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## ***Reflections on the Role of Optimal Design in the Tax Policy Process***

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MY REMARKS ARE STIMULATED BY MY READING of Robin Boadway's contribution in this volume in honour of Ian Stewart on rethinking tax/transfer policy in Canada (Boadway, 2011). His paper provides an interesting and readable overview of contemporary applied tax theory as embodied in the Mirrlees Review (2011). It begins with a concise survey of theory concerning business taxation, the individual income tax, transfers to low income people, indirect taxation and, going somewhat beyond taxation, of public policy to ensure equality of opportunity. The design in these respects that emerged from the Mirrlees Review (2011) is the center of attention.

In the main portion of the paper, Professor Boadway considers how the ideas about design that emanate from the Mirrlees Review play out when placed in the Canadian context. Five features of the country are acknowledged as being of particular importance to the application of Mirrlees to Canada: our federal structure; the role of natural resources, especially their geographical concentration as well as control by provinces; the absence of inheritance taxation; the

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relative (to the U.K.) unimportance of congestion; and the treatment of human capital which was not dealt with by Mirrlees for some reason that puzzles Robin. The paper then goes on to provide an erudite discussion of what a Mirrlees type tax design might look like in this Canadian context.

Since I am an observer and modeler of tax systems as they are, and not a tax designer, my comments on the paper will reflect that perspective.

The tax reform process as I observe it and have written about it with Walter Hettich (Hettich and Winer, 1999, and 2006), consists of three components: comprehensive reforms – the object of the present paper – which involve major readjustments, usually of several parts of the tax system, and which are quite rare; coordinating reforms that realign or readjust important parts of the system that have fallen out of sync – such as personal and corporate tax systems, which are intertwined and may need important changes in the face of shocks such as a decline in the cost of international transactions; and technical reforms which deal with specific features of particular taxes. Technical reforms are always ongoing, and coordinating reforms are the subject of budget speeches, in contrast to the rarely seen comprehensive reform. In recent years, perhaps only the introduction of the GST in place of the manufacturer's sales tax (MST) constitutes a comprehensive reform of the federal tax system in Canada.

All of these reform processes occur in a political context. I interpret their consequences as equilibrium outcomes of political competition that are conditional on, and evolve with knowledge about technical issues supplied by tax departments and academic and other advisers, along with information about various interests and constraints that are generated by political competition. The approach to policy design that Robin Boadway takes *explicitly* ignores this broader equilibrium context, and in the first instance engages in optimizing logic played out as if the political process did not exist. Such a choice is not a matter of being naïve. It is a choice about how to conduct normative policy design with a view to making sure that no possibly beneficial alternatives are ruled out.

The *implicit* view of the tax policy process here (I think this is a fair judgment) is that the job of actually implementing tax reform is that of the elected government, and that it will pick and choose what parts of the optimal design

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will actually be adopted. So expanding the set of ideas about what may be socially desirable, which hopefully will influence what governments do, is the object of the analysis. And certainly, at least, this paper does the former.

Of course, if the politician ends up picking and choosing from the designer's optimized menu, the original design is no longer relevant in a basic sense. This is an important point.

To continue, let's assume that we are not prepared to argue that any deviation from the economically optimal design is a result of politics corrupting good sense – if you believe that there are legitimate political costs, and that one cannot be sure of how to handle them or estimate them, then there should not be an implication that those who can do so and have to do so will get it wrong in the end. Then, is there another way to present a set of proposals from which political choices will be made in such a way that the analysis helps to channel those decisions in a desirable direction?

I think that, in the end, one has to make a guess about 'feasibility' while creating alternatives based on desirable general principles from which politicians may choose.<sup>1</sup> Boadway actually goes down this road at a few points in moving from the Mirrlees Review to the Canadian context. For example, in considering the desirable form of commodity taxation, the greater control by Quebec of the GST compared to control of the HST in other provinces is taken as a given. Federalism generally is another such constraint that is accepted, just as is section 25 of the Constitution Act that forbids the Crown from taxing the Crown, a basic source of the lack of access of the federal government to natural resource revenues (that properly concerns him) and a key source of the strain in the equalization system in Canada. These are not 'ordinary' economic constraints, and there will always be debate about what is relevant when defining them.

