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## The Changing Structure of the Canadian Tax System: Accommodating the Rich

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# The Changing Structure of the Canadian Tax System: Accommodating the Rich

## Abstract

The Canadian tax system underwent fundamental reform in the late 1980s. The principal effect of this reform has been to disable the tax system as an effective policy instrument for the redistribution of income. The fact that these reforms were an integral part of the larger neoconservative agenda to roll back the economic borders of the state and shift more power from the public to the private sector, is widely acknowledged. This paper simply illustrates how pervasively neoconservative ideology has influenced tax policy analysis. Every traditional objective of the tax system (to assist in reallocating resources, stabilizing the economy, and redistributing income), and every traditional criteria used to evaluate the tax system (equity, neutrality, and simplicity) has been reinterpreted in light of neoconservative doctrine. The changes to the tax system that have been justified by reference to this new orthodoxy have, in the main, accommodated only the rich and economically powerful.

## Keywords

Taxation; Canada

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# THE CHANGING STRUCTURE OF THE CANADIAN TAX SYSTEM: ACCOMMODATING THE RICH<sup>©</sup>

BY NEIL BROOKS\*

The Canadian tax system underwent fundamental reform in the late 1980s. The principal effect of this reform has been to disable the tax system as an effective policy instrument for the redistribution of income. The fact that these reforms were an integral part of the larger neoconservative agenda to roll back the economic borders of the state and shift more power from the public to the private sector, is widely acknowledged. This paper simply illustrates how pervasively neoconservative ideology has influenced tax policy analysis. Every traditional objective of the tax system (to assist in reallocating resources, stabilizing the economy, and redistributing income), and every traditional criteria used to evaluate the tax system (equity, neutrality, and simplicity) has been reinterpreted in light of neoconservative doctrine. The changes to the tax system that have been justified by reference to this new orthodoxy have, in the main, accommodated only the rich and economically powerful.

Some have sought to create and to use a tax system which would be an important instrument for concentrating wealth and income in their own hands and that of their class and section. Others have striven for a society free of glaring inequalities and have tried to develop and control a revenue system which would counteract the centralization of economic power. The success or failure of these campaigns has been bound up with the fate of democracy [Citations omitted].

—Sidney Ratner<sup>1</sup>

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<sup>1</sup> *Taxation and Democracy in America* (New York: John Wiley & Sons, 1967) at 13.

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## I. THE FRAMEWORK FOR THE ARGUMENT

An unprecedented wave of tax reform swept the globe in the 1980s.<sup>2</sup> Canada was not immune to these international changes.<sup>3</sup> Although the nature and comprehensiveness of the reforms varied from country to country, they had a number of common features: marginal personal income tax rates were lowered and the number of marginal brackets were substantially reduced; the personal income tax base was broadened; the corporate income tax rate was reduced; tax incentives were removed from the corporate income tax base; the consumption tax base was rationalized and broadened, often through a switch to a value-added tax; and there was a modest shift away from reliance on the personal income tax and towards consumption and payroll taxes.

This upsurge of interest in tax reform has been attributed to a wide range of factors. Most commentators trace the origins of the movement to the economic crisis of the 1970s—the coincidence of slowing economic growth, rising unemployment, and accelerating inflation—and the consequent perceived need for structural changes in western economies. In particular, many public finance analysts argue

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<sup>2</sup> For a sampling of the voluminous literature on the nature of these tax reforms, see R.M. Bird & S. Cnossen, eds., *The Personal Income Tax: Phoenix from the Ashes?* (New York: North-Holland, 1990); and M.J. Boskin & C.E. McLure, eds., *World Tax Reform: Case Studies of Developed and Developing Countries* (San Francisco: International Centre for Economic Growth, 1990).

<sup>3</sup> See J.M. Mintz & J. Whalley, eds., *The Economic Impacts of Tax Reform* (Toronto: Canadian Tax Foundation, 1989); and J. Whalley, "Recent Tax Reform in Canada: Policy Responses to Global and Domestic Pressures" in M.J. Boskin & C.E. McLure, *supra* note 2 at 73.

that the reforms have been driven largely by the perceived need for greater neutrality in the tax system. They note that there has been growing acceptance of the proposition that a proportional tax system with a broad base is more likely to be economically efficient than a graduated and selective one. Such a tax system is less likely to affect relative prices and, therefore, cause individuals and firms to substitute a preferred course of action with another simply because of the tax consequences. Public finance analysts also argue that the changes can be accounted for, in part, by the general belief that taxes generally, and marginal tax rates in particular, have simply become too high. The costs imposed by raising an extra dollar of taxation, however financed, has become prohibitively large compared to the marginal benefits of most public sector projects. Finally, they frequently note that the increasing mobility of capital and labour in the 1980s added urgency to the need to rationalize tax systems and to lower tax rates.

Undoubtedly, the confluence of these and other factors unique to specific countries explains, in part, the unprecedented tax reforms of the 1980s. However, instead of accounting for the relative weight of these factors in assessing the changing structure of the Canadian tax system, this essay suggests that these tax changes can best be understood as an integral part of the larger agenda that dominated political policies in the 1980s, namely, the rolling back of the economic borders of the state. This agenda was supported by an ideology that began emerging in the 1960s and became a powerful political force in the late 1970s. It is frequently referred to as neoconservatism.<sup>4</sup>

The central theme of neoconservatism is the reduction of the role of government in the economy and an increased emphasis on the role of individual choice and markets in allocating resources. Adoption of this ideology necessarily involves, of course, making those who exercise power in the private sector more powerful, and those who benefit from the distribution of resources as the result of market forces, richer. Some commentators contend that those who have been advocating this change in government stance are not true ideologues, who sincerely believe the world will be a better place as a result of the policies they advocate, but that they are simply selfish, money-mongering liars, whose only concern is to maximize their own wealth and

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<sup>4</sup> The *new right* is another term that has been used to describe the ideological movement to the right since the 1960s. This term was presumably coined to contrast the movement with the *new left*, which emerged as a clearly identifiable ideology at about the same time. Some commentators distinguish between neoconservatism and the new right. See M.P. Marchak, *Ideological Perspectives on Canada*, 3d ed. (Toronto: McGraw-Hill Ryerson, 1988). However, whatever differences there might be, they are not important for the purposes of this paper.

the wealth of those of their class. In the United States, for example, the remarks of Nobel Prize winner Robert Solow at a symposium on economic policy reflect a widely held liberal view: "What does the Reagan Administration care about? I think it cares about the distribution of wealth and power, and its program is and has always been the redistribution of wealth in favour of the wealthy and of power in favour of the powerful."<sup>5</sup> But, whatever the motivations of its proponents, neoconservatism has had a significant effect on the structure of the tax system over the past decade. Its main effect has been to disable the tax system as an effective instrument for the redistribution of income and, thus, to make the rich richer and the powerful more powerful.

To show how pervasive the triumph of neoconservatism has been and to reveal its influence on the tax system, this paper will review the objectives of the tax system and the traditional criteria used to evaluate it, and show how each has been reinterpreted over the past decade, under the influence of neoconservatism, to the advantage of the rich. The fact that tax systems became less progressive in the 1980s has been widely noted. The modest contribution of this paper is simply to document how thorough going the rationalizations for this change in the structure of tax systems have been. Under the influence of neoconservative ideology *every* objective and evaluative criterion of the tax system has been reinterpreted to accommodate the rich.

Although there is a much richer theory on the role of government than that provided by economists, the discipline of welfare economics has developed the most highly articulated theory on the need for government intervention in the economy. Since its theory is arguably the most explanatory of government intervention in western economies, Part III of this paper, on the changing objectives of the tax system, adopts this discipline's conceptual framework. This normative model of government has also driven all structural economic revisions in western industrialized countries over the past ten to fifteen years, including tax reforms.<sup>6</sup> Under this model, the tax system is seen as basically a policy instrument with which the government pursues its ultimate economic

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<sup>5</sup> "The Conservative revolution: a round-table discussion" (1987) 2 *Econ. Policy* 181 at 182. For representative criticism of the economic policies of the Reagan administration on the grounds that it unnecessarily redistributed income in favour of the wealthiest members of society, see F. Block *et al.*, *The Mean Season: The Attack on The Welfare State* (New York: Pantheon Books, 1987); M. Harrington, *The Next Left: The History of a Future* (New York: Holt, 1986); and R. Lekachman, *Visions and Nightmares: America After Reagan* (New York: MacMillan, 1987).

<sup>6</sup> See OECD, *Progress in Structural Reform: an overview* (Paris: OECD, 1992).

objectives of: (1) reallocating resources, primarily by providing goods and services that the market cannot provide efficiently, (2) redistributing income in a way that is more socially acceptable than that which results solely from market forces, (3) stabilizing the economy near full employment and a zero rate of inflation, and (4) encouraging economic growth. In Part III, the changing objectives of the tax system will be examined by referring to the neoconservative reinterpretation of these broad government objectives.

The overriding purpose of the tax system is to help government achieve its objectives. However, when designing a tax system, a number of evaluative criteria must be satisfied. These criteria are applied in evaluating all government policy instruments; however, their content has been most significantly detailed in the area of tax policy. They are derived from fundamental axioms of justice, and the basic premises of, and constraints imposed by, the prevailing economic and political system. In tax literature, these criteria have traditionally been listed as equity, neutrality, and simplicity. In recent years a new criterion has been added: international harmonization or competitiveness. Indeed, neoconservatives frequently argue that, in this age of globalization, the most important consideration in designing a tax system is ensuring that a country's system does not differ greatly from those in other countries, particularly as it affects income from capital and high-income taxpayers.

This framework suggests that alterations in the tax system might be accounted for by a change in the view of what the broad objectives of government should be, or by a change in the interpretation of the various criteria used in evaluating the tax system.<sup>7</sup> In short, this paper argues that the structure of the Canadian tax system has changed for both of these reasons to the benefit of the rich, and that this

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<sup>7</sup> Of course, technical changes might be made in the tax system so that it is better able to achieve its objectives or to meet the criteria of a good tax system as it is conventionally understood. Over the last decade, for example, the Canadian Conservative government has made numerous changes in the tax system to prevent blatant tax avoidance, including the introduction of a general anti-avoidance rule. But I would argue that this does not negate my thesis that the overriding goal of recent tax reform was to change the structure of the tax system in a way that reduced the tax burden on the rich. Indeed, presumably a crude Marxist analysis would suggest that closing blatant loopholes is necessary to preserve and even strengthen the legitimacy of a regressive tax system. Moreover, the Conservatives have failed to close numerous obvious loopholes, such as the capital gains exemption, and have actually created others—the most recent being the effective repeal of the twenty-one-year deemed disposition rule for trusts—that have provided billions of dollars in subsidies to the rich. See N. Brooks & L. McQuaig, "For the Rich, Life's a Loophole, Then They Die" (December 1992) *This Magazine* 13.

modification reflects a more profound shift in the prevailing ideology from Keynesian liberalism to neoconservatism.<sup>8</sup>

The thesis—that the Canadian government's commitment to neoconservatism explains its tax policies—might, on one hand, appear obvious, but on the other hand, is not easy to prove. The most obvious beneficiaries of neoconservatism, the rich and business interests, did not get everything they asked for in tax reform. And, if the rich and business interests are so politically powerful and adept at persuading political decision-makers to adopt their ideology, why did they wait until the 1980s? Obviously, countless factors explain the details of public policy outputs, and the power of business in the ebb and flow of that process. However, for many reasons business was able to acquire considerable control over the public policy decision-making process in the 1980s.<sup>9</sup> The basic ideology it appealed to in attempting to push back the economic borders of the state largely explains the reinterpretation of the objectives and criteria of tax policy.

The tax system is the government's most pervasive, visible, and contested policy instrument. As such, it is a particularly reliable barometer of shifts in the prevailing ideology. It has been called "a mirror of democracy."<sup>10</sup> Joseph Schumpeter, a well-known economic historian, observed that "nothing shows so clearly the character of a society and of a civilization as does the fiscal policy that its political sector adopts."<sup>11</sup> Before turning to examine the change in perspective regarding the objectives of the tax system and the reinterpretation of the criteria used in evaluating it, it is necessary to place these changes in a

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<sup>8</sup> As it applies to tax, neoconservatism almost perfectly mirrors what a U.S. tax attorney of startling brilliance and originality disparagingly referred to in 1962 as the ideology of barriers and deterrents. Louis Eisenstein observed that, according to the proponents of this ideology, progressive taxes, "dangerously diminish the desire to work; they fatally discourage the incentive to invest; and they irreparably impair the sources of new capital. Our economic system must come to an untimely end if private capital cannot accumulate and private initiative is destroyed." *The Ideologies of Taxation* (New York: Ronald Press Co., 1961) at 13. This tax ideology reflects characteristics common to all ideologies. It rationalizes a lower tax burden for the groups that it serves—business interests and high-income taxpayers. It does so by appealing to values that appear to transcend the private interests of those groups; in this case we are told that we will all prosper if the rich are untaxed. And, the ideology is expressed in terms that are designed to be self-evidently persuasive and emotionally satisfying—its contentious, empirical assumptions are obscured.

<sup>9</sup> For an account of the fluctuations in the political power of business in the United States, see D. Vogel, *Fluctuating Fortunes: The Political Power of Business in America* (New York: Basic Books, 1989).

<sup>10</sup> C. Webber & A. Wildavsky, *A History of Taxation and Expenditure in the Western World* (New York: Simon and Schuster, 1986) at 526.

<sup>11</sup> *History of Economic Analysis* (New York: Oxford University Press, 1954) at 769.



broader context. The next section briefly traces the recent change in the prevailing ideology of the role of government.

## II. THE SHIFT IN THE PREVAILING IDEOLOGY

During the 1950s and 1960s, a broad consensus emerged about the role of government and therefore the objects of public policy, including taxation. Reflecting the major blueprints for the future advanced during the late 1930s and 1940s,<sup>12</sup> it was widely believed that the government should correct the pervasive failures of the private market, including unemployment caused by deficient, private sector demand. During this period, governments in most western countries set up a welfare state, nationalized the basic infrastructure industries, and embarked on macroeconomic demand management.

There was undoubtedly substantial disagreement about the ways in which state power should be exercised. Keynesian liberals generally assumed that enlightened fiscal and monetary policies could ensure full employment and stable prices, while new social policies could usher in a more equitable society. Socialists, on the other hand, saw a greater potential in state action. In Canada, for example, the League for Social Reconstruction felt that capitalism had failed decisively in the 1930s and should be superseded by central state planning carried out by a national planning commission and an elite corps of technical experts. But despite their major differences, both of these schools of thought, and the Keynesian social democrats who fell somewhere in between, shared a faith that an activist state could resolve the pressing problems of modern society.<sup>13</sup> Although powerful conservative tracts were written during this

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<sup>12</sup> In Canada, the reports of three major royal commissions on economic policies trace rather accurately the shifts in the prevailing ideology. In 1939, the Rowell-Sirois Commission recommended a strong federal government presence in social policy [*Report of the Royal Commission on Dominion-Provincial Relations* (Ottawa: Printer to the King, 1940) (Co-chairs: J. Sirois & N.W. Rowell)]. In 1958, the Gordon Commission recommended government intervention in the economy to guide investment and ownership of Canadian industry [Royal Commission on Canada's Economic Prospects, *Final Report* (Ottawa: Queen's Printer, 1958) (Chair: W.L. Gordon)]. In 1984, the Macdonald Commission took the opposite line: it championed a weaker federal government and a market orientation to both social and economic policy [*Challenges and Choices: Report of the Royal Commission on the Economic Union and Development Prospects for Canada* (Ottawa: The Commission, 1984) (Chair: D.S. Macdonald)].

<sup>13</sup> For a description of the various ideologies reflected in Canadian politics during this period, see R. Whitaker, "Images of the state in Canada" in L. Panitch, ed., *The Canadian State: Political Economy and Political Power* (Toronto: University of Toronto Press, 1977) 28 at 30.

period, such as F.A. Hayek's *The Road to Serfdom*<sup>14</sup> in the 1940s, and Milton Friedman's *Capitalism and Freedom*<sup>15</sup> in the 1960s, they had little influence on public policy.

The general optimism about the efficacy of state action was reflected in debates over tax policy. Tax policy analysts expressed few misgivings about the ability of the tax system to raise revenue to finance the emerging welfare state, or about the use of the tax system to redistribute income and wealth. The issue that preoccupied tax policy analysts was the need to make the income tax base more comprehensive and, therefore, to increase its horizontal and vertical equity.

