humiliating retreat. That is a lesson of experience deeply burned into the psyche of government.

There is, however, other experience. The lesson of the past 30 years is that in taxation there are no sleeping dogs. To let a faulty system lie gives only the temporary appearance of a quiet life while the tax base is gnawed away.

At the middle of the last century, after the upheavals of depression and war, Canada had a reasonably good tax system for the needs and norms of the time. The economic and social changes of subsequent decades called for adaptations. There were adjustments, some for the better; but those were the exceptions. As politicians shied away from significant reforms, the real agents of change were increasingly the underminers of taxation, from without and from within. Sound rules were eroded by stealth, new rules written in the interests of greed. By now the accumulated result is plain. We have a tax system in disrepute, unfair and ineffective.

The particular problems will be discussed in the course of suggesting what to do about them. The general problem is, by its nature, acceleration: Widespread disrespect for the system breeds ever wider disrespect. Evasions multiply. The \$45 billion that Canadians transferred to tax-haven countries in 2001 was ten times what it had been in 1988. Those are the sparse official estimates. The flood is no doubt rising faster now. It is, moreover, only one aspect of the forces undermining present taxation.

There are, of course, people who welcome the erosion. Unchecked, it will compel governments to retreat from public health, education, welfare. That, however, is a wreck in which the officers on the bridge would be taken down with the ship. Politicians with some foresight must recognise that letting the tax system go on deteriorating is riskier for them than its reform. Staying put is not an option, and the deterioration has gone too far for tinkering to suffice. The question, in the absence of political alternatives, is whether Canada's Grand Old Governing Party has the capacity and the courage for effective reform.

This, I shall suggest in conclusion, is not as unlikely as may seem to be indicated by the party's recent past and especially by the encumbrances its new leader brings. But there will be plenty of powerful voices to frighten off reforming politicians, to tell the public that fair taxation is the ruin of nations. There will be few instant conversions. Thorough reform will require a process of vigorous thought and widespread discussion. Its principles may be plain but its details are complicated. Demonstrating that sound economics coincides with social betterment is the easier part of the task for reformers. The harder part is to build a consensus on a balanced package of measures that will appeal to too many interests, please too many people, to be set aside by politicians other than those completely wedded to extreme libertarianism.

This paper is an attempt to contribute to building such a package. Some people argue that the effort is vain for Canada in a globalised economy, that we can only follow the United States. The paper argues that we still have power to lead in realistic reform. One response will be to dismiss the proposals as revolutionary

idealism, or worse. In reality they are a cautious response to pressing need. But that realisation may not come promptly in the corridors of power. The immediate need is therefore not a paper for tax experts, which would be outside my power. It is to examine the principles of reform definitely enough for widening public discussion.

Proposals

The reforms proposed have three purposes. Personal taxation should be fair. Business taxation should be neutral. All taxation should be honest.

Fairness has two dimensions. Horizontal equity means that people with the same resources pay the same tax. Vertical equity recognises that a dollar taken away hurts more the fewer dollars you have; the rates are therefore graduated, higher for higher incomes.

Neutrality in business taxes means that what belongs to the market is left to the market; taxation should not tilt the scales to favour one business over another, established firms over new firms.

Honesty means two things: first, that the public principles of taxation are not negated by its fine print; second, that its operation minimises the room for cheating the intent of the taxes, either by legal avoidance or by illegal evasion of them.

Our present taxation fails these purposes. It fails primarily because some of the money people get is taxed as income, some is taxed less, some is not taxed at all. That is not only unfair in itself. It creates multiple opportunities to avoid or evade such tax as is theoret-

ically payable. The most fundamental reform is to treat all dollars the same, to put personal tax on a comprehensive basis – as was most famously urged by the Carter Royal Commission.

Spreading the range of taxation means that the same revenue can be raised from significantly reduced rates of tax on low and middle incomes, while also providing a refundable credit for people with incomes too small to be taxed at all.

Personal tax falls both on what you get, on income, and also on much of what you spend. For the second, the main federal instrument is the Goods and Services Tax, the GST. It is inherently unfair. An extra 7 percent on sale price limits what you can afford more sharply the poorer you are. The sales tax credit offsets this only at the bottom of the income ladder. For others, the unfairness of the GST is palpable.

The second basic reform of personal taxation is to replace the GST by an expenditure tax on a graduated scale, harmonised with income tax both for fairness among people and for friendliness to the economy.

The present tax on corporations is erratic in its incidence but has one heavy bias: It makes financing much easier for big established firms than for smaller and newer businesses. The basic reform is to tax corporations simply on profits they retain for their internal use. Profit paid out to shareholders would be taxed only as what it then is – personal income. The effect, in conjunction with the encouragement given to saving by a graduated expenditure tax, would be to introduce into business financing the virtues of a genuine, instead of a rigged, market economy.

The measures suggested for these purposes can be briefly summarised:

- In place of the present definition of taxable income, establish a comprehensive base for personal taxation, treating all financial receipts as wages and salaries now are.
- Reduce effective rates of income tax by sharply increasing the personal allowances before tax is payable.
- Extend this benefit to incomes below the taxable level by making the credit refundable.
- Further reduce average tax rates by widening the intervals between increases in marginal rates.
- In conjunction with these reforms, eliminate most of the special provisions that now create unfairness in the application of taxes.
- Abolish the GST.
- In place of the GST, introduce a graduated expenditure tax on net receipts minus savings.
- Legislate “No Representation without Taxation” so that Canadian citizenship carries the obligation to fill out a tax return irrespective of residence.
- Abolish corporate income tax on profits paid out to shareholders who are liable for Canadian personal income tax.
- Introduce a purely withholding tax on dividends paid to other shareholders.
- Introduce a corporate accumulation tax on undistributed profits.
- Link appropriate taxes with particular public services.
- Restore the basis for fiscal and policy collaboration with the provinces by making federal transfers to them definite and assured.

These are proposals for federal taxation, the same for all Canadians. Federal taxation is under constant attack from politicians wanting more room for their provincial taxes. Its repair is therefore essential to preserving the fiscal capacity, the federal tax room, without which we will fail to sustain the nation-wide programs that embody the Canadian identity in a crowded world.

Provinces have their own reforming needs, notably in relation to municipal finances and property taxes. In the many respects in which their taxes overlap with federal taxes, the provinces can of course go their own ways. Some are likely to follow in the federal direction. Others may not, but are unlikely to see any political benefit in directly countering the effects of the federal reforms for their residents.

In all of Canada, taxes will be greatly fairer, in principle and in practice. They will no longer be more burdensome because your resources are of one kind rather than another. Almost all discriminations will be eliminated. Most of the present avoidances will become impossible, the rest made much more difficult. Evasion will be possible only by hiding income, and that will be harder – for large sums, much harder.

The benefits will not be only in equity. A modernised tax system will increase savings and productive investment in a more efficient and innovative economy. We will be better able to meet the requirements of increasing interdependence, of globalisation. Above all, we will more readily and more fairly finance the education and health, the public services and public infrastructure, that will make Canada a still better place to live.

