Tax Foundation

"Global Tax Reform: Who's Leading, Who's Lagging, and Is the U.S in the Race?"

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How Will Large Advanced Economies Respond to these Global Trends?

Scott Hodge: We've asked our next three panelists to answer a couple of key questions. What is the influence of the new competitive global environment on their economies and tax policies? And how have they reconciled the need for tax revenues with the need to promote competition and at the same time maintain fairness in the system? And then what are the emerging challenges for tax reform in their countries going forward? And I'm very delighted to have our three panelists with us today. I'll introduce all of them and then we'll go in order.

Starting with Dawn Primarolo, who is a member of Parliament and Paymaster General in the United Kingdom. As Paymaster General, Ms. Primarolo has a strategic oversight over the UK tax system as a whole, including direct, indirect corporate taxation, capital gains tax, inheritance tax, VAT, European and international tax issues. That's a very, very broad portfolio to be able to get your arms around. She's been a member of Parliament for South Bristol since 1987.

And our second speaker will be Vadim Grishin who is the head of the Economic Office at the Embassy of the Russian Federation. We're very delighted that Mr. Grishin has joined us today. He concentrates his activities within the Economic Office on expanding Russian/American economic partnerships, especially business dialogues in promising fields such as energy, high technology and finance.

Our last speaker, our neighbor to the north, Bob Hamilton is Assistant Deputy Minister of Finance for Canada's Tax Policy branch with a responsibility for the development of evaluation of the Canadian Federal Tax Policies. I have to note I heard a radio report – the radio report told me that the number of Americans seeking to perhaps move to Canada increased from 20,000 a day before the election and now to 100,000 a day - I'm sure the Canadians right now are already starting to count on the new revenues they're going to get next year from all the Americans who appear to be inquiring on how to move to Canada after the election.

Our first speaker, Ms. Dawn Primarolo, welcome.

Dawn Primarolo: It is a pleasure to be here in Washington – and I'm delighted that the Tax Foundation has provided me with this opportunity to speak to you today.

Many of the principles of sound taxation that are promoted by the Foundation, including the emphasis on stability and transparency and the promotion of growth are principles that we have embraced in the formulation of fiscal policy in the UK. And they will continue to provide us with a firm foundation as we address the challenges and opportunities for our economy.

Providing stability, within a rapidly changing international economic environment is a major challenge for governments. This is a highly competitive world. None of us can afford to be complacent about our ability to attract future investment and none of us can ignore the impact that changing taxation policies can have on the dynamics of investment and employment. But while we adapt to new circumstances in the global economy, we must also provide the certainty and consistency in our approach to policy-making that will provide the stable climate that is necessary for investment.

We believe that the key to meeting the competitive challenge is to have policies that support stability and sustainable growth for the long term. As the Chancellor of the Exchequer set out when he addressed the Confederation of British Industry last week, there are important long-term economic choices to be made that require a consistency of purpose and direction.

In setting out our approach to taxation policy, we have made clear our belief in competitiveness and fairness as the key drivers for our business tax reform programme and we have worked to make business a partner in that process of reform.

We have consulted, as no UK government has done before, with business and with the professions on every step of our corporate tax reforms, to validate and sharpen our proposals and we have listened carefully to their comments and suggestions. We will continue to work with our business organisations towards our goal of ensuring that the UK is and remains the most competitive location in which and from which to conduct international business.

But the UK economy will not achieve its full potential unless there is confidence and growth in the global economy and a commitment to free but fair multilateral trade within the world community. And our challenge is to work with our fellow-governments within and beyond the European Union to embrace the benefits of globalisation, to resist the temptation of protectionism and to take the long-term decisions necessary to break down trade barriers around the world.

Within the EU, we have long argued for an outward-looking stance that recognises the importance of economic reform. We need to ensure that our firms can compete on a level playing field that rewards efficiency, innovation and enterprise; and avoid the flawed short-termism that underlies a protectionist approach, whether in government procurement or in the creation of predatory tax regimes.

We need more effective action across Europe on labour market reform to promote flexibility, underpinned by a commitment to enhancing skills in our workforces to equip them to face the challenges ahead. Success in a globally competitive economy depends on unlocking the talents of all our people. The most important resource of a firm or a country is the skill of its whole workforce.

Global economic change demands that Europe embraces a global vision. It must be outward-looking, reforming and open and have a programme of liberalisation, a new employment dimension and a modern and effective monetary and fiscal policy.

There is no doubt that the developed economies of Western Europe and even the US face significant economic challenges in the years ahead.

The balance of growth has shifted dramatically in recent years. China and India are a magnet for investment, not just because their wage rates are lower but because they have created a climate that positively encourages investment. Together they provide a huge pool of highly skilled new graduate labour every year that is the essential pre-requisite of a modern economy and for successful businesses. And, as investment leads to new wealth they will become huge markets for goods and services. We should embrace and prepare for that change and recognise the opportunity and competitive challenge that it will present to our businesses.

For those of us engaged in tax policy-making, we have to ensure that our taxation systems do not simply get in the way in meeting that challenge. The framework of taxation has to be secure enough to yield the revenues that our governments require but it has to be designed to support and not to hamper the competitiveness of our businesses.

Recognition of that reality has driven both our domestic tax reform programme and our approach in Europe and we will continue to promote competitiveness, liberalisation and reform to strengthen our own economy and that of Europe as a whole.

We must respond effectively to anti-competitive tax practices, ensure that our tax systems are efficient; and eliminate unnecessary rigidities in our approach to taxation that act as a barrier to business.

