



THREE MORE VIEWS OF THE FLAT TAX

To get three more views on the flat tax, Policy Options' editor William Watson organized a discussion among three economists who have studied the flat tax closely but are not quite so involved in the current debate as our earlier participants. Dale Orr is Senior Economist at WEFA, Inc., and Chief Economist, Canadian Services. He did a background paper for the Reform Party on the budgetary and macroeconomic impact of its single-rate-tax proposal. Pierre Fortin, of the Université du Québec à Montréal, has written a detailed study of the flat tax in the Canadian context. Jon Kesselman of the University of British Columbia is about to publish an in-depth assessment of the Alliance's flat-tax proposal for the Institute for Research on Public Policy. Here is an edited transcript of their conversation, which took place Sept 11.

Pour ouvrir trois perspectives nouvelles sur l'impôt à taux uniforme, William Watson, le rédacteur en chef de la revue Options politiques a organisé une discussion entre trois économistes qui ont étudié de près cette question, mais qui ne sont pas aussi engagés dans le débat actuel que ne le sont d'autres interlocuteurs dont nous avons déjà rapporté les propos. Dale Orr est Senior Vice-President de WEFA Inc. et économiste principal chez Canadian Services; il a préparé un document de travail sur les conséquences d'ordre budgétaire et macroéconomique d'un taux d'imposition unique, à la demande du Parti réformiste. Pierre Fortin, de l'Université du Québec à Montréal, est l'auteur d'une étude fouillée sur l'application du taux uniforme en contexte canadien. Quant à Jon Kesselman, de l'Université de la Colombie-Britannique, il s'apprête à publier à l'IRPP une étude sur la politique de taux d'imposition uniforme que prône l'Alliance canadienne. On trouvera plus bas la transcription de leur conversation qui a eu lieu le 11 septembre dernier.

William Watson: I'd like to begin by asking each of you for a very brief evaluation of the flat-tax proposal put forward by the Canadian Alliance.

Pierre Fortin: I don't see any objections to considering a flat tax *per se*. It's very much in the details that we have to see what it does to the economy, in terms of efficiency, and in particular to the progressivity of the tax system in general. I'm especially interested in generating more saving and investment in Canada, so as to encourage economic growth. In the plan before us, we get a lot less progressivity, and we don't get much more in terms of growth-enhancing effects, that is, favourable effects on saving and investment.

Dale Orr: I agree with Pierre that the proposal raises the important question of what is the optimum rate of

progressivity for personal income taxes in Canada. It also raises issues of the treatment of the single-earner family versus the dual-earner family, which I think is another area that people will want to look at carefully and make their own choice. It does provide less progressivity, but that's pretty much restricted to the very high end, where there aren't very many taxpayers.

Jon Kesselman: The flat tax is part of a package of tax proposals by the Alliance. If you look at the total package, almost all the other elements are almost accepted policy, certainly in the Progressive Conservative tax recommendations and in the government's own latest budget, both what they've done and what they're planning to do over the next five years. So the one thing that is unique in the Alliance package is the single rate that they

would apply to the personal tax. My evaluation of that is that, although it makes many claims for why it's the right way to go, I find none of the evidence offered in support of these claims convincing. You can reach all of the desirable economic and social goals that they're seeking, and even more so, through alternative ways of cutting and reforming taxes without the severe loss of effective progressivity in the tax system.

William Watson: When Al Gore talks about whether a tax proposal is risky or not, he usually has macroeconomic considerations in mind. What's your view of the macroeconomics of the flat tax? Is it a risky proposal?

Dale Orr: We looked at the proposal in January and, from a macro point of view, the impacts of the tax cuts were positive relative to an alternative

scenario where you put the money into debt reduction. Income and job creation would both be higher than otherwise. I would characterize those macro impacts as positive but reasonably modest.

Now the incremental impact is almost cut in half, because the personal income tax component of the Alliance package was in the order of \$90 billion over five years, and Budget 2000 introduced a five-year, \$58-billion package that covers many of the same points that are in the Alliance package. So now, as you compare the Alliance package to what the government introduced in Budget 2000, you're looking at an even smaller net impact on the economy.

