Introduction

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This introduction consists of three parts. The first outlines conditions that make tax reform possible and desirable. It is argued that these conditions exist in Canada at the beginning of the new millennium. The second part provides very short summaries of the papers included in this volume. The final part presents a simplified agenda for tax reform that emerged from the conference.

Conditions for tax reform

Major tax reform is needed and possible when three conditions are met. First, the existing tax code has become so cumbersome and complex that its operation is excessively expensive. Second, changes in the economic environment have made obsolete policies that were designed to deal with once pressing economic and political issues. Third, new theoretical and empirical knowledge has accumulated and shows that the costs of the existing tax structure are unnecessarily high relative to available alternatives.

The complexity of the present tax system

Most Canadians, especially after they have filed their annual personal income-tax returns every spring, are convinced that the Canadian tax code is too complex and costly to comply with. Revenue

Canada, now the Canadian Customs and Revenue Agency, has been adding directives to the existing code almost daily for decades so that the rules in force now occupy several feet of space on the shelves of libraries, accountants, and tax lawyers. One professional tax adviser working for one of the world's largest consulting firms once told me that, when he travels abroad to consult with foreign governments, he feels that his knowledge is obsolete upon his return to Canada one month later. That reflects how many CCRA bulletins and regulations he has missed and discussions and interpretations he has failed to share with his colleagues.

There are good reasons why Canada's tax code has become increasingly complex. The tax collectors, pushed by politicians, want the system to be fair in the sense that it responds to the special circumstances of individual taxpayers that are not covered by existing regulations. An employee of the Department of Finance in 1996 told the Finance Committee of the House of Commons (on which I served as the representative of the Reform Party) that the original legislation setting up the Registered Retirement Savings Account system covered one paragraph. The code has been amended ever since by many bulletins and it now covers many pages. These amendments were the response to demands by Canadians who were able to show that their individual circumstances made the existing code highly unfair. Often, their personal financial affairs, arranged a long time before the creation of the latest law, would result in costly consequences that were not intended by the legislation. I believe that the government is acting properly in taking account of such special personal circumstances and most Canadians would agree.

The complexities of the tax code also arise as a result of the desire of politicians to provide benefits to special-interest groups in the economy. For example, investment in the film industry is guided by many special tax rules designed to subsidize this activity. These rules favour certain types of workers and firms. They are designed to create a national capacity to make films and encourage an entertainment industry that promotes Canadian culture and values. These policies bring politicians support at the ballot box from those in one industry or another who benefit directly and from cultural nationalists driven by their own agenda. The cost of the rules in the form of higher other taxes or complexity of the tax code are relatively small for other Canadians and politicians do not face punishment from them at the ballot box.

As another example of unjustifiable complexity, consider the special treatment of broader industry classes. As discussed at length in Tom Wilson's paper, Canadian manufacturing industries benefit from preferential rates of taxation, certain resource industries are favoured by special allowances and deductions, and small, Canadian-controlled, private companies enjoy special low rates of taxation. Such differences in taxation levels cannot be justified on grounds of economic efficiency or equity. Their defenders, of course, justify the special privileges, on the grounds that they bring substantial, but largely immeasurable, non-market benefits to society. The technical Committee on Business Taxation (1997), also known as The Mintz Commission, recommended that the government should reform business taxation to correct the existing flaws. Wilson's paper provides useful perspectives on these flaws and what the government has done to fix them.

Changes in the economic environment

Economic development policies for Western Canada during the last half of the nineteenth century involved the encouragement of agriculture in the prairies. In the pursuit of this objective, the government made a deal with the Canadian Pacific Railroad. It granted the railroad rights of way and strips of land for development, and required that it bind itself to the shipment of grains across the Rockies at a fee that was fixed in perpetuity. The resultant "Crow rate" (after the Crow's Nest Pass on the border betweenAlberta and British Columbia) has long represented an inefficient subsidy to Canadian grain farmers in the prairies.