The extent and speed of such progress is, of course, matter for separate political decisions, outside the scope of this paper. It must therefore be emphasised that the arithmetic used to illustrate some of the proposals is necessarily concerned with shifts in relative tax levels. Absolute levels will depend on the public expenditures determined by the politics that future circumstances shape.

Spreading is fair

Some money is earned by working. Some money is received without working. The fundamental tax reform, central to both fairness and efficiency, is to treat all money the same. In place of income as now calculated on our tax forms, the base for taxation would be financial inflow from all sources. Wages and salaries, dividends, interest, rents, pensions, capital gains, inheritances, gifts, lottery winnings, perquisites, government transfers: All would be taxed equally. In the formal definition used by taxation experts, this “comprehensive income” is the sum of current consumption plus net addition to wealth from all sources.

In short, the tax burden will be spread. Government revenue will require a lower rate of tax than is now imposed on income from work and from some investments. If present taxa-

tion is a strong disincentive to work and investment, as is often claimed, its reform will much improve the productivity of the Canadian economy. And inequalities in the enjoyment of the product will be significantly reduced. As the Carter Commission is famous for saying, a dollar is a dollar. How a person’s money comes to him or her is beside the point in determining the proportion of it that should contribute to paying for the benefits of a civilized society.

The graduated income tax has been crucial to the development of Western democracies over the past century. It commanded acceptance as the way of financing government that is more geared than other taxes, than sales tax and the like, to people’s varying ability to pay. That principle has not changed over the century. Its effectiveness has. For much of the time, tax rates became on the whole more progressive. But in recent decades they have gone the other way. In part the reversal was the deliberate politics of the age of Margaret Thatcher and Ronald Reagan. To a greater extent, in Canada particularly, it has been erosion by stealth.

What has made that erosion increasingly possible is the narrow definition of taxable income. The process is self-reinforcing. Money makes money; and the more you have, the more easily the money it makes can go untaxed. If one kind of money is not taxable, why not another kind?

A lot of this logic is embodied in legislation, notably in the provision of so-called tax expenditures: remissions of taxation that are available to everyone but beneficial chiefly to people with relatively high incomes. Tax-free accumulation through RRSPs is one example, trust provisions are another. But they pale beside the fine art of tax avoidance. Today’s

alchemists are tax lawyers and accountants. In their skilled hands the nickel of taxable money can be transformed into the gold of non-taxable money. For the most part, this is not a matter of tax evasion. Avoiding tax is the entirely legal outcome of the segregation of money into taxable and non-taxable. That segregation was sustainable, indeed in part unavoidable, in less technically sophisticated times. Today it is incompatible with effective graduation in taxation.

The case for a comprehensive tax has been around in academic circles for 80 years. It was made precise for Canada by the Carter Commission nearly 40 years ago. Then it was a highly desirable reform. Today it has become also a pressing reform. Money is now too instantly transmittable to be divisible; the split into taxable and non-taxable has become an unsustainable artifice. Fairness and effectiveness in taxation require its removal.

Special cases

So basic a change poses other issues. The Carter Commission suggested that it could best be accompanied by altering the taxpaying unit from the individual to the family. That case has since been weakened, however, by the greater diversity and more frequent changing of partnerships. Both gender equality and administrative simplicity now favour retention of the individual unit. But doing so requires some modification to the comprehensiveness of the tax base.

Children of high-income homes start life with considerable advantages. Inheritances in adulthood pile up the inequality of opportunity. Fairness requires that they be taxed like other income. However, testamentary provisions for dependants – for children during

minority as well as for spouses – are special cases. While a blanket exemption, regardless of amount, could lead to abuse, substantial provision for untaxed inheritance within the dependent family unit should be made.

A family business is seen by many people as always entitled to special treatment, whether it is passing to a spouse or to the next generation. Exemption would defy the principle of horizontal equity; it would be unfair by comparison with other inheritances. But there is a strong case for sufficient tax deferment to facilitate comfortable financing of the ownership transition.

Such deferment would be a special case within a general requirement. For some people, money receipts from all sources will vary much more than income as now narrowly defined. Graduated tax on an annual basis would then be unfair. There must be provision for averaging liability over a period; in the case of a large lottery winning, say, over a considerable period.

There are more controversial issues. Within the present system, some people think that mortgage interest should be deductible from income tax; that would be seriously unfair to renters. With comprehensive taxation, a roughly opposite case is arguable: that the benefit derived from owning a house, rather than having to pay rent, should be imputed as income and taxed. But that would be a major administrative headache, sufficient for most of us to be willing to compromise the equity principle. Fortunately the inequity will in any event diminish as inheritances and gifts of houses become subject to income tax and purchases to expenditure tax.

Again, a case could be made for recognising capital gains and losses as they accrue, but allowance for inflation then becomes a pro-

blem. The simpler procedure is that financial transactions in either direction, purchases or sales, be reckoned as expenditures or receipts only when they occur. The proposed combination of income and expenditure taxes can then fairly be reckoned in current dollars, with minor requirements for indexation.

This is in no way to suggest that reformed taxation will become simple to administer. No fair tax can be that. But the fine print required for comprehensive taxation would be much less elaborate than is needed now, when the law has to try vainly to match in complexity the contortions that represent money received as something other than taxable income. The simplicity of the comprehensive base would cut off the main route to avoiding taxes.

Education and health

Another set of issues relates to the tax treatment of various public services. Financial transfers, such as pensions, are no problem if they are available universally, or on some fixed criterion. They are then part of comprehensive income. Services that are universally available are equally no problem, in the opposite sense. To treat the cost of public education as if it were an element of personal income would make no sense. But what about post-secondary education? A considerable part of its cost is provided by government financing of universities and colleges. The benefit is available to those who both have certain qualifications and are able to find or borrow the rest of the cost. It is a lifetime benefit in the sense that graduates generally have higher earnings than non-graduates. Should all or part of the public cost count as taxable income? If so, how and when?

The present patchwork of grants, scholarships and student loans produces many anomalies. There are better ways to reflect the combination of public interest in an educated society and private interest in the higher income that normally follows post-secondary schooling. The spirit and language of “student loans” (which I was involved in initiating 40 years ago) are now out-dated. Equality of opportunity would be most fairly served by a program of “educational advances,” readily available to qualified entrants but recovered by extra tax on their later incomes. Such an educational surtax might appropriately start when the student’s subsequent income exceeds the average earnings of Canadians in full-time employment. It could be graduated so that the educational advance is recovered quite quickly from people who soon become high-income earners, more slowly from those whose career paths yield less personal remuneration.

