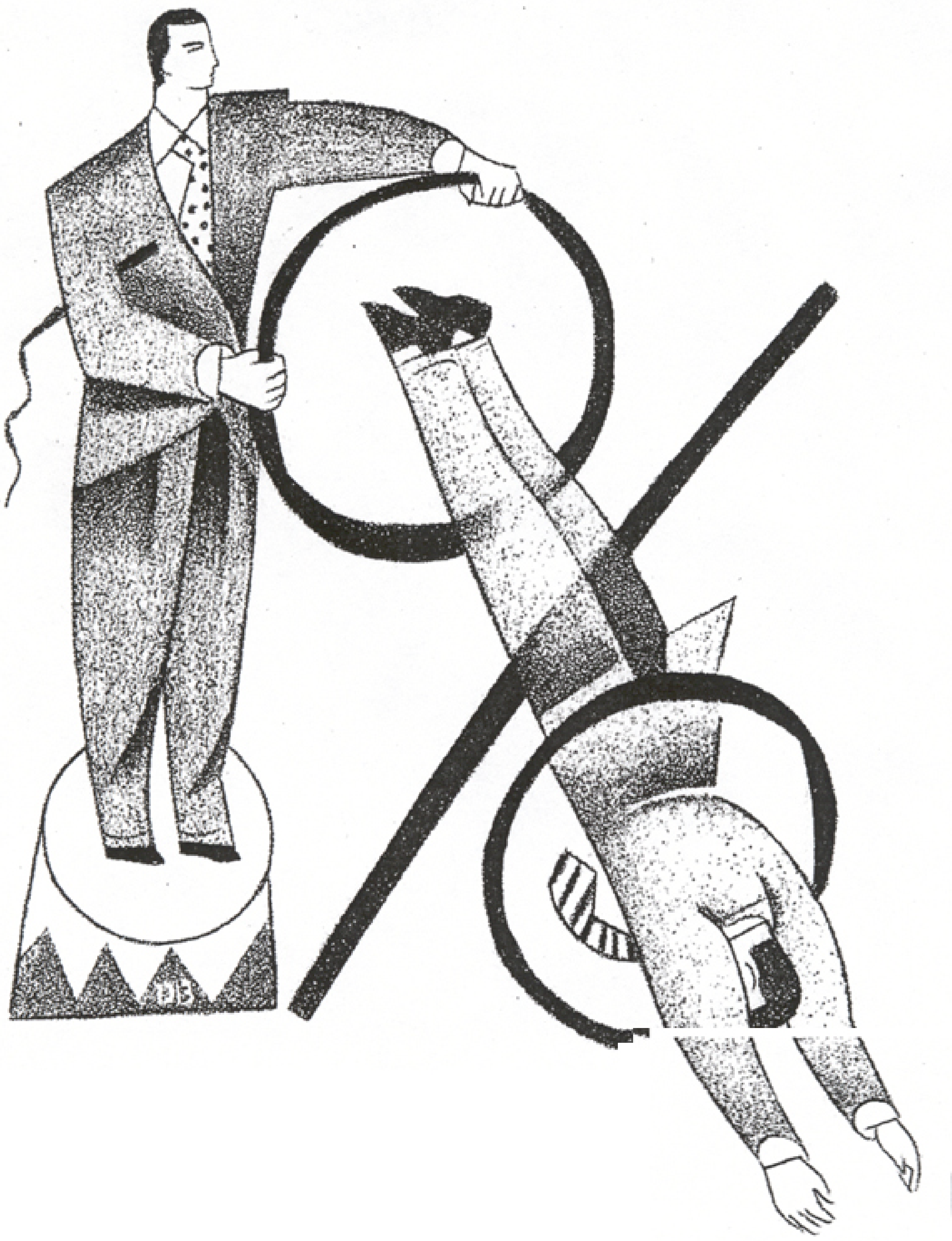
Tax reform: time to dive in

Election rhetoric has criticized high taxes, says business dean ROGER MARTIN, but that's only part of the problem



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Sally, whose name I've changed to protect her privacy, is a real person. If you analyze her 1999 tax return, it shows 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 $18,720. After tax, she takes home $1,235 a month. Most Canadians want to feel that our tax policies are designed to help a single mother and sole 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. To invest for retirement. To contribute to their child's future.

Yet Sally exhibits what appears to be irresponsible behaviour. She refuses a pay raise that would add $600 to her annual income. She never accumulates savings in her bank account. She rarely contributes to her RRSP.

Canada prides itself on a progressive tax system in which the rich pay higher taxes and the poor pay less. Indeed, Canadians pay no tax at all on the first roughly $7,000 they earn; we pay about 24 per cent (combined federal/provincial depending on the province) on the next $23,000; about 33 per cent on the next $30,000, about 39 per on the next $40,000, 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 $250,000 gets exactly the same tax holiday on the first $7,000 of earnings as a poor Canadian who earns only $7,000 during the entire year. And she pays the same tax on her first $30,000 as a Canadian making $30,000 for the whole year. In actual fact, a rich Canadian only pays higher tax rates — at the margin — on some portion of the amount he or she makes in excess of a given lower-income Canadian.

This is a key constraint of our chosen taxation technology. We give rich Canadians 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 federal treasury more than $25-billion in foregone revenue.

Ottawa tries to recoup that by making the progressivity of the brackets very high. We need the higher rates precisely because we give away so much on the first $30,000, $60,000 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 income taxes. Worse, the high marginal rates create a huge disincentive to working, saving and investing, which in turn hurts our national prosperity and creates an incentive for high wage earners to emigrate.

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 introduction of an array of programs designed to provide additional tax relief or support to the lowest wage earners. We used to deliver programs such as the old "Baby Bonus" to all Canadians. But such universality is fearsomely expensive. So we introduced means-tested programs targeted exclusively at lower-income Canadians (e.g. the Canada Child Tax Benefit, a refundable tax credit).

A progressive income tax structure with a targeted benefit overlay may seem like a clever way to help people like Sally. It isn't. If Sally earns an extra $1,000 in income (raising her from $18,720 to $19,720), she'll pay $240 more in income tax — a whopping 24-per-cent marginal tax rate. And, her means-tested benefits will be "clawed back" due to the additional $1000 she has earned.

According to a recent C.D. Howe Institute study by Finn Poschmann and John Richards, the effect on poorer households of the clawbacks — which are often multiple due to the crazy quilt of programs at federal, provincial, and municipal levels of government — is an effective tax rate of 60 to 70 per cent on every incremental dollar of income. Crazily, 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-rational. Her City of Toronto daycare subsidy, through which she pays $6 per month rather than a completely unaffordable $900 per month, comes with a draconian 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 RRSP, contact your caseworker to discuss how this may affect your eligibility."

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 invest, 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 with poverty-maintaining incentives. How can we create a system to provide better incentives to work, save and invest for the future and, if possible, put Sally's "caseworker" out of a job?

Let's consider switching the basis of taxation to consumption, defined as income minus savings (with additional subsidies 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-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 introduce means-tested, consumption tax exemptions on things like child care, housing, medicines and so on, reducing our need for expensive, cumbersome bureaucracies to police them. In this scheme, the direct tax on making more money, saving and investing is zero; everyone would have an incentive to work, save and invest more.

Sally would happily take the salary increase, because she wouldn't pay tax on the $600 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 now.

Pulling off such a tax revolution would be challenging.

However, we must measure this challenge 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.

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