Initially, the low, fixed tariff encouraged farming and grain exports. However, eventually the main effect of the subsidy was to raise the value of agricultural land and every new generation of farmers that bought the more expensive land faced the same eternal economic struggle with low prices for their output and high prices for their inputs. The subsidy did not help. In addition, the subsidy encouraged the shipment of grain when it would have been more rational to ship beef and hogs fed with the grain in the prairies. The railroad suffered increasing deficits on the Crow's Nest route as inflation raised the costs of operation while the price charged to farmers was fixed in nominal dollars. The Crow rate was removed, after nearly a century, in the middle of the 1990s and only after many studies had shown the real economic costs they had imposed on the entire economy and the limited benefits it provided present farmers.

There are other examples of tax rules and subsidies that once could be justified but that are no longer rational as economic circumstances have changed. Thus, exploitation of natural resources through farming, mining, fishing, and forestry once was the primary source of strength for the Canadian economy. However, at an increasing rate during the twentieth century, economic wealth in the world came to be created through manufacturing. For most of the century, the conventional wisdom was that autarky in manufacturing was desirable for national security and pride and, so, the government of Canada offered preferential rates of taxation to foster manufacturing. Now that Canada has a prosperous manufacturing sector and free trade has replaced autarky as the best road to prosperity, it is time to end the preferential tax treatment of that sector.

For another example of the use of taxation to foster the development of special industries and of the effect of changing conditions, consider the energy sector. The OPEC crisis of the 1970s resulted in increased subsidies to the discovery and production of oil and gas and the development of alternative energy resources like the Alberta tar sands and wind and solar power. These ongoing subsidies result in the over-production of energy for both domestic use and export. There is no rational economic case for the continuation of these subsidies in a world awash with energy and fully integrated globally.

Finally, the capital gains tax has become an increasingly costly burden because, during the last 20 years, the world's capital markets have become increasingly integrated. Investors have become much more responsive to small differences in expected rates of return, the safety of their property rights and political stability. Canadian wealth-holders are important players in these global capital markets. As a result of these developments, rules of taxation that impose higher costs on investment in Canada than exist abroad, result in the loss of capital in Canada until the after-tax rates of return are raised and again equal those abroad. As I argue in my own paper in this book, this new and stronger international tax arbitrage has made it likely that the capital gains tax in Canada has lowered tax revenue from other sources by more than is raised by the tax itself.

All of the negative aspects of the capital gains tax apply to the corporate capital tax. In addition, this tax has the disadvantage that it is payable whether or not a firm is profitable. Corporations find this feature to be especially burdensome since it results in cash-flow problems at times when business activity is depressed and profits are down. Jason Clemens, Joel Emes and Rodger Scott discuss various other damaging effects of this tax in their second contribution to this volume. (The paper was not delivered at the Toronto conference because of time limitations. It is a shortened version of a longer study published separately by The Fraser Institute.)

New knowledge about taxation

Canada's last major tax reform in the early 1970s was based to a considerable degree on the best knowledge about the nature and effects of taxation existing at the time. It was also based on the popular ideology that the fairness of the tax system and distribution of income were more important than efficiency and economic growth.

Since the 1970s, much has changed that impinges on the merit of the tax system created then. Communist, socialist and even social-democratic policies for taxation, income distribution, and economic management lost much of their appeal as the Russian empire disintegrated and the United States flourished under a regime favouring free markets. In Canada, the relative decline of per-capita income has prompted a debate over its causes that has pointed to the obsolete taxation system as a major factor.

More important for this study, research by economists, financial experts, and taxation specialists has produced much new knowledge about the nature and effects of taxation. There are two types of such research. The first involves theoretical modeling of economic processes and human behaviour and empirical estimates based on micro- and macro-economic data. Second, researchers compare the experiences of different countries that have different tax regimes or have gone through major tax reforms.

Induced changes in human behaviour

History provides an outstanding example of how taxation induces changes in human behaviour designed to avoid the payment of taxes: the taxation of property based on the number of windows in a house. This tax base is ideal from the point of view of tax collectors. It cannot be avoided by illegally designed transactions. It also cannot be evaded because it costs too much to redesign houses. However, as history has shown, although the evasion of the tax may have been impossible in the short run, in the longer run houses were rebuilt and new ones designed with ever fewer windows. It is important to note that the new designs of houses were accompanied by costs. Obviously, esthetically, homeowners had preferred more windows per house before the government induced them to have fewer. Less obvious, perhaps, are the implications for hygiene resulting from less ventilation and for the cost of lighting the houses. In sum, taxation not only resulted in a shrinking of its base, it also resulted in the misallocation of resources that lowered real incomes.

