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Ottawa needs defensible plan for action on taxes, says C.D. Howe Institute study

With the federal deficit finally tamed, it is time for Ottawa to put tax reform and tax relief squarely on the map, says a C.D. Howe Institute Commentary released today. Tax relief should focus primarily on personal income taxes, the study urges, with payroll and corporate taxes receiving smaller cuts. But getting it right requires adopting a rational framework for tax cuts, something the current government has yet to do.

The study, *Tax Reform, Tax Reduction: The Missing Framework,* was written by Jack M. Mintz, an economics professor at the University of Toronto, and Finn Poschmann, a Policy Analyst at the C.D. Howe Institute. The authors present a schedule for more than $14 billion in federal tax cuts over three years — a tax cut of about 10 percent — involving savings of nearly $1,000 per Canadian family per year by 2001.

Mintz and Poschmann say that, with the deficit gone, significant tax relief should be accompanied by needed reforms to make the tax system fairer and more efficient. Most important, a program of tax reform and relief should be set within a framework that responds to Canadians' expectations for both taxes and federal spending programs without compromising Ottawa's hard-won fiscal health.

The authors point out that a reform framework must deal with a changed Canadian economy: after-tax incomes have long been stagnant, the poor face severe difficulties climbing the economic ladder, the number of self-employed is growing, and financial capital and skilled labor are becoming ever more mobile in today's global economy.

Past fiscal mismanagement has driven taxes to historic highs, and interest on the public debt means that Canadians pay more than $1.40 in federal taxes for every dollar in services they receive, say Mintz and Poschmann. These taxes, by discouraging work, investment, and risk taking, make Canada less productive and less attractive as a home for businesses or for workers.

The highlights of the authors' tax-reduction and reform plan are as follows:

- Cut marginal tax rates — the amount of tax paid on the next dollar of income earned — for all taxpayers, regardless of income, but particularly for low-income families because they face the highest marginal rates of all.

- Fully index personal income tax thresholds and credits to inflation in order to avoid the continued erosion of after-tax income, and raise personal exemptions to compensate partially for the past effects of inflation.
- Streamline the federal tax rate schedule, and eliminate surtaxes over two years. The basic rates should be set at 15, 23, 28, and 31 percent, with each rate kicking in at thresholds higher than today's and the top rate applying only on truly high incomes (above $154,000).
- Fold the goods and services tax credit into a larger child tax benefit. This way, working families will not face the high marginal tax rates caused by clawbacks of multiple benefits. Also, a large nonrefundable credit reflecting the cost of raising children should be returned to the basic federal tax calculation, and the credit should not be income tested.
- In the light of Canada's aging population, encourage greater private saving for retirement and reduce the tax preferences current workers receive when they retire. Equalize the tax treatment of private medical insurance costs with respect to employer-provided versus individually purchased plans.
- Steadily reduce employment insurance premiums to the level required to fund benefits, and run the program according to realistic insurance principles.
- Reduce corporate taxes and eliminate the surtax on corporate income. Simultaneously, broaden the corporate income tax base to make the tax more neutral with respect to business decisions and less susceptible to avoidance.

Mintz and Poschmann stress that all these reforms can be accomplished within a schedule that delivers continued federal debt reduction, yet funds social programs at levels that keep pace with future growth in population and prices.

This study is part of a new C.D. Howe Institute Commentary series called "The Taxation Papers." The series deals with the tax policy opportunities presented by the rapidly changing Canadian fiscal environment — in particular, ways to reform personal income tax policy within a sound economic framework, rather than allowing policy to be driven by short-term political considerations. Papers in the series establish the fiscal room for tax reduction; identify specific problems with past choices about the taxes used to finance government (the tax mix); show how taxes interact with federal and provincial social support programs; and establish more equitable methods of taxing families. The editors of the series are Jack Mintz and Finn Poschmann.

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Tax Reform, Tax Reduction:

The Missing Framework

by

Jack M. Mintz and Finn Poschmann

The federal government has eliminated its deficit and is now in a position to deliver significant tax relief. But tax relief should proceed alongside reforms that make the tax system fairer and more efficient. Further, a program of tax relief and reform should be set within a sound framework that does not compromise federal programs or the government's fiscal health.

The framework must deal with key changes in the Canadian economy: long-stagnant after-tax incomes, the difficulties the poor face in climbing the economic ladder, the growth of self-employment, and increasingly mobile capital and skilled labor. Canadian taxes, which are at historic highs, make the economy less productive by discouraging work, investment, and risk taking, and Canada less attractive as a home for businesses or for workers.

Relief should focus on personal taxes, which should fall by about 10 percent, or $1,000 per family, over three years, but corporate taxes also should be somewhat reduced. Marginal personal tax rates should be cut for all taxpayers, regardless of income. The federal tax rate schedule should be streamlined, and surtaxes eliminated over two years. The tax base should be made fairer by providing greater recognition for the costs of raising children. The goods and services tax credit should be folded into a larger child tax benefit, so that working families do not face the high marginal tax rates caused by clawbacks of multiple benefits.

These and other reforms can be accomplished within a schedule that delivers continued federal debt reduction, yet funds social programs at levels keeping pace with a growing population.

Main Findings of the Commentary

- The federal government has eliminated its deficit and is now in a position to deliver significant tax relief. Long-needed reforms should be undertaken at the same time as tax reduction, in order to make the tax system fairer and more efficient.
- A program of tax reform and relief should be set within a sound framework that is responsive to Canadian taxpayers' needs and expectations, without compromising the delivery of federal programs or the government's fiscal health. The framework must take into account key changes in the Canadian economy: stagnant after-tax incomes, the difficulties the poor face in climbing the economic ladder, the growth of self-employment, and the mobility of capital and skilled labor in today's global economy.
- This means Canadian taxes — especially personal taxes — should be reduced. Fiscal mismanagement has led to historically high taxes that discourage work, investment, and risk taking, making Canada less productive and less attractive for businesses and workers.
- A medium-term plan for reducing taxes should include cutting marginal tax rates — the amount of additional tax paid on extra income earned — for all taxpayers, regardless of income, but particularly for low-income families, whose high marginal tax rates are the greatest barriers to earning income through their own efforts.
- Personal income tax (PIT) thresholds and credits should be fully indexed to inflation, to avoid the continued erosion of after-tax incomes. Personal exemptions should be raised to compensate partially for the past effects of inflation.
- The federal tax rate schedule should be streamlined, and surtaxes eliminated over two years. The basic rates should be set at 15, 23, 28, and 31 percent, with each rate kicking in at thresholds higher than today's and the top rate applying only on high incomes (above $154,000).
- The goods and services tax credit should be subsumed by a larger child tax benefit so that working families do not face the high marginal tax rates that are caused by clawbacks of multiple benefits.
- Private saving for retirement should be further encouraged, given the fiscal stress caused by an aging population. Tax preferences provided for current workers when they retire should be reduced.
- The tax treatment of private medical insurance costs should be equalized, with respect to employer-provided versus individually purchased plans.
- Employment insurance premiums should be steadily reduced to the level required to fund benefits, and the program reformed so that it more closely resembles a true insurance program.
- The corporate income tax should be reduced, the surtax eliminated, and the corporate tax base broadened with the aim of making the corporate tax more neutral and less susceptible to avoidance.
- These reforms will shift federal reliance away from the PIT and toward a revenue mix more reliant on consumption and payroll taxes. And they can be accomplished within a schedule that delivers continued federal debt reduction, yet funds social programs at levels keeping pace with future growth in population and prices.

For the first time in a generation, the federal government has presented a budgetary surplus, and the domestic fiscal environment holds the possibility of further surpluses in the coming years. This prospect has stimulated pressure on Ottawa to lighten the burden on Canadian taxpayers.

In this *Commentary*, we suggest a framework for the rationalization and reform of Canada's tax system, especially personal taxes. Even though recent global financial instability makes the exact amounts of future surpluses uncertain, there will be room for tax cuts in the next several years. It is important that this opportunity for tax reduction be used to reform the system and reduce Canadians' tax burdens.

Canadians urgently need a framework for tax policy now so that they can determine their priorities for the tax system in the future. Such a framework would provide voters with an informed basis for deciding how taxes should be adjusted in the most troubling areas of the tax system. Most important, the room now available for tax cuts provides a unique opportunity to reform the tax system to make it more efficient and fair, and to create a better climate for job creation and growth.

The need for reform follows from the recognition that Canadian personal income taxes (PITs) are higher than they now need to be, and that the average marginal tax rate — the typical rate of tax payable on the next dollar of income — is out of line with that of other countries and has a counterproductive effect. Further, the haphazard development of targeted relief over the past decade or more has taken place without a framework to guide the evolution of the system as a whole.

The absence of a principled framework for policy development manifests itself in unfortunate anomalies both in the rate structure and in the tax base itself. Thus, many taxpayers are paying tax on income that should not be taxed, and some are receiving income subject to unreasonably low tax.

The past combination of incremental change to the rate structure and the lack of a well-defined policy target has produced a tax system that is uncompetitive with that of Canada's trading partners and ultimately harmful to this country's growth prospects. The risk of working without a principled framework is highlighted in the example of the limited tax relief offered in the 1998 federal budget, which proposed narrowly aimed cuts that, for many of the taxpayers standing to gain, came at the expense of a rise in marginal tax rates[1] and a reduction in earnings incentives.

The lack of a framework has also made it difficult for the current government to articulate a case for a program of tax reduction, debt reduction, or both. In the absence of a set of medium-term goals for fiscal policy, the same economic growth that produces pleasant fiscal results forces the federal finance minister into a rearguard defense of those results. Without a well-understood and coherent plan, Ottawa has little principled ground to stand on when political pressure for program spending seeks to lay claim to the fiscal surpluses or tax cuts that might otherwise come to fruition.

Thus, while broad-based tax reduction with reform is due, what is most important is that Ottawa develop and articulate a schedule for that reform. Otherwise, the opportunity to achieve it may fruitlessly evaporate.

The following discussion of the available fiscal room for tax reductions is drawn from a set of fiscal assumptions derived from Robson (1998), which seeks to establish the available scope for tax decreases that would keep the federal government on a prudent fiscal course. Our purpose is to establish a reform schedule that is consistent with the room available for Ottawa to cut its overall tax take without returning the treasury to a precarious fiscal position. Our scenario also assumes, as fiscal prudence

probably requires, that Ottawa refrain from launching major new spending programs.

The agenda is to establish a set of guiding principles for reform — the basis of a rational frasmework for change. These principles would be the building blocks of a system that raised sufficient revenue for desired public expenditure, with as little economic cost as possible and as fairly as possible.

Principles are the guide to practice, and to sketch a practical tax relief and reform program is the ultimate purpose of this *Commentary*. Our fundamental conclusion is that the time is ripe, in economic and fiscal terms, for carefully staged tax reduction.

The reductions we recommend are primarily in the PIT, but there is both a sound economic rationale and sufficient fiscal room for allowing some payroll tax relief and some small but useful cuts in the corporate income tax (CIT). There is neither the economic need nor the fiscal leeway for decreasing federal consumption taxes.

The result of applying reductions that differ in relative scale across tax bases would be a shift away from federal reliance on the PIT and toward a tax mix more reliant on consumption and payroll taxes, a step we believe would enhance Canada's economic performance yet maintain a reasonable distributional burden of taxation.

While proposing an overall reduction in the PIT, we recommend that the federal government take the opportunity to make specific changes to personal and other taxes that would shift their incidence slightly and produce a fairer and more efficient tax system. These changes include lowering marginal rates for low- and middle-income taxpayers especially; explicitly recognizing the universal costs of childrearing; smoothing the marginal tax rate profile associated with taxing back benefits and credits; bringing employer-provided health benefits into taxable income; modestly enhancing provisions for tax-sheltered saving; and committing to annual adjustment of the tax system to fully account for inflation. We also support several reductions in and reforms of business taxes and employment insurance (EI) premiums that would complement changes to the PIT.

The final section of this *Commentary* spells out the specific targets for reduction and places them in an appropriate fiscal context. But since that context is also the background environment against which any reform must be set, we establish that background first.

The Fiscal Environment

Canada has taxes that are rather high in comparison with those of most of the developed world. The ratio of tax to gross domestic product (GDP) in Canada grew from about 31 percent in the 1976–79 period to 36.5 percent in the 1992–95 period.

Twenty years ago, there was little difference between Canada's tax-to-GDP ratio and the average of other Group-of-Seven (G-7) countries weighted according to their GDP shares within the G-7. Weighted thus, this ratio is not much different now (see Table 1).

But if one is concerned about the role of taxes in the decisions firms make about the costs and benefits of producing goods in Canada and exporting them abroad versus producing goods in foreign countries, what counts is the tax-to-GDP ratio of competitors when that ratio is weighted not by GDP share in the G-7 but by Canadian exports to those countries, because the tax burden is a component of the cost structure of exports. Thus, the trade-weighted tax rate comparison is one index of national competitiveness, indicative of the price competitiveness of Canadian products and the potential profitability of Canadian enterprise.

