

# Do we have to harmonize down? Canadian tax policy in a continental context

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Does a relatively high and progressive tax system undermine investment, growth, and productivity? Or are social advocates bang on about the need to maintain a larger and more progressive fiscal base than the United States, if we are to sustain lower rates of poverty, insecurity, and income inequality? What we need to understand is that pressure to harmonize the Canadian tax system down to U.S. levels undoubtedly exists to the extent that taxes do influence the locational decisions of higher-income taxpayers and corporations. However, the higher Canadian tax “burden” is offset by efficiency and not just equity gains. As a result, we have significant room to shape and reshape the implicit social bargain and preserve Canadian distinctiveness.

The U.S. tax “burden” increased in the 1990s expansion (from 28.9 percent of GDP in 1992 to 31.0 percent in 1999) and personal tax rates were made more progressive by the Clinton administration reforms of 1993, which increased the top rate of income tax from 31 to 39.6 percent. Stronger U.S. growth in the 1990s has been associated with reversal of some of the Reagan era “supply-side” tax cuts, which produced large deficits rather than stronger GDP growth. Advocates of harmonization of Canadian taxes to U.S. rates and levels seldom dwell on certain progressive features of the U.S. tax system, such as the existence of a not negligible tax on larger gifts and inheritances, and the absence of special income tax treatment for dividend income.

Finally, it is worth noting that Canada-U.S. productivity growth differences in the 1990s reflect important differences

in industrial structures and, above all, the much greater weight of high-tech industries in the United States. Tax factors may play a role here, but the structural difference is also very much a product of past patterns of historical economic development.

## THE TAX AND TRANSFER SYSTEM

It is true that the total tax share of GDP is significantly higher in Canada than in the United States (42.8 versus 31.0 percent of GDP in 1999). Most of the difference arises from the fact that upper, middle and high income earners incur a significantly higher income tax burden. Income and profits taxes provide about half of all tax revenues in both Canada and the United States. The major differ-

ence in tax structure is higher payroll taxes in the United States, balanced by higher consumption taxes in Canada.

Because of the combined workings of the tax/transfer system operating on top of a modestly more equal initial distribution of market incomes, the *median* Canadian in 1997 (someone at the precise midpoint of the national household income distribution) was, as a careful analysis by Michael Wolfson of Statistics Canada has demonstrated, better off than the *median* American in real after-tax terms, adjusted for differences of purchasing power. Significantly, the *average* American was better off than the *average* Canadian. (Canadian GDP per capita, adjusted for purchasing power, is currently calculated by the OECD to be 20 percent below the U.S. level.)

Low-income Canadians are significantly better off than low-income Americans in absolute purchasing power terms, and poverty rates are much lower. If poverty is defined as less than half median national income, the child poverty rate in Canada is 14 percent, compared with 23 percent in the United States, and the elderly poverty rate is 5 percent, compared with 24 percent (*Luxemburg Income Survey* data). In short, the advantages of higher U.S. GDP per capita accrue almost entirely to the advantage of the top 20 percent or so of U.S. citizens who are, indeed, markedly better off than affluent Canadians.

## PUBLIC SERVICES

Canada’s relatively more redistributive tax/transfer system is also complemented by a higher level of delivery of public services, replacing, to some degree, expenditures from after-tax in-

come. In the United States, medical care expenses consume a startling 13.96 percent of after-tax household income, compared with just 3.2 percent in Canada. (See Andrew Sharpe and Lars Osberg, *International Indicators of Economic Well-Being*, table 6.)

A recent OECD study found that private U.S. household spending on social security—contributions to pensions, health, disability, and similar plans—amounts to more than 8 percent of U.S. GDP, well above the 1-3 percent range in continental European countries, where such security is typically delivered through public programs. (See *OECD Labour Market and Social Policy Occasional Paper #32*, Willem Adema and Marcel Einerhand, “The Growing Role of Private Social Benefits,” 1998.) Comparable Canadian data are, unfortunately, lacking.

The key point is that a higher tax “burden” is associated not only with income redistribution programs, but also with offsetting access to free or heavily subsidized programs and services, which have to be paid for out of after-tax income in the more market-oriented United States.

Canada remains a “kinder, gentler” or at least modestly more equal society than the United States, in significant part because of the greater relative size of the tax/transfer system and higher levels of provision of public services. These differences have been eroded in recent years because of cuts to transfers (EI and social assistance) and to a range of spending programs. Total public expenditure on programs has fallen from 41.4 to 36.4 percent of GDP, 1990-99, but Canadian governments still spend about 9 percent more of GDP on programs than do U.S. governments. (Data from *OECD Economic Outlook*.)

This leaves us with an implicit social decision to have a higher-tax burden, particularly on higher-income Canadians, in order to maintain a more generous transfer system and a higher level of public provision of services. The key question that has to be answered is whether this implicit, albeit constantly

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politically contested, social decision in favour of greater equity and security carries a price in terms of forgone growth.

### EQUITY AND SECURITY AT THE PRICE OF GROWTH?

A simple OECD cross-country comparison shows that there is, in fact, no statistically significant link between the tax “burden” and GDP per capita growth or productivity growth, while there is a strong, positive relationship between the tax “burden” and low after-tax income inequality. (For a detailed examination, see Andrew Jackson, “Tax Cuts: The Implications for Growth and Productivity,” (2000), vol. 48, no. 2 *Canadian Tax Journal* 276-302.) In the 1990s, several smaller European countries—notably Denmark, the Netherlands, and Norway—with relatively high tax-to-GDP ratios (and low rates of income inequality) grew faster than the United States in GDP per capita terms, and achieved comparably low levels of unemployment. Clearly, the notion of a large growth payoff from lower taxes per se is unfounded.

