FINANCIAL INCENTIVES

THE GLOBE AND MAIL • FRIDAY, NOVEMBER 5, 2000

Tax reform: time to dive in

Elephant rhetoric has
criticized high taxes,
says business dean

ROGER MARTIN, but that’s
only part of the problem

Sally, whose name I’ve changed to protect her privacy, is a real person. And, you know, as her husband, I’ve often shown that in trying to create a "just society" that helps poorer Canadians, we have created a complex system of artificial taxes and credits that make it virtually impossible for lower-income people like Sally to save, invest, and plan for their future. Here’s how:

Each day, after Sally drops her son at daycare, she works for eight or nine hours as a store clerk (she’s considered a top performer) before picking her son up in the evening. She earns a gross annual income of $18,770. After tax, she takes home $1,235 a month. Most Canadians want to feel that their tax policies actually help a single mother and role earner like Sally — to ensure that hard-working people, no matter what their income level, have the chance to make a better life. To save and invest for retirement. To contribute to their child’s future.

Yet Sally exhibits what appears to be ir-
resistible behaviour. She refuses a pay raise that would add $500 to her annual income. She never accumulates savings in her bank account. She rarely contributes to her RSP.

Canada prides itself on a progressive tax system in which the rich pay higher taxes and the poor pay less. Indeed, Can-
adians pay no tax at all and, roughly $7,000 a year; they pay about 24 per cent (federal/provincial) on the next $23,000; about 33 per cent on the next $20,000, and about 44 per cent on everything else.

The first thing to note is that the rich actually don’t pay tax at a higher rate than the poor across the board. A Canadian
making $500,000 gets exactly the same tax
holiday on the first $7,000 of earnings as a poor Canadian who earns only $7,000 dur-
ing the entire year. And she pays the same tax on her first $30,000 as a Cana-
dian making $30,000 for the whole year. In
actual fact, a rich Canadian only pays higher tax rates — at the margin — on
about $20,000 of his income, which makes it easier of a given lower-income
up.

This is a key point of our chosen taxation technology. We give rich Cana-
dians an $8,300 federal income tax break on the first $100,000 of their income, upper-middle class a $5,300 break on their first $60,000.

These implicit tax breaks cost the fed-
eral treasury more than $20 billion in foregone revenue.

Given that input to worsen that by making the progressivity of the brackets very high. We need the higher rates precisely be-
cause we give away much on the first $30,000, $50,000 or $100,000 earned. It’s too bad, because $30,000 is a pretty low income level at which to start paying 33 per cent of the incremental dollar in in-
come taxes. But the marginal rates create a huge disincentive to work-
ning, saving and investing, which in turn makes the government expense of creating an incentive for high wage earners to em-

Most Canadians think the marginal rates are destructively high. Hence, the pressure for tax cuts. However, we also think that the poor pay too much, and have consistently supported the introduc-
tion of an array of programs designed to provide additional tax relief or support to the lower-income people. For example, in the 1997 federal budget, the government announced the child tax credit program, which— along with the "Baby Bonus" to all Canadians. But such univer-
sal tax relief is fiscally expensive. So we intro-
duced means-tested programs targeted

exclusively at lower-income Canadians

(e.g. the Canada Child Tax Benefit, a ref-
undable tax credit).

A progressive income tax structure with a targeted benefit overlay may seem like a clever way to help people like Sally, isn’t it. If Sally earns an extra $1,000 in in-
come (rasing her from $19,720 to $20,720), she’d pay $240 more in income tax — a whopping 24-per-cent marginal tax rate. And, her means-tested benefit will be "clawed back" due to the addi-
tional $1,000 she has earned.

According to a recent C.D. Howe Insti-
tute study by Finn Poschmann and John
Richards, the effect on poorer households
of the clawbacks — which are often multi-
ple due to the crazy quilt of programs at federal, provincial, and municipal levels of
government — is an effective tax rate of 80 to 70 per cent on every incremental dollar of income. Clearly, Sally faces a higher marginal tax rate than any rich Canadian, as do most families making under
$35,000.

Thus, Sally’s reluctance to save, invest, or take a raise is not irrational but hyper-
realistic. Her City of Toronto daycare sub-
sidy, through which she pays $4 per month rather than a completely unafford-
able $600 per month, comes with a discour-
ing warning: "You will be deemed ineligible for subsidy, regardless of your income. If the total of your assets exceeds the provincially determined ceiling... if you are considering making contributions to, or withdrawals from, a RISP, contact your caseworker to discuss this matter..."

How did we get to the point where a full-time worker needs someone to police her bank account? How can Sally save for her retirement when her assets may make

her ineligible for the child-care subsidy she needs? No matter how much she’s willing to work harder, to save, and to in-
vest, she’s stuck in a bind.

The basic problem is inherent in the progressive tax structure. In our effort to help poor Canadians, we trap them in poverty-maintaining incentives. How can we create a system to provide better incen-
tives to work, save and invest for the future and, if possible, put Sally’s "case-
worker" out of a job?

Let’s consider switching the basis of taxation to consumption, defined as in-
come minus savings (with additional sub-
sidies and credits for poor Canadians that are means-tested, based on consumption, not income). Most Canadians, recalling the hated GST, think of consumption taxes as "regressive." Sometimes they are. I’m proposing a radical tax-wash-what-you-buy approach that would encourage saving and investing by all Canadians — a system in which Sally would only pay tax on the dollars she spends. What she saves is tax-
 exempt, as it would be for all Canadians.

For people like Sally, we could intro-
duce means-tested, consumption tax exemptions on things like child care, housing, medicines and so on, reducing our need for expensive, cumbersome burea-
ucracies to police them. In this scheme, the direct tax on making more money, saving and investing is zero; ev-
eryone would have an incentive to work, save and invest more.

Sally would happily take the salary in-
crease, because she wouldn’t pay tax on the $400 if she saved and invested it! She wouldn’t pay any tax on this additional amount until she spent it. Besides, given her low level of consumption, she could be eligible for a means-tested exemption

from consumption tax — for example a consumption tax exemption on housing costs for Canadians consuming less than, say, $20,000 per year.

True, making such a radical change would be complex. But the current system is plenty complicated and doesn’t work.

Critics might also say that this scheme has its own disincentive: If consumption were highly taxed, our desire to earn more money to buy things would be lessened. This is correct, but the incentive to work will still be much higher than it is with 60-
to 100-per-cent effective marginal tax rates on income. Critics will also say that people will cheat — as if they don’t know.

Pulling off such a tax revolution would be challenging.

However, we must measure this chal-
lenge against the ignominy of running a system that seeks to help poor people by trapping them in poverty. Let’s stop "helping" poor people by trapping them.