The public service whose use varies most widely is health care. Most of the use is for treatment or protection against sickness. It is what Medicare is for. But some is by people fussing about their health, the more so because it costs them nothing and doctors have an incentive to accommodate them. The least that should be done is to make both patients and practitioners more conscious of the accumulation of cost to the taxpayer. An efficient information system could readily sum the costs of the health services provided to each individual each year and present them in the same way that employers and financial institutions issue T slips for attachment to income tax returns. The figure alone would make some doctors and patients pause. It would have wider influence if some of it were entered as income on the individual’s tax return.

This would be quite different from the discriminatory deterrent of user fees. The addition to the tax return would be limited to a small

fraction, say 5 percent or at most 10 percent, of other income. In conjunction with the doubled basic allowance proposed in this paper, the extra tax would be small or nothing for people with below-average resources, however heavy their medical costs. For other people it could be significant but well short of crippling.

This is, nevertheless, an idea that has been around for a long time with negligible support. It would be a tax on sickness, a compromising of the principle of equality in health care. The principle is already deeply infringed. Medical services are arbitrarily rationed by delays, made discriminatory by inefficiency and uneven quality. More than 30 years after its inception, Medicare remains uncompleted. The gaps in coverage leave some sick people with unaffordable costs for home care, for eye and dental care, above all – and increasingly – for drugs. And there is much else to be done. SARS has shown the inadequacy of our protections of public health. Preventive care, especially for children, promoting health rather than curing sickness, cries out for more resources.

Principle is not served by ignoring the straining of resources for health care in competition with education and other public goods. Pharmacare will not be advanced by being blind to the over-use that an entirely free service would invite. Realistic policy-making is a choice of the best compromises among policies. If – though only if – it is linked to effective modernisation of health services, including a portion of health benefits in taxable income would be a worthwhile item in tax reform.

Payrolls

There are, of course, social programs financed outside the tax system as such: “con-

tributory” pensions (the C/QPP), unemployment “insurance” (misleadingly, Employment Insurance). Their compulsory charges on payrolls are inferior economic policy but a diversification of taxation that provides too much political relief to be done without.

The Canada Pension Plan is genuinely social insurance, with a small measure of progressiveness incorporated. Although its disability provisions serve inadequately a purpose for which a different, and differently financed, program would be better, essentially the CPP is a fixture. The contributions will continue to be deducted from income before it is taxable, the benefits included in income to be taxed.

Employment Insurance, on the other hand, is not insurance, and in recent years even the pretence of distinct funding has been dropped in favour of boosting the consolidated revenue. However, neither better employment measures nor more effective income maintenance will remove EI entirely. The premiums will continue to be deductions and the benefits included in income. One thing could, however, be done to lessen the extent to which EI distorts employment towards the casual and the seasonal. The employer’s contribution could be levied on total payroll instead of the particular wages of employees who are “insured.”

The tax treatment of compensation for workplace injury and illness will no doubt remain an anomaly on which provincial politicians insist. Practical reform cannot be a pursuit of rigid consistency.

Graduation

The income tax structure was never as fully graduated in reality as high marginal rates

made it appear. Today it is no great exaggeration to say that high income taxes are not for top people. But they remain a harsh reality for people who live on wages and salaries. For those, tax is still sharply related to income at low and middle levels. The basic allowance – in effect income too low to be taxed – is only \$7,634. The initial 16 percent rate of federal tax rises in three quite close steps to the top 29 percent on taxable income over \$104,648 (for the 2003 tax year).

In international comparisons of the sources of government revenues, Canada is notable for relying more than others on taxing income, as opposed to consumption or wealth. The reliance is made possible by the low starting point and rapid acceleration of the tax. That structure of taxation is the reason why most wage-earners and professional employees in Canada pay appreciably more than their equivalents in the United States. It is also the reason why fewer Canadians are in poverty, in prison, without medical care. Our tax and transfer system does significantly lessen the insecurities and inequalities in the economy. But we should be clear that this social justice is financed by the middle class. The lingering belief that it is a redistribution from the rich has been receding further from reality for decades.

A comprehensive tax base spreads the load, in two ways. It enables government revenue to be less dependent on income tax. That major but indirect effect will be discussed in the next section. The obvious, direct effect is that the rate of tax on comprehensive income will be lower, for the same revenue, than the rate now levied on income narrowly defined.

Effective tax rates – the amounts payable on given income – can be cut either by raising the levels at which marginal rates apply or by lowering the rates themselves. The time for the

second may come, but it is not now. Present marginal rates of federal tax, ranging from 16 percent to 29 percent, are not steeply graduated. It is because the levels at which the rates begin are too low that ordinary employment and pension incomes are so heavily burdened.

Fixing rates is the business of annual budgets. This paper can only suggest a pattern, to be reconciled with the year's revenue needs and other tax yields. Indexation to the cost of living in any event changes the figures. In 2004 I would suggest \$15,000 each for the basic allowance and the spousal or other dependent allowance. This is roughly twice the present amounts. And the credit should certainly be made refundable. At the initial tax rates suggested below, the credit would total \$3,000 (\$2,250 against income tax at 15 percent plus \$750 against expenditure tax at 5 percent). Such enhancement of the lowest of individual incomes – making \$6,000 for a couple – would be a major advance against poverty.

The present Canada Child Tax Benefit is in principle the way to take account of family size in both taxation and low-income transfers, but it too is in need of approximate doubling, to \$5,000. The existing deduction for child care expenses, on the other hand, is one of the tax system's discriminations. The benefit is greater the better off you are. The aim should be to replace it by helping all parents to take advantage of facilities for early childhood development.

Fairness depends above all on a reformed structure of tax rates. It might start, for example, at 15 percent on the first \$50,000 of taxable income, rising in 5 percent steps at \$50,000 intervals to 30 percent on income over \$150,000. This is, of course, an indication only. A precise proposal will require wide discussion as well as

sophisticated calculation. But the example does show that reform would substantially cut taxation on low and middle incomes from the sources now taxed. An individual earning \$100,000 entirely in salary, and without deductions, paid \$20,344 in federal tax in 2002. The suggested schedule would reduce this to \$15,250.

Such dramatic savings would be very rare. Most people with six-figure incomes draw them in part from sources not now taxed and take advantage of deductions and avoidances that reform would eliminate. The point of making taxation comprehensive is not to reduce total government revenue but to eliminate the unfairness, the discrimination against work and enterprise, bred by selective taxation.

In place of GST

Personal, as opposed to business, taxation is chiefly on income and on consumption. Specific levies on alcohol, tobacco and gas apart, federal taxation of consumption means the GST. It is the worst of taxes. Any sales tax is inherently unfair. The same 7 percent falls on the rich and on the poor. It matters less the better off you are. It is clumsy to administer, costly for both government and business, but nevertheless inefficient: There is no way to prevent a flourishing underground economy in which the tax is evaded. Since its introduction in the second term of the Mulroney government, the GST has done almost as much as the anomalies of income taxation to intensify public disrespect for government.