Pierre Fortin: I think the effect is going to be zero whatever the package is. The reason is that we are in a monetary regime where the central bank tries to target inflation, and therefore, as an intermediate target, tries to hit an output level that will achieve this target rate of inflation. So whatever macroeconomic impact the tax reduction package would have would be taken into account by the Bank of Canada, which would then adjust the interest rate to the level that it figures it needs to achieve to make sure that the target output level is not changed, so that inflation target is reached. So, in other words, if you fold in the "central bank reaction function" in our economy, I think people now have to understand that fiscal stabilization is totally out of the picture. I'm exaggerating, but only a little bit.

Dale Orr: I agree with Pierre's last statement—namely, that it's a bit of an overstatement. I characterize the impact on GDP and on the level of employment as being modest from a macro point of view, but not zero. And I would characterize the Bank of Canada's posture somewhat differently than Pierre does. I think I'm quoting right from the Bank: They're trying to keep the level of inflation between one and three per cent, and when they see pressures building that they think are going to take the rate of inflation

above three per cent in the near-term future, then they're going to weigh in. But there's no indication that the Bank will try to keep the rate of inflation exactly at two per cent. I think there's still a reasonable amount of excess capacity in the economy and the modest amount of stimulation that this package would provide shouldn't threaten the bank's three per cent target. So I think there would be a macro impact that is positive, but modest, and I would see no reason for the bank to raise interest rates in response to this package.

Jon Kesselman: Canada's economy is at least approaching full employment and full productive capacity.

Dale Orr I would argue that the personal income tax cuts would have a modest macro stimulus...Look at the level of unemployment—seven per cent. If we can't expand the economy without inflation with an unemployment rate at seven per cent, that's a very sad commentary on the economy.

There's a lot of demand stimulus in the tax cuts in the Alliance package. I think that, given the state of the economy, there's a greater priority for tax cuts and other reforms that are more targeted on savings and investment than on filling up consumers' pockets and having them go out and spend. That would suggest faster movement on corporate income tax cuts, more aggressive moves in increasing access to registered savings plans, and lower taxation of capital gains. These are all funneled into investment that would raise productive capacity so that we can sustain and accelerate our business expansion and our long-range growth.

William Watson: If there were big tax cuts at the top end, which seems to be the consensus on this plan, would

the recipients of these tax breaks go out and consume their big tax increase or would high-income people provide a fair amount of new saving?

Dale Orr: The marginal propensity to consume of the higher-income people is certainly lower than for the average person, and their marginal propensity to consume imports is also a bit higher. So there are two reductions from the aggregate demand impacts on the economy.

Pierre Fortin: I would summarize this discussion as saying that the cyclical macroeconomic effect of this package is actually secondary. I totally agree with what Jon said concerning the importance of growth-enhancing policies, and we should focus on whether this package does exactly that. By "growth enhancing," I mean policies that act on the supply side rather than the demand side of the economy.

Dale Orr: I agree with both John and Pierre that from a cyclical point of view it's appropriate to have a high priority on tax cuts that work on the supply side and expand the economy, and here we would be talking specifically about cuts in corporate income tax and capital gains tax. But I would still argue that the personal income tax cuts would have a modest macro stimulus. I think there's a reasonable amount of room in the economy to permit that. Look at the level of unemployment—seven per cent. If we can't expand the economy without inflation with an unemployment rate at seven per cent, that's a very sad commentary on the economy. The core rate of inflation has stayed at a shade below two per cent and is stable. I say those are indications of an economy where there's still room for some modest expansion on the real side.

Pierre Fortin: I agree with all that, but I would say, along with [1999's Nobel laureate in economics] Bob Mundell, that we should try to assign policies to tasks. I strongly believe Dale is right, that there is at least room for testing the waters of lower and lower unemployment, but I don't see why it

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should be the responsibility of fiscal as opposed to monetary policy to do that. If anything, if we believe that the total overall macro policy is too restrictive right now, then we should advocate lower interest rates, not necessarily tax cuts. The tax cuts would be there to stay for many, many years. We should look at a better assignment of the two policy levers here: fiscal policy for the supply side and monetary policy for the demand side.