The Canadian Royal Commission on Taxation's report was the high-water mark of the tax reform movement during these heady years of Keynesian liberalism.<sup>16</sup> It unreservedly called for a totally comprehensive income tax base and progressive taxation.<sup>17</sup> In looking back at the era that gave rise to the Carter Report, Douglas Hartle, the research director for the Commission, has stated:

Since the state was perceived to have performed well both in the war and in the post-war period, the electorate's faith in the *potential* efficacy of government intervention was extremely high ... Thus the Carter Commission was born at a time that was prosperous beyond the imagination of most, which was, as a consequence, generous spirited and infused, at least temporarily, with a desire for greater fairness [and] justice.<sup>18</sup>

During the 1970s, as productivity growth declined, inflation accelerated, and unemployment remained high, this consensus about the role of government, and, therefore, tax policy quickly became unglued. Political debate shifted dramatically from social policies and their efficacy in achieving equality to the increasing size of the public sector and its harmful effect on economic efficiency. The elite perception of the relationship between the welfare state and societal crises was

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<sup>14</sup> (London: Routledge & Kegan Paul, 1944).

<sup>15</sup> (Chicago: University of Chicago Press, 1962).

<sup>16</sup> *Report of the Royal Commission on Taxation* (Ottawa: Queen's Printer, 1966) (Chair: K.L. Carter) [hereinafter Carter Report].

<sup>17</sup> Although the report is best known for its uncompromising advocacy that in issues of tax justice "a buck is a buck," to demonstrate the redistributive consequences of the Carter Report's recommendations, it was estimated that investors receiving more than \$300,000 would see their tax liabilities increase by about \$77,000, or about 45 per cent more than their 1964 direct taxes. L. MacDonald, "Why the Carter Commission Had To Be Stopped," in N. Brooks, ed. *The Quest for Tax Reform: The Royal Commission on Taxation Twenty Years Later* (Toronto: Carswell, 1988) 351 at 360.

<sup>18</sup> D.G. Hartle, "Some Analytical, Political and Normative Lessons from Carter" in Brooks, ed., *ibid.* 396 at 400.

summed up in the opening address of the Secretary-General of the Organisation for Economic Co-operation and Development (OECD) at a conference convened in 1981 to discuss the welfare state in crisis. He suggested that it had become clear

that the real social progress we can achieve is limited by economic means; that method of achieving social objectives should not be allowed to undermine the economic system which produces the means; and that we live in societies based on the principle that individual citizens and consumers are, in the main, the ultimate arbiters for allocating means to ends.<sup>19</sup>

Neoconservatism provided the ideological basis for this fundamental redirection in government policy. Generally, neoconservatism refers to a somewhat contradictory set of beliefs that draws not only upon traditional conservative thought but also upon more radical libertarian philosophy.<sup>20</sup> It combines, for example, on one hand, the desire for a weak state that will not interfere with private privilege with, on the other hand, the desire for a strong state to serve the needs of business.<sup>21</sup> Like traditional conservatives, neoconservatives believe in the efficiency and optimality of free markets and are concerned with the collective moral fabric (its position on social issues affecting women and minorities in particular have an uncompromising authoritarianism about them). But unlike traditional conservatives, neoconservatives do not stress the values of community or established institutions, nor do they assert the reciprocity of rights and duties. They do not concede that property and privilege entail any obligations to the community. This aspect of their philosophy is reflected in the quotation frequently attributed to Margaret Thatcher, "there is no such thing as society." In

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<sup>19</sup> E. van Lennep, "Opening Address" in OECD, *The Welfare State in Crisis: An Account of the Conference on Social Policies in the 1980s* (Paris: OECD, 1981) 9 at 9.

<sup>20</sup> The intellectual roots of the American new right are surveyed in G.H. Nash, *The Conservative Intellectual Movement in America, Since 1945* (New York: Basic Books, 1976); and P. Steinfels, *The Neoconservatives: The Men Who Are Changing America's Politics* (New York: Simon and Schuster, 1979). An incisive review of the contradictory policies of the new right can be found in B. Ehrenreich, "The New Right Attack on Social Welfare," in Block *et al.*, eds., *supra* note 5 at 161. For an analysis of the influence of the new right in other western economies see S. Hall & M. Jacques, eds., *The Politics of Thatcherism* (London: Lawrence and Wishart, 1983); R. Levitas, ed., *The Ideology of the New Right* (Cambridge: Polity Press, 1986); R. Miliband, L. Panitch & J. Saville, eds., *Socialist Register 1987* (London: Merlin Press, 1987); Marchak, *supra* note 4; and M. Savier, ed., *Australia and the New Right* (Sydney: George Allen & Unwin, 1982).

<sup>21</sup> Some of the most influential documents in shaping the philosophy of neoconservatism and the new right were the reports of the Trilateral Commission, which emphasized the importance of planning in the interests of transnational corporate interests. See for example, M.J. Crozier, S.P. Huntington & J. Watanuki, *The Crisis of Democracy: Report on the Governability of Democracies to the Trilateral Commission* (New York: New York University Press, 1975).

short, to be ungenerous, neoconservatism appears to combine a pro-business bias with a mean-spirited disposition,<sup>22</sup> or less judgmentally, its philosophy has been summarized by the slogan, "markets good, governments bad."<sup>23</sup>

This frontal assault on the welfare state has been an international phenomenon. It has been most visible in the United States, the United Kingdom, and New Zealand where it has been graced with the now familiar titles of "Reaganomics," "Thatcherism," and "Rogernomics." In Canada, the attempt to roll back the economic borders of the state has been slightly more subtle.<sup>24</sup> Although the reasons for this are undoubtedly complex, it has been suggested that the following all account for the more evolutionary nature of the Canadian government's shift to the right: the Conservative government's commitment to consultation and reconciliation; a strong opposition party in Canada; the nature of Canada's federalism; and the strong tradition of public support for the welfare state in Canada, including a Tory tradition that once emphasized group rights and a tolerance for state regulation of social and economic life.<sup>25</sup> Nevertheless, although its attack on the state has been less obvious, the present Conservative

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<sup>22</sup> And it might be added, a shameless rhetorical zeal. For example see G. Gidder, *Wealth and Poverty* (New York: Basic Books, 1981); and J. Wanniski, *The Way the World Works*, rev. ed. (New York: Simon and Schuster, 1983). While the excesses of popular authors might be understandable, the extravagant claims of the academic scholars that have been associated with the new right are harder to forgive. In his *Economics of Income Redistribution* (Boston: Kluwer-Nijhoff, 1983) at 164, Gordon Tullock, a scholar who has supplied an intellectual respectability to many of the arguments made by neoconservatives, says that the United States crop-restriction programmes should rank "with the work of Stalin, Hitler, and Mao among the major mass murder programs of our time." A reviewer of Tullock's book observed, "... even slight damage, would be hard to prove. For Tullock's unsupported claim of mass murder (which also implies intent), the irresponsibility is enormous." Jerome Rothenberg in (1987) 25 J. of Econ. Lit. 117 at 119.

<sup>23</sup> A. Gamble, "The Political Economy of Freedom" in Levitas, ed., *supra* note 20 at 30.

<sup>24</sup> Although the Conservative government's favouritism of the wealthy has not been all that subtle. For example, it is worth recalling that in justifying one of his first huge giveaways to the rich—the lifetime capital gains exemption—the Minister of Finance, Michael Wilson, stated that Canada needed more rich people. This seemed to be a clear indication that economic inequality was to be a deliberate objective and not just a by-product of Conservative government policy. Linda McQuaig reports that the capital gains exemption "was also such a blatant giveaway to the rich that even relatively conservative experts within Finance were rankled [by its enactment]." *Behind Closed Doors: How the Rich Won Control of Canada's Tax System ... And Ended Up Richer* (Markham, Ont.: Penguin Books, 1987) at 292.

<sup>25</sup> R. Mishra, *The Welfare State in Capitalist Society: Policies of Retrenchment and Maintenance in Europe, North America and Australia* (Toronto: University of Toronto Press, 1990) at c. 4.

government has espoused a neoconservative philosophy and has proceeded to implement its agenda.<sup>26</sup>

Most significantly, although the Conservative government has continued to pay lip service to the principles of fairness and equality of opportunity, and has stopped short of actually dismantling the main institutions of the Canadian social welfare state, the boundaries of these institutions have been changed in a way that will ensure their erosion over time. These changes include substituting market-based for government-planning solutions wherever possible, retreating from universality in the provision of social programmes, limiting contributions to provincial grant programmes, indiscriminately liberalizing restrictions on international trade and investment, restructuring the unemployment insurance programme, and cutting back on funding for social advocacy groups. Its strategy has been perceptively referred to as “social policy by stealth.”<sup>27</sup>

Neoconservatism has affected all government policy instruments; however, the shift away from Keynesian economic policies associated with traditional liberal orthodoxy is most apparent in the area of tax policy. Supply-side tax policy is the term frequently used in categorizing the resulting tax law changes.<sup>28</sup>

According to Keynesian doctrine, employment and economic growth are determined by aggregate demand. Unemployment and low rates of economic growth are caused by insufficient spending. Thus, conventional Keynesian economics requires governments to manage aggregate demand by using fiscal policy to influence the spending of consumers, businesses, and governments. During the late 1970s, when many western economies were suffering from stagflation—high rates of

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<sup>26</sup> Many popular books on current affairs trace the influence of neoconservatism in Canada. See in particular, R. C. Allen & G. Rosenbluth, eds., *False Promises: The Failure of Conservative Economics* (Vancouver: New Star Books, 1992); M. Barlow & B. Campbell, *Take Back The Nation* (Toronto: Key Porter Books, 1991); D. Drache & H.J. Glasbeek, *The Changing Workplace: Reshaping Canada's Industrial Relations System* (Toronto: Lorimer, 1992); M. Hurtig, *The Betrayal of Canada*, 1st ed. (Toronto: Stoddart, 1991); S. McBride, *Not Working: State, Unemployment, and Neo-Conservatism in Canada* (Toronto: University of Toronto Press, 1992); L. McQuaig, *The Quick and the Dead: Brian Mulroney, Big Business and the Seduction of Canada* (Toronto: Viking, 1991); and J.W. Warnock, *Free Trade and the New Right Agenda* (Vancouver: New Star Books, 1988).

<sup>27</sup> G. Gray [a pseudonym for Ken Battle], “Social Policy by Stealth” (1990) 11:2 Policy Options 17 at 17.

<sup>28</sup> Writing books on supply-side economics became a cottage industry among many of the entrepreneurs who made up the school. A search of Yorkline, the York University library computer base, turned up sixteen books on “supply-side economics,” all written between 1979 and 1984. Two of the leading texts are P.C. Roberts, *The Supply-Side Revolution* (Cambridge: Harvard University Press, 1984); and Wanniski, *supra* note 22.

unemployment and high rates of inflation—supply-side economists stepped in and argued that the preoccupation of Keynesians with demand had blinded them to the need for analyzing the effect of changing tax rates on productivity, investment, and incentives to work. They argued that instead of concentrating on demand, governments should concentrate on increasing the supply of goods and services. Elementary economics teaches that if aggregate supply can be increased, there will be higher real output and lower prices. Although supply-side economics addresses all aspects of aggregate supply, it focuses particularly on the appropriate role of government in encouraging growth through its taxation policies. The neoconservatives argued that a significant supply-side effect could be achieved through tax policies aimed at reducing the tax burdens on the rich and businesses so that the rich would have an incentive to work harder and save more, and so that businesses would have a greater incentive to invest.

There were actually three versions of supply-side economics: a modest version, a more ambitious version, and an extreme version. The modest version only claimed that the level and growth rate of output could be significantly increased through policies designed to promote a greater willingness to work and a greater willingness to save and invest. Although tax revenues would decrease, tax cuts were said to be the most effective instrument for increasing real output in this way.

The more ambitious version of supply-side tax policy asserted that a reduction in tax rates, not offset by an equivalent reduction in government spending, would increase real output enough to actually increase tax revenues even with lowered rates. The well-publicized Laffer curve was the major analytical tool that the supply-side school used to demonstrate this point. The curve was based on the logical premises that, at a zero rate of tax there would be no tax revenues, and at a 100 per cent rate no one would be silly enough to work, and, therefore, there would be no revenues at this high rate of tax either. It was also based on the empirical premise that the rate of tax in most industrialized countries was so high that it intersected the curve graphing the relationship between tax revenues and tax rates on the slope moving downward to zero at 100 per cent. That is, this theory assumed that existing high taxes had such a strong disincentive effect that, as high-income individuals reduced their work effort and savings behaviour, the tax base had shrunk to such a degree that the revenues it produced declined. Consequently, by reducing tax rates, tax revenues would actually increase as individuals worked harder, saved more, and businesses invested more.

An even more extreme version of supply-side economics, popular within the Reagan administration in the early 1980s, maintained that inflation could be stopped without unemployment by utilizing tax rate cuts to increase aggregate supply. Proponents of this version argued that, since inflation was simply the excess of aggregate demand over aggregate supply, there was no need to use Keynesian demand constriction, creating a recession, when supply could be painlessly increased. This version was called "voodoo" economics in 1980 by George Bush because of the magnitude of the effects required. Parenthetically, in the 1988 election, Bush embraced that economics and won the presidency. Although the basic tenets of supply-side tax policy were frequently ignored in justifying the tax policies of the Conservative government, Canadians were spared the more extreme versions.

### III. CHANGING OBJECTIVES OF THE TAX SYSTEM

In thinking about the role of government, and therefore the objectives of the tax system, economists start by assuming, or purporting to demonstrate, that competitive private markets are capable of functioning in a highly satisfactory way without government intervention and, thus, without taxation. In perfect competition, the actions of people pursuing their personal desires in free markets solve the problems of production, distribution, and exchange. Production will take place in the most efficient manner possible as producers compete for customers; distribution will reward those who satisfy the desires of others; and exchanges will always be fair because each party to a transaction must benefit or else they would refuse to deal.

Economists admit that in some cases markets will fail because: some goods and services have characteristics, which make them unsuitable for market provision; the market distribution of resources might not be socially desirable; and markets do not always stabilize at full employment or stable prices. Thus, the role of government is to intervene in the economy<sup>29</sup> in order to: (1) provide goods and services that are not allocated efficiently in free markets such as national defence

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<sup>29</sup> These are Musgrave's traditional three budget functions, which he brilliantly synthesized in 1959: R.A. Musgrave, *The Theory of Public Finance: A Study in Public Economy* (New York: McGraw-Hill, 1959). This conceptualization of government functions has been subject to numerous criticisms. See, for example, W.I. Gillespie, "Government Taxing and Spending Policy: Discarding the Mythology of the Multiple Budget Approach," (1981) 3 *Can. Taxation* 38. However, Musgrave is still persuaded of its utility and it still forms the basis of most economic and public policy texts. See R.A. Musgrave, "The Three Branches Revisited" (1989) 17 *Atlantic Econ. J.* 1.

and education—frequently referred to as the government's allocative function; (2) change the pattern in the distribution of resources that results from market forces and, in particular, raise the share of national income going to the poor—the government's distributive function; and (3) stabilize the economy at full employment and level prices (or close thereto)—the government's stabilization function. If the government corrected for these market failures, traditionally, economists were content to leave the rate of output growth in the economy to market forces. However, in recent years, at the urging of business groups, economic growth has achieved the status of a fourth goal of government intervention in the economy, and has even been elevated to the most significant aim.

In discharging these four functions, the government has a wide range of policy instruments available to it: direct regulation, credit controls, subsidies, nationalization, social control of monopolies, and so on. Tax law remains, however, one of the state's most potent policy tools. Thus, the ultimate goal of the tax system is to assist the government in achieving its broad economic and social goals. Consequently, in attempting to understand the changing structure of the tax system, it is useful to examine how the prevailing views of the government's responsibilities for discharging these four functions have changed, and what implications these changes have had on the structure of the tax system.

#### *A. The Role of the Tax System in Reallocating Resources*

One important role of government is to provide (or encourage or discourage the production of) goods and services that the private market fails to provide efficiently. Sometimes the market fails as a mechanism for the production and distribution of a good or service because of the nature of the particular commodity. For example, the market operating alone cannot provide the optimal amount of goods that must be consumed jointly, such as self defence and street lighting, because those who do not pay the market price cannot be excluded from benefitting from them. Also, when activities undertaken by consumers or producers generate significant benefits (or externalities) to those other than themselves, such as an inoculation against a communicable disease, the market will fail as a planning mechanism. In other instances the market fails as a planning mechanism not because of the nature of the good or service in question but because of the tendency in some markets for natural monopolies or wasteful competition. Traditionally, textbooks on



public sector economics have devoted a good deal of space to the identification of various “market failures” and therefore the justifications for government intervention in the allocation of goods and services in society.

