TORONTO STAR
www.thestar.com

Smart taxes vs. dumb taxes

Statistics show politicians'' focus on low versus high taxation is misplaced, *says Roger Martin*

Dec. 16, 2005. 01:00 AM

With the election season underway, the important issue of taxation has already come into play.

Among other initiatives, Finance Minister Ralph Goodale proposed reducing tax by increasing each person's individual tax exemption (called the Basic Personal Amount, or BPA) in his pre-election economic statement.

Stephen Harper promised to lower the goods and services tax from 7 per cent to 6 per cent if elected and then to 5 per cent within five years.

When it comes to taxation, the dialogue tends to be almost exclusively about level. Generally the right says "too high," as with Harper on the GST, while the left says "too low" as with Jack Layton forcing the elimination of corporate tax cuts in last May's budget.

However, the focus on level is entirely misplaced; a much more helpful focus would be on the intelligence of taxation design. Smart vs. dumb taxation should be the central question, not low vs. high taxation.

Taxation is a central political issue because of its relation to the twin goals of prosperity and economic equality.

Conventional wisdom holds that a low level of taxation is associated with high prosperity but with the penalty of income inequality; the thinking goes that low taxation encourages vibrant economic activity but provides little opportunity to redistribute the wealth created. It further holds that a high level of taxation is associated with low overall prosperity because it stifles growth but greater income equality because there is more tax revenue to distribute.

The United States provides a classical confirmation of conventional wisdom. Compared with all other relatively rich, industrialized countries, it has one of the lowest levels of tax revenues as a share of economic activity (only 29 per cent of GDP), and with it the highest average prosperity and the biggest gaps between the rich and poor.

Because the U.S is. so close to us, we use its example to validate conventional wisdom. But we are in error in doing so.

High taxes don't necessarily mean low prosperity. Denmark, where taxes are 50 per cent of GDP, is highly taxed but also highly prosperous.

And low taxes don't necessarily mean income inequality. Japan has even lower taxation (27 per cent of GDP) than the U.S. but has the most equal income distribution among industrialized nations. Italy has relatively high taxation (42 per cent of GDP) but one of the worst income distributions among industrialized countries.

As with a remarkable proportion of economic conventional wisdom, the thinking on level of taxation is dead wrong. Among industrialized countries worldwide, the bottom line is that there is no relationship between tax level and either prosperity or equality of income distribution. The U.S. is a convenient but highly misleading exemplar.

But does this mean that taxation is not relevant to prosperity? No.

But it is the intelligence — measured from dumb to smart —of the tax system that is critical.

A dumb taxation system raises revenue through taxes that are powerful disincentives to economic growth. By reducing the creation of prosperity, dumb taxation reduces the revenues that can then be distributed among its residents.

Taxes on corporate income, capital assets and business capital purchases are examples of dumb tariffs that discourage investment by business in productivity enhancement and the creation of high-paying jobs; the kind that fill the government coffers with personal income taxes and enable income redistribution.

Smart taxes, on the other hand, minimize barriers to invest for prosperity. Instead of discouraging what we want more of, they discourage things we want less of. Among the smartest taxes are consumption taxes — for example, the GST — and pollution taxes. We want to motivate individuals to consume less and invest more and we want businesses to pollute less.

Income taxes tend not to be terribly smart because they discourage work and investment, but personal income tax is smarter than corporate income tax. High corporate income taxes discourage the creation of high-paying jobs to begin with; high personal income taxes discourage more work hours by people with high-paying jobs — a less destructive disincentive.

Who has smart taxation? Two countries at the opposite ends of the high-low spectrum have the smartest: low-tax Ireland (30 per cent of GDP) and high-tax Sweden (a stunning 51 per cent of GDP). Both have high value-added taxes — above 20 per cent, compared with Canada's 7 per cent GST, thereby collecting a high proportion of their tax revenue from a smart tax.

Both have uniquely low taxes on capital investment by businesses, the dumbest tax — 14 per cent and 12 per cent respectively, way below the industrialized country average of 22 per cent.

Sweden has chosen to raise a relatively high level of taxation by combining exceedingly low corporate taxation with relatively high personal income taxation while Ireland, with low overall taxation, sports a very low personal income taxation level.

Who has the dumbest taxation? Low-tax U.S. (29 per cent of GDP), medium-tax Canada (35 per cent) and relatively high-tax Italy (42 per cent).

The U.S. eschews the smartest tax by having no value-added tax, is second highest on the dumb tax on business investment (38 per cent), but keeps overall tax rates low by having slightly below-average personal income tax rates.

Canada's value-added tax is relatively low, which isn't smart; the highest tax on business investment in the industrialized world (39 per cent), which is truly dumb; and average personal income tax rates.

Italy's value-added tax (20 per cent) is about average, which is relatively smart, the fourth highest tax on business investment (36 per cent), which is relatively dumb and above-average personal income tax rates, which doesn't help a bad situation.

With a dumb structure and low overall rates, the U.S. manages to achieve high prosperity, but it has the worst income inequality in the industrialized world. With a dumb structure and high rates overall, Italy has created a modestly prosperous, but stagnating economy with surprisingly poor income equality.

How dumb is Canada's structure? Sadly, it is pretty dumb. And are Goodale and Harper proposing to smarten it up? No, because they are focusing more on level — and reducing taxation — than intelligence of the tax system.

Goodale proposes a mix of smart and dumb taxation moves. Decreasing corporate income tax rates and taxation of dividend income raises the IQ of Canada's tax system. However, increasing the Basic Personal Amount lowers the intelligence of the system.

While it is sold as helping the poor, it does nothing for the desperately poor, who earn less than the current BPA, and delivers the vast majority of the benefits to the middle and upper classes.

Depending on your definition of "the poor" the basic personal exemption increase spends $5 to $10 on the not-poor for every dollar that gets to the poor who are not desperately so. That is a staggeringly dumb way to provide economic benefits to the poor and it will do nothing to stimulate investment and job creation in the economy.

How about Harper's GST reduction? It is equally in the dumb category. This is a reduction of the smartest tool in the tax arsenal.

The GST is the most investment friendly tax and Canadians need more investment to increase our productivity and our wages. Virtually any other tax reduction would be more helpful for Canada.

Why on earth would the Canadian electorate have presented to it at the start of a crucial election campaign disproportionately dumb taxation ideas? The answer typically given is "politics": i.e. dumb taxation ideas are politically palatable because they sound good — lower GST and higher personal exemptions sound great.

It is true that taxation is a terrifically complicated subject. But that is no excuse for one of the world's leading countries to vote for tax policy that is simply bad for it.

This is anything but a right vs. left issue. Sweden is hardly a bastion of conservatism, but it has a much smarter tax structure than Canada or the U.S. Italy is a home of Euro-socialism but has a dumber structure for equality than most industrialized countries. We have to ask politicians on both the right and the left to be smart not dumb with the tax policies they put forward.

Canada needs smarter tax policy regardless of the party in question. If we don't insist on smartness, we simply won't get it. We will be fed a diet of dumb taxation and blamed for being too dumb to object.

Roger Martin *is dean of the Rotman School of Management at the University of Toronto and chair of the Institute for Competitiveness & Prosperity.*