Once one does that sort of thing – that is, delve into feasibility – one is then in a deeper second best world where one is guessing at constraints that partly

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1 There is nothing new in this view. Debate over the importance of feasibility as a necessary (but not sufficient) criterion for designing or choosing among policies has a long history. See for example, Yehezkel Dror (1968). See also Dror (1969), who warns that assessments of feasibility should sometimes be taken up as a challenge rather than accepted as an absolute constraint.

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stem from places that lie outside the realm of economic theory. The end result, despite appearances, may be a set of proposals that is better than if theory were held onto regardless of where it leads. For the real choice is not between an optimal design and the world as it is. It is between alternative conceptions of what is both possible and desirable.

It is useful to recall the experience of Charles McLure who in the 1980s directed a team drawing up a U.S. tax reform that came to be referred to as Treasury I. This document proposed a broad based federal income tax for the United States despite economic theory which at the time had swung heavily in favor of an expenditure tax, a tax that in a somewhat more evolved form is also part of the Mirrlees Review. The rationale for the Treasury proposal, according to the account in McLure and Zodrow (2007), was that the designers in the Treasury knew that some components of the expenditure tax system would never be accepted by the President and, as a result, the outcome would be worse than if the Treasury proposed a broad-based, Schanz-Haig-Simons type income tax.

The component they were sure would be missing was the taxation of inheritances and bequests, which is required to preserve tax equity when an expenditure tax replaces a personal income tax. That is one key issue in Boadway's application to Canada also, though it is just one of several. It is key for at least two reasons: capital income is sheltered in the Mirrlees proposal for direct taxation of individuals, so that inheritance taxes are required to restore the progressivity that comes from indirect taxation of wealth via taxation of capital and capital gains incomes. Inheritance taxes are also recommended as a way to improve equality of opportunity.<sup>2</sup>

The problem facing those who want to put more emphasis on inheritance taxes and wealth taxation generally is that the taxation of inheritances has been declining in most western countries for a long time, for reasons that are not well understood. (The issue deserves further study). Perhaps the decline is the result of an aging electorate that wants to pass on hard-earned wealth to their children? But whatever the reason, it is a good guess that meaningful inherit-

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2 On the role of wealth taxation in fostering equality of opportunity, see Boadway *et al.*, 2010, chapter 8.

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ance taxation is not likely to be part of any comprehensive Canadian tax reform. Such taxes were eliminated in Canada as a result of the Carter Commission reforms in the early 1970s when the tax was handed over to the provinces who then proceeded to compete it away.

What then? Should one take this as a 'constraint' to be used in tax design? If so, it would appear that the proposals in the Boadway paper would look somewhat different. Boadway in fact suggests a Nordic style dual income tax as an alternative if inheritance taxation cannot be restored, involving the separate taxation of capital income at a uniform rate much lower than that on labour income.

Another possible alternative, given this 'constraint', is to drop the inheritance tax and combine the other tax elements with proposals for investment in education – *as a package* – which is not a pure tax reform. I guess that Boadway would not be opposed to such investment in any case. But in the tax reform context, doing this would preserve desirable elements of the design at some cost in terms of government size, or in terms of changes in the structure of public expenditure if we hold to revenue neutrality.

I have little faith in the ability of the tax-transfer system to redistribute income over long periods of time. As a whole the annual incidence of the tax system appears to be proportional (Vermaeten *et al*, 1995), while explicit taxation of inheritances and bequests is absent and the taxation of capital incomes is declining in the face of globalization.<sup>3</sup> It is also relevant to note here that there is some evidence that suggests that the smaller rise in inequality we have had in Canada since 1970 than that experienced in the U.S. stems in part from a relatively bigger increase in the supply of university graduates in Canada, which may have prevented as large a rise in the university/high school graduate wage differential (Murphy *et al.*, 1998)

Together, these observations raise the questions of whether and to what extent education – especially perhaps access by lower income or disadvantaged

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3 Calculated pre-tax Gini coefficients are always larger than post-tax ones, suggesting that the public sector does redistribute. But by how much in the long run when human capital and bequest decisions are involved? The problem is that uncovering the pre-tax Gini requires a complicated general equilibrium calculation encompassing such longer run decision making, and I think that such a calculation still remains to be made in a convincing manner.

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children to early education, as well as the income contingent loan program for higher education Robin Boadway also favors – may serve as a desirable replacement for an inheritance tax in a feasible tax design?

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