The government can use the tax system in a number of ways to assist in discharging its allocation function; however, most importantly, the tax system is used as an instrument to raise revenue to finance government expenditures necessary for the purchase of public goods and services, such as defence, education, and health services.<sup>30</sup> Neoconservatives launched a two-pronged attack on this function of government. First, they argued that the so-called market failures identified by liberals were not nearly as serious as had been contended. And even where such market failures existed, there were normally market solutions to them.

Secondly, and more significantly, neoconservatives directly questioned the government’s ability to deal with the misallocation of resources caused by failures in private markets. Although this theme has roots in classical political economy, in the 1970s, it developed into a distinct strand of theory and research called “constitutional economics” (or neo-Hobbesian public finance by some), of which public choice is an important subdiscipline.<sup>31</sup> This economic subdiscipline does not predict the economic effect of, for example, one particular tax rule as compared to another evaluated in light of some presumed social welfare function. Instead its main concern is predicting ultimate political choices, given existing institutional arrangements, that will be made if one rule is chosen over another, and evaluating these in light of what rules would have been chosen if the government were a perfect agent of its citizenry. Two particular lessons constitutional economists draw from the past have legitimated the attack on the government’s ability to discharge its allocation function. First, they argue that simply because a market failure is identified does not mean that government action will necessarily make things better. In traditional public finance theory, when conditions under which “markets fail” were identified, economists

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<sup>30</sup> Since the government can raise revenue simply by printing money or borrowing it, it is technically more correct to say that the purpose of taxation is to reduce private consumption and investment so the state can provide public goods and services without causing inflation, or balance-of-payments difficulties.

<sup>31</sup> See, for example, H.G. Brennan & J.M. Buchanan, *The Power to Tax: Analytical Foundations of a Fiscal Constitution* (Cambridge: Cambridge University Press, 1980) and *The Reason of Rules: Constitutional Political Economy* (Cambridge: Cambridge University Press, 1985); and, J.D. Gwartney & R.E. Wagner, eds., *Public Choice and Constitutional Economics* (Greenwich, Conn.: JAI Press, 1988).

called for government intervention to correct these failures. Constitutional economists, however, caution that often "politics fail," when judged by the same criteria used to identify market failures.<sup>32</sup> The reasons for the systematic failure of government are said to include the impossibility of predicting and controlling the ultimate economic consequences of government intervention and the effect of unintended incentives that distort the behaviour of government agencies.<sup>33</sup> Consequently, government intervention often leads to greater inefficiencies than those created by the identified market failures. Thus, the identification of a market failure is a necessary but not a sufficient reason for government action.

Second, constitutional economists assert that the structure of democratic politics leads to uncontrolled state expenditures. This conclusion is supported both by a demand-side and a supply-side analysis. On the demand side, it is argued that citizens accept more than an optimal amount of government spending because they misperceive its true cost in taxes partly because of the complexity of the tax system. Also, well-organized but narrowly focused interest groups that stand to benefit from specific government programmes will invariably have a greater incentive to lobby for them than individual taxpayers will have to oppose them.

On the supply side, an analysis of how politicians and bureaucrats are likely to behave as normal, rational, self-interested agents is used to support predictions of a massive over-supply of government services. For example, constitutional economists point to

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<sup>32</sup> One usually reliable way of following fashions in economic analysis is simply to note revisions made to the most recent edition of Samuelson's *Economics*. In the sixth Canadian edition, a section on public choice was added and students were warned that "[f]or a realistic understanding of modern economics, it is crucial to understand public choice. Otherwise we may know about market failures like monopoly or pollution but be naively ignorant of the political failures that arise from attempted solutions to these problems." P.A. Samuelson, W.D. Nordhaus, & J. McCallum, *Economics*, 6th Can. ed., (Toronto: McGraw-Hill Ryerson, 1988) at 714. Parenthetically, a recent review of introductory economic textbooks applauds Samuelson for softening the traditionally strong interventionist tone of his text. See T.J. DiLorenzo, "Classroom Struggle: The Free-Market Takeover of Economics Textbooks" (1987) 40 *Policy Review* 44.

<sup>33</sup> A vast literature is developing on government failures in which economists apply microeconomic theory to supply and demand in the public sector in much the same way they traditionally applied it to demand and supply processes in the private sector of the economy. Joseph Stiglitz, in his basic text on public finance, summarizes the systematic failures of governments to achieve their stated objectives under the following four headings: the government's limited information and ability to predict the consequences of its actions, its limited control over private response to its policies, its limited control over implementation by the bureaucracy, and the role of special interest groups in this political process. J. Stiglitz, *Economics of the Public Sector*, 2d ed., (New York: W.W. Norton, 1988) at 5-6.

the tendency of politicians to make decisions, which provide short-run obvious benefits at the expense of long-run hidden costs; the numerous incentives for politicians to support special interest groups; the fact that majority voting does not always lead to what is in the public interest because of the problem of the oppressive majority (in some situations, the majority will benefit but not by as much as a minority will lose); the voting paradox (in which majority voting leads to no clear winner); and log-rolling (in which one politician votes for a policy supported by another because that politician will return the favour). Also, they point to all the problems of bureaucracy, including the difficulty of controlling and evaluating a department's performance and the tendency for the government bureau and its budget to expand. Finally, they note the difficulty of reversing inefficient public expenditures.

Based in part upon these so-called advances in public sector economics, the neoconservatives have preached the doctrine of monetarism, the privatization of government services, the deregulation of private industry, the reduction of social security programmes, and the imposition of constitutional limits on what democratically elected governments can do in the field of economic policy. Most western industrial countries have shown a commitment to virtually all elements of this programme.<sup>34</sup>

This changed view of the government's allocative role had a number of tax law implications. First, and most obviously, it became more difficult for governments to raise taxes. Citizens were sceptical about the value of the goods and services their tax dollars were buying and became more hostile to paying taxes. Tax revolts and the threat of such occurrences became common in many industrialized countries. Partly reflecting this increased resistance to tax increases, between 1987 and 1989, total tax revenues as a percentage of gross domestic product (GDP) in the average industrialized country increased by only 0.1 per cent per annum. In the previous twenty years, it had increased about 0.5 per cent per annum.<sup>35</sup>

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<sup>34</sup> See OECD, *Economies in Transition: Structural Adjustment in OECD Countries* (Paris: OECD, 1989), which reviews the key structural adjustments that OECD countries have made in their microeconomic policies over the past decade.

<sup>35</sup> OECD, *Revenue Statistics of OECD members, 1965-1991* (Paris: OECD, 1992), Table 3. In Canada, taxes as a percentage of GDP dropped from 34.8 per cent in 1987 to 34.6 percent in 1988 but since have increased to an estimated 39.4 per cent in 1991, *ibid.*, Table 112. The explanation for this increase in tax revenues is that the Canadian government is attempting to reduce a large deficit brought on in large part by a fall in revenues in the late 1970s (tax revenues declined from 33.2 per cent of GDP in 1974 to 30.6 per cent in 1979) and a high interest rate policy in the late 1980s, which added substantially to government debt servicing charges. See H. Mimoto & P. Cross, "The Growth

Second, public disenchantment with the government sector has led to an increase in the use of tax and expenditure limits that will render further expansion of the public sector more difficult in the future. Between 1978 and 1982, almost twenty U.S. state governments enacted various forms of limits on tax revenue or the maximum allowed level of expenditures.<sup>36</sup> At the federal level, Congress passed the *Balanced Budget Act*, frequently referred to as the *Gramm-Rudman-Hollings Act*, in 1986.<sup>37</sup> The *Act* established targets for deficit reduction that if not reached, would require across-the-board expenditure cuts.

In Canada, there has been pressure for governments to enact tax and expenditure limits. In its February 1991 budget, the federal government announced the imposition of "mandatory, legislated limits on annual program spending over the next five years."<sup>38</sup> Undoubtedly, in the near future, if the neoconservative ideology prevails, discussions of tax limits will become increasingly common.

Third, the view that the political process overextends the public sector has manifested itself in the area of tax law through more frequent calls for the earmarking of taxes. Public choice scholars argue that identifying taxes with defined parts of public spending can assist in achieving a closer assessment of individual preferences for particular government services.<sup>39</sup>

A disingenuous attempt at earmarking, although it is perhaps a harbinger of things to come, was made by the federal government in its February 1991 budget. The government announced the establishment of a Debt Servicing and Reduction Fund into which all revenues from the recently enacted Goods and Services Tax (GST) would flow. This measure is almost entirely symbolic since total GST revenues will amount to only about half of what the government must pay annually to service the debt. However, presumably it was enacted to enable the government to argue that the proceeds of the tax are being used solely for deficit

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of the Federal Debt," (June 1991) 4 Can. Econ. Observer 3.1.

<sup>36</sup> See R.C. Fisher, *State and Local Public Finance* (Glenview, Ill.: Scott, Foresman and Co., 1987) at 439 ff.

<sup>37</sup> *Balanced Budget and Emergency Deficit Control Act of 1985*, Pub. L. No. 99-177, 99 Stat. 1038, 2 U.S.C.S §§ 900-22 (1993) at §902 (*Gramm-Rudman-Hollings Act*).

<sup>38</sup> For a description and analysis of the Act see Sixth Report of the Standing Committee on Finance, "Proposed Spending Control Act," House of Commons, Minutes of the Proceedings and Evidence of the Standing Committee on Finance, Issue No. 26, 26 November 1991. For a general discussion of the case for tax and spending limits in Canada, see H.G. Grubel, "Constitutional Limits on Government Spending Deficits and Levels in Canada" in H.G. Grubel *et al.*, *Limits to Government: Controlling Deficits and Debt in Canada* (Toronto: C.D. Howe Institute, 1992) 1.

<sup>39</sup> See generally, R. Teja & B. Bracewell-Milnes, *The Case for Earmarked Taxes: Government Spending and Public Choice* (London: Institute of Economic Affairs, 1991).

reduction and not for some unworthy purpose, such as increased social programme spending.

These general directions in tax policy relating to the government's allocation function will make it more difficult, in the long run, to support a vital and effective public sector. This situation will serve to accommodate the rich since, generally, government programmes leave working people healthier, better educated, more secure, and better buffered against business threats and thus, increasingly able to win a fair share of national income in the future. That is, government expenditures not only change the way national income is distributed today, but they also change the relative balance of power between workers and capitalists, which slightly reduces the private economic power of business.

In addition to raising revenue to finance government spending, the tax system can be used to change directly the market price of goods and services and, therefore, to reallocate resources. If the government wishes to encourage the production or consumption of a particular good or service, which the free market does not adequately supply, it can lower the cost of such a commodity by providing a tax deduction or credit to producers or consumers of the good. Such tax provisions are now widely known as tax expenditures.

As part of its tax reforms in the late 1980s, the Conservative government broadened the income tax base by reducing tax expenditures. For example, as part of the 1987 tax reform exercise, it repealed the \$500 employment expense deduction, the \$1,000 investment income deduction, a number of accelerated capital cost allowances, and the general investment tax credit. To further increase the neutrality of the individual income tax, the government also converted a number of tax deductions into tax credits: the basic personal exemption, the married and equivalent-to-married exemption, the exemption for supporting child dependents, the age exemption, the disability exemption, the \$1,000 pension income deduction, the deduction for contributions to the Canadian Pension Plan and premiums for unemployment insurance, the deduction for medical expenses, the deduction for tuition fees and the \$50 a month deduction as an educational allowance, and the deduction for contributions to charitable donations.

Converting tax deductions into credits would appear to make the tax system more progressive since tax expenditures delivered as deductions benefit high-income taxpayers more than tax expenditures delivered as credits. A deduction reduces a citizen's taxable income and, therefore, the amount of tax that is saved is related to the taxpayer's

marginal tax rate. The higher the taxpayer's marginal tax rate, the greater the savings. A tax credit, in contrast, is deducted directly from a taxpayer's tax owing and therefore saves all taxpayers the same amount regardless of their income and their marginal tax rate.

The rich have been the primary beneficiaries of the subsidies delivered through the tax system. Therefore, reducing these subsidies, or converting them from tax deductions to tax credits, might appear to be, not only consistent with free market ideology, but also equitable. However, when these changes were made, the rich were accommodated in two ways. First, although converting tax expenditures from deductions to credits reduced their value to high-income taxpayers, the rich were more than compensated for this loss through marginal tax rate reductions. Indeed, the government was careful to ensure that all the changes taken together—the base-broadening measures and the rate reductions—would be distributionally neutral.

Although on its face reducing tax rates in order to compensate for the repeal of tax expenditures or their conversion to credits might appear fair, in fact it results in a reduced tax burden on the rich. As explained above, tax expenditures are essentially spending programmes. If they are repealed or changed because they are inequitable, why should the former recipients have their income taxes reduced in order to make up for the loss of their subsidies? Perhaps this point can be clarified by noting that tax expenditures were not placed in the *Income Tax Act*<sup>40</sup> to increase the equity of the tax system. In fact, most commentators conceded that the repealed and converted tax expenditures were not fair but that they were enacted to achieve other social or economic goals. However, lowering tax rates for the beneficiaries of such subsidies when they are removed or converted to credits, would appear to rest upon the implicit premise that these tax expenditures were equitable. Arguably, reducing the taxpayer's tax liability at the same time as repealing an inequitable subsidy programme or tax expenditure from which the taxpayer benefitted simply legitimizes the inequities that were inherent in the subsidy programme.

The rich were also accommodated in this part of the tax reform exercise because four tax expenditures that primarily benefit the rich were not repealed or converted to credits: the child care expense deduction, the deduction for investments in flow-through shares, the capital gains exemption, and the deduction for contributions to various registered pension plans. Indeed, the tax expenditures that were repealed—such as the \$500 employment expense deduction and the

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<sup>40</sup> R.S.C. 1952, c.148.

\$1,000 investment income deduction—benefitted primarily low- and middle-income taxpayers.

A final way the government can use the tax system to affect the allocation of resources is by imposing excise taxes on those goods and services it wishes to discourage. This is commonly done when the good or service has obvious external costs, such as cigarettes or tobacco. Many commentators, and even the Canadian government, have suggested that additional excise taxes should be imposed on a broad range of goods that harm the environment. This might appear to be a reassertion of the government's allocative function, however, these taxes are generally less intrusive than alternative instruments for preventing environmental degradation, such as regulation, and are generally seen as consistent with a free-market philosophy. Moreover, since they fall on consumption, the poor inevitably pay a larger percentage of their income in excise taxes than the rich.

#### *B. The Role of the Tax System in Redistributing Income*

Most economists justify private markets on the grounds that they are the best way of organizing economic life in order to maximize the production of goods and individual freedom of choice. Only a few defend the market's ability to achieve a just distribution of income. Therefore, most economists are prepared to assign some role to government in achieving the socially preferred distribution of resources—in most cases redistributing resources from rich to poor. (There have been few serious claims that the economy, absent government intervention, generates too much income equality.)

The government's redistributive function might embrace one or both of two different conceptions. Stated in the form of questions, they are: (1) to what extent should the government raise the living standards of low-income individuals or families? and (2) to what extent should the government attempt to reduce the inequalities between the rich and poor by reducing the income and wealth of the rich? Even though there are different views about the fundamental purpose of assisting the poor,<sup>41</sup> the fact that the government should do so is not in dispute. The question as to what extent the state should attempt to equalize incomes has been much more contentious.

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<sup>41</sup> For a discussion of the different conceptions of the welfare state, see T.R. Marmor, J.L. Mashaw & P.L. Harvey, *America's Misunderstood Welfare State: Persistent Myths, Enduring Realities* (New York: Basic Books, 1990) at c. 2.