Economists in recent decades have developed the concepts of optimum taxation and the related marginal efficiency cost of taxation or marginal cost of public funds. These concepts formally incorporate and measure the costs created by changes in human behaviour caused by the imposition of a given tax. As one would expect, these costs depend on a host of conditions but, especially, the ease with which taxpayers can avoid a given tax, known formally as the elasticity of response.

It does not come as a surprise that the marginal efficiency costs are different for different taxes, both in the short run and in the longer run. Direct taxes on work, investment, and risk taking have the highest costs since individuals can easily change their behavior to avoid the tax. The growth of the underground economy reflects the shift of labour from the formal and taxed into the informal and untaxed markets. In addition, workers can avoid the payment of taxes by enjoying more leisure or using their time to do their own home and car repairs and engage in similar productive activities that legally escape taxation.

Taxes on capital and risk taking similarly can be avoided easily. People shift their investments abroad or, more important, consume rather than invest their money. They avoid risky investments in favour of government securities that are safer but have a lower return.

The lowest marginal efficiency costs are found for direct taxes on consumption, be they sales, excise, or value-added taxes. These taxes cannot be avoided since everyone has to buy goods and services to sustain and enjoy life.

In recent years, economists have made numerous studies to measure the marginal efficiency cost of taxation. Even the Department of Finance has produced research on the subject, which in turn appeared in a publication by the OECD. Bev Dahlby in his contribution below reviews these empirical studies, which confirm the theoretical expectations noted above.

The theory and empirical studies have some very important implications for tax policy in Canada. Dahlby argues that the substitution of direct for indirect taxes would reduce substantially the drag on efficiency due to the overall system of taxation. Increases in the GST and the provincial sales taxes and the lowering of taxes on personal and capital income would bring gains in efficiency in the short run as well as increases in productivity and labour income over the longer run.

One way in which the tax on work can be made less distorting is through the introduction of a tax that does not have progressive marginal rates. Jason Clemens and Joel Emes in their paper suggest that lost revenue can easily be made up by the elimination of existing tax exemptions and exceptions.

Given the importance of investment for productivity, living standards, and economic growth, several papers in this volume lament the multiple taxation of capital income under the present tax system. As it stands, businesses pay the corporate income tax on their profits. The dividends paid out of this after-tax business income are then subject to taxation in the personal returns of the recipients. Capital gains from the sale of the business are subject to capital gains taxation.

There is no doubt that such multiple taxation is unfair and results in lower investment. This fact has implicitly been acknowledged in the Canadian tax code, which in principle allows individuals to eliminate the double taxation of dividends. However, the system used is deficient in several ways stressed by Tom Wilson in his paper. There is a complicated system of grossing up of dividend income and a deduction from taxes owed, which most taxpayers do not understand. Dominant in the filing process appears to be the need to report dividends as taxable income in the first place.

In addition, the rates used for gross-up and deductions do not eliminate double taxation completely. This failure is due to the fact that the rates were set to assure the elimination of the double taxation of income from small business, which is lower than that for most corporations. Wilson argues that the preferential rates for small business should be eliminated for the sake of efficiency. If this were done, it would be possible to eliminate double taxation of business income very easily and clearly by a simple credit for the taxes already paid by the business.

The taxation of capital gains has similarly been studied and shown to result in larger losses in efficiency and smaller effects on the equality of income than had been known before. Grubel in his contribution argues that the new information makes a good case for the abolition of the capital gains tax.

International evidence

Unfortunately, it is not possible to engage in empirical tests of the validity of most of the policy conclusions that have emerged from new theoretical insights and the indirect empirical evidence assembled to measure the effects of different tax policies. Many of the favourable developments from changes in the mix of taxes will come about only slowly and are likely to be dominated by a host of other changes taking place in the economy.