Canada's tax-to-GDP ratio is now well above — by more than eight percentage points — the trade-weighted average of other G-7

Table 1: *International Comparisons of Tax-to-GDP Ratios*

	Canada	United States	United Kingdom	G–7 Average		OECD Average
				Weighted by Canadian Trade	Weighted by GDP	
			(percentage of GDP)			
1976–79	31.1	26.5	33.9	27.0	31.3	33.0
1980–83	32.9	28.8	37.0	27.6	34.5	34.0
1984–87	33.6	26.1	37.7	26.8	36.2	35.2
1988–91	35.6	29.4	36.4	27.8	36.4	36.2
1992–95	36.5	29.8	34.5	28.0	37.2	37.3

Note: Taxes are defined as total government receipts.

Source: OECD 1997b.

countries. More important, the tax-to-GDP ratio for the 1976–79 period was about four and a half percentage points higher in Canada than in the United States, its most important trading partner, but had risen to almost seven points higher in the 1992–95 period. Canada's tax-to-GDP ratio was also lower than the United Kingdom's in 1976–79 but higher in the more recent period.[2]

An important factor driving Canadian taxes has been the weight of mounting public debt charges as net public debt rose throughout the 1970s, 1980s, and the first half of the 1990s. The rising public debt, of course, reflects the choice of numerous successive governments to borrow rather than rein in spending or increase taxes by more than they did. But the inevitable product of mounting debt is mounting interest charges. As shown in Table 2, if Canadian governments had not increased interest charges as a percentage of GDP from 1980 to 1995, the tax-to-GDP ratio would have remained essentially unchanged (assuming the interest savings had been passed through in lower taxes and that total expenditure had remained consistent with a lower debt-to-GDP ratio).

The more recent impact of the combination of the federal government's limited fiscal restraint and high taxes has been finally to allow the sum of program spending and debt-service costs to be outstripped by total federal revenue. The resultant surplus, the inevitable product of tax revenues' growing faster than program spending, provides Ottawa with the opportunity to choose among three actions:

- Reduce the huge public debt (federal net public debt stands at more than 65 percent of GDP) and thereby gradually reduce the annual interest charges that consume nearly one-third of federal revenues.
- Finance new or expanded government programs, primarily social services (which, incidentally, would raise interesting federal-provincial coordination issues, since the provinces claim constitutional primacy in these fields).
- Cut taxes.

As in most complex cases, the choice will not be clear cut, and it is likely that Canada will consume some of the federal surplus by way of all three choices. Of these choices, we point out, only debt reduction actually makes use of the surplus; the other options prevent a surplus from evolving. And while substantial benefits for Canadian taxpayers would follow

Table 2: *Canadian Taxes, Debt Charges, and Deficits*

	Tax-to-GDP Ratio	Debt-Charges-to-GDP Ratio	Deficit-to-GDP Ratio	Tax-to-GDP Ratio Adjusted for Additional Debt Charges after 1980[a]	Zero-Debt Tax-to-GDP Ratio[b]
			(percentage of GDP)		
1976–79	31.1	4.6	2.4	31.1	28.9
1980–83	32.9	6.6	4.3	30.9	30.6
1984–87	33.6	8.3	5.6	29.9	30.9
1988–91	35.6	9.1	4.0	31.1	31.1
1992–95	36.5	9.4	6.0	31.7	33.1

[a] Calculated as tax minus government debt charges as a percentage of GDP plus 4.6 percentage points.

[b] We assume deficits are equivalent to deferred taxes, with no adjustment for expenditure. Therefore, the calculation is taxes plus deficits minus public debt charges, as a percentage of GDP.

Source: Canada 1997.

from up-front debt reduction, a tax-cutting strategy would also provide large long-term payoffs (see Robson and Scarth 1997). We believe, therefore, that a significant share of the available fiscal surplus should be used over the next few years to provide meaningful tax relief for Canadians.

Payback Time

In estimating the scale of tax cuts available, we rely, as already noted, on Robson (1998), who establishes the room for fiscal maneuvering congruent with the overarching need to keep the ship of government on a prudent fiscal course.

The underlying assumption is that prudence pushes the federal government to plan to set aside $3 billion for contingencies in every year through 2004 (equivalent to running a surplus of at least $3 billion in each year) and to establish a revenue plan that has a 90 percent probability of producing such an outcome, given the range of economic variables likely to influence that result.

We presume that federal expenditure, measured in real dollars per capita, stays flat (in other words, that the rate of increase in total spending matches the sum of the inflation rate plus the population growth rate). The economy is expected to show nominal annual growth in GDP averaging 3.8 percent over the forecast period. Treating expenditure as a predetermined variable and setting a target for the balance of revenue less expenditure (that is, a deficit/surplus target) leaves revenue as the arithmetic residual determined by tax policy choices.

The federal spending assumption — that the total can be held constant, in real per capita terms, over the planning period — is required to ensure that Ottawa maintains its capacity to fund the social safety net at the level to which Canadians have become accustomed. If federal spending does grow at the rate of inflation plus population growth, but not faster, some shifting of priorities may be required in the face of changing demand for particular programs. But Ottawa's underlying capacity to fund programs would be protected, and the financial foundation for future real spending growth (or future tax cuts), should Canadians desire such, would be firmly set.

Given the demands on fiscal policy just outlined, the residual room for tax cuts would be substantial. There would be room over the course of the next few budgets to lay out a set

of tax changes aimed at repairing the tax base and providing meaningful rate relief. Robson (1998) shows that Ottawa could stay on a prudent course and still deliver a cumulative total of about $23.0 billion in tax cuts over the next five years ($4.6 billion annually). This scale of tax reduction is what we intend to be delivered via the reforms described later in this *Commentary*.

Principles Guiding Tax Reform

The remaining issue is what sort of tax cuts there should be. This section discusses the principles that would govern the practice of tax reform and why tax reductions should be effected mostly through PIT cuts.

The federal government could take either of two broad approaches to taxes: tax relief or tax reform. The first is less appealing than the second.

Tax relief in our definition would be designed so that no one need pay more tax. This approach could involve cutting tax rates or providing additional deductions or credits to reduce tax payable.

Under tax reform, taxes would be cut in total, but, at the same time, the personal tax system would undergo changes, including reductions in special preferences for certain taxpayers, that would improve prospects for economic growth and enhance fairness among taxpayers. Under this second approach, a few taxpayers — who have been paying little or no tax because of those special preferences — might pay more tax, but most Canadians would benefit from both reductions in tax and a better system overall.

Tax reform is the preferable approach because it would contribute to a more efficient and productive Canadian economy; since tax relief could be delivered simultaneously, so much the better for Canadian taxpayers. In particular, tax relief would smooth the ruffled feathers of those potentially harmed by the reform component, making the package as a whole more palatable politically.

But whatever the extent of the relief or the depth of the reform undertaken, it is necessary to have a *set of criteria* to guide strategy and determine priorities. Without such criteria, it is difficult to answer the important questions Canadians face, such as:

- Should personal tax cuts be geared to low-income working Canadians?
- Should taxes on high-income individuals be cut or increased?
- Should the tax system be changed to balance differences in taxes according to the size of the family?
- Should the tax system encourage more savings for education, health care, and retirement?

However taxes are cut, the exercise should result in a better, not worse, personal tax system — in other words, Canadians should expect as an outcome that the tax system should be less complicated, fairer, and as efficient as possible.

In our search for criteria for a tax-cutting strategy, we take advantage of the accumulated historical wisdom that applies to tax analysis — in a nutshell, that efficiency and equity are the touchstones in evaluating tax policy, and that these are best achieved via a tax base as broad as possible and with tax rates as low as possible. However, our modern criteria for tax cutting must recognize a number of key shifts in the Canadian economy that have become apparent in the 1990s. These trends include the following:

- The rapid development of new technologies, which requires adaption to a fast-changing economic environment and acquisition of the knowledge and skills needed to meet the challenges of an evolving workplace. The implications are sig-

nificant. Earnings of skilled workers are rising more rapidly than those of unskilled workers, increasing pre-tax income inequality.[3] Further, the human capital acquired through training and education depreciates quickly, making imperative reinvestment in education and training throughout a person's lifetime.

- The growth of self-employment in the past decade, from 14 percent of the private sector work force in 1976 to 19 percent in 1996 (Technical Committee on Business Taxation 1998, 3.19), which puts new pressure on the PIT system, because traditional earnings in the form of employee salaries and wages have become a shrinking component of the tax base.
- The falling birth rate of the past several decades, which means that the ratio of seniors to the working population will rise. The pension and medical benefits the elderly receive through government programs must be supported by higher future tax revenues to the extent that the requirements of future seniors' programs (net of tax recoveries on total pensions) exceed current funding levels (see Oreopoulos and Vaillancourt 1998).
- The increased international mobility of skilled workers, especially with respect to the United States, which will place significant pressure on economic growth prospects for Canada. The availability of trained workers in Canada is a key determinant of the productivity of its economy and of its attractiveness to business. Canada gains many workers through immigration, but increased emigration of skilled workers involves a net loss.[4]
- The effect of inflation, which each year drives taxpayers with constant real pretax incomes into higher rate brackets and lowers the real value of their personal exemptions. Furthermore, no adjustment is made for the inflationary component of interest income, borrowing costs, or capital gains.[5] The failure to fully index tax brackets and personal exemptions since 1985 has resulted in the federal and provincial governments' now collecting an additional $10 billion a year in revenues — and the figure is growing.[6]

Overall, the criteria for tax reform must take account of these modern realities. They must also show the hallmarks of a good tax system — exhibiting fairness, encouraging economic growth and job creation, and minimizing compliance and administrative burdens — and encourage sensible tradeoffs among these objectives when they conflict, as is inevitable.

Fairness in Taxation

A Canadian framework for assessing a personal tax system must include fairness. But there is more to establishing fairness than the majority vote used in the legislative process to give policy the stamp of authority as an expression of public preferences. It is also important, to encourage voluntary tax compliance, that Canadians *perceive* the system to be fair.

Yet fairness is in the eye of the beholder, and there are divergent views as to the meaning of fairness in tax. Tradition has established two general principles in defining fairness: horizontal equity and vertical equity.

Horizontal Equity

The principle of ***horizontal equity*** is that like should be treated alike: individuals who have the same income and are in similar circumstances (such as having the same size family) should pay similar amounts in tax. The often forgotten corollary is that unlike should be treated unlike, that individuals who have the

same income but are in dissimilar circumstances should pay dissimilar tax.

The application of the principle is shown in the following examples.

Case A. A single working parent with two children and a childless person each earn $25,000 per year. Suppose that it costs $5,000 a year to maintain an adult at a minimum standard and $2,500 a year per child. The discretionary income of the working parent, net of expenses, is $15,000. Now assume for the sake of argument that discretionary income is the correct measure of ability to pay (since, for example, a parent is not permitted to allow a child to starve). Tax should, therefore, be levied on only $15,000 for the single parent with two children but on $20,000 for the earner without dependants. A single parent, incurring the unavoidable costs of raising children, should pay less tax than a single individual with no children.[7]

Case B. A disabled person pays $10,000 annually for items such as wheelchairs, special household expenses, and attendant care. If these costs are necessary either to earn income or to enjoy consumption, they should be recognized in determining the appropriate amount of tax to be paid by that person. A disabled person with additional living costs should pay less tax than a person facing no disability.

Case C. The wages of a working person could come to the same amount as social assistance provides to another. If the person receiving social assistance pays little tax, so should the working poor. Indeed, in the interest of ensuring equal treatment, the working poor should receive some financial support in respect of work-related costs, and this would serve as justification for supplements' being tied to earned income. (It has been remarkably little noticed that, since the 1998 federal budget reforms, receipt of what used to called the "working income supplement" is no longer contingent on a taxfiler's having earned income. Although some provinces have implemented their own replacements for the program, for individuals receiving social assistance the new federal benefit displaces an equivalent amount of provincial welfare money.)

The design of the current tax system — in particular, the limited value of nonrefundable tax credits and the absence of family-based exemptions or deductions — means that horizontal equity receives little attention (see Box 1). In brief, there is a sound tax policy basis for tax relief for families with children at all income levels, including middle income and above.

Horizontal equity is improved when the user-pay principle is applied to the funding of public programs whose benefits accrue directly to the individual. EI and the Canada and Quebec Pension Plans (CPP/QPP) are financed by program-specific contributions. Under the user-pay principle, contributions paid by individuals are related to the insurance coverage provided or benefits received from the program; the closer the relationship the better, since the funding is then more efficient and the economic cost of taxation lower.

The tax system also provides unfair advantage to individuals who receive certain forms of preferentially treated income. Examples include the following:

- Certain fringe benefits, such as medical insurance premiums paid by employers and self-employed individuals, are not taxed as income. Taxpayers who receive these fringe benefits therefore have an advantage over others.
- Individuals with business income are generally able to deduct more freely certain expenses, such as home-office, entertainment, and travel expenses, while employees are able to deduct only a few employment expenses, often on a more limited basis.

Box 1: ***Horizontal Equity and Family Taxation***

Canada's tax system fails to achieve horizontal equity in a number of respects, but the most glaring failure is its discriminatory treatment of families (see Boessenkool and Davies 1998). Indeed, Canada is one of the few countries in the Organisation for Economic Co-operation and Development that does not use an allowance, a tax credit, or a cash grant to provide families with universal child tax relief (the Canada Child Tax Benefit is an income-tested benefit).

