Four writers last Wednesday concurred that lifetime taxation wouldn't work. Nonsense, says Roger Martin, the plan's creator. All they need is vision

The tax of a lifetime

ROGER MARTIN

I can understand why the idea of basing personal taxes on our lifetime incomes makes so many policy wonks nervous. Change is always worrisome – that is why current bad things always overstay their welcome. However, if we are hysterical and illogical in the face of change, we will never get change when we desperately need it, as we do now in personal income taxation. The concerns about the change actually illustrate why we need change.

For example, the Fraser Institute's Jason Clemens and Niels Veldhuis worry about lots of people facing higher average tax rates under lifetime taxation. They are correct, but I can live with that. If you take a static view you would never change to lifetime taxation. However, what I care about is work, saving and investment, growth, and moving forward — the dynamic view.

In this respect, the current system has things backward. It gives Canadians generous exemptions on the first dollars they earn — a break of 29% on the first $7,600 of annual earnings (called the Basic Personal Amount), 13% on the next $24,100, 7% on the next $31,600, and 3% on the next $39,700, then no break — i.e. tax of 29% — on the remainder of income over $103,000. Most people think of this system as providing lower tax rates for low-income Canadians. It is not true. These exemptions apply to every Canadian from Ken Thomson and Galen Weston at the top end to a poor working single mom at the low end. In Canada, rich people don't pay higher taxes on their income than poor people. Counting from the first dollar a poor person earns to the last dollar, the poor pay exactly the same rate as a billionaire.

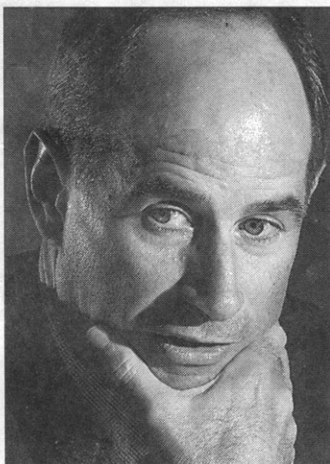
These breaks on the first dollars Canadians earn cost Revenue Canada $30-billion in lost revenues. The only way Revenue Canada gets the approximately $80-billion in personal tax revenues it needs — given the $30-billion giveaway – is to charge very high rates on the last dollar Canadians earn.

Economists know that the tax rate on the last dollar earned — the marginal tax rate — causes each individual to make their critical decisions: to work or not work one more hour; to save and invest or spend the next dollar. The higher the marginal rate, the more likely is the decision for leisure and spending rather then working, saving and investing. This is why no sale in history has advertised: "If you buy the first shirt at 100% off, you can buy a second shirt at 45% off, the third at 25% off, the fourth at 10% off and all the rest at full price."

I advocate investing the $30-billion in lowering the rate on the last dollar Canadians earn to generate a greater incentive to work, save and invest, which will produce greater prosperity, economic activity, and tax revenues — which in turn will create the opportunity to lower marginal tax rates for all Canadians even further.

Ryerson University finance professor Alan Kaplan asserts that lifetime taxation would exacerbate brain drain for those like his consultant "Jane" who stay in Canada until they hit the $1-million lifetime income and the top rate. Under my proposal, Jane, who makes $250,000, pays $8,750 more than under the current system on her first $103,000 and $2,940 less on her last $147,000. Nobody we would particularly want to keep in Canada would change countries to save a $5,810 per year in taxes on a $250,000 income - a mere 2% of income. If they leave for tax reasons, they leave for big, 15+ percentage-point differentials in marginal rates.

My approach reduces the Canada-U.S. gap in marginal rates and, as Jane's income increases, she reduces the net cost of giving up the non-marginal benefits — exactly the incentive we want to create. All the lower marginal rate has to do is provide an incentive for Jane to work a bit harder, because at $258,000 she recoups all $5,810 in taxes.



PETER REDMAN / NATIONAL POST

Roger Martin says lifetime taxation would benefit people at all income levels.