However, the experience of other countries with tax changes is relevant to questions about the likely effect of proposed similar changes in Canada. One of the most widely studied set of tax changes took place in the United States under the leadership of President Ronald Reagan. The cuts had been inspired by research known as supply-side economics and associated with the names of Arthur Laffer and Robert Mundell.

Not all economists agree with the theory and empirical evidence on the effect of tax and spending cuts on economic growth. However, many are convinced by, and have successfully advocated policies such as those introduced in Margaret Thatcher's Britain. The tax cuts undertaken under President George W. Bush in 2001 are based on this empirical evidence.

Ireland has been the poor cousin of its more prosperous neighbour Britain and continental Europe for many years. In the early 1990s, Ireland changed its economic policies. Since then, its economy has grown very rapidly. Ten years after the reforms, Ireland's per-capita income exceeds that of most of its neighbouring countries. How important were changes in the level and structure of taxation in this Irish success story?

The paper by Brendan Walsh in this volume examines this question and concludes that taxation reforms have been important but that there have been a host of other changes that contributed to the superior economic growth record. The removal of rigidities in the labour market, the adoption of the euro, and some subsidies from the European Community are shown to have played major roles in Ireland's economic renaissance.

The paper by Michael Walker introduces more evidence on the beneficial effects of taxation on economic growth. He draws on data from a large number of countries with widely different tax levels and concludes that indeed taxation is an important determinant of economic growth.

Conclusions

In my view, the studies found in this volume imply strongly that Canadians could gain much from lower levels of taxation and some important structural tax reforms. The theoretical insights developed since Canada's last major tax reform and the empirical evidence validating the theories, back up this recommendation.

All tax reforms produce some winners and some losers. That is one reason why reforms are so difficult and take place so infrequently. The losers tend to protest loudly and cause much political turbulence while the winners enjoy their higher incomes quietly. However, at the beginning of the new millenium there are large fiscal surpluses generated by rapid economic growth and caps on spending increases. These surpluses offer a rare window of opportunity to have tax reforms that lower the after-tax income of no one interest group. The government of Canada would be wise not to let this opportunity slip away.

Summary of papers included in this volume

The first two papers were presented to a general audience after lunch on the day of the conference. The speakers are the heads of the two leading economic think tanks in Canada, Michael Walker of the Fraser Institute and Jack Mintz of the CD Howe Institute. These authors set out in general terms the two different, but related, issues facing Canada's fiscal policy makers, the need to reduce the overall level of government taxation and spending and Canada's tax structure in need of reform, whatever the level of spending and taxation.

The level of government spending matters most
Michael A. Walker

The Economic Freedom Index published by The Fraser Institute in the annual reports, *Economic Freedom of the World*, shows that the level and growth rate of income in various countries are an increasing function of economic freedom—the level of taxation, regulation, and a host of other measurable determinants of economic incentives. Walker discusses Canada's world ranking in a number of areas. He concludes that the country's economic growth would increase substantially if the size of government were decreased to its optimum level.

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

The author sets the stage for the rest of the papers found in this book by stressing that the structure of taxes is important for incentives and, therefore, for economic growth and the well-being of Canadians. He then makes the case for replacing income tax with an expenditure tax. This goal can be achieved under the present personal income-tax regime if all savings and income from capital are exempted from taxation. He believes that this recommended tax structure would not only create powerful, growth-enhancing incentives but would also help in dealing with some important future problems like the aging of Canada's population and the strain it will put on fiscal resources, as well as the challenges created by the recent slow growth in productivity and competitiveness.

The flat tax—a model for personal and business tax reform
Jason Clemens and Joel Emes with Rodger Scott

Many economists and politicians in the United States and Canada have recommended the flat personal income tax to simplify the filing of returns and to eliminate the disincentive effects that are the result of the existing system. The authors of this paper consider the steps needed to introduce such a tax in Canada and provide empirical estimates of the rate of flat tax needed to raise the same revenue as raised by the present tax. They consider the incidence of the tax and the sensitivity of their results to changed assumptions about the size of the basic personal exemption and of different exemptions for families with children and contributions to charity.