The new Prime Minister should need no persuasion. He was the principal author of the original Liberal “Red Book” of election promises. “The GST,” it pronounced, “has undermined public confidence in the fairness of the tax system.” What followed was closer to a pre-

cise promise than almost anything else in the book: “A Liberal government will replace the GST with a system that generates equivalent revenues, is fairer to consumers and small business... .” Ms. Copps took the promise seriously. Perhaps Mr. Martin wanted to do so but was overruled. Ten years on, we will see.

Exemptions and credits can moderate the impact of a sales tax but not nullify its regressive nature. The consequence of the GST was to give the very idea of taxing consumption, as opposed to income, a bad name. That perception loses validity, however, if personal taxation is put on a comprehensive base. A tax on consumption can then be just as graduated as an income tax. Besides being better for the economy it is, in an affluent society, better socially.

Income is the individual’s return on what he or she puts into the economy. It may be a greatly distorted measure, because markets work by exaggeration. But it is the best we have. Consumption, on the other hand, is what the individual takes out of the economy.

So taxing income lessens the reward for productivity, for putting into the economy. Taxing consumption is a deterrent to taking out. Surely it is consumption that we should tax. This, in recent times, economists of philosophical bent have persuasively argued. They would replace both income tax and sales tax by one simple, graduated tax on consumption. Government’s direct drag on personal incentives, to work, enterprise, investment, would be gone; and taxation could become as egalitarian in effect as social standards required.

So drastic a reform may come, some day; but not now. The change would be too sharp. One role is sufficient for a new tax. The prac-

tical reason for it is to replace the GST. As such, it can operate in conjunction with the income tax which has the virtue of familiarity besides having most people's acceptance as, in principle, the fairest kind of tax.

The taxation of consumption – graduated expenditure tax is a better label for the proposal – would operate on the same comprehensive base as income tax. One return would list the year's receipts, without the exclusions of the present income tax form, together with financial assets at the beginning and end of the year. Filling out the return would be free from the complexities of the present gimmicks. Income tax would be reckoned directly from total receipts. Expenditure tax would be reckoned from the same total but with the calculated income tax subtracted; and from the amount therefore available for expenditure, any net increase in financial assets during the year would be deducted. That is, the tax would be on disposable income minus saving (or plus dis-saving).

As an example, suppose that A is a widow who starts the year with financial assets of \$50,000 and whose income from pensions and investments is \$40,000. Being of cautious nature, she still does some saving; her assets at the end of the year are \$55,000. So she will pay tax on expenditure of \$35,000 less income tax. On the other hand, B is a single worker who starts the year with \$20,000 in the bank, earns \$60,000, but takes \$5,000 out of his account to pay for an expensive holiday. He will pay expenditure tax on \$65,000 less income tax. That would probably be more than he now pays in GST, whereas A would be paying less.

The same basic allowance – the \$15,000 suggested earlier – would be used for both income and expenditure taxes. The expenditure of a two-income family could best be apportioned in ratio to the two incomes. The initial rates for

expenditure tax should be lower than for income tax: say 5 percent at first, rising at \$25,000 intervals in 5 percent steps. This would equate the two marginal rates at 20 percent on amounts above \$75,000, and they might stay together at 25 percent above \$100,000 and 30 percent above \$150,000.

These illustrative graduations mean that, while total tax on low and moderate incomes would be reduced, the marginal rate, of income and expenditure tax together, would rise to a top rate of 51 percent for the person who spends all of an increase in an already large income. The 51 percent is the combination of 30 percent income tax and 21 percent expenditure tax (30 percent on the 70 percent disposable after income tax). A single person would begin to pay at this rate if she or he started with an income above \$214,000, got an increase, and spent every one of the available extra dollars. Of course, the marginal rate would never be more than 30 percent on income, however large, that was wholly saved. In the mid-way case – the single person who spends half, saves half, of the disposable 70 percent of income over \$214,000 – the combined marginal rate, income and expenditure tax together, would be 40.5 percent.

In short, the proposed increase in tax rates is strictly on expenditure, not on income. Expenditure tax, like the GST it replaces, cannot be classified with other taxes, as inevitable as death. Beyond a conventionally well-to-do standard of living, paying it would be a personal choice, a choice not to save.

Consequences

The purpose of reform is firm, and clearly embodied in the proposed formula for comprehensive income and expenditure taxes. But of course their suggested rates are indications, not

predictions of budgets year by year. Economic circumstances apart, we can do little more than guess how, “other things being equal,” revenue would increase when the tax base was made comprehensive. So much is at present so murky. How much revenue is lost through the avoidance that can be eliminated, the evasion that can be closed off? How cleanly can the multitudinous concessions, exceptions, exemptions be ended? How fertile will the tax sources hitherto excluded prove to be? And how much avoidance and evasion will be tracked down by the reform of corporation tax?

Certainly the answers will add up to a great enrichment of the public purse. They will make possible both some of the needed improvements in public services and the most needed tax cuts. The feasibility of reform turns in large part on how it directly affects individual pockets. Who will be better off, who worse off, by how much? The answers can only be given in generalisations. Individual finances are almost as varied as people themselves. In particular, some get no benefit from the present anomalies of the tax system, some benefit enormously. Such differences have to be left out of account in any measured comparison of present and future. The fruits of reform, at the suggested tax rates, can then be summarised.

First, everyone will pay less income tax than now on money earned from employment and regular investments. For people on low incomes the difference will be great. Up to \$15,000 a year, tax will be eliminated; at \$20,000 a year, halved. At high income levels the cuts will be relatively too small to be noticed, but they will be there. The same principle, of strengthening the incentive to work, will apply to rich and poor alike.

Second, for individuals with incomes up

to about \$100,000, total taxes will fall. That is, while those with incomes of about \$40,000 and higher may pay more expenditure tax than the GST now takes, that increase will be less than the reduction in their income tax.

Third – and provided, it must again be stressed, that the income is the kind now taxed effectively – income tax will continue to be cut by a significant percentage on incomes well into the six figures. It will be the expenditure tax – not a disincentive to work but an incentive to save – that increases the total tax on people who nevertheless spend up to the level of substantial incomes.

Reasonable disparities in income serve the public interest not only in the obvious way, creating incentives, but also because otherwise savings and investment would usually be inadequate for economic growth. Hence the moderate 30 percent suggested for the top tax rate on income, however large. But the economic justification for large incomes is betrayed by people with flamboyant lifestyles. A capitalist society is simply defending itself if it rules that millions-of-dollars-a-year expenditures attract additional tax that is avoidable by saving instead of indulging.

Saving would not be the only alternative to paying expenditure tax. The other would be charitable giving. The present provision of income tax credits for donations seems to be remarkably little used by many rich people, perhaps because there are now so many other ways to minimise income tax. If donations for registered and supervised causes were fully deductible, high rates of tax on high expenditures might become an incentive to generosity that would considerably benefit civil society.