One way to illustrate the inequity is as follows: Suppose a family of four includes one earner whose employment income is $50,000 annually; if, for the sake of argument, each child is counted as half an adult, the number of "adult equivalents" within this family is three and their per capita income is $16,667. Federal income tax, however, is assessed on the basis of the earner's individual income, and the amount of tax comes to $2,341 per head, netting the family's child tax benefit entitlement against federal tax payable. On the other hand, a single earner without dependants who earns $16,667 has a tax liability of $1,265, net of the low-income goods and services tax credit. (For an explication of this "adult-equivalent" estimation of the family tax burden, see ibid.)

Thus, the per capita tax bill within the family, based on this accounting, is 85 percent higher than that of an individual with the same income. Were horizontal equity to be the guide within a family tax system using adult equivalents, the per capita tax bill would be the same in either case.

- Interest expenses incurred to earn investment income, including capital gains, are fully deductible, even though the income or capital gain may be realized at a later time.
- Social assistance is not taxable, while earnings are subject to tax. The interaction between benefit reduction and income taxation often creates an unfortunate result for social assistance recipients who make the transition to paid work.
- Taxpayers who tend to consume all of their income pay income tax only once. On the other hand, savers, to the extent that they prefer to save outside of, or in addition to, tax-sheltered vehicles such as registered retirement savings plans (RRSPs) pay tax twice: first on their earnings and later on the income earned by their savings. Thus, savers end up paying more tax on their earnings (on a present-value basis) than do consumers.

The PIT system does make allowances for some forms of savings preferences. For example, the dividend tax credit and the partial exclusion from taxable income of capital gains on equity shares are provided in recognition that taxes (the CIT especially) have already been paid on such income. Other preferences that either defer or eliminate taxes owing on income earned from saving plans (such as for retirement and education) create more horizontal equity between savers and consumers.

As a matter of policy, horizontal equity pertains to the issue of correctly measuring taxable income — that is, getting the tax base right. Generally speaking, the elimination of preferential treatment for certain sources of income would improve horizontal equity in Canada's tax system.

Vertical Equity

The principle of *vertical equity* recognizes that individuals have differing market incomes, which afford them differing abilities to pay taxes. An example of a tax that does not take account of vertical equity is a lump-sum tax such as the poll tax.

Were there no concern about vertical equity, Ottawa could simply have levied a poll tax of $5,000 on each Canadian to fully finance the $150 billion in its budgetary expenditure in 1998. But many Canadians clearly would not be able to afford a poll tax so high. Instead, in the interest of fairness as it is typically perceived, taxes are levied according to a measure of ability to pay.

One argument is that taxes should be the same proportion of income for all individuals. (For example, a common rate of 23 percent of Canadians' total personal income[8] would have been sufficient to run the federal government in 1998, without the goods and services tax (GST) or taxes on corporate income.

An alternative view is that the tax system should be progressive in its incidence so that low-income individuals pay less tax as a proportion of their income than do high-income individuals. The concept of progressivity goes back to the nineteenth-century utilitarian philosophers, who argued that government should redistribute income from the rich to the poor since a dollar in the hands of the poor is worth more to society than a dollar in the hands of the rich. In slightly more formal terms, if there is truth in the critical — but ultimately unprovable — assumptions that the incremental satisfaction derived from an extra dollar available for consumption is higher for the poor than for the rich and that aggregate social welfare is the sum of individual satisfactions, then a marginal tax rate that is lower for the poor than for the rich brings more social welfare than equal tax rates.

Such progressivity can be achieved in several ways. One is a personal exemption, which frees from taxation a greater percentage of income for low-income earners than for high-income earners. Also, or instead, the rate schedule itself can impose increasing marginal tax rates on taxpayers as they proceed up the income scale. Another option is to pay offsetting transfers to low-income individuals but not to high-income taxpayers, so that the amount of tax net of transfers paid by a poor person is a lesser proportion of income than is paid by a rich person. The declining value of such income-tested transfers as income increases is the arithmetic equivalent of a rising tax bite.

Canada's tax system uses a combination of all of these methods to produce a progressive incidence, but it does so in a largely uncoordinated way. If one takes into account all taxes paid by individuals — income, sales, property, and payroll taxes — net of government transfers,[9] taxes increase rather more than proportionally with income. (See, for example, Ruggeri, Van Wart, and Howard [1994], who find that average total tax rates generally increase with income.)

Clearly, measures respecting vertical equity have profound implications for tax policy. One is that, given an income tax base that is measured properly, the rate structure determines the tax incidence. Deciding on the appropriate incidence involves decisions about progressivity. Canadians may differ in their view as to whether the tax system should be more or less progressive than the current system; they can agree, however, that the current personal tax system, inclusive of transfers, is progressive.

The more critical issues are whether the progressivity of the tax system begins at too low a level of income and whether tax rates rise too sharply, so that the tax burden on the middle class is unfairly high. (We take up this question later in our discussion of tradeoffs among competing policy goals.)

Economic Growth and Job Creation

We intend the heading ***economic growth and job creation*** to capture the notion of economic efficiency, the benchmark for achieving the greatest potential economic gain to Canadians. A

tax system is efficient if taxes do not influence individuals' and businesses' decisions in allocating resources to their most productive use. A more efficient allocation increases incomes for all Canadians and promotes both economic growth and job creation.

Thus, granted that a certain level of taxes is needed to fund public expenditure, a critical criterion for tax policy is that the system not impair unduly the ability of the economy to grow and prosper. An efficient tax system improves prospects for rising incomes for all Canadians, rich or poor. A system that provides incentives for the lowest-income Canadians to increase their earnings in the long run will ultimately reduce inequality in pre-tax incomes and have positive economic and social effects.

The personal tax system can affect economic growth and job creation in several ways:

- High tax rates impair the efficiency of the economy by discouraging the work effort, entrepreneurship, risk taking, and saving that contribute to economic growth.
- High taxes encourage individuals to use cash in the underground economy to avoid reporting transactions for tax purposes (see Erard 1997).
- Tax burdens that are not internationally competitive may encourage skilled individuals to migrate to other countries; if this migration leads to an insufficient supply of skilled labor, it may discourage businesses from locating in the more highly taxed country. An example of this phenomenon can be seen today in the growing concern over the emigration of highly trained individuals to the United States, in part because of sharply lower average tax burdens in that country, even corrected for benefits received from public spending (see DeVoretz and Laryea 1998). Although this "brain drain" may involve modest numbers of individuals, the loss of key human resources could prove costly to Canada in the long run. For an individual with US$60,000 in income (a representative salary for graduate professionals), the income tax is more than US$10,000 higher in Canada than in the United States, an amount rather more than enough to offset any differential in private health insurance costs that the employee might have to bear.[10] Likewise, skilled workers are more highly taxed in Canada than in the United Kingdom, even though the latter has social benefit arrangements similar to Canada's.
- Canada's high PIT rates reduce the return on capital investment and the incentive for saving by residents. This naturally reduces the pool of investment capital available in this country, to the detriment of future growth in Canadians' incomes.

The increasing tax burden in Canada reduces the long-run potential for economic growth and job creation. Arguably, the effect of the tax burden on economic growth ought to be weighed against the benefits Canadians derive from the public programs offered by their governments, such as social security, health care, and education. Clearly, however, these do not fully account for the burden, nor does the value of these benefits necessarily offset the costs to income growth (see Box 2 on factors potentially contributing to Canada's tax burden).

In its 1997 economic survey of Canada, the Organisation for Economic Co-operation and Development (OECD) suggests that this country's tax system is the source of persistent problems and urges its governments to consider "the adverse locational effects that high average tax rates may have on the highly skilled and entrepreneurial portion of the work force." In particular, it warns of the "negative consequences for economic performance of high and uneven marginal personal income tax rates" (OECD 1997a, 103). Skilled individuals as well as capital are in-

Box 2: *Canada's Growing Tax Burden*

When comparing tax burdens in Canada and the United States, commentators often mention that the roles accorded government are quite different in each country and that a different overall size of tax burden is thus to be expected. One must remember, however, that the growth of the tax-to-GDP ratio in Canada over the past 20 years has not been a result of *new* social security, health care, or education spending programs. From 1967 to 1977, federal program spending grew by 4.9 percentage points of GDP and interest charges grew by another 0.8 points, but federal revenue increased by only 2.7 percentage points of GDP. Over the course of the next decade, neither federal revenue nor program spending grew as a share of GDP, but interest costs increased by an additional 2.7 percentage points of GDP.

The federal government's repeated failure to either reduce program spending or raise taxes inevitably meant mounting debt from the mid-1970s onward, relentlessly climbing interest costs, and ultimately higher taxes. Thus, from 1967 to 1987, total spending rose by 8.3 percentage points of GDP while revenue grew by only 2.6 percentage points. Interest costs came to take up fully one-third of federal revenue; their share is only slightly lower now. The result is that more than $1.40 in federal taxes must now be collected in support of each dollar in federal program spending (Canada 1998b).

In other words, today's relatively high tax rates are the cumulative fiscal hangover of the debt incurred to fund growing social programs beginning in the 1960s and of successive governments' unwillingness to either shrink those programs or tax at the level required to support them.

The import is that a reasonable level of social support, such as Canada's, might be funded at levels of taxation rather lower than today's. For example, many of our trading partners, most of which have overall tax rates that are lower than Canada's, also offer their citizens public programs such as social security, medicare, and education. The United States, for example, provides social security, free health care for the aged and poor, free elementary and secondary education, and low-cost postsecondary education at state universities, and does so with neither deficits nor high taxes.

To be specific, one cannot argue that Canada's high taxes are necessary to finance public provision of health care. In 1996, Canadian governments spent 6.7 percent of GDP on health care; in the United States, public health care spending came to 6.5 percent of GDP; furthermore, public health care costs were only 14.2 percent of total government expenditure in Canada but 18.8 percent in the United States (OECD 1998a).

To put the point succinctly, Canadians have benefited little from high taxes and spending in the past few decades for the simple reason that a growing amount has been consumed in servicing the public debt rather than funding public services.

creasingly mobile, and current differences in taxation are likely to lead to future relative declines in Canadian living standards. Canadian tax policy should be attuned to the fact that in the long run taxes bear most heavily on the least mobile factors of production; failure to recognize this fact will impinge on future economic growth.

The implication for tax policy is that both the structure of the system and the effective tax rates imposed via that structure must be arranged to levy taxes at the lowest possible rate consistent with achieving the revenue aims of government. To do otherwise is to limit the opportunity for Canadians to achieve the level of material well-being consistent with their ability to deliver goods and services of economic value.

Low Compliance and Administration Costs

Taxpayers spend resources to comply with the tax system; governments spend resources to

ensure taxpayer compliance. Taxes with preferences, differential rates, and complicated provisions increase compliance costs for taxpayers and administrative costs for governments.

For example, special provisions for the treatment of investment income, such as the lifetime capital gains exemption and the credit for investments in labor-sponsored venture capital funds, increase the administrative and compliance burden. Special rules have proved necessary to ensure that funds are put to their intended use and to minimize the revenue cost to governments arising from special incentives.

Sensible tax design can help reduce compliance costs. A recent study on federal and provincial compliance and administrative costs (Plamondon 1997) finds that compliance and administrative costs with respect to source deductions for the PIT are probably less than 3 percent of revenue, lower than for other taxes such as the GST or CIT.

One reason that compliance and administrative costs are held down is that the federal and provincial governments have harmonized their PITs. Indeed, all provinces except Quebec have entered into PIT collection agreements with the federal government. The joint collection of taxes has a significant impact in reducing administrative and compliance costs for governments and taxpayers.

Tradeoffs

The three objectives of fairness, efficiency, and low compliance and administrative burdens are the touchstones of a good tax system. But it is impossible to meet multiple objectives completely. This subsection provides several examples of important tradeoffs among the three key objectives.

Economic Growth versus Fairness

The most important tradeoff with respect to the taxation of individuals is related to the sometimes opposing objectives of fairness and economic growth. Canadians may agree that higher-income individuals should pay a higher proportion of their income in tax — including taxes on income, payroll, sales, and property — than low-income individuals. This is easily achieved by levying a progressive personal tax whereby the first taxable income tranche is taxed at a rate lower than that applied to income above a cutoff point (for example, 25 percent on income up to $25,000 and 50 percent on income above that point).

However, given a budget constraint (the government must raise a given total amount of revenue to fund its objectives), reductions in tax rates on low levels of income require upward adjustments in the rates on high levels of income. But high tax rates — more explicitly, the high marginal tax rates that arise from making the tax system more progressive — can impose significant economic costs on the economy by discouraging work effort, saving, and risk taking.[11]

For example, Canada's basic PIT imposes an economic loss in output equal to 38 cents for each additional dollar raised by increasing the rate (see Dahlby 1996).[12] Stiff as that cost may seem, the deadweight loss is minor compared with that imposed by the high-income surtax, for which each dollar increase means an economic loss of more than $12 (ibid.). Making the tax system progressive achieves one measure of fairness, but at the cost of lower output and growth.