Jon Kesselman: The Alliance tax package is intended to be implemented over five years, so if we're looking at the demand stimulus from it, it's not going to be quick and overnight—it's going to be over a number of years. We already have an economy growing above long-term trends, so we're going to see the unemployment rate and pressures on capacity continuing to tighten over the next one, two, three years before all of this demand stimulus comes on line.

William Watson: Let's move on from macro concerns to a discussion of, first, efficiency and then equity. Economists have argued that high taxes cause serious inefficiencies in the economy and the Alliance proposal would reduce taxes substantially, at least for some Canadians. What's your feeling about the likely efficiency effects of moving toward what they propose?

Jon Kesselman: First of all, we should look at the empirical and theoretical economics literature in public

finance. It tells us that the efficiency cost of taxes applied at the margin is highest on capital income and savings, and it's lowest when applied, again at the margin, to consumption and to labour income. The reasons for that can be approached from many different angles. The international mobility of factors of production is important. Capital flows much more readily across borders. Try to tax it much and you lose it. As for labour, we hear about the brain drain, but the numbers aren't actually that big. Relatively speaking, labour is a lot more tied to a country. There are other, more complex economic arguments that lead to the same conclusion.

The Alliance's flat tax cuts tax rates sharply, particularly at the high end, and substantially for the middle range of incomes, but it does relatively little in changing the base of the personal tax. It does provide a modest increase in the dollar limit on registered savings. It does not, at least in the form that they put out in January, contemplate any change in the tax inclusion rate for capital gains (which was reduced from three-quarters to two-thirds in last February's federal budget). Both of those are items that I think we should push further on. We should really open up access to tax-recognized savings. That's particularly important at upper incomes, where people are constrained in their saving, and on the capital gains side. The proposal has been made, not only by myself, but by the Commons Committee on Industry in its report on productivity, and by many other groups, that the inclusion rate for capital gains should be knocked back to 50 per cent, where it was between 1972 and about 1987.

Similarly, on the corporate income tax side we should move both faster and further than either the Alliance or the Progressive Conservatives or the Liberal government have so far proposed. In terms of long-run efficiency, we're going to get more of an impact out of that. Over the long haul, people at all ends of the income spectrum

benefit: It brings higher wages, more employment, just a generally more prosperous and growing economy.

William Watson: The average reader may find it a little curious that the distributional effects of cutting corporate taxes are more favourable than of cutting personal taxes, particularly at the top end. Can you elaborate on that a little?

Jon Kesselman: If we cut corporate taxes, the immediate impact is that the corporation pays less tax, it has more cash flow, and it can finance more investment. Plus, it makes Canada more attractive to foreign sources of capital as a place to set up business or expand business. Now, does that simply flow through as higher dividends and a giveaway to the rich? Well, obviously, there is a higher return initially to those who supply capital, who are disproportionately those at high incomes, but it also gives higher returns to all those unionized workers with their pension plans invested in equities. And the effect on the real economy is more real investment and more jobs, and there's also evidence that the new investment will tighten up the spread between high- and low-paid jobs. It will tend to push up the wages of less-skilled workers more. So we get some intermediate and longer-term egalitarian consequences in terms of the feed-through on the real economy.

Dale Orr: I'd like to fine-tune what Jon just said about the efficiency impacts of reductions in capital taxes

Pierre Fortin I think discussion of these two packages requires us to consider which way Canada should go. Should we reduce program spending as a percentage of GDP much more than currently, or should we try to continue to reduce it but more modestly?

versus reductions in taxes on labour. Basically, I agree with Jon, but I think things are changing just slightly in a way that brings bigger benefits from cuts in taxes on labour, and for two reasons. One is the proverbial knowledge-based economy: Returns now depend a lot more on labour, especially high-priced labour, than they ever did before. And labour, especially high-priced labour, is much more mobile than it used to be, so that taxing it has bigger efficiency costs than it used to and cutting taxes on it brings bigger efficiency gains.

