Taxation: the new wave

Management maven **Roger Martin** *suggests a system that could make Canada's economy a world leader*

Like many Ontario families, mine piled into the family station wagon on summer Saturdays to head to the beach for a day of sunning and swimming. Our favourite beach was on Lake Huron at a classic little beach town. One summer we arrived to find half the beach fenced off with a turnstile at its entrance. The other half, running north from the middle of town, was unchanged. I was about 10 years old, and on that day, I learned more about the dynamics of taxation than I learned in either economics at university, business at graduate school, or 18 years of strategy consulting around the globe.

The organization that had gained control of the southern half of the beach probably had dutifully counted the number of beach-goers the previous summer, divided that number in half, multiplied by a target admissions charge (about $1 a person) and had visions of the resulting windfall dancing in its head. The problem was that nobody used the south half of the beach that day, or any other day for that matter. Revenue was zero.

On that day I learned the seminal lesson of economics: That which you tax, you get less of; and that which you subsidize, you get more of. Tax lying on the beach and fewer people lie on it. Subsidize the beach by cleaning it, putting up washrooms and providing lifeguards all without charge, and more people go there. This outcome seems self-evident — yet, when it comes to national tax policy, we continue to tax what we want more of, subsidize what we want less of, and bemoan our resulting weak performance in the global economy.

If Canada is to win in the increasingly service-oriented new world order, our firms will need to compete on the basis of unique products and processes. To do that, we need more large Canadian firms competing globally — firms that are willing to invest heavily in research and development (R&D), and firms that continually face and overcome risk. We don't need more of what we have now: firms that invest too little in upgrading themselves; commodity producers; and small enterprises that choose to stay small (statistics show that small Canadian firms have lower productivity and R&D spending than large firms).

Yet our approach to taxation is designed to produce the opposite. Commodity producers, especially mining and oil and gas companies, enjoy corporate income taxes a fraction of those faced by the average manufacturing or service firm. Small businesses' incomes are taxed at about half the rate of large firms.

Meanwhile, we tax Canada's largest and most profitable firms, especially those in the service sector, at some of the highest income-tax rates in the industrialized world. We tax provision of risk capital by maintaining high capital-gains taxation. We tax capital investment at one of the highest rates in the industrialized world. In essence, we discourage the activities and behaviours we most need in order to prosper in the global economy, while encouraging those we don't want or need — and then wonder why our relative prosperity continues to slip.

Among countries in the developed world, Canada has one of the most perverse tax systems for competing in the 21st century. We must reconfigure it boldly to make a prosperity-creating system unique among industrialized nations. And we must do it so as to enhance rather than diminish the social policies we cherish.

One needs look no further than Ireland for confirmation. Until 1987, the Irish standard of living was half that of Canada. Ireland's standard of living in 2000 is by conservative estimates equal to Canada's — some say 20 per cent above. What changed?

In 1987 Ireland decided to stop taxing what it wanted more of (investment and innovation) and subsidizing what it wanted less of. It slashed corporate taxation such that the effective tax rate on a dollar invested in a business was one-fifth that of Canada, one-quarter that of the United States and one-third that of the United Kingdom. Note: It did not match tax rates with the U.K., but rather blew by its closest competitor. Now that Ireland's government coffers are filled to overflowing with tax revenues from a hugely increased base, its ability to provide social benefits is now double what it was a mere decade ago.

The lesson for Canada is to be bold, daring, and unique. Dismantle a tax system designed to reinforce stagnation in the 20th century, and create one consistent with the innovation and investment-based economy of the 21st century.

Where should we start? Blow past Ireland: Eliminate corporate income taxation. Corporate income taxation accomplishes no social purpose other than constraining our prosperity. We want corporations to seek the highest possible profits and invest the greatest possible amount in achieving that goal. Corporations are not "fat cats" who deserve to be punished for being successful. We can get every dollar we want from them in an economically more efficient manner from their shareholders. The double taxation of corporations (at both corporate and shareholder levels) serves no purpose but to create disincentives to investment by corporations.

Corporations are getting smarter and more adventurous in their global positioning. They are figuring out how to earn profit in the most tax-effective jurisdictions regardless of where their headquarters or operations are situated. That's why the contribution of corporate income taxes to total taxation in Canada fell to nearly half its 1965 level by 1995. These revenues are about as secure over the next decade as revenues from the south end of that beach from my childhood. As more countries take the kind of steps that Ireland has, more corporations will leave Canada. If we reverse field and become the north end of the beach relative to other jurisdictions, Canada will become an even more powerful magnet for investment than Ireland.

On the personal-income-tax front we should also take radical steps. Currently we tax individuals on the basis of one-year slices of their life; the amount of income in that year is the key factor in determining tax paid. A 30-year-old and a 50-year-old making the same income will pay (largely) the same tax. They are equal despite the reality that on average the 30-year-old has a much greater need for the last dollar of disposal income than does the 50-year-old, thanks to the way most of us spend and invest beyond our means early in life and then progressively work our way out of debt, while saving for retirement. Of course the pattern varies — but on average, younger people need those after-tax dollars more than people later in the cycle.

That's why our personal income tax system feels more onerous to younger Canadians than older ones. The paradox carries through: Canada's absence of estate taxes means taxes are lowest at the very point we have least use for our dollars — on our deathbed.

The U.S. system is the reverse. Income taxes are lower across the board in the States but dramatically favour younger taxpayers. These people can deduct mortgage interest (an advantage for younger taxpayers who hold mortgages that are larger in relation to their income and net worth than older taxpayers). As well, the United States has quite severe estate taxes — and revenue from estate taxes reduces the need to tax younger taxpayers.

The effect is to encourage young Canadians to move to the States for their most productive years and then come home to die under our medical care. Americans have the incentive to work in their home country until they are old, then renounce citizenship (and wait the required period) and pass away elsewhere. Young graduates of the Indian Institute of Technology, now a prime hunting ground for Silicon Valley firms, have a huge incentive to do graduate work in affordable Canadian universities and then emigrate to the States to find jobs.

We should move past the States with a lifetime taxation scheme. Instead of asking Canadians to pay 17 per cent of the first $30,000, 26 per cent of the next $30,000, and 29 per cent of the remaining in federal taxes in each tax year, let's structure lifetime taxation as 17 per cent of the first, say, $500,000 of lifetime earnings, 26 per cent of the next $500,000, and 29 per cent of the rest. And let's, with care, reintroduce estate taxes at a level lower than the United States, in order to reduce tax rates on everyone else. This would not discriminate against older Canadians; everyone pays the same tax at the same level of cumulative lifetime income. The tax burden is simply switched across time to a period where it feels less onerous.

Neither of these radical changes would affect our social programs other than to increase Canada's wealth and give us greater ability to invest in whatever we choose. My proposals are designed to make Canada an internationally attractive place to work and invest. They are neither pro-business nor pro-rich. What they are is pro-prosperity for the 21st century.

◆ ◆ ◆

Roger Martin is dean of the Rotman School of Management at the University of Toronto.