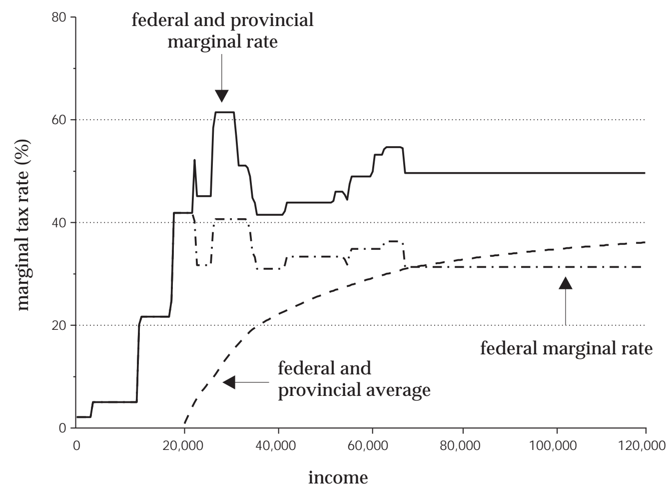
There is no clear answer as to how progressive a tax system should be. It depends very much on citizens' willingness to trade the economic costs of progressivity for a particular conception of fairness. We note, however, that in Canada during the past few decades, the potential for damage from rising progressivity via higher marginal tax rates has increased. Canadians have greater access to work permits or retirement visas in other countries. Canadian businesses often must bring certain skilled

workers to Canada if they are to continue producing their products or services here. A larger share of the work force is now self-employed, shrinking the ordinary wage and salary tax base and perhaps allowing more opportunity to avoid or evade tax altogether. Business inputs, including capital and management, can move to other countries so that income earned might be subject to less tax in Canada.[13]

Overall, it is now more difficult and more expensive to achieve some incremental degree of progressivity through the tax system than it was just two decades ago.

We believe that a limited degree of effective rate progression in the tax system is appropriate, so that higher-income individuals pay a larger share of their income than poorer members of society. But Canadians should make their decision on progressivity with full recognition of its costs and consequences.

Figure 1: ***Marginal and Average Tax Rates in Ontario for a Single Earner with Two Children, 1999***



Note: Calculations include CPP and EI premiums, refundable credits, and Ontario tax reduction and sales tax credit.

Source: Authors' calculations.

Some of the most important consequences flow from the fact that the Canadian PIT structure is extraordinarily steep in its marginal rate progression in the lower- and middle-income brackets; it is easily the most sharply graduated of the systems of all OECD countries.[14] Once Canadians start to earn income approaching the average industrial wage, tax rates rise to comparatively high levels in international terms. The top basic federal rate (29 percent before surtaxes, for a typical combined federal-provincial rate of more than 45 percent) kicks in at C$59,180 in taxable income, which is equivalent at the time of writing to US$38,645, a point at which a US married couple filing jointly would still be facing the bottom federal tax rate of 15 percent. And although the top US federal rate (39.6 percent) is higher than Canada's, state and local taxes, which are deductible on the federal form, are much lower than provincial taxes. The top US rate does not apply until the income of a married couple filing jointly exceeds US$271,050 (about C$415,000).

Moreover, given the clawbacks of the child tax benefit, the GST credit, and the credit for seniors, many taxpayers' marginal tax rates exceed 60 percent at incomes much lower than $60,000. Canada's income tax system is steeply progressive for incomes less than $30,000, suggesting that *rich* is being defined at extraordinarily low levels of income. The steep rate progressivity, including clawbacks, results in a poverty trap — a tax structure with substantial income support for low-income Canadians but with devastating tax penalties for those who seek to raise their incomes. The essential absurdity of the marginal rate structure is revealed by Figure 1, which illustrates the chaotic relationship between income and combined federal and provincial marginal tax rates.

Several other points are important in assessing Canada's current rate structure:

- Personal taxes on capital income — income from investments — are generally higher

in Canada than in the United States. The effective burden also compares unfavorably with that of many other countries, including the Nordic group. Thus, the after-tax returns to savings and entrepreneurship are lower in Canada.

- Some taxes are regressive and weigh more heavily on lower-income individuals. For example, EI premiums are collected on wage income up to $39,000 but not above, so the burden, as a percentage of income, is greater for low-income taxpayers than for their better-paid compatriots. Although the benefits of EI are also limited by income and accrue proportionately more to lower-income Canadians, the current payment of premiums is in excess of the benefits. This excess is a regressive tax.

Complexity versus Fairness

Complexity is a negative feature of a tax system since it makes compliance more costly and the rules less clear than otherwise. However, given an overarching desire for fairness, a degree of complexity may be necessary to ensure that some individuals are not given unfair advantage. The fact that taxpayers must submit receipts in claiming credits for tuition fees or medical expenses is an example of how increased compliance costs are inevitably associated with the desire to achieve fairness.

A much simpler approach would be to base the credits on a certain percentage of income, without requiring itemization, or to provide no credits at all. In both cases, however, taxpayers who incur a substantial amount of medical or educational expenses would be clearly disadvantaged. Indeed, one can argue that fairness demands that the tax system allow the deduction of education and medical costs in calculating taxable income since a taxpayer may necessarily incur such nondiscretionary expenses in order to earn income.

Some commentators express considerable interest in a flat tax for Canada — one with a single rate applied to broadly defined income and few deductions or credits (see, for example, Mills 1998). We applaud any attempt to simplify the tax system by eliminating ineffective tax preferences, and we recognize the powerful efficiency arguments for a uniform rate of income taxation. But while graduated rates complicate the tax system,[15] the most complex parts of the *Income Tax Act* deal with determining taxable income, not calculating tax liability given a particular tax base. Thus, a single-rate tax might not contribute as much to simplicity as would reforms streamlining the calculation of taxable income.

Graduated rates may be fair if, given a particular tax base, they are needed to ensure that high-income individuals pay more tax as a share of income than do the poor. Selected deductions and credits may be necessary to recognize that some taxpayers bear unavoidable costs in earning income or deriving its benefits — costs such as medical, disability, and child-rearing expenses. These deductions and credits may be justified to the extent that they help maintain horizontal equity in the tax system. Whether achieving that degree of equity is worth the efficiency cost associated with graduated tax rates is a question to be revisited in future.

The Practice of Tax Reform

As noted at the beginning of this *Commentary*, Canadians are today in the unusual situation of contemplating budgetary surpluses at the federal level. Although these surpluses are neither massive nor assured, we argue that evolving fiscal elbowroom should be used not just to reduce personal taxes but to improve the structure of the tax system. Some changes would provide benefits to Canadians over and above the benefits of the tax cuts themselves.

Table 3: *Federal Government Gross Revenue, fiscal years 1996/97 and 1997/98*

Revenue	1997/98 Amount	1997/98 Share	1996/97 Amount	1996/97 Share
	($ millions)	*(%)*	*($ millions)*	*(%)*
Personal income tax	75,672	46.0	68,122	44.7
Corporate income tax	22,496	13.7	17,020	11.2
EI premiums	18,802	11.4	19,816	13.0
GST	22,353	13.6	20,951	13.7
Other tax revenue	14,373	8.7	13,866	9.1
Total tax revenue	153,696	93.5	139,775	91.7
Total non-tax revenue	10,666	6.5	12,697	8.3
Total revenue	164,362	100.0	152,472	100.0

Note: Because of rounding, some columns do not quite add to total shown.

Source: Canada 1998b.

In the remainder of this paper, we address the issue of what taxes should be cut, when, and by how much.

The Taxes to Cut

A case can be made for reducing virtually any tax, but given the limited fiscal room for tax cuts — and that room's becoming available only over several years — it is necessary to establish priorities for tax decreases. The federal government raises the great bulk of its revenues from four sources: PIT, CIT, the GST, and EI premiums (see Table 3). Each is a candidate for reduction, and each is considered below.

EI Premiums

The EI payroll tax stands out as a target for reduction, because the current level of premium collections is far in excess of the amount required to fund program payouts, and this tax is not well designed for generating general government revenue.

At the 1998 employee premium level of $2.70 for each $100 of covered wages, plus another $3.78 paid by employers, EI revenues for the year exceeded related costs by more than $7 billion. Further, the surplus in the EI account — the cumulative excess of premiums over costs — will likely reach $20 billion by the end of fiscal year 1998/99. This "surplus" would certainly be sufficient to provide an appropriate cushion for the inevitable fluctuations in EI revenues and costs, ensuring that premiums would not be forced upward when economic downturns increase "withdrawals" from the EI account.

Of course, there is no separate EI fund of assets (as there is for the CPP/QPP); the annual excess of revenue over operational costs flows directly into Ottawa's annual budget. To continue EI premiums at their present level indefinitely or to allow only small cuts (such as the 36 cent combined reduction for employees and employers already implemented for 1999) would, in part, transform EI from a self-financing program benefiting employers and employees into a general payroll tax supporting other government spending.

The level of EI premiums has, therefore, been subject to strong and persistent criticism. Provincial governments, small and large em-

ployers, and employees all refer to the excess premiums as an unnecessary "tax on jobs" and as a "revenue grab" by Ottawa.

The case for *modest* cuts in EI premiums — by which we mean gradual reductions over, say, five years, to a level that would balance revenues and costs over the course of the business cycle[16] — can be supported by a number of arguments, such as those that follow:

- To the extent that EI premiums are a tax — in that collections far exceed related benefits — they are moderately regressive, not only because of the cap on contributions but also because wage income (the EI tax base) comprises a larger share of total income for low-income taxpayers than for those higher up the scale, who earn investment and other income not subject to the EI levy.
- The use of EI premiums to support general federal revenues is highly irritating to the provinces since it involves the use of a federal social security program as a revenue source, which may be construed as an unconstitutional tax on the Crown. The provinces are aware that they and their employees pay far larger EI premiums than their employees receive as benefits.
- Continuing large surpluses in the notional account are an open invitation to expand benefits and thereby erode past EI reforms.
- Continuing large surpluses may fund policy adventurism on the part of the federal government outside the EI benefit structure, raising the efficiency cost of the program above the cost of the tax wedge required to finance it. The likely result — constitutional clashes with the provinces over jurisdictional questions — would be a distracting sideshow.
- Lowering EI premiums would not be quite as costly as it may appear because the decreases would flow through to reduce both business costs (raising employers' taxable income) and PIT credits,[17] thereby recouping for the federal and provincial governments more than one-quarter of the revenue otherwise forgone.
- While payroll taxes are largely passed on to employees in the long run, a cut in EI premiums, 58 percent of which are borne immediately by employers, would lower labor costs in the short run and prove helpful in — perhaps temporarily — reducing unemployment.

We note that delaying a large reduction in EI premiums could lead to a further major benefit: it would give the federal government more time to develop useful reforms, such as implementing an experience-rated EI premium system, as recommended by the Technical Committee on Business Taxation (1998). As the committee's report details, setting premiums on the basis of the layoff experience of individual employers could lead to a significant efficiency gain to the economy. Moving to such a system would be most feasible if it were done at the same time as the general level of EI premiums was being reduced, so that no individual employer would face a significant rate increase, while employers with good records of employment stability would earn major reductions.

Other reasons for hesitancy about proposing major, immediate cuts in the EI premium rate include the following:

- Canada's reliance on payroll taxes is among the lowest in the OECD. An economic case can be made for keeping a moderate level of payroll taxes as part of a rational tax mix.
- Over time, about 80 percent of employer-paid payroll taxes tend to be passed on to employees in the form of lower wages (see Dahlby 1992). To the extent that payroll taxes are shifted elsewhere, they are not job killers (because the taxes do not increase labor costs if they instead depress wages)

but rather function as a crude income tax on covered wages.

- Most important, an immediate cut in EI premiums to a level that would balance current EI costs would preclude near-term personal tax relief for Canadians, unless Ottawa could find expenditure cuts (or alternative taxes to raise) that would offset the loss in EI revenue.[18]

On balance, it appears that Ottawa's wisest course of action would be to recognize that the EI program should not be used as a long-run source of general revenues, since that is simply not the purpose of the program.

The necessary (and probably inevitable) reductions in EI premiums to levels that approximate long-run EI costs should be phased in over a period of a few years. This phased reduction would give Ottawa the fiscal room to undertake both the reform of EI and the reduction of other taxes, particularly PIT. Achieving a lower PIT rate in a reformed system would provide better incentives and more immediate relief than a reduction in EI premiums alone, since the latter would be focused on a limited range of income and would not reduce marginal rates for many taxpayers. The federal government needs fiscal flexibility to allow it to address some major issues in the tax system — and this flexibility would be constrained by a major cut in EI premiums.

Ottawa should, however, commit itself to reforms that would make EI more closely resemble an insurance plan by 2004. This would require premiums to roughly balance benefits over the long run. Experience rating and similar measures should be introduced to make the system more efficient and fair.

The GST

Although Canadians' level of resentment toward the GST may be declining, it remains a deeply unpopular tax. But despite its relative unpopularity, it is not now a good candidate for tax reduction.

The GST is similar to the value-added taxes levied by many countries around the world, typically rates at higher than Canada's. Despite the failure of the provinces other than Quebec, Newfoundland, Nova Scotia, and New Brunswick to integrate their sales taxes with the GST — thereby improving the efficiency of the tax and easing the compliance burden — it remains a reasonably efficient tax.