Restructuring the Canadian Tax System by changing the mix of direct and indirect taxes
Bev Dahlby

Direct taxes like the personal and business taxes have much stronger disincentive effects than indirect taxes like sales and value-added taxes. For this reason, many economists believe that Canada's tax system should be reformed by changing the present mix of direct and indirect taxes. Dahlby expands on this recommendation by a review of the estimates of the available gains found in the literature. He concludes that the proposed new tax structure would have small but significant effects on Canada's rate of economic growth and future living standards.

An evaluation of business taxes
Thomas Wilson

The author was a member of the team of experts that produced the Mintz Report on Business Taxation. This report recommended to the Minister of Finance a number of important changes to the existing system of business taxation that would increase its efficiency and equity. Wilson reviews these recommendations and examines what policy changes have taken place since they were made. He found that most of the recommendations have been ignored. The author the goes on to analyze the merit of a more transparent and complete integration of the corporate and personal income taxation.

Why there should be no capital gains tax
Herbert Grubel

Drawing on much new empirical evidence, the author makes the case that the capital gains tax brings more harm than benefits. The tax has a substantial negative impact on economic growth while it raises little revenue and falls on those earning low and moderate incomes as much as on the rich. Canada should abandon the capital gains tax and deal with problems of tax arbitrage in the way Hong Kong does.

The corporate capital tax—Canada's most damaging tax
Jason Clemens and Joel Emes with Rodger Scott

The authors describe the nature of the corporate capital tax, which imposes a levy on business whether it is profitable or not. This newest Canadian tax is very damaging to investment incentives, is costly to administer, and raises very little revenue. The elimination of this tax should be high on the agenda of any policy makers interested in raising Canada's productivity and economic growth.

Interprovincial fiscal competition in Canada—theory, facts and options
Finn Poschman and William B.P. Robson

There is a widespread belief that provincial policies that lower taxes induce a competitive race to the bottom that leads to a less than efficient and equitable level of government spending. The authors examine this belief critically and come to the conclusion that such a race to the bottom is unlikely. The decisions to locate and invest in a given province are based on both the levels of taxation and the services provided with the revenue. Provinces that provide good and wanted services will attract immigrants and capital even though they have higher taxes than other provinces. Competition among jurisdictions to provide the best level and mix of government services for any level of taxation is beneficial for Canada.

Taxation and foreign direct investment in Ireland
Brendan Walsh

Advocates for lower and better taxes consider Ireland's recent, stellar growth performance as a powerful example of the merit of their policy recommendations. Walsh shows that tax reforms and spending propensities in Ireland indeed contributed significantly to Ireland's recent success but he also points out the importance of other policy changes, like reform of the labour market, targeted tax subsidies, the adoption of the euro and transfers from the European Economic Community.

A tale of two provinces—tax policy in Alberta and Ontario
Kenneth McKenzie

The governments of Alberta and Ontario in recent years have cut spending and lowered taxes. The author examines the nature of the tax changes in both provinces and discusses the impact they have had on labour and capital markets and how they can explain the bursts in economic growth enjoyed by these two provinces.

Outline of proposed tax reforms

The following is an outline, simplified and without attribution, of the proposals for tax reform that emerged from the conference and are reflected in the papers in this book.

1 The taxation of income from work, investment, and risk-taking should be eliminated or, at least, reduced significantly. The taxation of consumption should be increased correspondingly. These basic objectives can be attained by two different approaches:

  a Turning the current income tax into an expenditure tax by exempting from taxation all savings. This goal can be achieved by the removal of all limits to tax-free contributions to RRSPs.

  b Raising the rates on indirect taxes like the GST, sales and excise taxes and lowering correspondingly the rates on direct taxes like personal, business and capital income.

2 The multiple taxation of income from investment should be eliminated. To attain these objectives it is necessary to consider the following policies.

- **a** The tax regimes for personal and business income should be integrated so that taxes on profits paid by business can be used to reduce personal income taxes due on dividends.
- **b** The taxation on capital gains should be eliminated.
- **c** The capital tax paid by business should be eliminated.

3 The personal income-tax system should be simplified and disincentives to work, investment, and risk taking should be eliminated by the following measures.

- **a** Progressive income-tax rates should be replaced by constant marginal rates.
- **b** Most deductions from the personal income-tax base should be eliminated.
- **c** The personal and business income taxes should be fully integrated.