Will lifetime taxation do away with brain drain? Of course not. We have chosen a size of government that necessitates higher tax rates and a social compact that specifies a progressive tax structure. We have a built-in incentive that drives brain drain. Lifetime taxation will ameliorate it by giving entrepreneurially minded high income earners a vision of a lower differential in marginal rates as they pursue economic success in their future.

Satya Poddar at Ernst and Young and William Robson at the CD Howe Institute worry about the elderly, those with fluctuating incomes and the poor being devastated when they run out of their lifetime exemptions. To get a handle on the potential for devastation, consider the absolute extreme of "devastation" possible under the lifetime proposal. The absolute maximum by which annual tax payable under my proposal would be higher than under the current system is $8,750 — and that maximum only occurs for someone making exactly $103,000 in income after having accumulated $1-million in lifetime earnings. Everyone else's difference would be lower than $8,750.

The current tax system has things backward, which hurts poor Canadians

Let's consider the case of a 65-year-old who averaged at least $30,000/year in income across his career, so is above the $1-million lifetime threshold and let's say he now exists on $30,000 in annual income from his retirement savings, RRSP and pension(s). Indeed he would pay $8,100 versus $3,600 in taxes and, of course, he wouldn't prefer that. However, it is hardly a devastating difference, given the opportunities to accumulate more assets earlier in life due to the upfront breaks on early income.

Alternatively, let's consider the suddenly laid off Jane, the consultant from Kaplan's example. She gets alternative employment at McDonald's flipping burgers for $15,000 for a year before landing another consulting job. She pays $4,000 in taxes because all the income is at the top rate. Is that devastating? I don't think so, especially taking into account her previous work at $250,000/year and the savings she should have been putting aside.

Finally on this point, let's consider the truly poor. Taxation of the poor is ill understood in general. Canada's working poor face obscenely high marginal income tax rate which kick in at about 24% federal-provincial combined when they earn $8,000 — a mere halfway to the poverty line. Because the tax system is terrible for the poor and they both need and deserve help, we provide them with a wide array of social programs to funnel money back to them — typically through bureaucratically intensive means.

Because these social programs are too expensive to give to richer folks, benefits under these programs are means-tested and clawed back. That is, for every additional dollar a poorer Canadian earns, the government reduces the benefit. In this way, each of these programs subjects poorer Canadians to yet another marginal tax rate. Robson's clever colleague at the CD Howe, Finn Poschmann, did a brilliant analysis several years ago that showed that poorer working Canadians typically face effective marginal tax rates of over 60% on income below about $35,000. So actually it is poor Canadians, not rich Canadians who face the highest marginal tax rates.

The lifetime proposal was developed with poor working Canadians in mind by giving them a decade (e.g. 10 years @ $25,000) or more of tax-free earning to get them started and providing a huge incentive to work, save and invest. If they are still working poor — say making $20,000/year thereafter — they will face a tax bill $800/year higher, but will have had a decade to save and keep more out of debt, have a lower marginal tax rate and a continued higher incentive to work, save and invest. If these factors help them earn $21,000 instead of $20,000, they are out ahead in after-tax income.

The critics also point to implementation challenges as if they are impossible mountains to climb, but I think there is too much hysteria in the concerns.

For example, what about immigrants and Canadians who leave and come back? On the first, ask the immigrant how old he is. Calculate the median lifetime income of Canadians of that age and assign that income as the starting median lifetime income for the immigrant in question. If he objects, he can choose not to come. On the second, consider a Canadian who leaves as she turns 30 and returns when she turns 34. Calculate the median income of Canadians in their 30th, 31st, 32nd and 33rd years and add that amount to her lifetime Canadian income when she returns. For both of these allegedly insurmountable problems, nothing more is required than the creation and application of a single table.

Would it be easy to move to a lifetime income taxation system in Canada? No. I acknowledge fully that it would be a real challenge. Remember that it took a long while to create the current system. It would take careful, deep thinking and rigorous logic. But I am not deterred. I am simply not willing to sit back and accept that, because our current counter-productive, complicated and confusing system has high switching costs, we should stay firmly entrenched in the lose-lose box.

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