The state's redistributive aims involve basic value judgments about the nature of a "good society," which remain unsettled. However, it seems fair to assert that during the 1950s and 1960s, it was widely believed that the tax system should be used to control an undue concentration of income and wealth. Neoconservatism shattered any existing consensus. One of the most successful assaults neoconservatives have launched against the welfare state has been their efforts to reduce the progressivity of the income tax system. For a number of reasons this is not surprising. First, tax policy is quintessentially a matter of class politics, and progressive tax rates are, at least symbolically, a minor victory for the masses. Irrespective of their actual effects, ideologically, progressive tax rates have always irritated conservatives. Although the quotations are well known, it is worth repeating at least one famous acknowledgement regarding the class nature of progressive tax rates, particularly since neoconservatives attempt to obscure this fact by arguing that reduced tax rates are a matter of economic imperative, not political choice.<sup>42</sup> Karl Marx, the greatest authority on the class struggle, asserted that taxation was "the oldest form of class struggle."<sup>43</sup> Marx's well-known endorsement of progressive taxation as an instrument for achieving a communist state has ensured that in any political debate on progressivity, class politics is only slightly below the surface.<sup>44</sup>

A second reason why neoconservatives turned their attention to progressive taxation is that, while advocates of social security programmes were placed on the defensive in the 1970s, these programmes proved surprisingly resilient against neoconservative attacks. Tax reductions, by contrast, generally attract widespread public support. Thus, by cutting taxes and reducing the progressivity of the rates, neoconservatives hoped that the resulting deficits would bring

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<sup>42</sup> For an excellent article tracing the tax debate over the last century from acknowledged, bitter class struggle at the turn of the century to apparent investment-dependant logic in which everyone benefits from reducing burdens on the rich in the 1960s, see R.F. King, "From Redistributive to Hegemonic Logic: The Transformation of American Tax Politics, 1884-1963" (1983) 12 *Pol. and Soc.* 1. See also J.E. Cronin & T.G. Radtke, "The Old and New Politics of Taxation: Thatcher and Reagan in Historical Perspective," in R. Miliband, L. Panitch & J. Saville, eds., *supra* note 20 at 263.

<sup>43</sup> Karl Marx, as quoted in J. O'Connor, *The Fiscal Crisis of the State* (New York: St. Martin's Press, 1973) at 203. O'Connor, *ibid*, affirmed that "[e]very important change in the balance of class and political forces is registered in the tax structure. Put another way, tax systems are simply particular forms of class systems."

<sup>44</sup> For particularly fanatical charges linking progressive rates with communism see D.A. Wells, "The Communism of a Discriminating Income Tax" (1880) 130 *North America Rev.* 236 and, S.B. Pettengill, "The History of a Prophecy: Class War and the Income Tax" (1953) 39 *A.B.A.J.* 473.



indirect pressure on spending programmes.<sup>45</sup> Despite the Reagan administration's rhetoric, the tax cuts in the United States in 1981 were not driven by the claims of supply-side advocates so much as by a ploy to halt expansion of government spending—the Administration planned to cut taxes, let budget deficits spiral, and then force the U.S. Congress to come to grips with spending cuts.<sup>46</sup> It was well understood that the strategy would require at least a doubling of the deficit, and, given the fact that Reagan had promised to reduce the deficit, it was a bold gambit that underscores how desperate the administration was to eliminate government spending programmes.<sup>47</sup>

Three factors made progressive tax rates particularly vulnerable to attack. First, inflation, along with the fact that the tax system was unindexed, led to “bracket creep,” which meant that during the period of high inflation in the 1970s, many middle-income taxpayers were automatically boosted into higher tax-rate brackets, even though their real incomes remained constant or even declined. Thomas Edsall, along with other commentators, has noted that because of bracket creep, the progressive tax rate system “was no longer separating the very rich from the majority of taxpayers” and it therefore, created “a strong base of deep, anti-tax sentiments” among the working and middle classes.<sup>48</sup> Thus, the political issue of taxes was “one of the most volatile of all questions facing politicians.”<sup>49</sup> The increasing tax burden on the middle class presumably led many voters to conclude that tax levels must be increasing dramatically, even though in most countries there was little increase in public spending in the 1970s. This presumably contributed to the belief that this was one reason for stagnating economic growth. It is somewhat ironic that the effect of inflation on the distribution of the tax burden, which arguably increased tax inequity, would serve the

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<sup>45</sup> The new right also hoped that a less progressive tax system would make it more difficult to raise taxes in the future. For example, Richard Epstein, a legal scholar from the University of Chicago, argues that one virtue of a flat rate tax is that “[a] rule that says you must pay a dollar for the dollar that you wish to exact from your neighbour is not a perfect safeguard against political intrigue, but it acts as an effective constraint.” R.A. Epstein, “Taxation in a Lockean World” (1986/87) 4 Soc. Philosophy & Pol. 49 at 70.

<sup>46</sup> See F. Block “Rethinking the Political Economy of the Welfare State” in *The Mean Season*, *supra* note 5 at 109 and at 137.

<sup>47</sup> See R.S. McElvaine, *The End of the Conservative Era: Liberalism After Reagan* (New York: Arbor House, 1987) at c. 3.

<sup>48</sup> T.B. Edsall, *The New Politics of Inequality* (New York: W.W. Norton, 1984) at 211.

<sup>49</sup> *Ibid.* at 213.

neoconservative's crusade to make the tax system even more regressive.<sup>50</sup>

A second factor that made progressive rates particularly vulnerable to an attack by neoconservatives was the fact that the 1960s and 1970s were periods of intense examination of the income tax system, and proposals for its reform were rampant. In arguing for lower tax rates, the new right was able to hijack, therefore, a tax reform movement, which had already gained considerable momentum. The liberal reformers who lead the tax reform movement in the 1960s were pushing primarily for a broadened tax base and increased tax simplicity. In hijacking the movement, the new right argued that rate reductions were a logical, or at least a politically necessary, corollary to base broadening, and that simplicity would be greatly facilitated with a flatter rate structure. Indeed, within their arguments for lowering tax rates, the conservatives embraced virtually every problem the liberal reformers had identified. Typical of the hyperbole is a statement by Australian economist, R.L. Matthews, "Nearly all the factors which inhibit horizontal equity, neutrality, simplicity, certainty, and tax effectiveness ... have their origin in the attempt to use progressive income taxes as the means of the achievement of income redistribution."<sup>51</sup>

Parenthetically, it should be noted that liberal tax reformers left their reform movement open to co-optation because they adopted a particular political strategy with respect to base broadening. In addition to showing how much revenue could be raised for social programmes by broadening the tax base, reformers also frequently emphasized how much tax rates could be lowered if revenue-neutrality was supported.<sup>52</sup> Although this latter outcome was not the liberal reformers' first policy choice, its repeated demonstration made it easy for neoconservatives to link politically base broadening to rate reductions.

Finally, neoconservatives were able to use recent findings by conservative economists to support their pervasive attack on progressive taxes. In the late 1970s and early 1980s, conservative economists argued that: (1) resources were much more equally distributed than previously supposed; (2) the tax system was more redistributive than previously believed; (3) increased government intervention in the economy over the

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<sup>50</sup> See R. Kuttner, *The Economic Illusion: False Choices Between Prosperity and Social Justice* (Boston: Houghton Mifflin, 1984) at 189-90.

<sup>51</sup> R.L. Matthews, "Tax Reform in English-Speaking Countries" (1988) 6 *Environment and Planning C: Government and Policy* 1 at 4.

<sup>52</sup> The first article of this genre was J.A. Pechman, "Erosion of the Individual Income Tax" (1957) 10 *Nat'l Tax J.* 1.

last thirty years did not significantly contribute to greater equality in the distribution of income; and (4) any small increase in equality that had been achieved was won at a much greater cost to efficiency and lost output than had been anticipated.

To provide a sense of how thorough the rethinking of traditional tax policy analysis was, and how supportive the findings were of the neoconservative agenda, a few of the numerous studies done during this period will be mentioned here. Traditionally, studies showing the distribution of the tax burden across income classes, such as those undertaken by Joseph Pechman and Benjamin Okner<sup>53</sup> in the United States, and Irwin Gillespie<sup>54</sup> in Canada, concluded that overall, the tax system was proportional or somewhat regressive. This result was reached partly because both the sales and property taxes were considered regressive. The steeply progressive rates of the income tax, at most, balanced out the effect of these regressive taxes. In the late 1970s and early 1980s, a series of studies purported to show that the tax system was much more progressive than previously believed and, therefore, it was argued, income tax rates did not have to be as steep in order to achieve the government's redistributive goals.

The conventional assumption in incidence studies was that sales taxes were borne by individuals on the uses or spending side of their budgets, in proportion to their consumption of taxed commodities. In 1978, in a study frequently cited by neoconservatives, Edgar Browning argued that sales taxes were in fact more likely to fall on factor incomes—on wages and profits on the sources side of one's budget.<sup>55</sup> He makes two key arguments to support this claim. First, transfer income from the government is indexed, and thus, rises to compensate transfer recipients fully for the imposition of sales taxes. Since wages and profits do not adjust in a corresponding manner, persons who derive their income from factor payments will see the real value of their income reduced by the full increase of the tax. Not surprisingly, since the ratio of factor income to total income increases dramatically as income increases, this approach yields a progressive pattern of incidence for the sales tax.

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<sup>53</sup> J.A. Pechman & B.A. Okner, *Who Bears the Tax Burden?* (Washington: Brookings Institution, 1974).

<sup>54</sup> W.I. Gillespie, *The Redistribution of Income in Canada* (Agincourt, Ont.: Gage, 1980).

<sup>55</sup> E.K. Browning, "The Burden of Taxation" (1978) 86 J. of Pol. Econ. 649. See also, E.K. Browning & W.R. Johnson, *The Distribution of the Tax Burden* (Washington: American Enterprise Institute, 1979); E.K. Browning, "Reply to Professor Due" (1986) 39 Nat'l Tax J. 541; and E.K. Browning, "Tax Incidence, Indirect Taxes, and Transfers" (1985) 38 Nat'l Tax J. 525.

Browning's second argument in presenting sales taxes as progressive is that it is wrong to assume, as the traditional sales tax incidence studies do, that high-income families will not pay sales tax on their savings. They will obviously not pay sales tax on their saved income in the year it is earned; however, they will pay the tax when they eventually consume their savings plus the interest it has earned. Therefore, on a discounted present-value basis, savings and consumption bear the tax equally, justifying his result.

In a related attempt to show that the sales tax was not as regressive as previously thought, other commentators argued that its incidence should be considered with respect to life-cycle consumption, rather than consumption in a single period. In a pioneering study, Jim Davies, France St-Hilaire, and John Whalley developed a micro-simulation model of lifetime distribution and tax burdens.<sup>56</sup> They argued that much of the observed regressivity in commodity-based and other forms of tax are due to the fact that consumers, in different periods of their lives, spend quite different proportions of their income. If an individual's lifetime expenditure equals lifetime income, then over that person's life, a broadly based commodity tax will lose much of its regressivity.

Traditionally, the property tax was seen as also falling on the uses side of the household budget, and was considered highly regressive since the consumption of housing services represents a larger share of a low-income family's budget than that of a high-income family. Following the work of Peter Mieszkowski<sup>57</sup> and Henry Aaron,<sup>58</sup> a "new" view emerged suggesting that property taxes were borne almost entirely by capital income. This new view implies that the property tax is less regressive, and may even be progressive, since the burden of the tax is assigned to recipients of capital income on the sources side.

This is not the place to assess the merits of the claims that the sales tax and the property tax are somewhat progressive, and by implication, that the income tax does not have to be as progressive to achieve the desired degree of redistribution. My point here is simply to provide an illustration of how academic economists provided support for

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<sup>56</sup> "Some Calculations of Lifetime Tax Incidence" (1984) 74 Am. Econ. Rev. 633. See also, J. Whalley, "Innis Lecture: Regression or progression: the taxing question of incidence analysis" 17 Can. J. of Econ. 654.

<sup>57</sup> P. Mieszkowski, "The Property Tax: An Excise Tax or a Profits Tax?" (1972) 1 J. of Public Econ. 73.

<sup>58</sup> H.J. Aaron, *Who Pays the Property Tax: A New View* (Washington: Brookings Institution, 1975).

the neoconservative assault on the state. Suffice it to say that both these reinterpretations of the incidence of the sales and property taxes have been subject to extensive criticism.<sup>59</sup>

Proponents of progressive taxation in the 1950s and 1960s buttressed their case for using the tax system to achieve a more equitable distribution of income by asserting that taxes on the rich had little effect on their behaviour. They argued that taking one dollar from the rich and giving it to the poor was relatively costless in terms of economic output or welfare. Studies on the allocative effects of taxes, such as the seminal work done by Harberger in the early 1960s,<sup>60</sup> suggested that the efficiency or dead weight losses created by the tax system were only in the order of 1 per cent of the gross national product (GNP).

In the late 1970s and early 1980s, a number of studies argued that increased attention should be paid to the excess burden of taxes in measuring the tax burden. They substantially raised previous estimates of the efficiency loss caused by government redistributive activity. These studies implied that taxes have a significant effect on taxpayers' labour supply, savings behaviour, and investment decisions. Therefore, the tax system imposes a substantial loss on taxpayers in addition to the amount of revenues the government collects. This "excess burden" (or dead weight or welfare loss) arises because taxpayers change their behaviour in response to tax and therefore reduce their welfare and the economic output of the economy.

A number of studies undertaken in the 1970s estimated the welfare cost of taxes to be five to ten times greater than that estimated by Harberger, anywhere from 5 to 10 per cent of GNP.<sup>61</sup> To make the losses caused by tax distortions appear to be even more imposing, researchers began expressing them as a percentage of revenue collected instead of the gross domestic product (GDP). In a 1985 study, Charles Ballard, John Shoven, and John Whalley estimated that the welfare loss

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<sup>59</sup> For a review of the extensive criticism of the Browning view of the sales tax, see N. Brooks, *The Canadian Goods and Services Tax: History, Policy, and Politics* (Sydney: Australian Tax Research Foundation, 1992). For a review of the criticisms of the "new" view of the property tax, see R.M. Bird, "The Incidence of the Property Tax: Old Wine in New Bottles?" (1976) 2 *Can. Public Pol.* 323.

<sup>60</sup> See essays in A.C. Harberger, *Taxation and Welfare* (Boston: Little, Brown, 1974).

<sup>61</sup> These studies are reviewed in F. St-Hilaire & J. Whalley, "Recent Studies of Efficiency and Distributional Impacts of Taxes: Implications for Canada" in W.R. Thirsk & J. Whalley, *Tax Policy Options in the 1980s* (Toronto: Canadian Tax Foundation, 1982) at 28. See also, J.B. Shoven & J. Whalley, "Applied General-Equilibrium Models of Taxation and International Trade: An Introduction and Survey" (1984) 22 *J. of Econ. Lit.* 1007.

of the U.S. tax system was in the range of thirteen cents to twenty-four cents per dollar of revenue collected.<sup>62</sup>

Of greater interest in terms of arguing against additional tax increases is the marginal welfare loss associated with taxes—the added amount of excess burden caused by a slight proportional rise in existing tax rates. In the mid-1980s, C.E. Stuart estimated that the marginal welfare loss from an added dollar of tax revenue on labour income was approximately 20 to 25 per cent of revenue raised in the United States, based upon pre-1976 estimates of labour supply responsiveness.<sup>63</sup>

The estimated welfare loss caused by taxes that are redistributed as transfers appears even more alarming than that caused by taxes alone since the labour supply effect on both taxpayers and transfer recipients must be considered. In a study frequently referred to, William Johnson and Edgar Browning developed estimates of the marginal cost of redistribution for a policy composed of equal per capita grants financed by a flat-rate tax on labour income. On the basis of their study, they estimated that it costs those in the upper quintiles of the income distribution \$3.49 in reduced economic well-being (a marginal efficiency loss of \$2.51 associated with a transfer worth \$1) when the U.S. tax and transfer system is used to increase the welfare of those in the lower income quintiles by one dollar.<sup>64</sup> Welfare losses of this magnitude are likely beyond most people's expectations. Would most people be willing to transfer an additional one dollar to the poor if they knew that this would involve reducing the well-being of upper-middle class people by \$3.50, that is to say, that for every one dollar transferred to the poor, \$2.50 of economic welfare was wasted?

In spite of the tentative nature of much of this new work on the welfare losses due to taxation, the shockingly large figures produced by economists, and their apparent precision, seem to have influenced policy-makers and are undoubtedly responsible, in part, for the recent trend of reducing marginal tax rates. Again, it is not my intention to assess this work. Needless to say, critics have found the estimates to be outrageously high.<sup>65</sup> Richard Goode, for example, recently concluded,

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<sup>62</sup> "The Total Welfare Cost of the United States Tax System: A General Equilibrium Approach" (1985) 38 Nat'l Tax J. 125.