Comprehensive taxation requires, as

noted earlier, arrangements for averaging, because inheritances and other components are more volatile than salaries. Consumption usually has a marked pattern over a lifetime. Before middle age, most people are heavy spenders in relation to income; later, they save; in retirement, most dis-save. It would therefore be fair to provide deferred tax accounts for durable consumer goods. Expenditure tax on the purchase of a principal residence might be spread over as much as 20 years; for other major items, such as cars, an appropriate spread would be considerably more limited, in time and size. Outstanding amounts in deferred accounts would be, of course, a first charge on dispositions at death.

Transparency

Administratively, income and expenditure taxes fit well together. The comprehensive base that they have in common means also, and most importantly, that their economic and social consequences are mutually reinforcing.

The primary social benefit is fairness. Income tax becomes genuinely graduated to ability to pay. So, in contrast to the sales tax it replaces, is the expenditure tax.

The primary economic benefit is invigoration. Income tax becomes less burdensome for people whose resource is work by hand or brain. Expenditure tax encourages the saving needed for the investments of a dynamic economy.

The public good, economic and social, rests on a foundation of trust. Of that an essential component is the honesty of the tax system. Faith in it is now much corroded. Everyone is aware of the flourishing underground economy, of widespread avoidance and evasion. Together, comprehensive income and expenditure taxation

completely change the game. They require full financial reporting, by persons, financial institutions and companies. Attempting to conceal money received will become a great deal riskier. And it will become the only kind of cheating. When financial assets and receipts are known, the amount of taxation is inevitable. Even successful spiriting of money to tax havens will be of dubious benefit. It will have to be represented as spending, be taxed as such, and serve as an invitation to future probing.

Inadequate probing has been an unspoken policy. “Practical” politicians and administrators saw tolerance of some evasion as a necessary safety valve in the tax mechanism. They let it blow enough for steam pressure in the engine to fall. For that and other reasons, for 20 years from the mid-1970s to the mid-1990s, governments continually shied away from taxing enough to match their spending. With budget deficits went high interest rates, economic recessions and reduced revenues, but increasing need for higher revenues to service burgeoning debt.

Mr. Martin merits the primary credit for appreciating, after he was in office, that this vicious circle had grown too much to be gently wound down; it had to be quickly broken. Public opinion was with him. It had come to wide understanding that government has to be paid for, later if not sooner, that continual deficits result in less value for tax dollars because more and more of them are needed to pay interest instead of providing public services.

There is, however, a necessary condition for sustaining public commonsense about fiscal policy. It requires the commitment of politicians to honest taxation and accounting. It requires, in the current jargon, transparency.

Financial officials, however, have a pro-

fessional interest in the arcane. It facilitates their domination over other government departments. One kind of deliberate obscurity is the melting pot of the consolidated revenue: All taxes go into it, all expenditures come out. The process maximises Finance's control by minimising public accountability, which calls for linking what we pay and what we get. It would be easy to understand a higher tobacco tax helping to pay for pharmacare, gas tax for public transit and urban infrastructure. Corporation tax links naturally with economic programs, income tax with debt servicing, expenditure tax with environmental programs. Obviously, rigid dollar-for-dollar identifications are not practicable. They were not in the 1950s, when some income tax was attributed to the financing of Old Age Security. Linkages of program and tax are practicable now. They would help to strengthen the democratic base for responsible fiscal policy.

RPPs and RRSPs

The most damaging obscurities are those within the tax regime. This paper urges encouragement of saving. An expenditure tax does it openly and clearly, for all saving; there is no discrimination according to people's different motives for saving. This contrasts with the present special encouragement for one kind of saving, for retirement. It is not just the encouragement that everyone can see and understand: contributing saves income tax now. Registered pension and retirement saving plans (RPPs and RRSPs) have a very special feature. The investments in them earn interest and dividends which, along with capital gains, accumulate and compound, year after year, free of tax.

This unique privilege, hardly talked about in public and barely understood, is a vast benefit for people with incomes high enough for

them to take advantage of the generous levels now permitted for the plans: an annual \$14,500 for RRSPs and the equivalent for RPPs. The RRSP program was originally presented as a help to ordinary people to help themselves. In fact it now enables high-income earners to build retirement savings of millions of dollars. It is a leading example of the ways in which the present tax system has been subtly distorted, so that its apparent progressiveness is largely offset by discriminations that favour the well-to-do. The proposed expenditure tax will create an incentive for everyone to save, without any limitation at all on amount. But interest or other returns on the capital would be taxable like other income, as received. There would no longer be a discriminatory benefit according to the individual's rate of tax.

A comprehensive tax base would cut the burden of income tax on wages and salaries; an expenditure tax would create an even-handed encouragement to saving at all levels for all purposes. If these had been the policies of the past, nothing near the present discrimination could have developed. There might well have been some allowance for deducting pension and retirement contributions from income tax. But tax-free accumulation would have been a discrimination too blatant for acceptance.

However, realism requires its recognition as a policy now well embedded. Its complete cancellation would be too great a disturbance for too many people. It can and should be moderated. The present ceiling contribution for RRSPs is almost twice the miserable basic allowance before tax on low incomes starts. The government's present, indefensible plan is to push it yet higher, to \$18,000. At least the movement should be down. Half, not twice, the basic allowance would be a fair standard. Under the proposals of this paper, that would be \$7,500: a reasonable

compromise.

Federalism

Tax structure is central to federal-provincial relations. Their consideration is basic to constructive tax reform. The Mulroney government's introduction of the GST was resented as an intrusion on the field of retail sales tax hitherto occupied by the provinces only. Six provinces should now welcome a federal expenditure tax in place of the GST. Alberta, of course, is a special case, eschewing sales tax. The three provinces that have recently consolidated their sales taxes with the GST require special consideration. If they wish to return to their own taxes, Ottawa should be willing not only to cooperate but to bear the transitional costs. It should be equally obliged to collaborate, collecting the appropriate revenues for them, if they prefer to join in the expenditure tax. The same offer would be open to other provinces.

Besides their general taxes, both Ottawa and the provinces draw revenue from particular kinds of consumption, notably gas, tobacco and alcohol. Transparency could be helped by coordination in dedicating them to such areas as health and public transit. Protection of the environment may well call for taxes and user charges on a widening range of pollutants, making federal-provincial coordination crucial from the start.

Most important of all, however, is the familiar area of conflict, the split of taxes and revenue generally. It is the area where Mr. Martin's past record is the creation of mayhem. In 1995 the unilateral Canada Health and Social Transfer destroyed any assured federal commitment to transfers for provincial programs. It was also the destruction, whether

deliberate or unknowing, of the federal government's capacity for effective leadership in areas of provincial jurisdiction that are also matters of major national concern. And the damage has been further intensified by the increasingly unsatisfactory and uncertain outcomes of Ottawa's elaborated formulas for fulfilling the constitutional requirement of equalisation.

Capacity for leadership is essential for our federalism and it rests essentially on trust. What the federal government says it will do must be timely and firm. This is not a paper about federalism, but it cannot be too strongly emphasised that federalism requires a fiscal structure that is reliable nationally. The federal contribution to provincial programs must be specific and assured, a rock on which provinces can rely in their plans and commitments. The degree of trust had dwindled earlier, plunged in 1995, and is as yet unrestored.