Even though Canada relies far more on sales taxes than do the United States or Japan (see Table 4), its use of consumption taxes is relatively low by international standards (see Duclos and Gingras, forthcoming). Further, important economic arguments favor the use of consumption taxes over a heavy reliance on personal income taxes. All income taxes have a bias against savings and investment, since the tax is payable both on the income out of which savings are accumulated and then on the income earned from the investment of those savings — a form of double taxation.

Indeed, one could argue that Canada could improve its overall tax mix if it *increased* its reliance on consumption taxes and used the revenue to buy down personal tax rates. Australia is implementing just such a change. Although an increase in the GST would be politically unrealistic, the merits of a higher emphasis on taxes on consumption, rather than on income, should not be lost sight of in reviewing of the PIT.

Our preference for greater reliance on consumption taxes does not diminish the substantial merit of a broadly based PIT system. As already discussed, personal taxes provide a means of distributing a large share of the tax burden according to ability to pay, adding fairness and equity to the tax system and helping to achieve a desired level of income redistribution. Numerous PIT measures, such as the tax treatment of pensions, RRSPs, and occupied home ownership, partially shelter capital in-

Table 4: *International Comparisons of the Tax Mix, 1995*

	Personal Income Tax	Corporate Income Tax	Social Security	Property Tax	Taxes on Goods and Services	Total[a]
			(percentage of GDP)			
Canada	13.6	3.0	6.0	3.8	9.2	36.2
Italy	10.8	3.8	13.6	2.3	11.4	42.1
Germany	10.2	1.2	15.4	1.1	10.9	38.8
United States	10.2	2.6	7.0	3.2	5.0	28.0
United Kingdom	9.6	3.3	6.2	3.7	12.5	35.4
France	6.3	1.7	19.4	2.3	12.2	44.8
Japan	6.1	4.4	10.2	3.3	4.3	28.3
OECD						
Europe	10.4	2.8	11.7	1.7	13.1	40.4
America	11.9	2.8	5.2	2.8	7.6	27.0
Total	10.4	3.0	9.8	1.9	11.9	37.5

Note: The data are based on a three-year moving average.

a Other taxes are included in the total calculation.

Source: OECD 1998b.

come and may provide a more accurate consumption tax base than indirect sales taxes. But an overreliance on the PIT has negative effects, and it is not necessary for personal taxes to be as heavy as they are to achieve Canadians' distributional goals.

Taxes on Corporations

The taxation of business in Canada is the subject of a recent comprehensive report from the Technical Committee on Business Taxation (1998). We do not consider here in detail its analysis and recommendations, but we do note that the committee concludes that the tax system needs important changes in its treatment of business, in order to reduce adverse effects on investment and employment.

In particular, the report argues for the adoption of generally lower CIT rates and a broader and more neutral tax base. As in the case of the PIT, changes here would offer significant economy-wide improvements in allocative efficiency and fairness.

Of particular interest is the fact that the report was prepared within the constraint of revenue neutrality: tax cuts in one area had to be offset by tax increases in another. This constraint did not permit an examination of the appropriateness of the overall level of tax on business.

The Technical Committee report observes that the aggregate level of taxation on business in some sections of the Canadian economy — notably manufacturing and resources — is not substantially above international norms. All the same, the burden of taxes on business, mainly those unrelated to income, has risen in Canada in recent years, especially in relation to the burden in the United States.

For certain sectors in Canada — notably the growing services sector — taxes on business are clearly high, both by broad international in standards and in comparison with those the United States. This differential is important because many areas of the services sector have become more internationally open and competitive. The risk is that the business sectors that have become increasingly impor-

tant to Canada's economy are now exposed to more international competition, while facing a relatively stiff tax burden that limits their profitability and ultimately restrains domestic investment and growth.

This point is where the requirement of maintaining revenue neutrality bound the Technical Committee most tightly and limited the extent to which its broad recommendations can be acted on easily. To reduce the tax burden on an overtaxed sector yet guarantee the net yield to the federal government obviously requires raising taxes on some other sector. Thus, the opportunity for reform depends on both the ability to find sectors capable of withstanding higher taxes while maintaining international competitiveness and to the political viability of proposed reforms that include tax increases for those sectors. For this reason, it is doubly imperative to seize the opportunity for overall tax reduction as the moment for instituting tax reform.

The Technical Committee report puts forward a package of revenue-neutral changes to improve the efficiency of Canada's taxation of business. For the reasons noted above and for the more pragmatic reason that important structural change is more feasible when accompanied by some moderate general tax reductions, it is time to look again at the aggregate level of taxes on some business sectors and to consider the need for relatively modest tax relief as a complement to meaningful structural improvement.

As we point out elsewhere in this *Commentary*, the primary target in the tax-reduction exercise must be personal income taxes. It is nonetheless important to recognize simultaneously the need to revise some business taxes. Giving relief to business need not prevent a main focus on PIT cuts: an annual revenue loss of less than $1 billion, for example, would permit a meaningful change in CIT rates.

Beginning the task of modernizing the taxation of business, including moderately reducing CIT rates to more competitive levels and reducing some perverse incentives, would result in substantial efficiency gains to the economy yet would not imperil the significant reduction in the PIT that, we argue, is the first priority. Important targets for reduction, therefore, should include the corporate income surtax, which is currently at 4 percent, and the basic federal CIT rate tax, which stands at 28 percent. Decreases in these rates would be helpful in the services sectors, particularly the financial services, where statutory and effective rates are high by any standard.

We also see a pragmatic reason why business tax changes should not be left until after major PIT cuts have been implemented. A balanced program of personal and business tax changes, with a heavy emphasis on PIT reductions, could, we believe, be explained and justified to the Canadian public. If personal tax cuts were to come first — and over several years, owing to revenue constraints — the necessary changes to structure as well as to rates would be postponed unduly on the business side. They might also be politically more difficult to implement if brought forward by themselves, without complementary PIT relief. It is important to present a balanced package of needed tax changes, so that the Canadian public can consider the interrelationships and balance of the various elements. A well-thought-out framework for tax policy should include changes to business taxes as well as to personal ones.

The PIT: The Priority

Personal income taxes are the largest single revenue source for both the federal and provincial governments. This is the tax field where Canada's burdens are increasingly out of line with international norms, and where the present system could be the most damaging to the country's long-term economic performance. The latter fact may be the more

important one in establishing priorities for tax reform and reduction.

The PIT system provides an extraordinarily large — and growing — proportion of the total tax revenue of the federal and provincial governments. It is the workhorse of the Canadian tax system, generating ever-expanding revenues and providing the means of reaching federal and provincial goals in social policy and other areas, including income redistribution and encouraging favored economic activities. The weight of evidence yields the conclusion that Canadian governments have overused and misused the personal income tax system.

Canada's PIT system does contain some favorable elements: for example, administration that is relatively efficient by international standards; a high level of federal-provincial coordination regarding the definition of taxable income and its allocation among provinces; and a reasonably broad tax base. But even in these areas there are signs of strain. A number of provinces have introduced a variety of special credits or other relief, usually with clawback features, that generally add to the excessive progressivity, complexity, and perversity of the overall tax structure.

The evident willingness of the federal government to give the provinces more flexibility in the personal tax field — consider the movement toward a "tax on income" rather than a "tax on tax" base — could result in a rash of yet more provincial incentives and special relief measures, unless there is some agreed harmonization in the design of credits.

Another step would be to recognize that, whether low-income benefits are delivered by federal or provincial tax credit programs, continually enhancing them while containing costs by steeply clawing back taxpayers' incremental incomes is a policy development that makes future PIT reform harder, rather than easier.

The reason is that tax changes increasingly tend to be judged according to the view that tax incidence must become ever more geared to income. Thus, the perceived merit of a program hinges more and more on whether it delivers more benefit to low-income families. These views are ultimately a deadend, for the needed reforms aimed at reducing the marginal rates that apply to earned income can only rarely pass this political test.

Useful reforms would include increased exemptions, which might give *proportionately* more to lower-income taxpayers, and reduced marginal tax rates on low- and middle- income taxpayers. But it is important that cuts to marginal tax rates reach through the upper-income brackets as well.

To summarize, there are cogent reasons why the overall burden of Canada's PIT structure should be reduced as government finances permit. This reduction should be broadly based, extend across virtually all rate brackets, focus on reducing marginal rates, and be accompanied by structural reforms to make the system fairer and less damaging.

A Package of Personal (and Some Business) Tax Measures

An all-but-infinite number of alternative changes in tax rates, brackets, exemptions, and base adjustments could achieve any particular desired level of tax relief. In selecting our proposals for personal and business tax changes, we have sought a combination of adjustments. The full package achieves the aims discussed above:

- To provide less steep increases in marginal tax rates for middle-income Canadians generally.
- To reduce the adverse effects of clawbacks of targeted low-income relief by reducing the marginal tax rates for Canadians with modest incomes who seek to expand those incomes or save for retirement.

- To give greater recognition to family issues and provide some recognition, at all income levels, of the ability to pay of family units with larger numbers of children and dependants.
- To reduce the disincentives to investment and savings.
- To improve the overall fairness of the personal tax structure.

The personal income tax base is also in need of tuning in several areas: the treatment of savings for retirement, the taxation of retirement income, the taxation of investment income, provisions for school tuition costs, provisions for medical expenses and health insurance premiums, and the specific issues of flow-through shares and labor-sponsored venture capital funds.

To achieve these aims, we propose a package of changes to be implemented in the federal budgets of 1999 through 2001 (or beyond, should it prove necessary). The size of the prospective tax cuts is predicated, of course, on our assumptions regarding the available federal surplus, on continuing restraint in the growth in government spending, and on reasonable future levels of economic prosperity. Because we anticipate that the federal surplus available for tax cuts will grow over the next three or four years, we provide a package that can be implemented in stages over this period. But keep in mind that the ultimate stage — the tax changes that would apply after 2001 — is the objective of the exercise.

We set out below a series of recommendations intended to achieve our objectives. Changes to personal amounts and other nonrefundable credits are discussed alongside structural reforms (those affecting the definition of taxable income), followed by consideration of progressivity and other tax-rate issues.

Personal Amounts

The basic personal amounts for the taxpayer and spouse should be increased by $500 for all taxpayers, in lieu of the income-graduated supplementary credit system proposed in the 1998 budget.

Our proposal would eliminate the unnecessary and complicated clawback mechanism introduced in that budget and thereby reduce the marginal tax rates faced by labor market entrants; it would also undo some of the erosion in the real value of the basic exemption/credit that has taken place since the end of full indexation in 1985.

Amounts for Dependent Children

As we discussed under the heading of horizontal equity, a portion of the unavoidable costs of childrearing should be recognized as nondiscretionary income. A deduction would be the most appropriate form of recognition, but the modest step of reintroducing a broad-based credit for dependants would go a long way toward meeting the policy goal. For this reason, we recommend, as described in Boessenkool and Davies (1998), returning to including a generous amount — we suggest $2,000 per child — in the calculation of nonrefundable credits for all taxpayers with children.[19] Alongside should be a modified child tax benefit.

This measure would benefit all families with children and help rectify the current apparent presumption that recognition of the cost of childrearing should be viewed solely within a redistributive context, without attention to horizontal equity.

Indexation

Ottawa's failure to fully index the PIT structure since 1985 has resulted in a steady increase in the number of low-income Canadians who face tax bills even as their incomes remain

static or decline in real terms. It has also lessened the real value of the thresholds at which taxpayers face each higher tax rate, the result being steadily higher average effective marginal tax rates with concomitant efficiency costs to the Canadian economy.

Reform of the income tax system must not only recognize the perverse effects of this failure to fully index the system over the past 13 years, which has raised the total federal PIT take by about $10 billion above its status quo level; it must also make meaningful proposals as to how the situation can be changed to prevent this problem from recurring. Changing the income tax structure so as to provide automatic full indexation of credits and rate thresholds — as recommended, for example, by the Alberta Tax Review Committee — may not be the first choice of cash-strapped federal and provincial governments, but it is necessary to avoid a norm of annual tax increases and to remove the ability of governments to raise effective tax rates each year without going before their legislatures for authority to do so.

In our view, the changes to the personal amounts and lower tax rates we propose here would go some way toward redressing the wrongs committed in the era of partial indexation. Looking forward, a return to full annual indexing is the surest route to preventing such wrongs from recurring.

RRSPs and Pensions

The present tax treatment of retirement plans involves the deduction from income (within limits) of contributions to a plan, the exemption of the earnings of plan assets, and the taxation of benefits paid out of the plan to individuals, with the requirement that such income payments begin by a set age. A fundamental review of the appropriate tax treatment of retirement income would raise a number of searching questions about the tax status of such registered plans, their contributions, and their earnings.