<sup>63</sup> "Welfare Costs per dollar of Additional Tax Revenue in the United States" (1984) 74 Am. Econ. Rev. 352. See also, C.L. Ballard, J.B. Shoven & J. Whalley, "General Equilibrium Computations of the Marginal Costs of Taxes in the United States" (1985) 75 Am. Econ. Rev. 128.

<sup>64</sup> "The Trade-Off between Equality and Efficiency" (1984) 92 J. of Pol. Econ. 175.

<sup>65</sup> See, for example, G. Bartless & R. Haverman, "Taxes and Transfers: How Much Economic Loss?" (March/April 1987) Challenge 45.

after reviewing the shaky foundation of much of this work, that “at this stage quantitative estimates of welfare gains and losses due to tax provisions strike me as unhelpful for policy appraisal.”<sup>66</sup>

These findings of conservative economists, that the tax system was more progressive than previously supposed and imposed a substantially greater efficiency cost on the economy, lead to a profound shift in tax policy analysis. Tax issues tend no longer to be addressed in terms of how government services can be paid for in the fairest and most equitable fashion, but rather how they can be paid for with the least sacrifice to economic growth. This shift in tax policy has been noted by many commentators.<sup>67</sup> For example, the Royal Commission on the Economic Union and Development Prospects for Canada observed:

When the Royal Commission on Taxation (the Carter Commission) reported in 1966, one of the foremost goals of policy analysts was the establishment of a tax system that was equitable in its treatment of different groups. While equity remains an important goal, tax specialists now stress the need for a [tax] system that is calculated to encourage economic efficiency.<sup>68</sup>

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<sup>66</sup> R. Goode, “Lessons from Seven Decades of Income Taxation” in J.A. Pechman, *Options for Tax Reform* (Washington: Brookings Institution, 1984) 13 at 26-27.

<sup>67</sup> The most frequently cited account of the new orthodoxy and the evolution of tax policy advice is Charles McLure’s description in “The Evolution of Tax Advice and the Taxation of Income from Capital in the U.S.A.” (1984) 2 *Environment and Planning C: Government and Policy* 251 at 269 (“Tax economists have traditionally been more concerned with the distributional equity of taxes than with the distorting effects taxes can have on the allocation of resources. Recent theoretical and quantitative analysis suggests that the adverse allocative effects of tax-induced distortions of economic decisions may be greater than previously thought.”). For a summary of the literature see F. St-Hilaire & J. Whalley, “Recent Studies of Efficiency and Distributional Impacts of Taxes: Implications for Canada,” in W.R. Thirsk & J. Whalley, eds., *supra* note 61 at 28; and, B.G. Dahlby, “The Incidence of Government Expenditures and Taxes in Canada,” in F. Vaillancourt, research coordinator, *Income Distribution and Economic Security in Canada* (Toronto: University of Toronto Press, 1985) 111.

<sup>68</sup> *Report of the Royal Commission on the Economic Union and Development Prospects for Canada*, vol. 2 (Ottawa: Minister of Supply and Services Canada, 1985) at 206. This report reveals generally the pervasiveness of neoconservative ideology. The Commission was appointed in 1982 to report on “the appropriate national goals and policies for economic development.” The Commission relied heavily on briefs presented to it by business interests and studies done for it by more than 300 mostly conservative academics. It completely ignored the briefs presented to it by groups representing labour, farmers, women, the unemployed, the elderly, churches, and the poor. The Commission’s primary conclusion, not surprisingly, was that Canada needs to “significantly increase [its] reliance on market forces” in solving economic problems. *Ibid.*, vol. 1 at 66. Reviewers of all chapters of the Commission’s report in a special supplement to *Canadian Public Policy*, vol. 12, Feb., 1986, were unanimous in finding that the Commission championed a market orientation to social and economic problems. For a severe critique of the Commission’s report see D. Drache & D. Cameron, eds., *The Other Macdonald Report: the consensus on Canada’s future that the Macdonald Commission left out* (Toronto: J. Lorimer, 1985).

Also reflecting this trend was the Economic Council of Canada's decision to examine tax reform in 1984. It deliberately set aside questions relating to the redistribution of the tax burden and concentrated on the query, "How does the tax system affect the efficiency of the Canadian economy and our standard of living?"<sup>69</sup>

While these theorists might indeed be correct, and despite what was previously thought, the tax system *is* more redistributive than assumed and imposes larger costs on the economy; a number of other explanations, however, may also be offered to explain this trend in tax policy. They are, namely: the more general revival of economic liberalism; the relatively harder economic times in the 1970s and 1980s, which increased public concern for greater economic productivity; the increasingly technical bias of economic research;<sup>70</sup> or, simply the bias of economists themselves, who may be able to speak with authority on questions of economic efficiency, but who have no comparative advantage on questions of equity.<sup>71</sup>

Although the rich benefitted in many ways from the shift in emphasis from equity to efficiency, the most significant result of the neoconservatives attack on tax progressivity was the emergence of the flat-rate tax movement in the late 1970s. Its success, and failures, have been thoroughly chronicled.<sup>72</sup> The movement largely started in the United States, however, it quickly spread to other industrialized countries. In the early 1980s there was some public discussion of a flat-

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<sup>69</sup> Economic Council of Canada, *Road Map for Tax Reform: The Taxation of Savings and Investment* (Ottawa: Minister of Supply and Services Canada, 1987) at ix.

<sup>70</sup> Richard Musgrave has hypothesized that the change in emphasis from equity to efficiency concerns "may reflect the fact that efficiency considerations are more amenable to the exercise of technical tools, a practice that brings rewards to the young professional but may not be most helpful to a balanced view of reform." "Tax Reform or Tax Deform?" in W.R. Thirsk & J. Whalley, eds., *supra* note 61, 19 at 25.

<sup>71</sup> Robert Kuttner, in noting the claim that equality harms economic efficiency and that this claim largely underpins the resurgence of *laissez-faire* ideology, has observed: "It is convenient indeed for the wealthy and the powerful that economic recovery should depend on their further enrichment. Self-interest is successfully masquerading as a technical imperative. Ideology has appropriated the costume of value-free positive economics." Kuttner, *supra* note 50 at 2.

<sup>72</sup> See M.J. McIntyre, "Implications of U.S. Tax Reform for Distributive Justice" (1988) 5 *Austl. Tax Forum* 219 at 231-34 and articles cited there.



rate tax for Canada,<sup>73</sup> and business press and conservative think-tanks incessantly called for lower marginal rates.<sup>74</sup>

In response to these pressures, the Canadian government has substantially flattened the income tax rate structure. Prior to 1972, the Canadian income tax structure had fourteen brackets ranging from 6 per cent to over 80 per cent. In 1972, the top rate was reduced to about 63 per cent. Almost a decade later, the number of brackets had reduced to ten, with the top rate at about 53 per cent. The Conservative government's tax reform exercise in 1988 completely altered the tax rate structure. It now has only three brackets, and the top statutory combined federal and provincial rate is about 46 per cent.

### *C. The Role of the Tax System in Stabilizing the Economy*

For most of the last fifty years, the prevailing economic wisdom was that full employment and stable prices did not come about automatically in a market economy even if the government corrected for the misallocation of resources and inequalities in the distribution of income. In the absence of public policy guidance, market economies tended to be subject to substantial fluctuations, and could suffer from sustained periods of unemployment, inflation, or both.

The overall level of employment and prices depends upon the level of aggregate demand for consumer and investment goods relative to the potential output in the economy at prevailing prices. The level of aggregate demand depends, in turn, upon the spending decisions of individual consumers and investors. In the nineteenth century, classical economists argued that market economies would tend to move toward full employment. They assumed that, if consumers reduced their

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<sup>73</sup> The proposals are summarized in M.A. Walker, *On Flat-Rate Tax Proposals* (Vancouver: Fraser Institute, 1983). This interest was perhaps reflected in the fact that the Canadian Tax Foundation had a paper delivered at its 1982 annual tax conference on the flat-rate tax, although they invited an American to give the paper, see J.J. Minarik, "A Flat Rate Income Tax for Canada?" in Canadian Tax Foundation, *1982 Conference Report, Report of the Proceedings of the Thirty-Fourth Tax Conference* (Toronto: The Foundation, 1983) at 37.

<sup>74</sup> The Fraser Institute, Canada's most conservative think tank, has continually campaigned for a flat-rate income tax. See the testimony of the Director, Michael Walker, before the House of Commons, *Standing Committee on Trade, Finance and Economic Affairs*, No. 12:3 (2 December 1986). Another conservative think tank, the C.D. Howe Institute, has also called for drastically reduced rates. Its Vice President and Director of Policy, Edward A. Carmichael, testified before the House of Commons, "I believe there is some magic in lowering marginal tax rates that none of the models will ever capture, that is truly there." *Standing Committee on Finance and Economic Affairs*, No. 23:4 (26 January 1987) at 24.

spending, prices and then wages would fall as workers were laid off. This would raise the real value of people's savings and since they would feel richer, they would spend more, thereby raising employment. These economists also assumed that a flexible rate of interest would effectively equate the amount people saved with the amount others invested. As people increased their savings, the interest rate would fall and demand for capital investments would increase. Thus, while classical economists did not deny the existence of cyclical fluctuations in economic activity, they maintained that deviations from full employment and price stability were temporary and self-correcting.

The performance of western economies after World War I and, in particular, the prolonged depression of the 1930s, threw the assumption of inherent stability in a free market economy into question. John Maynard Keynes, in *The General Theory of Employment, Interest and Money*,<sup>75</sup> argued that aggregate demand, which is the chief determinant of the level of economic activity, might stabilize the economy at points other than full employment. He suggested, therefore, that government intervention in the economy was important in order to manage aggregate demand, and to ensure the economy was operating near its potential output.

Keynes argued that government fiscal instruments—spending and tax policies—were the most effective tools for demand management. In order to increase aggregate demand in periods of economic downturns, for example, the government should increase its spending on public works, provide more money for social assistance, offer loans and other forms of relief to small businesses hurt by a decline in demand for their goods and services, and cut taxes for people who tend to consume most of their incomes, namely those in low-income brackets. Keynes suggested that monetary instruments to control the money supply, such as bank reserve requirements, discount rates, open market policies, and selective credit controls, might also be used to help achieve the government's stabilization policy, but these instruments were not as important, or as effective, as fiscal instruments.

"Keynesianism," the term that came to be applied to government policies aimed at reducing the severity and duration of downturns in the business cycle, became widely accepted among industrialized countries. By the late 1960s, many economists were predicting that prudent use of fiscal policy to manage aggregate demand would ensure that business cycles were a thing of the past.

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<sup>75</sup> (London: MacMillan, 1936).

Keynesianism was never accepted by *laissez-faire* economists, such as Milton Friedman, who argued that changes in the level of prices and in economic activity, including the Great Depression, could be explained solely in terms of movement in the stock of money.<sup>76</sup> The work of Friedman and his disciples provided an intellectual foundation for the swift unravelling of the Keynesian consensus in the 1970s. In the early 1970s, as unemployment and inflation reached levels unprecedented in the post-war period, and as economic growth slowed in several of the main capitalist economies, the effectiveness of the discretionary fiscal policies that comprised the key weapons in the Keynesian arsenal were increasingly questioned. With uncommon speed, Keynesianism was replaced as the prevailing orthodoxy by a stabilization policy known as monetarism.

Although the economic doctrine of monetarism can be restricted simply to the belief that the money supply alone determines the level of real economic activity, as an ideology opposed to Keynesianism, it acquired connotations of political conservatism that logically go far beyond this prescription. The subtleties of the debate between monetarists and Keynesians cannot be neatly summarized; however, the following are some of their important differences. Keynesians regard wages and prices, the signals used to clear private markets, as suffering from rigidities; persistent unemployment and economic fluctuations as central and continuing problems in a market economy; government intervention as desirable to stabilize the level of economic activity; and fiscal policy as the most important instrument the government has to regulate aggregate demand and, therefore, the level of economic activity. Monetarists, in contrast, believe that labour and other markets always clear, with wages and prices adjusting quickly to any disturbances; the private sector of the economy is inherently stable, but that the public sector can have a destabilizing effect; fiscal policy is ineffective in regulating aggregate demand; the quantity of money has a major influence on economic activity and the price level; and that the objectives of monetary policy are best achieved by targeting the rate of growth in the money supply.

In the early 1950s and 1960s, the debate between the Keynesians and the monetarists focused almost exclusively on the relative effectiveness of fiscal and monetary policy in changing aggregate demand. However, in the 1970s and early 1980s, after the apparent

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<sup>76</sup> His outstanding publication on monetarism relating the behaviour of the economy to the behaviour of the stock of money, which he co-authored with A.J. Schwartz, is *A Monetary History of the United States, 1867-1960* (Princeton, N.J.: Princeton University Press, 1963).

failure of Keynesianism, a series of academic studies severely questioned the effectiveness of any stabilization role for government, eventually resulting in a complete victory for monetarism. Challenges to government stabilization policy included,

(1) Theories based upon the notion of rational expectations (government demand-management intervention will never be effective since people form their own expectations about future prices rationally and prospectively, and therefore, since a knowledge of the typical countercyclical policies are included in their expectations, these policies are thereby negated);

(2) The natural rate of unemployment (this is much higher than assumed because of the nature of labour markets and government tax/transfer policies, so there is no long-run tradeoff between inflation and unemployment);

(3) Crowding out (government borrowing will largely displace private spending); and,

(4) Ricardian equivalence theory (individuals will unravel the effect of government policy by, for example, simply saving more in order to pay future taxes if the government borrows money to increase current consumption).

The ideology of monetarism as the basis for government stabilization policy was warmly embraced by neoconservatives. The business community had always been greatly concerned about the Keynesian commitment to full employment since it shifted the balance of power between workers and capital in favour of labour by reducing the ability of business to discipline labour, and by increasing workers' bargaining power. Monetarism, in its most extreme form, essentially meant that the government had no stabilization function to perform.

In the years following 1970, Canada moved gradually from Keynesianism to a monetarist approach to macroeconomic policy. From mid-1975 until mid-1982, the Bank of Canada made a determined effort to follow monetarist prescriptions by trying to target the growth rate of the money supply. Although that experiment with monetarism was largely judged a failure,<sup>77</sup> in 1987, the Governor of the Bank of Canada fully embraced the ideology of monetarism. He announced that zero inflation or price stability would be the sole objective of monetary policy.

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<sup>77</sup> See C. Gonick, *The Great Economic Debate: Failed Economics and a Future for Canada* (Toronto: Lorimer, 1987); J. Jenson, " 'Different' but not 'Exceptional': Canada's Permeable Fordism," 26 *Can. Rev. of Soc. & Anthro.* 69 (1989); and D.A. Wolfe, "The Rise and Demise of the Keynesian Era in Canada: Economic Policy, 1930-1982," in M.S. Cross & G.S. Kealey, eds., *Modern Canada, 1930-1980s* (Toronto: McClelland & Stewart, 1984) 46.

The Bank asserted that without price stability, other objectives—lower unemployment, higher growth, and balanced trade—could not be achieved. To complete the government's embrace of monetarism, in his budget speech in the spring of 1991, the federal Minister of Finance formally agreed with the Bank's strategy when he listed a series of steps, which the federal government would pursue over a period of years designed to bring inflation close to zero. Simultaneously, as part of its constitutional proposals, the federal government proposed amending the *Bank of Canada Act* to confine its responsibilities to the achievement of price stability.<sup>78</sup>

Throughout the late 1980s and early 1990s, the federal government remained preoccupied with price stability and the deficit, even though its policies were taking a heavy toll on the economy. This was shown by the highest rates of unemployment seen in Canada since the 1930s and a dramatic increase in the deficit due to high interest rates. The triumph of monetarism was complete.

The government's abandonment of any meaningful stabilization function has had a number of implications for the changing structure of the Canadian tax system. Most significantly, the government could alter those aspects of the tax system that were originally designed to automatically stabilize aggregate demand without having to face the charge that it was impairing its ability to stabilize the economy. Traditionally, one of the arguments for progressive taxation was that it *had* a stabilizing effect on the economy. In periods of changing prices and wages, progressive taxation has the effect of changing the average effective rate of tax. For example, as economic activity and therefore incomes decline, the average effective rate of tax declines, leaving consumers with more after-tax income and consequently increasing demand. The steeper the degree of progression, the more responsive the tax to changes in economic activity. Without any stabilization function, the government did not have to confront this argument for progressive tax rates when it flattened the rate structure.