Pierre Fortin: Two aspects have to be considered. One is the size of the tax cut advocated by the Alliance, and the other is its effect on growth. In terms of size, it seems to me that if you compare the Liberal package to 2004/5 and the Alliance package to 2004/5, the Liberals are announcing \$22 billion of tax cuts and the Alliance \$34 or \$35 billion. So they propose a much greater reduction in taxes than the Liberals have been ready to announce. The main reason for this is that the Liberals are ready to let program spending rise by three per cent per year, whereas the Alliance would allow only one or 1.5 per cent per year.

I think discussion of these two packages requires us to consider which way Canada should go. Should we reduce program spending as a percentage of GDP much more than currently, or should we try to continue to reduce it but more modestly? So far, the two parties are both advocating reductions in program spending as a share of GDP. The split between the private and public sectors in terms of delivering goods and services to Canadians is something that we should talk about. Also, given that we decide to deliver services through the public sector, how are we going to minimize the unit cost of delivery? We should talk about that, too.

Both the Alliance and the Liberals pay little attention to reducing the nominal debt, in the sense that they are ready to see it decrease a little bit, but not very much. They are on the

same footing in this respect. We should discuss that. Should we have more debt reduction than has been announced by the two parties?

Finally, in terms of efficiency, I don't see the Alliance package as bringing so much more saving and investment to Canada. I question the importance of the growth-enhancing effect of the tax cuts that are advocated. I think we should try to look for alternatives that would be much more savings-friendly. For example, we should look seriously into alternatives such as the "USA Tax," which would, in terms of Canada, be called the URSP or Unlimited Registered Savings Plan—which is an income tax from which you could deduct all savings, thus making it a consumption tax. In other words, as Jon mentioned, we should raise the limits on the registered savings plans very, very substantially. And we should also look on the corporate side, too, not only to the corporate tax rate, but to how we treat capital expenditure. Do we continue with the kind of depreciation allowances we have now or do we allow investment expenditures to be totally expensed when they're made?

Jon Kesselman: As I've read the Alliance tax package, it involves really quite extreme restraint on spending. The flat-tax package actually has federal program spending growing just \$1 billion per year. That's less than one per cent a year. They say they want to raise program spending only at the rate of population growth, which is about eight-tenths of one per cent per year, and they don't want to raise it at all for inflation. So, if inflation is chugging along at even two per cent a year over five years, then that would bring a 10 per cent cut in real per capita spending—while the economy is growing in real terms.

Where do you find that amount of savings? The package refers to wasteful spending, bureaucrats that are unneeded, etc., but I think anyone concerned about fairness and distribution has got to be worried about that degree of spending restraint—unless they really

believe there are many more than a few of those fountains in Jean Chrétien's riding to be cut.

The tax savings for those at the lowest incomes will be very small—because they pay little income tax now—and they will lose much more from the Alliance program cuts than they can possibly save in taxes. And this actually affects the majority of taxfilers, who have incomes below \$30,000. This large group will save not a penny from flattening the entire tax rate schedule to 17 per cent, since that is the rate they currently pay. But this

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is also the group that is disproportionately reliant on a wide range of public services and transfer programs.

William Watson: This gets to the basic exercise of comparing the social returns to debt reduction, tax cuts and spending increases. If you look at some of the estimates on the efficiency costs of taxation, they are quite high. What's your gut feeling about the rate of trade-off between debt reduction, tax reduction and spending expansion?

Pierre Fortin: First of all, it's not a trade-off of tax cuts vs. no tax cuts. The debate about debt reduction is on the pace of tax reduction. If we are slow to reduce debt, then we have more in tax cuts now and less later, whereas if we reduce debt faster now,

Dale Orr Pierre's discussion about the possibility of extinguishing the debt seems a long way off from anything that either of these parties has in mind. They're talking about a \$3 billion or \$6 billion per year reduction on a debt that stands at \$577 billion.

we have less tax reduction now but a lot more later—essentially because the debt service is going to be reduced.