In this paper, we do not propose such a review, partly for lack of space and partly because of the transition difficulties with respect to retirement arrangements with a time horizon of 50 years or more. We do, however, note the following points:

- Demographic changes mean that an increasing proportion of the future population will be past retirement age, and eligible to receive public support (a good part of it income tested). The funding requirement for public income-support programs will grow, straining public finances, so Canadians who can save more for their retirement should be encouraged to do so. The tax system should help, not hinder, this saving.
- The present income tax structure contains a bias against savings and investment. It could be ameliorated by shifting the tax base from income to consumption, but doing so directly may be neither feasible nor politically acceptable. It is appropriate, however, to recognize that a modest increase in the levels of deductible contributions would move the present structure slightly closer to a consumption levy for more individuals.
- A bias remains against defined-contribution pensions and RRSPs, compared to defined-benefit plans.[20] The self-employed and employees who change jobs relatively often depend on the use of the former. Given the growth of the self-employed sector and higher turnover rates (increased labor mobility), the bias against defined-contribution pensions and RRSPs should be removed.

We suggest, therefore, that access to tax-deferred retirement accounts should be made easier over time and that the amount of personal savings that can be sheltered in such plans be increased.

As a first step in this program, the increase in the maximum RRSP annual contribution to $15,500 — now scheduled to occur in 2005 — should be brought forward to 2000. Thereafter, this limit should be indexed to the rate of inflation. Limits on registered pension contributions should be adjusted annually in the same way.

Additional Pension Changes

The withdrawal of the proposed package of changes affecting seniors (including what was called the seniors benefit), originally brought forward in 1996, means that the present system of tax credits in respect of age and pension income will continue unless specifically modified.

Currently, under the pension income amount, retired Canadians age 65 or over are entitled to include in their tax calculation an amount up to $1,000 in respect of pension income, which is multiplied by the nonrefundable tax credit rate and taken against basic federal tax otherwise payable. This concession applies only to pension income, and it represents tax relief over and above the substantial commitments to personal retirement savings already contained in the tax system. Such a preference has no economic justification.

In addition, Canadian taxpayers age 65 and over have available an age amount of $3,822 (also used in calculating nonrefundable credits), but it is reduced at a relatively steep rate of 15 percent of net income above $25,921. The claimed justification for the age credit is that the cost of living for the elderly is greater than it is for other Canadians. We are not aware, however, of any support for this proposition, except in relation to medical expenses, and most such expenditures are covered by government health care plans or are eligible for the medical expense deduction.[21]

We believe that the existing pension exemption — applicable only to one specific type of retirement income — is outmoded and unnecessary: it yields benefits to some retired people while providing no relief to Canadians of similar circumstances and age who are still working or who do not have the precise type of income that qualifies as a pension. This $1,000 exemption should be eliminated, but since some Canadians may have built its continuance into their retirement plans, we suggest that half of its present value continue to be available to all Canadians who are now age 60 or over.

This reduction in the pension amount would be more than offset by our other proposed measures to reduce taxes on all Canadians, including the elderly. For those Canadians who are now younger than 60, the exemption (otherwise available when they reach 65) would be withdrawn, but this loss would in part be offset by the fact that they would face more generous limits on overall private pension plan contributions prior to their retirement.

We suggest that the age amount might be continued for the time being, in part because its existence reduces the income range over which the Guaranteed Income Supplement (GIS) is reduced in proportion to other income at the same time as that income is subject to tax. However, the steepness of the credit reduction rate should be adjusted in line with our general proposals on clawbacks, and in the longer run the preference itself should be considered for elimination.

Investment Income

As already noted, income taxes are inherently biased against savings and investment: taxpayers pay tax on the income from which their savings are made and then again on the investment income earned on those savings. The rate and bracket changes proposed later in this *Commentary* would provide modest relief on investment income but would still leave the effective tax rates on such income relatively high

by international standards, particularly in comparison to the situation in the United States, and especially with respect to capital gains.

Some countries have considered a further issue in the taxation of investment income — namely, that investment capital is a highly mobile resource. The decision of the Nordic countries to limit personal tax rates on investment income to levels well below those applying to earned income reflects not only the general issue of the double tax on savings but also a practical concern about the possible flight of investment capital and concomitant reduction in the domestic tax base.

Canada already has two measures affording limited relief for some types of investment income:

- only 75 percent of realized capital gains, rather than 100 percent, are included in the tax base; and
- dividends from taxable Canadian corporations generate a dividend tax credit, which, for taxpayers in the higher brackets, reduces the tax on dividend income by about a quarter.

Since corporations and their shareholders often have a choice as to whether to distribute corporate income as capital gains or dividends, it is important that there be a rough balance in the tax rates bearing on these two types of income.

We suggest, as a longer-run measure, that the federal government consider partial indexing of the adjusted cost base of investments to give some recognition to the effects of inflation. The issue is not simple. To the extent that investments are financed with borrowed funds, taxpayers already obtain a benefit equivalent to indexing their cost base (because the inflationary component of interest paid is deductible).

Some rough justice might be obtained through either of the following suggestions:

- Give taxpayers full indexation for inflation of the cost base of their investments, but with the annual upward adjustment reduced by a fraction of whatever interest expense they claim against investment income.
- Give taxpayers half-indexation for inflation on their equity investments, on the assumption that equity investments are half-financed by borrowed funds, whose cost does not need an inflation adjustment.

We note that additional RRSP room would serve as an incremental stimulus to domestic saving (since investment income is not taxed within such plans), pushing down the cost of capital for Canadian business.

Further, in recognition of the role of retained earnings in building the value of small businesses and family farms and in generating savings for retirement, rollover provisions should be enhanced so that capital gains realized on the sale of small businesses and farm properties can be brought untaxed into RRSPs. Such an arrangement would permit the elimination of the remaining lifetime capital gains exemption with respect to gains on the disposition of these assets, without imposing undue harm on the families and assets these tax preferences are intended to shelter.

Tuition Costs

The present PIT system provides a nonrefundable credit for most postsecondary tuition costs, presumably on the grounds that increasing the general level of education provides public as well as private benefits and that the cost of education is perhaps a necessary expense for enhancing future income. But this support is now provided only through a tax credit (at the rate about equal to the tax rate on

the lowest income bracket), rather than through a deduction from income that would give relief at the taxpayer's marginal tax rate. Furthermore, the future income derived from education may be taxable at rates far higher than the present relief provided by a credit.

Increasingly, advanced training is a prerequisite to many job roles. And increasingly, students at the postsecondary level are facing substantially higher tuition fees, leading to concerns about the accessibility of advanced education.

We recommend that the present tax credit for postsecondary tuition be converted into a deduction for arriving at net income and that an indefinite carryforward be provided for tuition costs that the student cannot or chooses not to deduct in any particular year. This treatment of tuition fee expenses as an investment in human capital would parallel the tax treatment given to retirement savings, and a deduction, rather than a credit, for tuition would remove the extant tax bias against human capital investments.

This change would allow students a better opportunity to claim meaningful tax relief for tuition costs, particularly if they had the opportunity of deferring the deduction until they were earning sufficient income to put them into higher tax brackets.

It would also eliminate a potential difficulty with employer-provided tuition under the current system. Employer-provided training results in a deductible expense for the employer and, if the training is job specific, in a nontaxable benefit to the employee. If the employee pays for the training, only a personal tax credit — at an effective rate of 25 to 28 percent, depending on the province — is provided, often yielding an advantage for employer-provided training.

Further, if an employer funds education that is not related to the firm's activities, that training is a taxable benefit to the individual. He or she can then claim a tuition credit, but its value (generated, for example, at a 25 percent rate) may be considerably less than the taxable benefit to an employee with income of more than about $30,000. If the individual could claim tuition fees as a deduction, there would be no difference in the tax treatment of employer- and employee-funded training.

Base Broadening, Fairness, and Efficiency

In considering our package of suggested reforms, we keep returning to basic equity and efficiency. A few more points that are pertinent to the tax base touch on these questions.

A Fairer Base

In any income tax system, it is important that the basic definition of income — the base on which tax is imposed — be broad and comprehensive. A broad base permits income tax rates to be kept relatively low, thus reducing their adverse effects on incentives and personal effort. And a broad base tends to be neutral, avoiding investment-directing incentives and special treatment that divert capital and effort in less-than-optimum directions. Further, only a comprehensive tax base provides fairness and equity to taxpayers by treating those with similar streams of economic income in a similar fashion.

Canada's basic definition of income is already fairly broad by international norms. A series of changes over the three decades since the Royal Commission on Taxation (the Carter Commission) has eliminated many of the incentives that once distorted the Canadian tax system. However, the following examples of remaining special treatments should be reviewed for cancellation, in order to improve both the fairness and reduce the distortions in the current system:

Flow-Through Shares. The special tax provisions that allow some corporations to flow

through resource expenditures to individuals who have bought their shares have proven a relatively inefficient way to provide incentives to the resource sector. The concept has some theoretical justification in that it allows deductions that cannot be claimed at the corporate level to be used by individuals who have funded them. However, like most tax-shelter investments, flow-through shares involve large transaction and intermediation costs. And the incentive is focused on the resource sector, which already receives major tax incentives at the corporate level.

Labor-Sponsored Venture Capital Funds. Special tax deductions and credits — reduced in the 1996 federal budget, but more recently enhanced — are available with respect to investments in labor-sponsored venture capital funds. The tax incentives are evidently not rich enough to maintain investor interest, so tax reformers must choose whether to enhance the special treatment so as to enable the funds to continue, or to end it after a transition period.

The original program, now expected to reduce federal revenues by about $85 million annually (Canada 1998a), was designed to involve labor organizations in channeling investment funds to smaller enterprises. Most of these funds are started and managed by investment dealers or financial houses with only nominal involvement from labor organizations (Osborne and Sandler 1998). The program is marked by high transaction costs, and there is some question as to whether this type of relatively long-term investment should be undertaken through funds with easily redeemable shares, thus encouraging participation by taxpayers whose investment horizons may be inappropriate for the supply of venture capital.

The program does not seem to have a great deal to recommend it as a permanent part of the Canadian tax system. It may be more appropriate to encourage the supply of venture capital through an investment tax credit, which might deal more directly with the information problems that may lead to an undersupply of capital to new businesses (see Mintz 1997).

Health Care Costs. At present, taxpayers are allowed to claim a nonrefundable tax credit at a rate of about 25 percent (including provincial taxes) in respect of the net cost of most health-related expenses for the taxpayer and his or her dependants or spouse in excess of the lesser of 3 percent of net income or $1,614. The expenses allowed in calculating the credit include unreimbursed medical, hospital, drug, and other costs, plus, for employees, private health insurance premiums. In contrast, health insurance premiums paid by an employer are not considered a taxable benefit to employees, and the 1998 budget made them a fully deductible expense for self-employed individuals.

The current system involves significant differences in the treatment of taxpayers in respect of the growing cost of private health insurance. For some — employees whose premiums are borne by employers and, now, the self-employed — the costs are paid out of before-tax income. For others, the cost must be met out of after-tax dollars, with only a partial tax credit available.

A fairer way of treating all health insurance costs would be to make all employer-paid premiums into a taxable benefit and to end their deductibility for the self-employed. All taxpayers should then be entitled to include such premiums in their claims for allowable medical expenses. This approach would also avoid the distortions in the current system, which can lead employees to prefer, solely for tax reasons, nontaxable benefits to equivalent cash compensation.

Canada's current health care system has both rapidly growing costs and significant inefficiencies. A more radical solution that might be worth considering would be to treat all

health-related costs covered under either public or private plans as taxable benefits. To enable calculation of tax liability, individuals would be given an annual list of benefits received. The maximum benefit to be included in income would, of course, have to be limited to avoid the otherwise disastrous implications of extraordinary health care expenses. One such limitation could be the lesser of $5,000 per family or 5 percent of family income.

At present, a wide range of health services are — to the consumer — free goods, leading to possible overuse or at least insensitivity to their costs. Moreover, accountability is compromised since expenses are presently submitted by providers of health care services without the knowledge of the patient.

Many other countries with comprehensive public health plans have some limited user fees as part of the package, but these seem politically unacceptable in Canada. The inclusion of insured costs in the tax base would give Canadians some sense of the cost of insured services, as well as an improvement in accountability (see also Gordon, Mintz, and Chen 1998).

Progressivity

In addressing the reform of the personal tax system, it is important to face directly the issue of progressivity — the extent to which the system should take more of a person's income as that income increases. In what might be considered the lower- and middle-income brackets — the range of incomes from $20,000 to $60,0000 — the Canadian system is probably *too* progressive, owing both to its basic structure and to its use of clawbacks that limit tax relief, such as the GST credit and child tax benefits, to lower-income individuals.

Frequently, federal budgets contain tables showing that the tax reductions or relief granted reduce the burden of lower-income Canadians by more than those in upper-income brackets, both relatively, as a percentage of total personal income tax, and, in some cases, absolutely. The justification usually given for this inequality is the need to focus tax reductions on those least well off in society.

However, if budget after budget delivers most of its tax relief only to low-income Canadians, frequently through programs designed to claw back that relief as the income of those citizens increases, the effect is to make the system more and more progressive — without limit. The PIT structure must provide incentives for work, entrepreneurship, effort, and investment, and the current structure does not serve these aims well. Increasing progressivity is not the only end — or even a desirable end — in making further changes to the tax system.

