

tional dollar earned that they keep. And as the government looks for new politically popular spending programs and for new ways to save money on old ones, the number of such transfers is growing.

Canadians cannot look forward either to continued increases in living standards or to continued fiscal balance, if government policy is tilted so strongly against work and saving.

The most ominous prospect on this front is the Seniors Benefit that is due to replace existing elderly benefits in 2001. As proposed, this program will impose a 20-percent clawback—over and above regular income taxes—on other income over \$26,000, sharply increasing many Canadians' effective marginal tax rates when they turn 65. The result will be less work, as more people retire early, and less saving, thanks to lower earnings and punitive tax rates on retirement income. The proposal is unpopular and may yet change. But some obvious sweeteners—enriching the benefit for the worst off or extending the clawback range—could increase the number of people facing 60-percent-plus effective marginal tax rates after age 65.

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saving.

A LABOUR OF HERCULES

Vanquishing a hydra requires more than cutting off one head after another. As Hercules discovered, it requires making sure that heads, once removed, do not grow back.

By balancing the budget, Mr. Martin has cut off one head of the hydra. Two other heads, however, taxes and clawed-back transfers, have gained strength and are on the attack. The growing hostility of Canada's tax and transfer system to work and saving threatens to further erode Ottawa's tax base and boost demand for its transfer payments. If it does, the old threat of deficits and mounting debt may yet return.

Only by leaving more of each additional dollar earned in the hands of those who earned it can Mr. Martin defeat the fiscal hydra, and finally earn the right to put away his sword.

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TOWARDS A REALISTIC TAX POLICY

BY JONATHAN R. KESSELMAN

The 1998 federal budget cut income tax rates for all taxpayers except those at upper incomes. In excluding higher earners from the tax cuts, the Finance Minister stated that the priority must be relief for middle- and low-income Canadians. As a result, the high-income surtax was left in place, and abolition of the general surtax was phased out between incomes of \$50,000 to \$65,000 so as to yield no cuts at higher incomes.

Cutting tax rates for upper earners poses obvious political difficulties, even for right-of-centre parties.

One could argue that cuts in the top marginal tax rate are a priority for the next federal budget. Such cuts can be justified to improve incentives, enhance economic efficiency, and augment job creation. While this change is not the end-all for tax reform, it is a pressing need that can be achieved at modest, if any, revenue cost.

Top-bracket taxpayers are relatively small as a group but are highly influential in the economy's overall performance. They face marginal tax rates exceeding 50 percent in all provinces except Alberta, which has a top rate of 46 percent. B.C. has the highest combined federal-provincial top marginal tax rate, at 54 percent.

Cutting tax rates for upper earners poses obvious political difficulties, even for right-of-centre parties. In the last

B.C. election campaign, the Liberals proposed a 15-percent cut in provincial income taxes but, remarkably, they would have left the top marginal tax rate unchanged. Ontario's Tory income tax cuts are being offset in part by a new surcharge on those at higher incomes, which will still leave the top marginal rate at nearly 50 percent when fully implemented.

Economic analysis for Canada and the U.S. has found the costs of imposing high marginal tax rates to be large. With B.C.'s surtaxes, for example, the loss of valued economic activity has been estimated at \$65 for each extra dollar of tax revenue; for Quebec's surtax the figure is over \$70. Using plausible assumptions about behaviour, total tax revenues might actually be increased by cuts in the top-bracket marginal rates.

These strong results can be explained by individuals' actions to curtail their taxable incomes when confronted with high tax rates. They will reduce their work effort, substitute untaxed production of home services for taxed market work, take more compensation in untaxed fringe benefits, decline promotions, postpone the sale of appreciated assets, invest in legal tax shelters (including home equity), and find ways to evade taxes.