The risks of being unamerican

This discussion has certainly not addressed all the administrative complexities of comprehensive income and expenditure taxation. Nevertheless, it is clear that they are significantly less than the ever-growing difficulties of sustaining anything near coherence and acceptability in the operation of the existing tax system.

It may therefore seem to be time to turn to the fundamental lines of objection to the proposal. One – that it is too egalitarian – is meat for discussion in terms of moral and political philosophy. This does not mean that the issues are all absolutes. Some are matters of degree. Tax rates have been given here only as illustrations to clarify exposition. In practice they would be set by political decisions in response to economic

circumstances and program priorities. Discussion will no doubt modify some features of the proposal. The relative weights of income and expenditure taxes could well be an example. But in the final analysis tax reform will reflect some consensus of personal values about equality of opportunities and of outcomes.

The second, and probably commoner, line of objection is very different. It is that, however desirable the reformed taxation might be for an isolated community, it is impracticable for Canada in a world where other tax systems, that of the US in particular, remain as they are. It would lead, some will say, to immediate crisis, to flight of capital and people. A more gradualistic view might be hardly less gloomy: that a significantly more egalitarian Canada would be a nation with an economy increasingly inferior to the American. People and capital might not flee but would ebb away.

Such arguments must, of course, be addressed. They will also be used, however, to resist proposals for the reform of corporate taxation. The place to take them up therefore comes later.

Corporations untaxed

In the make-believe world of law, a corporation is a person. The effect in the real world is that corporations are destroying the market economy. The way it can be saved is to have corporation income fully distributed to shareholders.

The legal pretence originates, of course, in the necessity of limited liability. Without that, there would have been no industrial revolution, no putting together of capital on the scale that has transformed living standards in much of

the world. And if liability was to be limited, if shareholders individually were not to be held responsible, then the corporation itself had to have some of the legal rights and obligations of a person: to own property, to make contracts and be held to them, to sue and be sued. But the artifice of the law went further, extending corporate rights beyond the necessities of business to affairs of citizenship: notably, until recently in Canada, to the donation of corporate money to politicians favoured by the corporation's executives.

It was the politicians, not the courts, who made the decision that most expanded the role of corporation executives. When personal income taxation began it was clearly impossible to allow shareholders to avoid it by the simple device of leaving their money in the corporate treasury. Theoretically such deposits could have been deemed to be dividends and taxed as personal income. The alternative was a separate tax on corporation income. It was simpler and was adopted, with unforeseen consequences.

The conspicuous effect was to elevate the manager relative to the shareholder. Executive compensation and perquisites were blessed as pre-tax charges. Empire-building became the accepted corporate culture. Retaining earnings was an apparently cheaper way to expand than raising new capital. Richer shareholders were content because dividend income meant less to them than capital gains through rising stock prices. "Share value" became the lode-star. It made stock options a wondrous form of compensation that need not be shown as a cost in the corporate accounts. Government encouraged concentration by devices as blatant as allowing a company to deduct from its taxable profits the cost of the interest on loans borrowed not for its own business but to buy the shares of another company. Tax policies in recent decades

have been increasingly directed to encouraging not business as such but big business getting bigger.

Corporation executives cannot be expected to shun opportunities to build their empires, but there might have been some thought for the consequences. Capital sequestered in large corporations is capital denied to free markets. It is capital reserved for established interests, kept from small entrepreneurs competing for funds according to their ability to innovate, to do things better. And bigness likes bigness. Banks and other financial institutions sniff at small and new undertakings while falling over themselves to lend to corporate giants, even those chiefly occupied in practising to deceive by shuffling paper assets.

Most often, of course, the growth of a corporation does make some contribution to the growth of the economy. But market capitalism is supposed to be more than that. It is about making the most of human enterprise and inventiveness, which serve the public good when directed by the hidden hand of competition. We have created a financial system that cramps the hand. For large, established companies, capital comes easy. For small and medium-sized businesses it is scarce. The scales are particularly weighted against new enterprises. Big business pays lip-service to the merits of flexibility, of enterprise adjusting to rapid change, but the market is distorted at its most critical point: the flow of equity capital into risk-taking innovation. Our world is generally good for corporate executives, for established wealth, for speculators in paper. It is not as good for smaller entrepreneurs or for most of the innovators on whom real development depends.

Conventional economists are fond of de-

nouncing the restrictive effects of government regulations and union practices. On occasion they are justified. But what chiefly restricts market economies is concentrated control of capital. Tax reform can make the economy freer. It can shift some operations, at least, to the genuine hand of competitive markets that reflect the judgments of many individual investors.

The key is to distinguish between business income distributed to shareholders, which should be entirely free from corporation tax, and income retained and used within the business, which should be taxed at a rate somewhat higher than personal income. If the top rate of personal tax is 30 percent, as suggested earlier, the surviving corporate rate might be 35 percent.

It would then be to the distinct advantage of shareholders to assert their rights, as the owners of the corporation, and have its earnings distributed to them. This need make little difference to a closely-held corporation. If the owners believed that expansion would be profitable, they could put back their after-tax dividends, as equity comparable to earnings previously retained after corporation tax. It would be open to a public corporation to try for the same reinvestment, offering new stock to shareholders willing to plough their dividends back into the same undertaking. But in that case the executive of the corporation would no longer be the boss. Its shareholders individually would have decided where their money was best invested. Reality would be more like the world of Adam Smith.

It would be a better world, but initially shocking for some corporations. They would, of course, keep their existing funds, retained from previous years. But some might be part-way along with investment programs predicated on finance from future retained earnings. The

easement of transitional provisions should be available. For example, a company might for some years continue to retain, and pay, the pre-existing corporation tax on a level of earnings approved by a general meeting of shareholders.

This is an illustration of a general point. Some tax changes must be implemented on a fixed date for everyone. Switching from the GST to an expenditure tax is an example. But in some areas, particularly of corporate taxation, more gradual and flexible transitions are administratively practicable.

Withholding

With reform, dividends payable to individual Canadians would be like any other personal income, taxed no more and no less. To pay them in full, before tax, the corporations would need only the SINs of their individual shareholders. For the recipients, the complications – and unfairnesses – of the present dividend tax credit would disappear.

Shareholders who are not payers of personal tax require more complicated arrangements. Some are non-residents, companies or individuals. Some are other Canadian companies and institutions. While those are fewer in numbers than individual shareholders, they include financial institutions with massive holdings. There is also a complex maze of inter-company shareholdings, motivated in part by their use to minimise payment of the present corporation income tax.

Reform would cut through the maze by the legislation of a corporate dividend withholding tax. Its rate would be the same as the top rate of personal income tax, the suggested 30 percent. All corporations, public or closely

held, would be required to deduct the withholding tax from their dividend payments to shareholders who do not have SINs. There would be no discrimination between kinds of shareholders, between Canadian and foreign. The sole point of the withholding is to ensure that in the end all dividends are taxed by one set of principles, that shelters and havens don't succeed.