Conventional Keynesian wisdom also held that a shift from income tax to consumption taxes would impair the built-in cyclical stabilizing powers of the tax system. Income tax revenues fall more rapidly than sales tax revenues during recessions and rise more rapidly during economic booms, thus moderating changes in disposable income

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<sup>78</sup> For a discussion of this proposed change in the bank's mandate, see Canada, Parliament, Sub-committee on the Bank of Canada, *The Mandate and Governance of the Bank of Canada: First Report of the Sub-committee on the Bank of Canada: Eighth Report of the Standing Committee on Finance* (Ottawa: The Sub-committee, 1992).

over the business cycle, and dampening economic fluctuations. Again, since the government abandoned its Keynesian stabilization function, this justification for a significant role for the income tax in the overall tax mix was substantially weakened. During the debate in Canada over adoption of the GST and shifting more of the tax burden from income to consumption, the relative sensitivity of the two tax bases to the business cycle was seldom mentioned as a factor in the decision.

In Canada, until 1989, the unemployment insurance (UI) scheme was financed, in large part, by a payroll tax. However, about 25 per cent of the estimated cost of the benefits were financed from general government revenues. Financing some of the cost of the programme out of general revenues partly offset the regressivity of the UI payroll tax and assisted in achieving the programme's macroeconomic stabilization objective. Since 1990, all unemployment insurance expenditures have been financed by premiums. The government announced that it would continue to contribute to the financing of the programme in difficult economic times, however, the shift to financing more of the benefits from the income tax to a regressive payroll tax was clearly made more politically possible because of the denigration of the government's overall stabilization function.

The federal government's 1991 budget revealed how completely it had abandoned even the pretence of concern regarding the government's role in maintaining full employment by offering tax cuts or increased transfer payments to middle- and low-income Canadians during periods of weak demand. Amidst one of Canada's deepest recessions, it refused to offer any special counter-cyclical measures, and instead restrained automatic fiscal responses, increasing the tax burden on middle-income Canadians.

The federal government announced an expenditure control plan, which included among other spending cuts: extension of a 5 per cent cap on the growth of Canada Assistance Plan payments to the "have" provinces; a freeze until 1994-95 of total cash and tax transfers to all provinces under Established Programs Financing; a 15 per cent reduction in planned funds for new social housing; a reduction in grants by \$75 million in 1991-92 and by \$125 million thereafter; and a cap on public service wages.

Taxes were increased in two areas. UI rates were raised to \$2.80 per \$100 of insurable earnings for employees, and to \$3.92 for employers—increases of 32 per cent and 27 per cent respectively. The budget projected that the increase in UI premiums would raise an additional \$2.0 billion in 1991-92 and \$2.4 billion in 1992-93. Tobacco taxes were also raised significantly by three cents per cigarette.

To explain why it did not provide aid to relieve the economic misery of the poor or the growing ranks of the unemployed, the government said:

In earlier times, periods of economic weakness have been occasions for Ministers of Finance to put some extra money in people's pockets, spend more on programs, and worry less about the government's fiscal position. But in earlier times, we did not have to face persistently high deficits, high public debt and the economic damage that would result from ignoring these serious problems.<sup>79</sup>

D. *The Role of the Tax System in Increasing the Rate of Economic Growth*

Theoretically, economic growth may not appear to be an appropriate government goal. If the government ensures the efficient allocation of resources, and, through its stabilization policy, ensures the full utilization of the factors of production, then the growth of output in the economy will presumably reflect that desired by Canadians.<sup>80</sup> Nevertheless, economists have always been interested in growth, or the productivity of the economy, and have usually assigned some responsibility to government for ensuring an adequate rate of economic growth.

Until 1957 the prevailing view among economists was that the rate of economic growth was determined predominantly by the percentage of GNP allocated to saving and investment. However, in a paper written in that year for which he was later awarded the Nobel prize in economics, Robert Solow challenged doctrines assigning primacy to capital formation as an explanation of the growth process.<sup>81</sup> Working with data on the performance of the American economy between 1909 and 1949, he estimated that over 80 per cent of the growth in output per labour hour in the United States had been due to factors other than growth in the input of capital per labour hour. These other factors are usually referred to compendiously as technical factors. The challenge to policy makers was thus to determine what causes technical progress.

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<sup>79</sup> *The Budget: Tabled in the House of Commons by Michael H. Wilson, Minister of Finance, Feb. 26, 1991* (Ottawa: Department of Finance, 1991) at 5.

<sup>80</sup> Unless market imperfections that cannot be corrected directly inhibit growth.

<sup>81</sup> R.M. Solow, "Technical Change and the Aggregate Production Function" (1957) 39 *Review of Economics and Statistics* 312.

Throughout the 1960s, as the rate of economic growth continued unabated, little sustained attention was paid to methods of increasing the rate of technical progress. Without much theoretical support, governments generally continued to implement policies designed to increase private investment in plant and equipment, and in expenditures on applied research and education. However, beginning in the mid-1970s, and extending through to the present, industrialized countries around the world have become much more concerned with strategies for increasing the rate of economic growth. The cause of this concern has been the general slowdown of productivity growth. In Canada, for example, output per hour in the business sector fell from an average rate of 4.1 per cent in the 1946-73 period to 1.5 per cent in the 1973-89 period.<sup>82</sup> This slowdown has important implications for the rate of advance in material well-being. In the 1946-73 period, real income could have potentially doubled every seventeen years, given the rate of productivity growth. Since 1973, the doubling of real income requires forty-seven years, nearly three times as long.

The major factors that caused the initial slowdown in the early 1970s are relatively easy to identify: the end of the movement of workers from the low productivity farm sector to the higher productivity activities in the non-farm sector, slower business sector output growth, and the end of the favourable convergence of productivity-enhancing forces, such as unprecedented technological advances. Minor factors include increased energy prices and rates of inflation in the 1970s. However, the lack of productivity growth in the 1980s has been more troubling. In the 1980s there were a number of factors that in principle should have been favourable to productivity growth: lower energy prices, lower inflation, increased international competition, and, most importantly, the massive introduction of computer-based technologies.

The neoconservative response to the productivity slowdown was to blame it on structural impediments caused by excessive government intervention in the economy. Thus, neoconservatives held that the only way to increase economic output was to reduce the amount of government involvement in the economy. This response was endorsed and closely monitored by the major organizations of the industrialized countries, most notably the OECD, and was closely followed by Canada

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<sup>82</sup> Canadian Labour Market and Productivity Centre, "Productivity: The Health of Nations" (Winter/Spring 1991) Quarterly Labour Market Productivity Rev. 27.



and other countries that were dominated by neoconservative governments in the 1980s.<sup>83</sup>

In Canada, the details of the neoconservative model for increasing productivity were set out in considerable detail in a policy paper released by the newly elected federal Conservative government in 1984, entitled *A New Direction for Canada—An Agenda for Economic Renewal*.<sup>84</sup> Its basic premise was that the private decisions of consumers and producers should provide the dominant means of determining what was valued in Canadian society and of allocating resources. Thus, it emphasized the absence of state-imposed restrictions on the free flow of labour, investment, and financial capital. The paper formed the philosophical basis, if not the blueprint, for most of the government's economic initiatives over the rest of the decade: privatization, deregulation, deficit reduction, trade liberalization, labour market restructuring, and tax reform. Perhaps to signal this change in emphasis in the role of government, the Conservative government appeared to prefer to use the term *competitiveness* instead of *productivity growth* in describing its policies.

The tax prescriptions that followed from this change in the role of government were straightforward: first, to ensure that the allocation of resources are left up to market forces, the tax system should not influence business decisions; and second, to ensure that Canadian businesses are competitive, the tax system should not impose a greater cost on corporations than that imposed by Canada's competitors. Broadening the corporate income tax base to reduce the disparity in effective tax rates among industries was one of the major goals of the 1987 tax reform exercise.<sup>85</sup> Many corporate tax reductions and credits were eliminated or modified. The most important of these were reductions in selected depreciation rates, elimination of the general investment tax credit (credits for regional development and research and development were retained), limitations on the use of the remaining investment tax credits, elimination of earned depletion, and changing the tax treatment of insurance companies. Pre-reform average rates of corporate tax by sector varied from 14.5 per cent to 24.5 per cent of financial statement income. Post-reform the range of average corporate

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<sup>83</sup> For a summary of the major structural adjustments being done in OECD countries see OECD, *Economies in Transition: Structural Adjustment in OECD Countries* (Paris: OECD, 1989).

<sup>84</sup> (Ottawa: Department of Finance, 1984).

<sup>85</sup> See Canada, Department of Finance, *Tax Reform 1987: Income Tax Reform* (Ottawa: Department of Finance, 1987) at 42.

tax rates were estimated to have narrowed to between 15.5 per cent and 22.6 per cent.<sup>86</sup>

The other major thrust of corporate tax reform, and the one that appeared to preoccupy the government over the next few years, was the need to ensure the competitiveness of the Canadian corporate tax system. In response to the cut in the U.S. top statutory corporate tax rate in 1986 from 46 to 34 per cent, the Canadian government reduced the general federal statutory corporate tax rate from 36 to 28 per cent in 1988. Then in almost every subsequent budget it gave further concessions to corporations under the guise of ensuring Canada's tax system remains competitive. For example, in the 1992 budget, under the heading "Competitiveness and the Tax System" the government announced a series of measures that would result in a reduction of the tax burden on the income earned in Canada by foreign corporations by about 4 percentage points.<sup>87</sup> The government stated that "These ... important structural changes will have a positive influence on the manufacturing and processing sector's investment plans for Canada by increasing the rate of return on new investments. Consequently, firms will have an incentive to allocate more of their investment in Canada."<sup>88</sup>

Almost every aspect of the Conservative government's tax reforms reflected the fact that competitiveness had become the most significant objective of tax policy. These include the reduced personal marginal tax rates; the enactment of the GST and the shift of the tax burden to consumption and payroll taxes; and the enactment of tax breaks for savings and investment, such as the lifetime capital gains exemption and the increased contribution levels for registered retirement savings plans.

In addition to the neoconservative response, there is, of course, another model for increasing productivity and international competitiveness in which the public sector plays an even more substantial role than it has traditionally. In contrast to the neoconservative low-cost strategy, it has been referred to as a high value-added strategy. The model rests on the premise that an economy will be productive if there is a highly trained, well paid, secure, and cooperative labour force that is willing and able to adapt to changing technologies and innovations; a well developed, public infrastructure including health,

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<sup>86</sup> *Ibid.*

<sup>87</sup> Canada, Department of Finance, *The Budget 1992: budget papers tabled in the House of Commons by the Hon. Don Mazankowski, Minister of Finance* (Ottawa: Department of Finance, 1992).

<sup>88</sup> *Ibid.* at 152.

education, and transportation systems; a professional public sector that is capable of taking the lead in the process of gathering information, targeting potential high-growth areas in the economy, and allocating public resources; and a society in which equity is actively promoted. In Canada, this model has been set out in a number of consultative documents published by the Ontario New Democratic Party government.<sup>89</sup>

Under the high value-added strategy it is not necessary to accommodate the rich and hope the benefits trickle down. Instead, to the extent that the government uses the tax system to achieve a higher rate of economic growth, it would direct benefits to, for example, high-growth, high-technology sectors, which could be expected to generate above-average returns and spin-offs for other industries; firms that provided worker participation in workplace decisions; firms that provided worker training; firms that provided compensation packages that lengthened the time horizons of and encouraged risk taking by corporate managers; and firms that engaged in activities to increase the pace of innovation. But most significantly, the tax system would be used to raise a substantial amount of revenue to finance public goods and services, and to increase social equality by redistributing income and wealth.

Obviously, the debate over which strategy is most likely to lead to an increasing rate of economic growth cannot be resolved here. The point is simply to illustrate the way the structure of the tax system has changed over the past decade to accommodate the rich because of this changed view of the government's role in fostering economic growth. However, some correlational evidence across countries suggests that a tax system, which raises a significant amount of revenue and policies that redistribute income are not inconsistent with growth in productivity. Taking the G-7 countries plus a random sampling of other industrialized countries, one finds that, in recent years, those countries with the largest rates of increase in labour productivity tend to be those nations that have also had the highest rates of growth in taxes and more equally distributed levels of income (Table 1).

Countries where tax revenue as a share of GDP increased the most tended to experience higher rates of growth in total factor

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<sup>89</sup> See, for example, "Budget Paper E: Ontario in the 1990s: Promoting Equitable Structural Change," in Ontario, 1991 Budget, 29 April 1991 at 85; Ontario, Ministry of Industry Trade and Technology, *An Industrial Policy Framework for Ontario* (Toronto: Queen's Printer of Ontario, 1992); and Ontario, Ministry of Treasury and Economics, *Investing in Tomorrow's Jobs: Effective Investment and Economic Renewal*, a supplementary paper to the 1992 Ontario Budget (Toronto: Ministry of Treasury and Economics, 1992).

productivity than those where the growth in tax revenues was relatively small. Most notably, the country that saw its tax burden grow the least—the United States—also saw a zero gain in productivity from 1973 to 1990. The countries where productivity growth was greatest—Japan and Italy—were the countries where the increase in the tax burden was also the largest.

TABLE 1

Average Annual Increase in Total Factor Productivity, 1973-90, Increase in Tax Revenues as a Percentage of GDP, 1975-89, and Index of Inequality for 1980-87

<i>Country</i>	<i>Productivity Growth</i>	<i>Tax Revenue Increase</i>	<i>Index of Inequality</i>
United States	0.0	1.1	8.9
Canada	0.5	2.9	7.1
Sweden	0.6	12.5	4.6
Australia	0.7	2.5	9.6
Austria	1.0	2.4	----
United Kingdom	1.1	1.0	6.8
Netherlands	1.2	2.3	5.6
Germany	1.3	2.4	5.7
Denmark	1.3	8.5	7.1
Belgium	1.5	2.5	4.6
France	1.7	6.9	6.5
Japan	1.7	9.7	4.3
Italy	1.8	11.6	6.0

Sources: Productivity growth: OECD, *Economic Outlook*, no. 50 (Paris: OECD, 1991), Table 43; Taxes: OECD, *Revenue Statistics of OECD Members, 1965-1990* (Paris: OECD, 1991), Table 3; Index of Inequality: World Bank, *Human Development Report 1991* (Oxford: Oxford University Press, 1991), Table 38.

One possible explanation for the hypothesis that raising taxes might stimulate productivity growth is that such taxes are used, in part, for public-sector capital formation. Three kinds of capital are important in ensuring that workers are productive: private capital, such as factories and equipment; human capital, such as education and training; and public capital, such as airports and roads. The three are clearly

complementary—an economy must invest in all three. Thus, an increase in public capital could raise productivity to a higher level than would be achieved without such investment. Also, as Robert Reich has noted, in a global economy where private capital and technology are becoming infinitely mobile, only two factors can provide a nation with a significant comparative advantage: a high calibre labour force and a sound, public infrastructure.<sup>90</sup>

Also, utterly contrary to what neoconservative theories would predict, Table 1 shows that the degree of equality in a country is positively, not negatively, related to productivity.<sup>91</sup> The more equal the distribution of income, the more likely the economy will be productive. Indeed, this positive relationship is so strong that it is almost statistically significant. Countries like Australia, the United States, and Canada had a relatively unequal distribution of income and also had low productivity growth from 1979 to 1988. Countries with a more equal distribution of income, like Japan, Belgium, and Sweden, had higher rates of productivity growth.

The fact that policies to promote equality will boost productivity seems obvious. Aside from anything else, there is an enormous waste of resources when gifted individuals end up in dead-end jobs or are under-employed because of economic class, gender, or colour. Providing a top-

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<sup>90</sup> R.B. Reich, *The Work of Nations: Preparing Ourselves for 21st Century Capitalism* (New York: Alfred A. Knopf, 1991). There is some direct evidence that investment in public infrastructure can influence productivity. In a recent attempt to pin down such a relationship more precisely, a well-known American economist, David Aschauer, linked aggregate productivity to the public-sector stock, and argued that the puzzling productivity slowdown in the United States in the early 1970s could be explained by the roughly contemporaneously slowdown in the rate of investment in productivity. He concluded that in the postwar U.S. economy, an extra dollar of public investment in infrastructure, especially for transportation purposes, has had a payoff in higher GNP equal to three or four dollars of private capital. D. Aschauer, "Is Public Expenditure Productive?" (1989) 23-24 *J. of Monetary Econ.* 177. Of course, the effect of infrastructure spending on productivity has been the subject of considerable dispute. For a summary of the literature, see J.A. Taton, "Should Government Spending on Capital Goods Be Raised?" (March/April 1991) Federal Reserve Bank of St. Louis 3.