My way of looking at these matters is to ask "What would it do to the Canadian economy to extinguish the \$600 billion federal debt?" Even a simple calculus indicates that, using the standard relationship between the amount of capital in the economy and output, extinguishing the federal debt within 10 to 15 years would bring an eight per cent increase in GDP. Less of Canadians' savings would be frozen in financing the federal debt and more would be channeled into private sector investments. This is a big number. Granted, having that much more capital might reduce the marginal productivity of capital. The more capital you have, the less productive it is at the margin, but not by so much as to make this goal of eliminating the federal debt ill-advised.

I'm aware that there would be important political obstacles to doing it, but just on the face of it, just reasoning logically, it seems to me that all of us, including myself, have paid too little attention to the option of postponing some of the tax cuts to somewhat later and putting more emphasis on debt reduction. There are other reasons for that, like intergenerational equity and others, but that's the way I see it.

Dale Orr: Just to put things in a bit of perspective, what we can expect from the government is a reduction in the debt of about \$3 billion a year, the amount of the contingency fund. The

Alliance has said they would make that \$6 billion, fiscal conditions permitting, and they've made a major commitment to significantly more tax reduction. So Pierre's discussion about the possibility of extinguishing the debt seems a long way off from anything that either of these parties has in mind. They're talking about a \$3 billion or \$6 billion per year reduction on a debt that stands at \$577 billion. The differences in debt-to-GDP ratios that we would see between these two parties five to ten years out would be rather small. But I think it's important to ask whether the pace of debt reduction in both of these two proposals isn't too slow. And I wonder, is that the point you're making, Pierre?

Pierre Fortin: Yes, exactly. I'm not saying that the Alliance is worse than the Liberals here. I think neither party goes far enough. But we'll see. The Prime Minister suggested recently that he might like to consider alternative debt strategies that would pay more attention to debt reduction. We'll see.

Jon Kesselman: My inclination is also to see more and faster debt reduction than \$3 billion a year. I think Pierre has pegged the point. It's really a matter of more or less tax reduction now, or more or less in the future. And we also have to focus on issues of intergenerational equity and the sustainability of public spending when we really need it for public pensions and health care with the big explosion of the elderly population 10, 15 years from now.

Dale Orr: On that point: The Alliance proposal is much more favourable to RRSPs than the government's. There was virtually nothing on RRSPs in the budget, other than the higher limit on foreign content. The Alliance is not only bumping up the total amount that can be put in, they would allow everyone to put in at a pace of 30 per cent of their income, as opposed to the current 18 per cent. So that would lead to a reasonable amount of more savings than otherwise.

Jon Kesselman: Raising the limit from 18 to 30 per cent is a bit of a silly

proposal because almost no one puts in 18 per cent, except those who are constrained by the dollar ceiling of \$13,500. Remember you have a cumulative carry-forward, and that if in any year you miss any part of your contribution, you can put it in in a later year. Anyone who saves more than 18 per cent of their lifetime labour earnings is going to be living much, much better as a retiree than they ever did as a working person. Very few people do it. In fact, very few people at moderate, middle and even slightly upper-middle incomes even hit the *dollar* limit. It's only at high incomes that they do. It's really the dollar constraint that is a problem.

I think we should also explore other ways of increasing access to tax-recognized savings that would follow the approach taken in the US, where Roth IRAs don't give a tax deduction up front but allow tax-free accumulation and tax-free withdrawals. The revenue cost, if you want to call it that, is completely eliminated at the front end and is spread over future years. If we can go that route, I would say raise the ceiling to \$30,000 or even higher, but keep it at 18 per cent of earned income in any year.

William Watson: That gets us to the distributional effects. What's your view of the distributional effects of the flat tax that's being proposed?

Dale Orr: There's no doubt that families with income above about

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\$80,000 a year will pay a lot less under the Alliance proposal than they would under the Liberals, but when you look at the two proposals side by side, a more striking difference leaps out. It is the fact that under the Liberal plan the family that's earning a given amount of family income from a single taxpayer is paying a lot more tax than the dual-taxpayer family. In fact, for dual-income families, the amount of tax that they would pay, and the pace of progressivity, are very similar between the two parties. They only begin to part above about \$85,000, which includes only about five per cent of taxpayers. So this difference between how the parties treat single-earner versus dual-earner families is a major factor.