For an external shareholder, individual or corporate, the process would depend on the country of residence. The terms of a tax treaty with Canada would normally make all or most of the withholding an offset to other taxation. Canada would hand on withheld amounts. But if the country is one with which we do not have a tax treaty – notably, if it is a tax haven – the tax withheld could become the revenue of Canada.

The shareholdings of Canadian companies in other Canadian companies would result in more diverse trails. Many shares are held in accounts for registered pension and retirement savings plans. While the proposed reforms will lessen the future inflow into those accounts, they will remain large. The tax withheld from such dividends would be promptly passed to the institutions responsible for the plans. But such simplicity would not extend to shares owned by other companies. Dividends would no longer pass automatically free of tax. Instead there would be an equitable rule that withheld taxes are refunded as soon as, but not before, the proceeds of dividend payments to companies eventually emerge as dividends paid to personal Canadian taxpayers. A virtue of the rule is that some inter-company complexities, previously designed to delay or avoid tax, would lose their point for the owners and be abandoned. Subsequent tax administration should be simpler as well as fairer and more effective.

Compensation

Simplicity would also be the virtue of the new corporation tax, limited to retained income. Devices such as accelerated depreciation, deferring or reducing taxes, would be gone. Capital cost allowances would be standardised. Auditing would certainly not be more difficult and could become, in the wake of Enron-style scandals, less dubious.

There is, however, a danger. Tax reform would lessen the scope for corporate empire building but not necessarily for executive grandeur. Compensation and perquisites are theoretically in the control of the shareholders whose money is being spent, but in practice corporate lifestyle is determined within a club of “Joneses keeping up with the Joneses.” There is no sign that spectacular failures and scandals are shaming the club into retrenchment. There has to be doubt whether lessening of the executive grip on investment within the corporation will be more effective. Consolation for diminished power might in some cases be sought in even greater grandeur.

Whether or not shareholders restrain such a tendency, taxpayers do not have to encourage it. The new corporation tax could be applied to income that is undistributed to shareholders, whether because it is retained for investment or because it is used within the corporation for grand levels of compensation and benefits. An objective criterion would be some multiple of average full-time earnings in the country: a ratio that would at present produce about a million dollars seems reasonable. Costs above that level for any individual would be subject to the 35 percent corporation tax.

This ceiling, it should be noted, would apply only to the incomes of executives as hired

hands of the corporation. The innovator who builds his or her own corporation, who keeps control by ploughing back his own money as part of the capital for expansion, could still come to draw a huge reward for success, an annual fortune in dividends, without attracting any tax to the corporation. Not until such an individual sold out, or the shares passed to heirs, would the wealth be subject to tax on more than the dividend income and personal expenditure.

It is the costs of the executive as an employee that would be free from corporation tax only up to the \$1 million ceiling. Anyone that the directors thought worth more – \$10 million, \$20 million or whatever – could still be paid it, if the shareholders agreed. Corporation executives could continue to hope that vast differences in remuneration are compatible with a flourishing market capitalism, but Canadian taxpayers would no longer be subsidizing that dangerous illusion.

The Council of Chief Executives will no doubt think that this is a proposal to strip Canadian business of talent; people such as they will not want responsibility that is inadequately rewarded or will go to countries where it is. The records of performance, the number and cost of golden handshakes, do not support the claim. There is no reason to doubt that disinterested selection would yield men and women content with a million dollars who are capable of running the largest corporations as well as they are run now.

We can be Canadian

That view, however, will not be readily accepted. It will encounter the belief, noted earlier, that Canada cannot be a leader. Some will argue that even if the proposed tax struc-

ture is the way advanced market economies should go, will go, Canada must wait for others, for the United States in particular. The case for complacency about taxation boils down to the claim that being different invites economic stagnation if not ruination.

There is, of course, a theoretical degree of difference that would justify such fear. What is proposed does not. It is a proposal that Canada shift moderately away from the extreme autocracy of the contemporary North American economy. Performance north of the border would not be damaged, would rather be improved, by a gradual dose of relative democracy.

“Gradual” will be challenged, but not with conviction. True, a comprehensive tax base will reduce tax avoidance and evasion not only greatly but promptly. That, however, can hardly be cited as economic disaster. The real objection is to taxing inheritances and other financial gains equally with employment earnings. In the long run that will indeed work a great social change. But at the top tax rate of 30 percent it will do so over generations, not quickly.

The earlier effect is reduced taxation on wages and salaries. Under the proposed rate structure the relief will be significant on incomes up to the level of the upper middle class. That is hardly a discouragement to work and enterprise. Certainly it will help to stay any further ‘brain drain’ of professional and skilled workers to the United States.

Nowadays, however, it is not the incentive to work that is emphasized in propaganda for tax cuts, but rather the incentive to save. That is hardly surprising when the cuts are designed to benefit chiefly the rich, and when personal savings in the United States are minimal despite the existing huge disparities of incomes, con-

ventionally justified by the need for savings to invest. The plea will no doubt intensify as the US budget absorbs more American capital and inflows of foreign capital become more dubious.

For us the situation is easier, and tax reform will help. For most people, the incentive to save will be strengthened. The most general motive – to provide for a rainy day – will be encouraged at all income levels. The most noble motive – to have money to give or leave to good causes – will also be strengthened for everyone, but particularly for the rich. The saving for retirement that is already made easy will be affected only for people who can now afford to put aside more than \$7,500 every year. They will be divided between some who decide that, without the bonus of tax-free accumulation, saving more is no longer worthwhile, and others who prefer to make up for the lesser return by saving yet more.

The motive that will be weakened is saving to provide inheritances to the next generation. One reaction, since it is the recipient who pays the tax, may be that some testators concentrate less on a favourite son, spreading their money wider. However, in one way or another the effect will be that fewer people are rich simply because their parents or remoter ancestors were. The tax rates proposed are not draconian. They will not drastically demolish existing fortunes. The reforms as a whole will make it easier than now, not harder, for people starting from nothing to become, without cheating, multi-millionaires. What they will do is limit the passing on of fortunes and the growth of millions to billions. They are democratisation within reason, appropriately Canadian.

In sum, a tax-reformed Canada will be a Canada with more personal saving to fund investment. Entrepreneurs will have reason to

cheer. If there is genuine concern about a tax system less like the American, it must be found in something other than savings.

It is not that corporations will be more heavily taxed. The proposal is to tax them less. The difference to their finances is solely that their managements will not be able to sequester funds for use free from the test of market competition. That change will be cushioned by the suggested transition period. Afterwards, financing will be competitive in a market enlarged by more saving. Champions of economic freedom should not forbear to cheer.

Nevertheless, some people will fear that established subsidiaries of foreign companies will object to going outside for capital to expand. They may, it will be said, withdraw from Canada, and foreign companies that might have been new investors here will be deterred by not being able to plough profits back into the same enterprise automatically.