Redress of the problems discussed above would require coordination among the various federal credit and benefit programs. The provinces would also have to redouble their efforts to enmesh their credit programs with those offered by Ottawa, and to do so with an eye firmly fixed on combined marginal tax rates (see Sayeed, forthcoming). For the purpose of federal tax reform, we suggest that the current two-tiered federal child benefit be collapsed into one and subsume the GST credit now directed at low-income families.[22] This restructured credit should be reduced less quickly than at present but starting at a lower income level, in part to restrain the additional cost of a lowered clawback rate, but in the main to reduce the extent to which the reduction range applying to the credit would overlap the middle federal income tax bracket.

More Efficiency

The major argument that we make in this paper is that the extraordinaly progressivity of the Canadian PIT structure at middle-income levels must be reduced, which in turn calls for tax relief focused on middle-income taxpayers. In order to smooth the marginal rate profile, we recommend that the top PIT rate — which taxpayers now reach at a level of about $60,000 a year of taxable income — should be

applied only to incomes above a much higher level, such as $150,000 a year.

If the top rate of PIT cut in at a substantially higher annual income, it would be possible to contemplate a top combined rate even higher than at present. This would restore an otherwise missing element of progressivity at the far upper end of the income scale, recoup a small amount of the revenue losses associated with tax relief below this level, and perhaps help make the total package more politically feasible.

However, the top personal marginal rate of income tax is itself a critical factor in the tax system, and it is important to consider the adverse implications of raising that rate or even of failing to lower it. A country's top personal marginal rate imposes the greatest economic cost by penalizing effort. Other governments have substantially lowered personal income tax rates in recent years to reduce the economic cost of taxation. The top personal rate in Canada — an average of 51 percent in combined federal and provincial taxes — is well above that in the United States (where a representative combined federal and state rate is about 44 percent) and in the United Kingdom (where the rate is about 40 percent).

Further, the top rate applies to a subset of taxpayers with substantial earned income or investment income, many of whom are quite mobile. A consideration, therefore, is that high top marginal rates induce tax-planning activities that could move more individuals — and more certainly, a significant part of their income — outside the country.

A Proposed Schedule of Changes

Practicality suggests introducing many of our suggested changes over the course of several years. Below we provide a list of all of the tax reductions and adjustments as we envision them being implemented in the budgets of 1999 through 2001. Table 5 summarizes briefly the changes projected for each tax year and their total cost. The impact would slightly shift the mix of federal tax revenues away from the PIT and CIT and toward consumption and payroll taxes, as shown in Figure 2.

As noted earlier, our intention is to keep these proposals in line with the prudent scenario described in Robson (1998): a schedule that has a 90 percent probability of producing an annual federal budget surplus at least equivalent to the $3 billion contingency reserve. Robson conceives this exercise as involving five years of annual tax cuts of $4.6 billion (in constant dollars) with annual overruns (or underruns) being subtracted from (or added to) future years' tax cuts on an interest-adjusted basis. Thus, our schedule below calls for total tax cuts of about $14 billion cumulated over three years.

1999

The reform process would start on a good footing were Ottawa to announce in the 1999 budget that it will do the following for the current year:

- Increase the personal exemption amount — the amount in respect of which personal exemption credits are granted — by $500 for all taxpayers.
- Eliminate the 3 percent federal surtax for all taxpayers.
- Increase by 0.9 percent all personal amounts, rate thresholds, and credits to account for inflation through September 1998.
- Decrease employer and employee EI contributions by a combined 36 cents per $100 in covered wages (as already announced by the Minister of Human Resources Development).

The February 1998 budget proposed the first two steps above but limited the benefits to relatively low-income individuals by way of

Table 5: *Summary of Proposed Federal Budget Measures*

Implementation	Measure	Federal Revenue Cost
		(current $ billions)
1999 tax year	Increase personal amounts by $500 for all taxpayers	
	Eliminate 3% federal surtax for all taxpayers	
	Increase by 0.9% all personal amounts, rate thresholds, and credits (restore full indexing)	
	Decrease employer and employee EI contributions by a combined 36 cents per $100 in covered wages	
	Net cuts for 1999	*3.4*
2000 tax year	Eliminate the 5% federal surtax applicable to middle- and upper-income Canadians	
	Reduce the bottom bracket federal tax rate to 15%	
	Decrease combined employer and employee EI premiums by a further 24 cents per $100 in covered wages	
	Increase the upper limit on annual RRSP contributions to $15,500	
	Increase personal amounts, rate thresholds, and credits by 1.5% (to account for inflation through September 1999)	
	Eliminate the 4% corporate surtax; broaden tax base for partial offset	
	Net cuts for 1999–2000 cumulative	*9.5*
2001 tax year	Include $2,000 per child in calculating personal non-refundable credits	
	Adjust federal rates and brackets as follows: 0 to $30,759: 15% $30,760 to $61,518: 23% $61,519 to $153,795: 28% $153,796 upward: 31%	
	Increase personal amounts, rate thresholds, and credits by 1.5% (to account for inflation through September 2000)	
	Decrease employer and employee EI premiums by a further 24 cents per $100 in covered wages	
	Reduce pension income deduction by $500, and limit eligibility to taxpayers above age 59	
	Eliminate the GST credit	
	Increase the child tax benefit by $207 per child to offset loss of the GST credit, combine the basic and extended per child amounts	
	Lower the reduction rate for the child tax benefit to 7.5% for all family sizes, and lower the threshold to $18,570	
	Increase GIS benefits by an amount sufficient to offset the loss of GST and other credits for low-income seniors	
	Decrease the general CIT rate tax rate from 28 to 25%, and broaden the base	
	Include employer-provided health coverage in taxable income	
	Net cuts for 1999–2001 cumulative	*13.9*

Sources: Revenue estimates derived via Statistics Canada's Social Policy Simulation Database and Model, Release 6.1; and authors' calculations (see text for assumptions).

unfortunate increases in marginal rates for some taxpayers. We propose that the 1999 budget continue the process by extending these changes to all taxpayers.

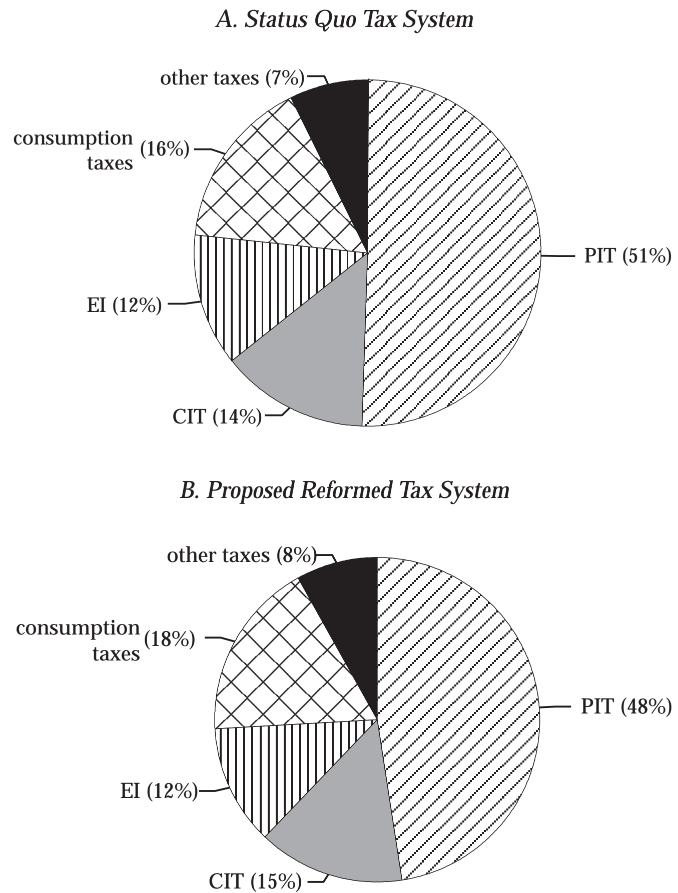
The total cost to Ottawa of this package would be approximately $3.4 billion in 1999, delivering relief of about $240 per family, or about $280 per family if one includes the impact on provincial taxes. This amount is lower than one might have imagined for this group of reforms; the reason is the aforementioned 1998 budget changes, which already delivered many of these benefits to low-income families.

2000

For the 2000 budget, we propose the following additional changes:

- Eliminate the 5 percent federal surtax applicable to middle- and upper-income Canadians.
- Reduce the federal tax rate on the first tax bracket ($0 to $29,590 in taxable income) from 17 percent to 15 percent. A similar change in the credit rate would apply to the nonrefundable amounts.
- Decrease combined employer and employee EI premiums by a further 24 cents per $100 in covered wages.
- Increase the upper limit on annual RRSP contributions to $15,500 — as announced in numerous budgets past.
- Increase personal amounts, rate thresholds, and credits to account for inflation through September 1999 (likely to be in the neighborhood of 1.5 percent).
- Eliminate the 4 percent corporate surtax for large and small businesses, and undertake a broadening of the tax base with respect to the treatment of international income (for example, the treatment of interest expenses and the qualification for foreign-affiliate status). The revenue cost would be about $250 million.

Figure 2: ***Distribution of Federal Tax Revenue, 2001***



The total federal cost of this package in 2000 (including the 1999 changes) would be about $9.5 billion, or about $625 per family, producing average gains of a little more than $760 per family when provincial impacts are included.

2001

For the federal budget of 2001, in addition to the tax changes introduced in previous budgets, we propose the following additional steps:

- Provide $2,000 per child as a personal amount in respect of which all taxpayers,

regardless of income level, could claim a non-refundable credit (at the rate of 15 percent).

- Reduce the pension income deduction by $500, and serve notice that it will no longer be available at all for taxpayers then under age 60.
- Eliminate the GST credit.
- Combine the basic and per child portions of the child tax benefit into a single benefit.
- Increase the child tax benefit by $207 to offset the loss of the GST credit.
- Lower the reduction rate applied to the child tax benefit to 7.5 percent for all family sizes (the range is now 12.1 to 26.8 percent), and lower the threshold at which reduction begins to $18,570 (it is now $25,921 for the basic benefit and $20,921 for the extended per child portion).
- Increase GIS benefits by $257 to offset the loss of the GST credit for low-income seniors ($257 per person) and increase the spousal allowance by $457.
- Decrease employer and employee EI premiums by a further 24 cents per $100 in covered wages.
- Increase all personal amounts, rate thresholds, and credits to account for inflation through September 2000 (likely 1.5 percent).
- Adjust federal rates and brackets as follows:

  0 to $30,759, 15 percent;
  $30,760 to $61,518, 23 percent;
  $61,519 to $153,795, 28 percent;
  $153,796 upward, 31 percent.

- Decrease the general CIT rate from 28 to 25 percent, and broaden the tax base (by reducing preferences for capital cost writeoffs and tax credits and further tightening the criteria for deductibility of business entertainment expenses) for a net federal cost of $250 million.
- Bring the value of employer-provided health coverage into taxable income. The amount would, of course, be an eligible medical expense and therefore generate a partially offsetting tax reduction.[23]

This complete package would come at a cost to the federal government of about $13 billion — around $900 per family, or 10 percent of federal tax — with total savings on federal and provincial taxes of $1,100 per family.

Given that the principle goal of the package is to reduce and smooth marginal tax rates, it is not surprising that the dollar value of benefits delivered should be skewed upward on the family income scale (see Table 6).

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All tax revenues estimates presented here were derived via Statistics Canada's Social Policy Simulation Database and Model, Release 6.1. Responsiblity for the use and interpretation of these data is entirely that of the authors.

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Table 6: *Effect on Disposable Income of Measures Proposed to Be in Effect by 2001, by Census Family Type*

Net Income Group	1 Adult with Children		2 or More Adults with Children		1 Elderly Adult		2 or More Adults, at Least 1 Elderly		Single Adult		All	
	$	% change	$	% change	$	% change	$	% change	$	% change	$	% change
≤ 20,000	411	2.4	530	3.3	21	0.2	38	0.2	–88	–0.8	23	0.2
$20,001–30,000	1,325	5.3	1,629	6.1	175	0.8	241	1.0	277	1.4	515	2.2
$30,001–40,000	1,570	5.4	2,185	7.0	880	3.4	563	1.8	819	3.2	1,089	3.8
$40,001–50,000	1,840	5.3	2,192	6.0	1,408	4.2	864	2.3	1,124	3.6	1,397	4.0
$50,001–60,000	1,886	4.9	2,268	5.3	2,064	5.3	1,193	2.8	1,594	4.3	1,715	4.2
$60,001–70,000	2,554	6.1	2,350	4.9	2,649	6.2	1,664	3.5	2,183	5.1	1,963	4.1
$70,001–80,000	2,564	5.1	2,679	4.9	2,333	4.7	2,063	3.7	2,631	5.3	2,258	4.2
$80,001–90,000	2,642	4.2	2,925	4.9	3,180	4.9	2,612	4.2	2,810	4.9	2,512	4.2
$90,001–100,000	2,347	4.5	3,281	4.9	3,517	6.2	2,616	3.8	2,765	4.6	2,870	4.3
≥ $100,001	3,617	3.9	4,523	4.4	3,932	3.3	4,701	3.6	3,739	3.3	4,142	3.9
All	878	3.9	2,372	5.2	189	1.1	679	2.1	444	2.2	1113	3.3

Source: Derived via Statistics Canada's Social Policy Simulation Database and Model, Release 6.1.