There are several key reasons why such a link does not exist. First, to the extent that higher taxes simply represent a choice to finance social security and some services from taxes as opposed to after-tax income, the “burden” is simply a reallocation of funds from private to public consumption. The tax “burden” is offset by free or subsidized public goods. This may have positive ef-

iciency effects, as in the case of public health care and public pensions, which have demonstrably lower overhead costs than market equivalents.

Second, redistribution to raise the after-tax incomes of low- and middle-income families may have positive growth and efficiency impacts above and beyond the realization of equity goals. A recent, authoritative survey in the *Journal of Economic Literature* noted that, despite the economic dogma of an equity/efficiency tradeoff, cross-country surveys almost universally find a negative correlation between growth rates and inequality (Philippe Aghion, Eve Caroli, and Cecilia Garcia-Penalosa, “Inequality and Economic Growth: The Perspective of the New Growth Theories” (December 1999), vol. 37 *Journal of Economic Literature* 1615-60.)

### HUMAN CAPITAL/ SOCIAL CAPITAL

The key linkage from low rates of inequality and poverty to growth is through higher accumulation of “human capital” and “social capital”—two concepts that are now at the centre of much economic theorizing about the sources of “endogenous” growth. Put another way, social deprivation and exclusion are economically counterproductive because of the waste of talent and skills, and because of high overhead social costs arising from unequal and divided societies.

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formance has been in the so-called new economy, in which the United States has experienced double-digit productivity growth and has also benefited from a much larger new economy relative to the total economy in the first place. Clearly Canada faces major challenges to keep pace with our southern neighbour in the new economy.

Now the reader may challenge this contention with the point that just about every economy in the world is behind the U.S. new economy. And the reader would be right. So, if we Canadians want to feel better about ourselves, we could compare our performance with that of non-U.S. economies. If we really want to feel good, we could compare ourselves with Russia. The problem, though, is that the United States is our dominant trading partner and neighbour. Like it or not, Canada-U.S. comparisons are most relevant for Canada.

My point, then, is that business-as-usual, status quo policies are inadequate for Canada in the new century. Let me offer two alternatives to the status quo.

### AMERICANIZATION

One option would be to copy the Americans in the hopes of replicating their superior performance. If you can't beat them, join them. We could copy the Americans on everything from external tariffs to taxation and social policy. We could even go for a common North American currency, which is a euphemism for Canada using the U.S. dollar.

## We're much better off with a flexible exchange rate than we would be if we simply used the U.S. dollar.

There are two dimensions to this issue—politics and economics. On the politics, it's a question whether we attach any value to a distinct Canadian identity. Personally, I do, but that's just the political judgment of one citizen. On the economics, the question is whether we'd do better economically through the Americanization route. Here, my answer is "yes and no"—yes, we'd do better if we could reduce remaining border impediments, since that would enhance investment, both Canadian and foreign, on the northern side of the border; and no, we're much better off with a flexible exchange rate than we would be if we simply used the U.S. dollar.

### CANADIAN ADVANTAGE

The better option, in my opinion, is for Canada to seek to do better than the Americans in selective areas, rather than simply to copy them. On the tax front, we should strive to reduce the Canada-U.S. gap on personal income tax. I also agree with Jack Mintz that we could do an Ireland by getting our business tax rates lower than those in the United States, and this could be done at the relatively

low cost of around \$3 billion.

In terms of non-tax policy, there is a role for government in fostering basic research and innovation and also in providing funds to the most pressing social needs, such as the homeless and the aboriginal population. At the same time, in both health and education, there is scope for Canada to outperform the Americans, with very positive longer-term implications for our economy and citizens.

It is important to emphasize that this is a problem involving the private sector as well as governments. Indeed, a recent report by Michael Porter and Roger Martin suggests that the problem resides at least as much in Canadian companies as in Canadian governments. So we have to hope that better policies will have a positive impact on the performance of Canadian businesses.

Finally, recent Canadian budgets have moved in the direction I am recommending, so it is possible to end on a note of guarded optimism for the medium-term outlook of the Canadian economy, as well as a note of guarded euphoria on the short-term outlook. ♣

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Finally, a huge economic literature documents the positive impacts on growth and productivity of public investment in infrastructure, education, training, health care, basic research, and development, and so on. The notion that public investment is unproductive is manifestly wrong. The thrust of current research is to show that the growth-enhancing impacts of well-selected public investments outweigh any inefficiency costs arising

from the taxes needed to finance the investment.

These points suggest a conclusion that is intuitively fairly obvious: good public programs can have economic benefits that justify the cost in terms of taxes. This leaves open a huge set of questions with regard to the mix of programs and tax measures that represent the best balancing of equity and efficiency goals. The implicit Canadian social bargain of higher taxes

in return for greater equality, greater security, and higher levels of "social cohesion" does not appear to have greatly eroded. "Tax rage" is easier to discover in editorials and columns than in public opinion surveys. That said, there is no reason for progressives to deny the case for some tax relief as growth picks up, as the cost of servicing accumulated public debt shrinks, and as needed reinvestments in public programs are made. ♣