Clearly, no one benefits if tax rates are set so high that revenue is actually decreased. Even short of such rates, the cost to the economy in reduced supply of productive labour and capital services and entrepreneurial activity is high. Employment is reduced for other individuals at more modest wage and skill levels,

which in turn reduces the income and sales taxes that they pay. Hence, any modest gains in income tax from high rates imposed on top earners may be more than offset by reduced revenues from taxes on other economic actors.

[Politicians] are captives of rhetoric about "tax equity", which in common usage assumes that ever-higher tax rates on upper earners is necessarily equitable. But if those higher rates do not produce greater revenues, or if they do so only at great cost to the economy, we are all victims of the rhetoric.

High tax rates on upper incomes further discourage the location and expansion of business in Canada as opposed to lower-taxed locales. Canada becomes less attractive to potential immigrants with special skills, business acumen, and high wealth. Much of the fuss over the proposed new reporting rules for foreign assets would not have arisen if Canadian tax rates were lower (the U.S. already has more stringent reporting requirements).

Why can't politicians appreciate these economic truths and moderate the top tax rates? They are captives of rhetoric about "tax equity", which in common usage assumes that ever-higher tax rates on upper earners is necessarily equitable. But if those higher rates do not produce

greater revenues, or if they do so only at great cost to the economy, we are all victims of the rhetoric.

A desirable target for top marginal tax rates would be in the low 40-percent range. This could be achieved by elimination of all federal surtaxes on upper incomes, combined with elimination of the high-income surtax rates applied in several provinces. These moves would place Canada in the company of other major Western economies.

The top U.S. marginal tax rate is 39.6 percent, though this arises only for taxable incomes above US\$264,000 or about CDN\$370,000, five times the threshold for top rates in Canada. (Most states also impose an income tax but at much lower rates than the Canadian provincial taxes.) In Britain the top marginal income tax rate is 40 percent. New Zealand cut its top rate from 66 to 33 percent, with beneficial effects on productivity and real wages.

Even egalitarian, heavily-taxed Sweden has come to appreciate the damaging effects of high tax rates. Its top marginal rate on labour earnings is now down to 51 percent, and capital incomes face a flat tax rate of just 30 percent. Germany's plans to cut its top tax rate from 53 to 39 percent were scuttled last year by the Social Democratic opposition on the grounds of "tax equity".

For those concerned about the loss of equity from reducing the top tax rate, the response is two-fold. First, since taxing at very high rates may generate little if any incremental revenue, the loss of equity would be more symbolic than substantive. Second, if there were much revenue loss, other taxes could be applied to those at upper income and wealth levels—such as taxes on higher-valued homes, cars, and estates—with signifi-

cantly less damage to the economy.

The inevitable losers from excessive marginal tax rates on those at upper incomes are in fact the most disadvantaged members of society. They remain unemployed, underemployed, or underpaid in an economy that cannot generate enough jobs. Many of the well-off who are targeted by high tax rates can shift their capital, consumption, and businesses off-shore or even emigrate.


High marginal tax rates also cause upper earners to press the political process for special tax preferences. Moderating top tax rates would enhance the ability of governments to apply a broadly based income tax. Hence, reducing high tax rates may itself be a prerequisite to more fundamental tax reforms to accompany the broader tax cuts that will become feasible in the coming years.

The burden of high tax rates on managerial, professional, and technical workers is transferred partially into higher prices for the goods and services they produce. Cutting those tax rates will increase their productive supply and thereby yield price cuts that benefit consumers at all income levels. Lower dental and legal fees, for example, will be welcomed by moderate-in-

come families.

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Indeed, the federal Liberals could take a leaf from the B.C. NDP government's recent budget. That budget will cut the provincial upper-income surtax such that the total top marginal tax rate will fall from its current 54 percent to 49.9 percent within three years. The cited rationale was a need to facilitate the hiring of managerial and technical workers for new-economy industries.

At last we may be entering an era where taxation policy can transcend political ideology and populist politics to recognize the economic imperatives for a growing and prosperous economy. 

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