<sup>91</sup> The table uses a simple measure of the degree of income equality in a country. It compares the ratio of the share of after-tax income received by 20 per cent of the least affluent households in the country to that of 20 per cent of the most affluent households. Thus, a country where income is distributed highly unequally, for example, Australia, in which the bottom 20 per cent of households receive 5.4 per cent of national income while the top 20 per cent received 47.1 per cent, is assigned an equality index of only 0.11. By contrast, a country where income is distributed more equally, like Japan, in which the bottom 20 per cent receive 8.7 per cent of national income and the top 20 per cent receives 39.9, is assigned an equality index of 0.23. Although I tested different periods of time to ensure that the correlation was invariant to different time periods, in the figure above, a country's index of equality for the late 1970s is compared to its labour productivity for the period from 1977 to 1988.

quality education to everyone increases productivity directly, but also reduces the social alienation that breeds drug use, criminality, and other forms of unproductive behaviour.

Of course the positive relationship between increases in tax revenues and productivity growth, for example, does not indicate the direction of causality, and these kinds of simple correlations are subject to all sorts of confounding variables. But these statistics do suggest that if a country embraces egalitarian economic policies that involve an important role for the public sector, there is some comparative evidence that this will enhance, not diminish, labour productivity. At the very least, the correlation contradicts what neoconservative ideology would predict, namely, that the rich must be accommodated in order to achieve a respectable rate of productivity growth.

#### IV. CHARACTERISTICS OF A GOOD TAX SYSTEM

Tax systems are not enacted to increase the fairness or neutrality of the economy or to make life simpler for people. Presumably, most people would agree that the fairest, most neutral, and simplest tax system would be no tax system at all. The purpose of the tax system is to assist the government in achieving its broad objectives of resource allocation, distribution, stabilization, and economic growth. However, once it is conceded that a tax system is required for these purposes, then it clearly should be designed in a way that satisfies the familiar criteria of a good tax system: equity, neutrality, and simplicity. Changes in the tax structure might, therefore, be accounted for not only by an alteration in the broad purposes of government, but also by a change in the understanding of one or a number of these evaluative criteria.

The meaning and application of these criteria went unchallenged for many years. However, beginning in the mid-1970s, all three criteria were reinterpreted by conservative analysts.<sup>92</sup> These reinterpretations invariably acted as a rationalization for a tax system, which was less effective as an instrument for redistribution. It would be impossible to deal here with all of the challenges that have been made to the traditional tax policy criteria over the last two decades. However, I will review a sufficient number to illustrate my general thesis that almost all

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<sup>92</sup> For an excellent review of these various challenges and a defence of the traditional criteria, see J.G. Head, "The Comprehensive Tax Base Revisited" (1982) 40 *Finanzarchiv* 193. See also, W. Hettich & S. Winer, "Blueprints and Pathways: The Shifting Foundations of Tax Reform" (1985) 38 *Nat'l Tax J.* 423.

recent developments in tax policy analysis have suggested changes to the tax system that would benefit the rich.

### *A. Equity*

One of the most fundamental axioms of social justice is that people in the same circumstances should be treated the same way. In tax policy analysis this evaluative criteria is referred to as horizontal equity: people in the same circumstance should pay the same amount of tax. Arguably it is the most important criterion with which to evaluate the tax system. If the government was not concerned about horizontal equity, it could raise revenue simply by confiscating resources or by printing money. What distinguishes a tax from other methods of reducing private consumption is that a tax is premised on some notion of equity or fairness. The difficult question is—in determining whether two people are similarly circumstanced or have the same ability to pay, and, therefore, should bear the same tax burden, which of their personal circumstances should be considered?

Traditionally, tax policy analysts have asserted that the characteristic of income should be used in determining whether two individuals are similarly circumstanced for tax justice purposes—two people with the same annual incomes should pay the same amount of tax. This has resulted in a heavy emphasis on the role of the income tax in a fair tax system. However, in recent years, this criterion has been challenged on the grounds that it is inequitable to tax individuals on the return to their savings. That is to say, analysts who take this position argue that, in determining whether two individuals are similarly circumstanced for tax purposes, the value of their consumption and not their income should be compared. This equity argument for reducing the tax burden on the rich (because the rich save a greater percentage of their income than the poor) was frequently referred to by the federal government when it increased the amount of income that could be saved tax-free in registered retirement savings plans and provided other tax breaks for income from capital. This reasoning was also used to justify shifting some of the tax burden from the income tax to the newly enacted GST.

A number of arguments have been put forward to justify reinterpreting horizontal equity so that it refers to two taxpayers with the same consumption and not necessarily two taxpayers with the same income. However, simply to illustrate how this reinterpretation

accommodates the rich, I will only briefly note the two that were urged in justifying a shift in the Canadian tax mix from income tax to the GST.<sup>93</sup>

One of the most frequently asserted equity arguments made by the government and business interests in favour of the GST was that it is fairer to tax people on the value of goods and services they take out of the economy, as reflected in the goods and services they purchase, than to tax them on the value of the goods and services they contribute to the economy, as reflected in the income they earn.<sup>94</sup> This argument, which praises the fairness of consumption taxes, has a respected lineage in public finance. It was first made by Thomas Hobbes in 1651 in the following frequently quoted passage:

the Equality of Imposition, consisteth rather in the Equality of which is consumed, than of the riches of the persons that consume the same. For what reason is there, that he which laboureth much, and sparing the fruits of his labour, consumeth little, should be more charged, than he that living idly, getteth little, and spendeth all he gets ...<sup>95</sup>

Despite the frequency with which this argument has been made in recent Canadian tax reform debates, its underlying ethical intuition is not obvious. It seems to be based upon the belief that a consumer uses up something at someone else's expense, while a saver contributes something to someone else's well-being. If this is the idea behind the argument, it rests upon a misunderstanding of the economic functions of both consuming and saving. First, consumers are not taking anything out of the economy: the goods and services they consume may be gone, but the price they paid for the goods is now in someone else's hands. That is to say, consumption is not necessarily a claim on community resources; it involves an exchange between private individuals, after which, presumably, both are better off. Second, there is nothing virtuous about saving. The rate of return savers earn presumably fully compensates them for the use that is made of their money. Although not taxing savings may convey the connotation of rewarding foresight and thrift, in fact, the purpose of saving, in many cases, is simply for future consumption. Therefore, a sceptic might ask why wanting to consume in the future should have moral primacy over wanting to consume in the present. In other words, what a person takes out of the economy is necessarily equal to what he or she puts in, subject of course

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<sup>93</sup> These and other arguments in favour of consumption taxes are elaborated on and refuted in N. Brooks, *supra* note 59. Large parts of this and the following section are taken from this monograph.

<sup>94</sup> *Ibid.*

<sup>95</sup> T. Hobbes, *Leviathan*, C.B. Macpherson, ed., (London: Penguin Books, 1969) at 386-387.



to any gifts that person might make or receive, so why should timing make a difference? Third, both consumption and saving are necessary to support the economy. Although at a given point in the business cycle one might be more important than the other, in the long run, both are necessary conditions for a balanced economic environment.

There is another, even more fundamental, difficulty with this argument, which strikes at the very essence of the dispute between those who support an income tax and those who favour a tax on consumption. The argument for a tax on consumption assumes that a taxpayer's earnings are a reflection of his or her "contribution" to society, and that therefore it is morally less just to impose a tax on earnings than it is to tax the value of the taxpayer's consumption. Those who favour consumption taxes almost invariably assume that the pre-tax distribution of earnings in a market economy is just. By contrast, many income tax proponents assume that the earnings of suppliers of both capital and labour in a market economy are morally inappropriate, and that therefore, an important purpose of the tax system is to achieve a more just distribution of income.

A second general equity argument, often made by Canadian economists to support shifting the tax burden to consumption taxes, rests on the proposition that determining whether two taxpayers are similarly situated for the purpose of applying the horizontal equity norm should be done by comparing their lifetime circumstances instead of their circumstances over much shorter periods of time, such as annually.<sup>96</sup> According to this perspective, two people who have enjoyed the same level of consumption over their lifetimes (and have left the same value of bequests), have enjoyed the same level of utility and should, therefore, have paid the same amount in lifetime taxes. The argument then asserts that, if lifetime circumstances, or utility, is the relevant standard of equality, then annual consumption expenditures including bequests are likely to be a better surrogate for utility than annual income. Two persons with the same lifetime consumption will pay the same amount of tax if their consumption expenditures are taxed annually. However, if their income is taxed, even though the value of their consumption expenditures over their lifetimes might be identical, their lifetime tax payments could be quite different depending upon the timing of their incomes, borrowings, and expenditures.

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<sup>96</sup> See, for example, D. Sewell, "Towards Longer Time Horizons in Personal Taxation" (1988) 26 *Osgoode Hall L.J.* 235, and N. Bruce, "Ability to Pay and Comprehensive Income Taxation: Annual or Lifetime Basis?" in N. Brooks, ed., *supra* note 17 at 157.

This equity argument for consumption taxes, however, appears to break down fairly easily if we compare it to the present value of after-tax consumption, which is really what matters to individuals. Moreover, the argument ignores the fact that savings have value to people aside from the future consumption possibilities they provide. For example, the existence of wealth enables individuals to feel more financially secure, to require less insurance, and to avoid the liquidity constraints that may cause sub-optimal lifetime consumption patterns. In addition, this argument rests on the mistaken empirical premise that people judge their economic well-being by reference only to their lifetime income. In fact, largely because of the amount of economic uncertainty in most people's lives, individuals are much more likely to judge their economic well-being from income earned or about to be earned over much shorter periods of time.

### B. *Neutrality*

The second traditional criterion by which taxes are evaluated is neutrality: taxes should avoid distorting the workings of market mechanisms. The assumption underlying this criterion is that in free markets individuals make decisions about how hard to work, how much to save, and so forth by comparing the benefits they derive from these actions with their costs. Since individuals are the best judges of the benefits and costs to themselves with respect to particular choices, their welfare will be maximized if all their decisions are made freely on the basis of market prices. The most serious effect taxes might have on the welfare of individuals is that they may distort taxpayers' decisions to work or save. Although other behavioural effects are important, and all were reassessed in the late 1970s and early 1980s, to illustrate the changing importance attached to tax neutrality, I will again only briefly review these two.

Until the mid-1970s the conventional economic wisdom, based upon countless empirical studies, was that taxes had very little effect on taxpayers' decisions to substitute leisure for work. An OECD survey of the empirical studies done up until 1975 concluded unequivocally that "the net effect of taxation on labour supply is not large enough to be of great economic or sociological importance."<sup>97</sup> Thus, this possible effect of taxes was largely ignored in tax reform exercises.

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<sup>97</sup> OECD, *Theoretical and Empirical Aspects of the Effects of Taxation on the Supply of Labour* (Paris: OECD, 1975) at 126.

However, the consistent finding of earlier studies, which were largely based on survey data or experimental data derived from negative income tax experiments, were contradicted by a series of largely econometric studies in the late 1970s and early 1980s.<sup>98</sup> The work of Jerry Hausman is perhaps the best known.<sup>99</sup> Based upon data from the mid-1970s, he estimated that the tax system reduced the number of hours worked by almost 9 per cent of total desired hours. This would imply that the tax system, particularly as it applied to high-income individuals, was decidedly not neutral in terms of deciding to work.

More recent studies have been unable to replicate Hausman's findings. They have confirmed the long-standing conventional wisdom that even moderately high income tax rates have little effect on work effort or related matters, such as career choices.<sup>100</sup> Also, Canadian studies have consistently found that both the compensated and uncompensated elasticities of labour supply are small.<sup>101</sup> In a recent

<sup>98</sup> For a comprehensive survey of the studies, see M.R. Killingsworth, *Labour Supply* (New York: Cambridge University Press, 1983).

<sup>99</sup> J.A. Hausman, "Labour Supply" in H.J. Aaron and J.A. Pechman, eds., *How Taxes Affect Economic Behaviour* (Washington: Brookings Institution, 1981). For a survey of studies reaching similar conclusions, see J. Hausman, "Taxes and Labor Supply" in A. Auerbach and M. Feldstein, eds., *Handbook of Public Economics Volume 1* (Amsterdam: North Holland, 1985) 213.

<sup>100</sup> See T. MaCurdy, D. Green & H. Paarsch, "Assessing Empirical Approaches for Analyzing Taxes and Labour Supply" (1990) 25 J. of Human Res. 415 at 462 ("The results of this study ... raise serious questions about the reliability of evidence [Hausman's estimates] cited by much of the literature to support recent tax reform proposals aimed at lowering marginal tax rates. ... According to the estimates [reported in this study] ... all substitution and income effects are essentially zero"); R.K. Triest, "The Effect of Income Taxation on Labor Supply in the United States" (1990) 25 J. of Human Res. 491 at 512-13 ("The results of this paper suggest that the labor supply of prime aged married men is relatively invariant to the net wage and virtual income [Triest's results show the income coefficients driven to zero in the maximum likelihood estimations]. ... It seems safe to say that taxation causes fairly little reduction in the labor supply of prime-aged married males in the United States.")

<sup>101</sup> See, for example, C.J. Eden, *Taxes and Labour Supply of Married Women in Canada* (Ottawa: Economic Council of Canada, 1986); J. Ham and C. Hsiao, "Two-Stage Estimation of Structural Labor Supply Parameters Using Interval Data from the 1971 Canadian Census" (1984) 24 J. of Econometrics 133; and A. Nakamura and M. Nakamura, "Part-time and Full-time Work Behaviour of Married Women: A Model with a Doubly Truncated Dependent Variable" (1983) 16 Can. J. of Econ. 229. These studies and others are reviewed in S.A. Rea, "The Impact of Taxes and Transfers on Labour Supply: A Review of the Evidence" in D.W. Conklin, eds., *A Separate Personal Income Tax for Ontario: Background Studies* (Toronto: Ontario Economic Council, 1984) 106; and L. Osberg, *Behavioral Response in the Context of Socio-Economic Microanalytic Simulation, a Report to the Social and Economic Studies Division* (Ottawa: Statistics Canada, 1986). For an analytical review of tax effects on a number of specific decisions of labour supply tax, see D.G. Hartle *et al.*, *A Separate Personal Income Tax for Ontario: An Economic Analysis* (Toronto: Ontario Economic Council, 1983) at 333 ("The general conclusion of this chapter is that labour supply considerations are important. Nevertheless, the limited information available from the best current research suggests that the labour supply effects of likely [income tax] changes are uncertain and probably

exhaustive review of the labour supply research in the United States and Canada, and an analysis of labour supply behaviour in a Canadian negative income tax experiment, Derek Hum and Wayne Simpson conclude:

Although precise measurement of labour supply response is a very difficult problem, and one that economists and econometricians have not yet mastered, we have narrowed the range of reasonable estimates to those that indicate that individuals and families are likely to be fairly insensitive to changes in the tax-transfer system facing them.<sup>102</sup>

However, even though the recent studies tend to confirm the long-standing finding that income tax has little effect on work effort, the studies done in the late 1970s and early 1980s that purported to contradict these original premises had a dramatic effect on tax reform and the changing structure of the tax system. In lowering the top federal marginal tax rate, the federal government frequently alluded to large economic gains that would be realized because taxpayers would be induced to increase their work effort.

A second important decision that taxes could affect is the choice between consuming income during the year it is earned or saving it for future consumption. Neoconservatives have expressed particular concern about the effect of taxes on this decision because they argue that an increased rate of saving is essential if Canada is to maintain or increase its rate of economic growth. To support this line of argument, neoconservatives have had to dispute three reasonably well established empirical propositions: reducing taxes on the return to savings will not necessarily lead to an increase in the rate of savings; the cost of capital is not a particularly important determinant of new investment; and an increase in private capital will not necessarily act as a substantial boost to the rate of economic growth, even if investment is increased.

Up until the 1970s, empirical research regarding the effect taxes have on private savings was unanimous. It found that private savings are basically insensitive to the after-tax rate of return on capital income. Colin Wright summed up the previous work on this question in 1969 by noting that "no evidence exists which supports the hypothesis that the substitution effect upon consumption of changes in the rate of interest is negative."<sup>103</sup> Then, in the late 1970s and early 1980s, a few researchers,

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suggests that the labour supply effects of likely [income tax] changes are uncertain and probably fairly small.").