Viewed as a percentage of income, however, the benefits are much more evenly distributed and are largest, in relative terms, for middle-income families.

The Endgame in Context

We have deferred until now comment on the specific economic benefits of this pattern of reform. The principle effect would be the across-the-board lowering of marginal tax rates.

The changes in rates and brackets that would ultimately be effective in 2001 — replacing the current three federal brackets with a four-bracket system — would go a substantial way toward smoothing and making less steep the progressivity of the system in the middle tax brackets. Note that because of the surtax elimination and the abandonment of the incremental credit relief proposed in the 1998 federal budget, the number of effective tax brackets would be reduced, not increased. Also, because of the surtax elimination, the top federal marginal rate would drop from 31.32 to 31.00 percent.

The net impact of these changes on the combined provincial and federal marginal rate structure is illustrated in Figure 3. The grouping of low-income credits under one umbrella and their reduction to a low but fiscally supportable rate would decrease marginal tax rates across a broad swathe of low- and middle-income families. In particular, the high rates associated with the child tax benefit clawback would fall to 7.5 percent, and there would be no stacking of that clawback on the GST credit reduction range. Granted, this improvement would be accomplished at the expense of spreading out somewhat the income range over which these benefits are reduced, but lowering the middle tax rate and slightly raising the income level at which it kicked in would mostly compensate for this effect.

In any case, beyond the immediate benefit to Canadian taxpayers that would flow from lower average and marginal tax rates, the country's long-run growth prospects would be

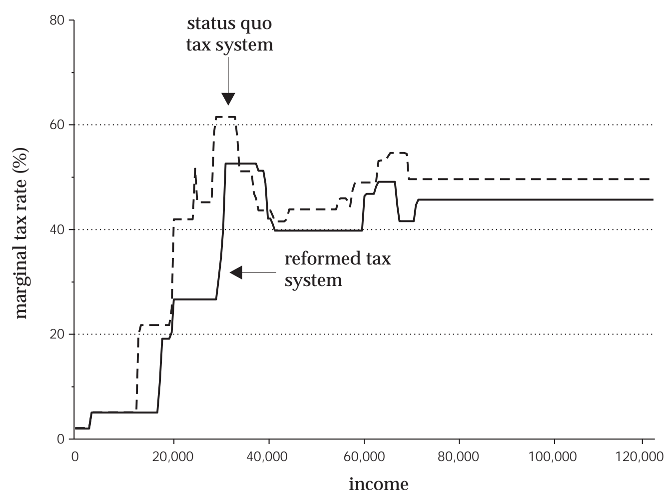
enhanced by the marked decline (more than four percentage points) in the average marginal tax rate and the pursuant drop in the efficiency cost of taxation.

Our calculation of the net tax saving for Canadian families — a little more than $900 per family, or 3 percent of after-tax income, on average, as shown in Table 6 — includes federal and provincial impacts. Our assumption is that the provinces would maintain their current tax rates, which, of course, is not assured.

The proposed cuts in basic federal PIT (about $12 billion in 2001) would reduce the tax bases of all the provinces other than Quebec. However, these losses would be largely offset by incremental revenues from the economic activity stimulated by two separate processes: first, the additional consumer expenditure and concomitant output growth that would follow from the increased disposable income that would be a direct result of federal income tax cuts; and, second, the growth in output and income that would follow from increases in the supply of labor and investment owing to lower marginal income tax rates.[24]

But whatever the ultimate dynamic effect, static revenue losses to the provinces would be on the order of $3 billion, or about 10 percent of provincial PITs, assuming that the provinces leave their rates unchanged and keep to a tax-on-tax regime rather than a tax-on-base mechanism. This scale of tax revenue reductions would be broadly affordable to the provinces because their revenues would be raised relative to expenditures by the same economic forces that would generate surpluses for the federal government. But although most provinces are now (or soon will be) in sound fiscal shape, some are not and may not be in future, as demographic shifts bring more pressure in expenditure areas for which the provinces bear responsibility.

Figure 3: ***Marginal Federal plus Provincial Tax Rates under the Status Quo and a Reformed Tax System, 2001***
(Ontario, single earner, two children)



Note: Calculations include CPP and EI premiums, refundable credits, and Ontario tax reduction and sales tax credit.

Source: Authors' calculations.

In particular, further revenue cuts might cause acute difficulties for British Columbia, because of that province's economic lassitude, and for Ontario, which has already delivered substantial income tax cuts and may be relying on status quo growth to return its fiscal status to near balance. Further, a pronounced federal shift away from the PIT might push Ontario into an undesired position with respect to its own tax mix.

Although these concerns are important, they are unlikely to be critical roadblocks. The provinces either would or would not find the revenue losses that proceeded from federal tax cuts affordable. If they did, well and good. If they found that they could, in fact, afford more, they should be encouraged to adopt similar or complementary measures that might provide yet more benefit to Canadian taxpayers and their economic futures.

On the other hand, if provinces found that these future revenue cuts would leave their budgets untenably out of balance, they would

have the option of increasing such taxes as would make them fiscally whole and yield their desired tax revenue mix. If any required tax increases were pursued in a way congruent with the measures proposed here, taxpayers would be no worse off than before the reforms; Canadians' net benefits would simply be limited to the federal tax relief we have proposed.

Some people have a residual fear that provinces might for their own reasons adopt measures that would undo (or more than undo) the fiscal and economic impacts of the federal tax changes we are proposing. Many provinces are convinced, however, that the best interests of their own residents lie along the path we have described and that reductions in personal or other taxes at the federal level are necessary in today's economic and political climate.

Concluding Notes

The theme of this paper is the need for a set of PIT reforms that address the numerous structural difficulties that have evolved over the course of several decades of incremental change to Canada's tax system. The reform imperative carries a sense of urgency because Ottawa now has a golden opportunity to implement not only tax reductions but also a package of reforms that includes elements that might not otherwise be palatable politically.

The changing economic world has put pressure on the PIT in particular. The correct response to that pressure is to yield in a careful manner so that governments' requisite revenues can be generated within a system that allows average tax rates to increase smoothly with taxpayer income; that does so without the spikes and lumps in marginal tax rates that work against the goal of a prosperous and productive populace; and that preserves Canada's ability to maintain essential public and social services.

An eye on international and unavoidable changes in the work world leads us to believe that such tax changes can best be implemented within a rational framework that responds to the multiple goals the tax system is intended to achieve, and that strikes an effective balance between efficiency and fairness, and between growth and equity. That is what the recommendations we present are designed to achieve.

Notes

We thank Bob Brown for many ideas expressed in this *Commentary*. As an early co-author, Bob contributed vital energy to drafting this paper, prior to his appointment as Clifford Clark Visiting Economist at the federal Department of Finance, and has since assisted us by providing comments on later drafts. We also wish to thank Bev Dahlby, Angela Ferrante, Louis Lévesque, Bill Robson, and Munir Sheikh for their very helpful advice and comments while this paper was in preparation.

1 Both the low-income supplement to the basic personal amount and the surtax rate relief are encumbered by complex formulas that reduce their value as taxpayers' net income increases, thus increasing their marginal effective tax rates. This problem is discussed in some detail in Poschmann (1998a).

2 Other countries, particularly the United States, are considering tax reductions that would push their tax shares down further yet relative to Canada, in the absence of policy change here.

3 Beach and Slotsve (1996) show that inequality in pretax earnings increased somewhat from 1980 to 1993, while there was little apparent change in inequality in post-tax, post-transfer incomes.

4 Data on the changing mobility of skilled workers are found in DeVoretz and Laryea (1998).

5 Other than the rough justice of the partial (75 percent) inclusion in taxable income with respect to capital gains, this inclusion is anyway required and to ensure similar treatment of dividends and capital gains.

6 See Poschmann (1998b) for details of the process and the amounts involved, as well as the distributional impact.

7 Since the decision to have children is a product of parents' desires, one might argue that a reasonable assumption is that children's psychological value to a family is at least as great as their financial cost. Given this view, the decision to have children and to expend resources in raising them is a matter of consumption preference, and no special deduction ought be provided for children. Nonetheless, children are citizens and not commodities; they do not exist simply for the sake of benefiting their parents, and the use of fiscal tools to expand the resources available for children's development has broad external benefits for society. Therefore, we do not agree with the view that the tax system should give no special recognition for children. Fuller discussion of the issue is given in Boessenkool and Davies (1998).

8 Statistics Canada's national accounts figures for 1998 suggest that Canadians collectively earned a little more than $700 billion in total income for persons and unincorporated businesses; the federal government could be run with less than a quarter of that amount.

9 One should bear in mind that the social welfare system is not well integrated with the tax system. Although assistance benefits are untaxed, their steep reduction rates expose potential labor market entrants to extremely high marginal effective tax rates, yielding for some income ranges a rather unattractive profile of the relationship between income and tax rates. See Sayeed (forthcoming), who considers the extent to which Ottawa and the provinces have succeeded in reducing the unfortunate interactions between taxes and social benefits.

10 Using Statistics Canada's Canada-US purchasing-power-parity definition, probably the best macromeasure available for comparing living standards, 65 percent of US families have higher after-tax incomes than similarly situated Canadian families. In other words, US families whose after-tax income is just higher than the lowest 35 percent of families have higher after-tax incomes than Canadian families at the same relative point, and so on up through each point on the percentile scale. See Wolfson and Murphy (1998).

11 Economists point out that the economic cost of an additional dollar of tax collected is proportional to the tax rate. Thus, a 50 percent tax rate has about twice the economic cost of a 25 percent tax rate, assuming that low- and high-income individuals respond similarly to the impact of taxes on their labor, saving, and risk-taking decisions.

12 Dahlby's results assume an (uncompensated) labor supply elasticity of 0.1 and infinite elasticity in the market demand for labor.

13 In today's world, business inputs have become more mobile. Crossborder transactions of capital have increased markedly: worldwide foreign direct investment has doubled as a share of fixed capital in the past two decades (Schwanen 1998). Moreover, skilled labor in Canada has become more mobile because of new trade agreements, since it is easier for Canadians to obtain visa status in the United States and other countries. For example, the number of professional workers leaving Canada for work in the United States has doubled in the past decade relative to the decade previous (DeVoretz and Laryea 1998).

14 As measured by the scale of the marginal rate jump as taxpayers move from two-thirds to all of the average production worker's wage (OECD 1997a, table 19).

15 Most obviously, graduated tax rates complicate household labor decisions by having a higher marginal tax rate bear on the family member whose market earning power is higher; they complicate invest-

ment and estate planning; and if high they increase incentives to move economic activity underground. On the other hand, to the extent that analysts consider the labor supply elasticity of secondary earners to be higher than that of primary earners, economic-efficiency arguments militate for a graduated rate schedule.

16 Since this strategy would mean a rising surplus in the EI account for the next few years, and because that account accrues interest when it is in surplus, equilibrium premium rates would be lower than if the program moved immediately to a cyclically balanced rate. The result would be a wash for representative taxpayers, since an equivalent amount of taxes of other types would be required to pay interest to the fund, but the overall tax mix would, of course, be slightly different than otherwise.

17 In the longer run, lower premiums would result in higher wages and higher PIT collections, as employers' savings were passed through to employees, but presumably these higher wages would come at the expense of lower future CIT income (compared to the immediately higher corporation taxable income resulting from lower labor costs) as pass-through of the EI premium cut manifested itself in those higher wages.

18 As noted in Boessenkool, Poschmann, and Robson (1998), major EI premium reductions might be achievable at the same time as personal income taxes are cut, if the EI revenue were to be replaced by a general federal payroll tax. Despite the economic appeal of this option, it might not be wildly attractive on political grounds.

19 Boessenkool and Davies (1998) recommend using a deduction as opposed to a credit — a route that is logically well supported in that the necessary costs associated with raising children are not conceptually different from the extant child care expense allowance. But as a practical and political matter, developing the mechanism within the current personal tax structure may be more reasonable at this time. We suggest, however, that these and other tax credits that help achieve horizontal equity be converted to deductions in future, when the marginal tax rate profile is flatter and the resultant cost to federal revenue lower.

20 The bias consists of the greater room for tax-sheltered saving within a registered pension plan, rather than an RRSP. This bent was redressed in part by the 1990 federal budget, but that repair was contingent on further increases in the maximum allowable annual RRSP contribution, which have not yet been implemented; rather, those long-scheduled increases have been postponed in budget after budget.

21 One implication is that reducing the lower limit (now 3 percent of net income) imposed on otherwise deductible medical expenses might be a rational alternative to the age amount.

22 Low-income singles, who would not benefit from enhancement of the child tax benefit, would benefit from the lower tax rates and increased personal amounts to be delivered at the same time. Low-income seniors, who would not gain from the child benefit increase and would not have taxable income to be offset by increased personal amounts, might be compensated via judicious increases in the GIS.

23 For the purpose of estimating the distribution of these benefits, we assume that the total cost of employer-provided health insurance may be allocated to full-time employees and scaled according to their income. These two factors are the strongest explanatory elements in describing the likelihood of receiving health benefits, as described in Reesor and Lipsett (1998).

24 The average marginal tax rate cuts of about four percentage points would, given any reasonable (positive) estimate of supply elasticities, lead to significant increases in investment and in hours of labor supplied to the market.

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