Pierre Fortin: One thing I like is the element of horizontal equity that the Alliance package reintroduces by suggesting that the \$3,000 deduction from taxable income be made for every child. I know a lot of people who earn \$60,000 and among them there are families with five cats and no children and other families with no cats and five children, and they're being treated the same. So at least this would reintroduce some element of horizontal equity, a small element. I've never understood why Ottawa at one point removed the notion of essential need and the previous elements of horizontal equity.

On the other aspects of progressivity, what you find in the Alliance program is that a taxpayer earning \$50,000 has a 20 per cent income tax reduction whereas the taxpayer earning \$100,000 has a 40 per cent tax cut. I'm going to become very rich out of that personally, but only five to 10 per cent of people would be targeted by this measure, which would be quite regressive. I think that's precisely the reason why, politically, it's totally impossible to get through. In the next election, it will be child's play for the Liberals to get a huge majority of popular opinion to reject the Alliance's tax cut program.

I think some reduction in pro-

gressivity should be in order, if only to be prudent with respect to the mobility of high-skilled people—even if the evidence is not entirely convincing that there's an important effect on migration. I think we should remain prudent in this respect, so that some reduction in progressivity would be in order, but there's an order of magnitude difference between the present level of progressivity and that advocated by the Alliance program. So, I would say that, politically, it's just not feasible as an electoral platform. It's going to be crushed by the electorate.

Jon Kesselman: I don't think there's any way to deny that the Alliance tax package, particularly the flattening of the federal rate schedule, causes a radical reduction in effective progressivity. They kind of conceal the extent of the change in progressivity and the magnitude of savings for very high-income people. If you look at the material on their Web site, or their underlying analytical document, they show the tax savings by income level, but the top bracket they show is \$70,000 to \$80,000. Well, when you start to go much above that, to \$100,000, \$150,000, \$200,000, maybe there aren't a lot of people up there, but you get big, big changes in their tax liabilities.

The plan is packaged with a large increase in the basic taxable threshold because of the higher exemption for the filer or spouse or equivalent spouse, and the new per child deduction. So 1.9 million people are taken off the federal tax rolls. But these very low-income people who have their federal tax wiped out weren't paying much tax to begin with. The massive change in tax liabilities is at the upper-middle and particularly very high incomes.

As an economist, I think we've really got to ask: What is being bought by this big change in progressivity? Are we getting improved incentives and a lot more efficiency and real growth for the economy? Yes, maybe we are getting some of that, but we can get even

more of those positive economic outcomes with much less reduction in progressivity by shifting the personal tax base, by pushing it more towards consumption, and also by pushing further and faster in the corporate income tax area.

A lot of what motivates the flat tax is the idea that our top marginal tax rates are too high compared to those in the US. But if you really compare like with like, that is, a high-tax province with a high-tax state, or a low-tax province—let's say Alberta next year with its 10.5 per cent tax—with a low tax-state, one of the seven

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or eight that have no state tax, you find in terms of top marginal tax rates that we are very competitive in our taxation of employment income and of self-employment income. We are almost spot-on in those two categories. In terms of taxation of interest income, we are also very close. On both dividends and short-term capital gains we are much lower in terms of our top marginal tax rates, and only on long-term capital gains are we significantly higher. Now, of course, it is true that you hit the top marginal rates sooner on our income tax schedule than in the US, but to fix that, we should widen our brackets.

I cannot see any good reason, assuming the goal were to make our tax system competitive with the US, to cut the top marginal rate of 29 per

cent. Now, the federal high income surtax could go. There are historical reasons for getting rid of it. But that only knocks 1.5 percentage points off top rates. To the extent that there are problems, they are that our brackets, particularly the middle bracket, has got to be started at a higher income and end at a much higher income. I would recommend raising the income level where the middle bracket ends and the top bracket begins from \$60,000 to, say, \$120,000 .