<sup>102</sup> *Income Maintenance, Work Effort, and the Canadian Income Experiment* (Ottawa: Economic Council of Canada, 1991) at 91.

<sup>103</sup> "Saving and the Rate of Interest" in A.C. Harberger & M.J. Bailey, eds., *The Taxation of Income from Capital* (Washington D.C.: Brookings Institution, 1969) 275 at 285. See also, A.S. Blinder, "Distributional Effects and the Aggregate Consumption Function" (1975) 83 J. of Pol.

most notably Michael Boskin<sup>104</sup> and Lawrence Summers,<sup>105</sup> purported to find that reducing top marginal tax rates could have a relatively dramatic effect on increasing household savings. They estimated elasticities between 0.4 and somewhere above 1.0.

Over the next decade, the findings of Boskin and Summers prompted intense research into the empirical magnitude of the relevant elasticity of savings. Their results were challenged by almost every subsequent researcher. For example, E.P. Howrey and S.H. Hymans<sup>106</sup> checked to see how sensitive Boskin's findings were to changes in the time period for estimates, and to changes in the measure of the rate of return employed. According to them, Boskin's results were not robust. Using several other real rates of return and restricting the time period to the post-war period, they found negative interest elasticities of saving.<sup>107</sup> These researchers also made their own estimates and concluded, "There are many good reasons for tax reform, but there is no good evidence to support the view that a positive interest elasticity of loanable-funds saving is one of them."<sup>108</sup>

Irwin Friend and Joel Hasbrouck took an even stronger objection to Boskin's findings. They boldly state, "This paper will demonstrate that there is little scientific justification for the recent literature purporting to show a strong positive interest elasticity of saving"<sup>109</sup> In another study, Barry Bosworth used a specification similar to Boskin's, and, using data from 1952 to 1980, came up with similar results.<sup>110</sup> But when the period was restricted to 1952-70, the interest elasticity of saving was insignificantly different from zero.<sup>111</sup> Bosworth also notes that his equations, like Boskin's, severely overpredicted savings for the early 1980s. During this period real interest rates went

Econ. 447.

<sup>104</sup> See M.J. Boskin, "Taxation, Saving, and the Rate of Interest" (1978) 86 J. of Pol. Econ. S3.

<sup>105</sup> See L.H. Summers, "Capital Taxation and Accumulation in a Life Cycle Growth Model" (1981) 71 Am. Econ. Rev. 533 (finding a savings elasticity of about two not on the basis of empirical testing, but on a simulation exercise with a highly restrictive savings model).

<sup>106</sup> "The Measurement and Determination of Loanable-Funds Savings" in J.A. Pechman, ed., *What should be taxed: income or expenditure?* (Washington: Brookings Institution, 1980) 1.

<sup>107</sup> *Ibid.* at 13.

<sup>108</sup> *Ibid.* at 31.

<sup>109</sup> I. Friend & J. Hasbrouck, "Saving and After-Tax Rates of Return" (1983) 65 Rev. of Econ. & Stat. 537.

<sup>110</sup> B.P. Bosworth, *Tax Incentives and Economic Growth* (Washington: Brookings Institution, 1984) at 79ff.

<sup>111</sup> *Ibid.* at 82.

through the roof, while saving rates actually fell. Bosworth concluded, "Assertions that an increase in the return to capital will or will not raise the overall private saving rate must be based on personal beliefs because the existing empirical evidence must be judged as inconclusive."<sup>112</sup>

Numerous other research studies,<sup>113</sup> the conclusions of several comprehensive literature reviews of studies on savings behaviour,<sup>114</sup> and the conclusion reached by authors of leading macroeconomic textbooks,<sup>115</sup> have upheld the traditional view that the aggregate savings elasticity is close to zero: personal savings show little, if any, positive response to increases in after-tax returns on investment. As Barry Bosworth has recently noted, "There is only one study that I know of in the U.S. that is able to find a positive effect of interest rates on savings. One outstanding characteristic of it is that no one has ever been able to replicate it and there is no matching result that I know of."<sup>116</sup>

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<sup>112</sup> *Ibid.* at 84.

<sup>113</sup> See, for example, O.J. Evans, "Tax Policy, the Interest Elasticity of Saving, and Capital Accumulation: Numerical Analysis of Theoretical Models" (1983) 73 *Am. Econ. Rev.* 398 (challenges the robustness of Summer's simulation results on several grounds); R.E. Hall, "Intertemporal Substitution in Consumption" (1988) 96 *J. of Pol. Econ.* 339 (finding no saving response to increased interest returns and explaining away apparent findings that savings respond to increased interest); and J. Skinner and D. Feenberg, "The Impact of the 1986 Tax Reform on Personal Saving" in J. Slemrod, ed., *Do Taxes Matter: The Impact of the Tax Reform Act of 1986* (Cambridge: MIT Press, 1990) 50 (the *Tax Reform Act* of 1986 resulted in relatively little change in aggregate personal savings but seems to have had some effect on the composition of personal saving; for example, contributions to individual retirement accounts fell drastically after tax reform).

<sup>114</sup> B.B. Aghevli et al., *The Role of National Saving in the World Economy: Recent Trends and Prospects* (Washington: International Monetary Fund, 1990) at 20 and at 31 ("the weight of the empirical evidence ... supports the view that the partial correlation between the interest rate and the saving rate is likely to be small, irrespective of the sign" and "on the whole, the effect of taxes on the level of private saving has been relatively small"); A. Lans Bovenberg, "Tax Policy and National Saving in the United States: A Survey" (1989) 42 *Nat'l Tax J.* 123, at 128 ("Empirical studies on the interest elasticity of saving generally suggest that interest rates have only a small direct impact on saving in the United States."); R.S. Smith, "Factors Affecting Savings, Policy Tools and Tax Reform: A Review" (1990) 37 *International Monetary Fund: Staff Papers* 1 at 57 ("there are no clear guidelines on how to alter the rate of private saving"); D.A. Starrett, "Effects of Taxes on Savings" in H.J. Aaron, H. Galper & J.A. Pechman, eds., *Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax* (Washington: Brookings Institution, 1988) 237 at 265 ("While statistical evidence of an association between savings and rates of return can be uncovered, I find the empirical relationship more tenuous than the theoretical arguments suggest.")

<sup>115</sup> See, for example, R. Dornbusch, S. Fischer & G.R. Sparks, *Macroeconomics*, 3d. Can. ed. (Toronto: McGraw-Hill Ryerson, 1989) at 281 ("Typically, research suggests the effects [of a rise in interest rates on saving] are small and certainly hard to find.")

<sup>116</sup> B. Bosworth, "The Debate Over Savings" in B.L. Fisher & R.S. McIntyre, eds., *Growth & Equity: Tax Policy Challenges for the 1990s* (Washington: Citizens for Tax Justice, 1990) 83 at 87-88.

Yet, in spite of the strong evidence refuting the claim that taxes affect savings behaviour, research purporting to show the opposite had a great influence on tax reform. In 1981, President Reagan explicitly reduced the top U.S. marginal income tax rate on investment income from 70 per cent to 50 per cent to increase savings. One of the most frequently stated rationales the Canadian government gave for introducing the GST was to increase the rate of personal savings in Canada by taxing only consumption.

Even if tax rates did affect savings behaviour, attempting to increase the rate of personal savings by reforming the tax system would only increase domestic investment if a rise in domestic savings reduced the cost of capital to Canadian corporations, and if the cost of capital was an important determinant of new investment.

Until the late 1970s, studies examining investment decisions almost unanimously found that changes in tax laws had little effect on a business' decision to expand investment. In their 1985 edition, the authors of the leading macroeconomic text in the United States and Canada asserted:

At least on evidence through 1979, it seems that the cost of capital empirically does not much affect investment and that accordingly the simple accelerator model [investment is determined by demand for output] does as well as the neoclassical model [the cost of capital and expected output determines investment] at explaining investment.<sup>117</sup>

However, in the early 1980s, studies by Martin Feldstein and others<sup>118</sup> purported to show that the cost of capital does affect investment. This caused the authors of the macroeconomic text referred to above to revise their assessment of the evidence slightly in their most recent edition, and to admit that the results of the empirical research are somewhat uncertain.<sup>119</sup> However, still the most reasonable conclusion the evidence has garnered is that the cost of capital has some effect on business investment in plant and equipment, but that these effects are modest and occur gradually over a long period of time.<sup>120</sup>

Finally, to support the proposition that reducing the tax rate on savings will foster economic prosperity, neoconservatives would have to

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<sup>117</sup> R. Dornbusch, S. Fischer & G.R. Sparks, *Macroeconomics*, 2d. Can. ed. (Toronto: McGraw-Hill Ryerson, 1985) at 277.

<sup>118</sup> Referred to in Dornbusch, Fischer & Sparks, *supra* note 115.

<sup>119</sup> *Ibid.* at 316-17. ("It is clear from the conflicting findings that the evidence is not strong enough to decide the precise relative roles of the cost of capital and expectations of future output.")

<sup>120</sup> See B.P. Bosworth, *Tax Incentives and Economic Growth* (Washington: Brookings Institution, 1984) at 109-110.

be able to show that private capital investment will boost the rate of economic growth. Generally, other things being equal, a country is better off with a larger capital stock. However, the claims made by business groups and right-wing governments about the importance of increasing private investment are often exaggerated.

Growth accounting, a branch of economic research that has attempted to identify the sources of economic growth and measure their effect, has been unable to find a strong correlation between capital investment and economic performance. In 1957, Robert Solow, in a study that was largely responsible for his later selection as a Nobel Prize laureate, estimated that over 80 per cent of the growth in output per labour hour in the United States had been due to factors other than growth in the input of capital per labour hour.<sup>121</sup> Subsequent studies have confirmed Solow's initial finding that capital accumulation accounts for only a relatively small fraction of productivity growth.<sup>122</sup> For example, in a frequently relied upon study, Barry Bosworth concluded that only 0.1 to 0.2 percentage points of the productivity slowdown in the United States in the late 1970s could be assigned to differing rates of change in the capital-labour rate.<sup>123</sup> According to standard estimates, even a doubling of the U.S. net private investment rate would raise the growth rate of real income by less than half a percentage point per year.

Once again, in the late 1970s and early 1980s, a series of studies purported to challenge this conventional wisdom, most notably in the work done by Dale Jorgenson and his associates.<sup>124</sup> Nevertheless, a recent survey of the literature concludes that the standard model's estimates do not need to be revised upward on the basis of subsequent developments in theory and empirical analysis.<sup>125</sup>

This brief review of the effect of taxes on work incentives, savings, and investment does not do justice to the weight of the evidence.

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<sup>121</sup> Solow, *supra* note 81.

<sup>122</sup> See, for example, E. Denison, *Trends in American Economic Growth, 1929-1982* (Washington: Brookings Institution, 1985).

<sup>123</sup> Bosworth, *supra* note 110 at 29.

<sup>124</sup> See D.W. Jorgenson, F.M. Gallop & B.M. Fraumeni, *Productivity and U.S. Economic Growth* (Cambridge: Harvard University Press, 1987).

<sup>125</sup> M.N. Bailey & C.L. Schultze, "The Productivity of Capital in a Period of Slower Growth" in M.N. Bailey & C. Winston, eds., *Brookings Papers on Economic Activity: Microeconomics* (Washington: Brookings Institution, 1989) 369. See also Dornbusch, Fischer & Sparks, *supra* note 115 at 648 ("The early finding by Solow that growth in the capital stock makes a minor, though not negligible, contribution to growth stands up well to the test of later research.")



Intuitively appealing theory, common experience, and the results of the vast preponderance of empirical studies, overwhelmingly suggests that high tax rates are not an important disincentive to working, saving, or investing. Yet in the late 1970s and early 1980s, a series of studies by conservative economists purported to find the opposite result, and in doing so, strongly supported the neoconservative tax agenda of obliging the rich.

### C. *Simplicity*

Everyone agrees that a tax system should be as simple as possible. This criterion has been frequently referred to by neoconservatives when justifying reducing the progressivity of the tax system. In fact, because government officials and tax practitioners can speak publicly about the need for simplicity and still appear like statespersons, simplification has often been used as a slogan to obscure a hidden agenda.

In one of the most shameless uses of the “simplification slogan,” the Conservative government used it to justify flattening tax rates in its 1987 tax reform exercise. It said that lowering the top federal tax rate from 36 to 29 per cent and reducing the rate structure from ten brackets to three, would greatly simplify the tax system. Brought to its logical conclusion, this argument would suggest that the simplest income tax system would be one with a flat rate—and this is perhaps, where the government is heading. However, the argument is nonsense. The number of rate brackets is irrelevant when calculating a person’s tax liability. The great majority of taxpayers use the tables that come with their returns to compute what they owe and, thus, never even see the rate schedule. Taxpayers whose income is too high to make use of the tables must make two calculations to determine their tax liability whether the rate structure has eighty-seven brackets or only two.

It might be argued that progressive rates complicate the tax system not because they complicate the calculation of tax, but because they require a number of complex provisions in the *Income Tax Act* to ensure that taxpayers do not avoid the high rates, and that taxpayers do not pay an unfair amount of tax if their incomes fluctuate from year to year. However, even to the extent that complex rules are necessary in a progressive tax system for these reasons, they apply at most to only one-third of the highest-income taxpayers. In Canada, over two-thirds of taxpayers pay tax at the lowest rate. For them, the tax rate structure is flat.

More importantly, tax avoidance rules to prevent high-income taxpayers from escaping the progressive rates do little to complicate the *Act* even for these taxpayers. The following quotation from Boris Bittker, an eminent tax scholar, reflects a widely held view among tax specialists:

having begun my teaching career two decades ago with a conviction that most of the complexities in federal income taxation (especially problems of timing and income splitting) were indissolubly linked to progression, I am now convinced that proportionality would not contribute much to simplicity.<sup>126</sup>

Even a cursory glance at any tax textbook or the hundreds of tax cases that are reported each year reveals that a trivial amount of complexity in the tax system would be removed by having less progressive rates. This point might be reinforced by noting that the corporate income tax system is a flat-rate system and yet no one has ever argued that the corporate tax is simpler than the individual income tax.

What makes a tax system complex is loopholes, or departures from the tax base, not the application of rates to income. If the tax loopholes were eliminated, most personal tax returns could be two or three lines, no matter how steep the rate structure. If a person is earning income from a business or income from investments, then in some cases, difficult calculations must be undertaken to arrive at annual income for tax purposes. However, these complications arise because of the complexity of business and investment transactions, and they will remain even if all the loopholes are closed and the rates are flattened.

## V. CONCLUSION

The neoconservative attack on state power has been unrelenting. It has drawn support from the work of conservative economists, and has been sustained by the apparent imperatives of an internationally competitive investment climate. Perhaps in no area of public policy has its effects been as pervasive as in tax policy. Over the past few decades, nearly every objective and evaluative criterion of the tax system has been reinterpreted to accommodate the rich and those who would like to see more unrestrained power in the private sector. The direction of tax policy in the 1990s will depend upon how two important questions are answered. First, is it necessary to cater to the interests and power of the rich in order to achieve economic prosperity? And second, in the

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<sup>126</sup> C.O. Galvin & B.I. Bittker, *The Income Tax: How Progressive Should It Be?* (Washington: American Enterprise Institute for Public Policy Research, 1969) at 33.

present political climate, is it still possible to foster informed public deliberation about where the public interest lies, and define an appropriate role for government in society?

As an afterthought of sorts, the brief review of recent analysis of the economic effects of taxes contained in this paper reveals that public finance scholarship appears to have been blown by the winds of political power. By whatever mechanism, government power has had considerable influence on the economic academy. Certainly, the economic ideas, methods, and subdisciplines that have become hegemonic are those that are most consonant with the surrounding conservative political environment.

On a less grand scale, but equally troubling, the authors of some of the recent research on the economic effects of taxation on behaviour have concluded with strong and unequivocal policy prescriptions. In terms of the policy importance of the results, the tough ethical question facing any social scientist in the public forum is—what can reasonably be asserted on the basis of one's discipline, and what should be put in the domain of opinion and political preference? My impression of some of the recent studies is that the authors have used the authority of their discipline where the writ does not go. One cannot help but feel that some of these economists have grossly over-estimated their intellectual accomplishments. Unfortunately, since they have also furthered the ideological goal of accommodating the rich, neoconservative politicians have rushed to embrace them and their work.