There could be a contrary fear: that domestic companies will be disadvantaged by having to go to the market for capital, but foreign subsidiaries can still get retained earnings from their parents. On this view, far from deterring foreign investment, the tax reform may result in yet more taking over of Canadian business.

The two opposite fears have a common origin. They show no faith in the rationality of business.

If corporations are hard-headed calculators, they come, stay, leave according to their prospects of profitable operation in Canada. Their assessments take account of many factors, Canadian and international. Relative taxes certainly count. But if the Canadian operation is a wholly owned subsidiary, or largely so, the tax reform proposed in this paper would not hurt the

parent company's bottom line. If it is partially owned, with significant outside shareholdings, after-tax profit would be increased. (The shareholders would be paying their own taxes.) The reform would result in heavier taxation on the company, however closely or otherwise owned, only if it insisted on financing expansion by directly retaining profits it generated. Whatever the motive for that, taxation would not be closing the operation.

In sum, there is no basis for thinking that tax reform, as proposed, would reduce business investment, Canadian or other. The ways in which Canadian tax would be less like American tax are not ways hostile to enterprise. On the contrary, the incentives of the market economy would operate more freely here. The Canadian economy would be strengthened.

Except, some will argue, for one factor not yet mentioned: the desertion of the rich.

No representation without taxation

Opponents of tax reform may be driven to concede that it would not immediately disrupt the economy, might even strengthen it temporarily, but still claim that we must stay close, get closer, to the American tax structure. They may say that in time, within years, in a decade or a generation, wealth would move out of Canada; and with that, the spring of the economic mechanism would run down.

Certainly the proposed reforms will make Canada less hospitable to some forms of wealth: not to high incomes as the law now understands income; not, that is, to high wages, salaries, pensions, bond interest, dividends; not, particularly, if high incomes fuel high savings rather than high expenditures.

What will be taxed more is, above all, income on which taxes are now in multitudinous ways avoided, deferred, forgiven, evaded. Transfers to tax havens may not be entirely eliminated but getting away with them will become difficult. Capital gains and stock options – if they survive at all – will be taxed more. Gifts, inheritances, lottery winnings will be newly taxed.

Such changes in personal taxation are sometimes represented as being, in some mysterious way, reasons for Canadians to do more investing outside Canada. In fact, most people invest where they see the best return on their money. As long as they are residents of Canada, they pay the same tax whatever country the income comes from. Allocation of the tax is a matter between governments. It does not affect the individual's liability. The relative attractiveness of investing at home or outside is exactly the same before and after reform in taxation. That is, as long as the Canadian stays in Canada.

In other words, tax reform will not directly move wealth. To have that effect indirectly, it has to move people. They have to change their country of legal residence.

Some do that now. There are major proprietors of Canadian businesses who technically live not in Canada but in warm tax-haven islands. Apparently, as wealth accumulates some attachments decay. The proposed reforms – notably the taxation of inheritances and gifts – can be expected to further the decay. Determination to keep wealth in the family may outweigh any price in other separations.

Taxes on inheritances and gifts fall, however, on the recipients. To escape them, the heirs as well as the parent will have to move out of Canada. Continuing control of the business may then be more difficult even despite the contem-

porary ease of communications. Separation of management from ownership may be further intensified. That will not strengthen public regard for business. Whether it makes much difference otherwise will no doubt vary from case to case.

More generally, how much does it matter if more Canadians who have grown rich then live elsewhere? For the operation of the economy, for productivity and employment, little if at all. Many are away much of the time anyway. But wholesale moves could diminish the revenue yielded by a given level of taxation. Other Canadians would pay a little more tax or get a little less public service. However, if the loss were to grow to be significant, it would not be because of the difference between Canadian and US personal tax rates. It would be because many rich North Americans, of both kinds, had taken to legal residence in tax havens. At that point there would no doubt be serious US action to close down the havens.

Nevertheless, the possibility of capital flight from Canada alone requires mention because of the vehemence of the scare-mongering directed against reform proposals such as those of the Carter report. A safeguard that could be taken now would be to legislate that Canadian citizens are required to make a Canadian tax return wherever they live. Tax liability would of course be struck after taking account of treaty provisions for taxes payable in the country of residence. For those who have fled to tax havens, however, the liability would be much the same as if they had remained here.

The equity of such legislation is compelling. To be identified as Canadian, to enjoy the protection of a Canadian passport, is a status in the world with which goes a responsibility: an obligation to contribute to Canada according to

one's means, an obligation not to be shrugged off by a residence of convenience. "No Representation without Taxation" is a fair inversion, for the contemporary world, of the slogan that inspired the creation of the United States. Few people will value freedom from Canadian tax above their Canadian identity. It is fair that those who do should have to declare their choice.

Can it happen?

Discussion will no doubt refine, perhaps revise, the proposals of this paper. Its central point is that we do not have to live with a tax system that is discredited and dysfunctional. Our closeness to the United States does not make thorough reform impracticable. The requirement, as so often, is political will.

Is there any prospect of such will? Without reasonable hope, there may be well-meant discussion of reform but it will lack focus and vigour.

This should be a time of opportunity. The end of corporate financing of parties and their leaders is an emancipation, freeing politicians from the grip of chief executive officers. The start of a new government is the best of times for new policies. And though the Liberal party has had its worst of times, its periods of lethargy and misdemeanour in power, it has in the past proven its capacity also for phases of firmly constructive reform.

Whether we can now look forward to progressive times depends, as our political system now operates, on Mr. Martin. The good sign is the political courage that he first showed as

Minister of Finance, acting where others had dithered. But that was that. For seven more years in the portfolio he mainly coasted on his initial success. He did not move on to constructive financial reform. Charitably, the political setting may be offered as an excuse. Until almost its end, indeed until Mr. Martin had left it, the spirit within the Chrétien cabinet was mostly that of the quick fix for today's problem, rather than concern to do good for the long term.

Mr. Martin is now in a position to do better. Though surely embarrassed by the unseemly financing that helped to get him there, he is not – thanks to Mr. Chrétien – dependent on it for the future. And the political situation gives him reason to break free. With the uniting of the Right, however acrimonious, would-be power brokers have a new agency to promote. Mr. Martin's strategists should be able to see that there is no longer political advantage in stretching partial neo-conservatism over shreds of liberalism. Marginal voters will soon think they might as well go for the real thing, by 2008 giving real force to the disposition to throw the rascals out at last. Those who cannot stomach the Right will go to the NDP – unless the Liberals can by then run again on the record of a genuinely reformist first term.

If that were to be Mr. Martin's disposition and calculation, he is uniquely qualified – by knowledge and by experience – to fashion a tax system, distinctively Canadian, that could be the envy of the democratic world. The hope may be of the faint kind, but it may be enough for people who desire a fair society and a progressive economy to press on with discussion and planning for the key measure, for tax reform.