There are also problems with a few of the provinces' high-income surtaxes, which bite too hard. But if you deal with the federal high-income surtax, and some of the provinces start to address their high-income surtaxes, you really don't have a problem with being competitive on rate schedules with the US. You don't have to go as far as Alberta has. It's in a league with the no-tax states in the US. But Saskatchewan is planning to introduce its new rate scale over the next three years with a top rate of 15 per cent. If you add 15 per cent to the top federal rate of 29 per cent, with the surtax eliminated, you have a top rate of 44 per cent. The Saskatchewan 15 per cent rate will apply only at incomes above \$100,000, which is a big move in the right direction, and one that demonstrates that pursuing desirable tax cuts is not a preserve of the right end of the political spectrum. Presuming that we still regard Saskatchewan, with its NDP government as left of centre, good policy can come from any of a variety of sources.

Dale Orr: I've got comments in two areas. The first, briefly, is in response to Jon: You are comparing plans in Canada to what exists in the US and saying "Maybe things aren't quite as out of line as people might think." But if you compare Quebec and BC and some of the other high-tax provinces today to what the US could look like a couple of years from now if George W. Bush is elected, you get a very different picture.

The other point I want to make concerns progressivity under the

Alliance proposal. I hope that people looking at these tax packages won't get fixated on who wins or loses most in the changes. Examining the tax savings by dollar amounts is misleading because high-income people pay so many more dollars in tax. And if you examine the tax savings as percentage savings, that's misleading, too, because low-income people pay so little, you can give them a huge percentage saving, even a hundred per cent saving, but that doesn't represent very much income to them or very much revenue loss to the government.

So, rather than look at dollar savings or percentage savings, I encourage people to look at the average rate of tax that would apply for different

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income groups under these proposals. And when you do that, I come back to this same point, that for the dual-earner family, the average rate of tax between these two proposals is pretty similar over the range where you find virtually all taxpayers. For example, at \$50,000, dual-income families' average rate of tax under the government's plan is eight per cent. Under the Alliance plan it's also eight per cent. Go all the way up to \$100,000 and for the dual-income family it's 14 per cent for the government plan and 12 per cent for the Alliance's. The huge difference is that under the government plan, if you're a single-income family you'd be paying 21 per cent. That's

where the big difference is.

It's quite possible that the Alliance may have a big public relations problem on their hands, but I think we have to put it in context. That problem arises beyond the \$100,000 range—where we're talking about just three per cent of taxpayers.

Pierre Fortin: I've made calculations of the elasticity of tax payments relative to total income, not taxable income, and, in technical jargon, the elasticity of taxation with respect to total income is 1.5 currently. Under the Liberals, it would be 1.45 and under the Alliance proposal, 1.25. In other words, if income rises one per cent, income taxes currently rise 1.5 per cent. Under the Alliance plan, that would fall to 1.25 per cent. Even if you agree with the special cases mentioned by Dale, I think it is just impossible to deny that there would be a substantial overall reduction in progressivity in this system.

William Watson: Would the consensus here be that there *should* be a reduction in progressivity but that this is too much?

Dale Orr: I agree that this is a reduction in progressivity. I don't know whether it's too much. I find it hard to cast a judgment on that from a purely economic point of view. I mean, how progressive should it be? How progressive is too progressive? And how progressive is not enough? That's one of the key decisions people are going to have to make when they look at these two packages. But I don't think that we as economists can say that the optimum amount of progressivity for Canada is *X*.

Jon Kesselman: I'll stick my neck out. If you like the Alliance proposal for a federal flat tax, you would probably already have enthusiastically supported Alberta's flat tax, which will come in next year at 10.5 per cent. If you had both of them, 10.5 plus the federal 17 per cent tax, you'd have a total flat tax rate of 27.5 per cent, whether your taxable income is \$11,000, \$20,000, \$200,000, or \$2 million. That is a really radical reduc-

tion in progressivity from what we have now and from what almost any major OECD country has. A 27.5 per cent marginal rate is less than is applied in the US by the federal tax alone to a single filer at \$26,000, where they hit the 28 per cent bracket, or to a married joint return with \$44,000 in income. (Those are both US dollar figures.) And that's completely ignoring the fact that 40-odd states have a state tax on top of that, plus the fact US federal taxes go up to above 40 per cent on labour income, because you've got the federal income tax plus the federal medicare premium without any upper ceiling. So we would just be in a totally different league.

Dale Orr: Jon, again you're looking at Alberta.

Jon Kesselman: I'm looking at Alberta, but it's...

Dale Orr: They represent only about eight per cent of the population.

Jon Kesselman: Well, if you took a typical province, the provinces seem to be scaling back their high-income surtaxes; certainly BC has been doing it. If you have a 17 per cent federal rate and let's say a typical 15 per cent provincial rate, as it will be in Saskatchewan, you're up to a 32 per cent rate. Compare that with the US and though you have to move further up the income scale to hit 32 per cent that's way below the top federal rate alone in the US.

Dale Orr: Again I'd like you to compare Quebec or BC now with what the US might look like in a couple of years, particularly if George W. Bush is elected, though both presidential candidates are promising to reduce income taxes.

Jon Kesselman: I can tell you what BC's going to look like in a few years, too. Very different.

William Watson: Can I ask for some speculation on another thing that we economists are not really qualified to speculate on, which is, whether this thing is going to sell? Pierre, you've already expressed the opinion that ...

Pierre Fortin: No, period.

William Watson: ... that they're going to get hammered on this.

Pierre Fortin: Yes.

Jon Kesselman: I'm not as certain as Pierre that policies will necessarily be rejected just because they are poor. Tax policy is complex. Here you have a policy that sounds like it's simple: Everyone pays in and everyone pays the same rate. To some people that may even sound fair. "What's unfair about that?" It sounds like it's very simple. You get the first X dollars tax free and then 17 per cent. Of course, it ignores the fact that virtually all the complexity in the tax system has to do with how you measure the tax base, income—what's included, how is it measured, and what's deductible. The

Pierre Fortin I would think it would be rather easy for the Liberal party to argue that people are going to have \$10 billion less in health care in order to finance the \$10,000 or \$20,000 reduction in taxes that the Alliance wants to grant to those richer people. That will do it. It might be demagogic, but it will do it.

complications are not mainly from the rate. But ask your man and woman in the street and a fair number may find some appeal to this. Will it sell? I would tend to agree with Pierre that it's going to have problems once the distributional aspects are discussed more widely. I wouldn't completely count it out in political terms, but I think it would be a very uphill battle because of the single rate component of it.

Dale Orr: It's obviously difficult to speculate, but let me just raise a couple of points. Alberta has gone for a flat tax and as Jon is telling us, many people in Canada want signifi-

cantly flatter taxes. The other thing that hasn't got very much discussion is that the Alliance proposal really does reduce taxes very significantly for the lowest taxpayers. It lops off almost two million taxpayers from the rolls and then it cuts the taxes of the other lowest-income taxpayers reasonably significantly. So, you could turn it around and say: How are the Liberals going to win if the Alliance is being kinder to the lowest-income tax payers?

Pierre Fortin: I would think it would be rather easy for the Liberal party to argue that people are going to have \$10 billion less in health care in order to finance the \$10,000 or \$20,000 reduction in taxes that the Alliance wants to grant to those richer people. That will do it. It might be demagogic, but it will do it.

But another point here is that, since the program spending consequences of cutting taxes so much are so severe, it is very likely to cause further federal-provincial conflict. It may well be that if there is not enough money coming from the federal government in transfers, then the provinces will increase their tax rates, and therefore there will be no net gain for many taxpayers. You would get a provincial tax hike after getting a federal cut. There would be the added political problem that it would reduce the importance, the weight, the power of the federal government in the economy, which a lot of people in Ottawa think has declined too much already.

Dale Orr: The Alliance has been very clear that they're going to keep expenditures at a level sufficient to maintain health care. I think they're very sensitive to that and will be right out front saying "You're going to get as much health-care spending under the Alliance as you would under the Liberals." The cuts in program spending would be elsewhere.

William Watson: I want to close by thanking you all for a very comprehensive discussion. Thanks very much for doing this.