Within Europe, the UK Government has resisted pressures to move back to outdated concepts in taxation that will not serve us for the future. We have resisted the savings tax proposals that would have damaged our financial markets and we will continue to resist the pressure for changes that will constrain our competitiveness. A modern Europe in a competitive global environment cannot afford to make the mistake of limiting its flexibility and restricting its ability to adapt. We must empower our businesses to compete.

Tax systems must continue to be modernised if we are to meet the wider economic challenge but, in modernising, we have to recognise diversity and national preferences. However much we share a set of common objectives, the governments in our different countries need the flexibility to respond in different ways to the challenges we face. Our tax systems, as they have developed are the result of the cultural preferences that are at the heart of our individual nations. And the different emphasis within our tax systems allows governments to recognise those national preferences on the role, the structure and the aims of taxation.

We do not need to question this diversity. We have said, as a government, many times that we do not need to harmonise to meet the challenges we face. But we do need to foster the natural dynamism within our economies.

The key is to preserve that natural dynamism while strengthening the effective co-operation between governments; to create a level playing field so that our businesses can compete based on innovation and efficiency, not on access to niche regimes that provide short-term ring-fenced benefits.

It is to achieve that level playing field that the Government supports the steps taken by the international community to promote the roll-back of anti-competitive discriminatory practices and has attached great importance to the work of the OECD and the EU in this area.

We have supported the OECD's work in the Forum on Harmful Tax Competition and we continue actively to support the work on the EU Code of Conduct on business taxation which I have chaired since 1998.

The Government firmly believes that the rollback of such discriminatory practices, coupled with greater transparency and exchange of information, are necessary preconditions for strong and fair competition which in turn will release the dynamic forces in the economy.

But let me, at this point, say a few words about our domestic tax reform programme. The UK has long been a hub for global business. There are many factors that make the UK particularly attractive and the natural location for business, including our sophisticated financial markets, our strong trading links with all parts of the world and the status of English as the global language of business.

When we came to office in 1997, we recognised that the tax system must complement these attractions. It must not stifle business but should empower it to compete in the global marketplace.

The system we inherited in 1997 needed urgent action to meet our objectives. So we embarked on a series of reforms to enhance both competitiveness and fairness, to build a system that would better respond to the changing needs of business and that would provide a stable framework into the future.

We started by cutting the main rate of corporation tax from 33% to 30%, the lowest ever rate in the UK, to act as a spur to investment; and we have gone on to reduce still further the rate for small and medium sized companies to provide a climate in which they can prosper and grow.

Outdated elements of the tax system have been swept away and we have made significant progress towards avchieving structural simplification.

We abolished Advance Corporation Tax (ACT) which affected the structure and investment decisions of many multinationals.

And we abolished payable tax credits on dividends, removing a distortion that encouraged companies to pay out dividends rather than to retain them for investment.

We recognised the importance of intangible assets to our knowledge-based economy and saw that the UK system of taxing intangibles was a barrier to growth. So we introduced a comprehensive new system of reliefs with a consistent framework to support business investment.

We introduced new measures to encourage research and development. We saw the evidence that a strong R&D base was essential to the Government’s strategy for improving the UK's productivity performance and competitiveness. Comparisons with other countries showed the extent to which the UK trailed behind other major industrialised countries in business R&D, even though our science base was strong. We saw that this translated into lower levels of innovation so we introduced an R&D tax credit, first for SMEs and then for all companies with qualifying expenditure.

Looking at the UK today, we believe that it now offers a highly attractive tax regime for multinational business.

But because we are not complacent about the future, we have an active programme of corporate tax reform. And we continue to work with our business community to develop the taxation system in ways that will encourage and facilitate investment. And we value their contribution to the policy-making process.

We will also continue to work with them to ensure that the framework of UK corporate taxation is robust against challenge in the European Court of Justice. We acknowledge the role of the ECJ in policing the application by Member States in their domestic legislation of the fundamental freedoms in the European Treaties. Governments today are ever more conscious of the need to ensure compliance with their treaty obligations.

While US policy makers do not have the ECJ or the state aid rules to contend with, we share a common adherence to the rules of the World Trade Organisation and recognise its importance in helping to ensure the level playing field that we seek to achieve. Although at times it can seem as if these organisations create only challenges for us – and I am conscious of the long and sometimes difficult debate that preceded the recent introduction of the American Jobs Creation Act – we have to acknowledge that their rules are designed to facilitate and not to hinder the achievement of our objectives of removing unfair discrimination and enabling balanced and sustainable growth in the global economy.

We should also acknowledge that, while we compete for investment and jobs, we have a great need, as governments, to work together.

Effective international co-operation is required to ensure that national tax systems can deliver the real benefits of global integration.

Of course international co-operation on tax issues is not new. Indeed, it dates back to the first half of the twentieth century, with the signing of the first bilateral double taxation treaties and the early precursors to the OECD model. And throughout the past hundred years, governments have continued to recognise that there is an important role for co-operation to address new international tax challenges.

But as global integration deepens, and as emerging markets and developing countries increasingly participate in the global economy, there is now an even greater need for countries to co-operate to address cross-border issues, including the problems of avoidance and evasion; and to ensure that all taxpayers contribute their fair share to the provision of the public goods and services that they use.

In Europe, in seeking to combat evasion of income tax on savings, we have recognised that the existence of global financial markets means that tackling tax avoidance inevitably involves the co-operation of countries outside the Union. And, going forward, the UK will work with the EU at expanding co-operation on transparency and the exchange of information to other important financial centres.

The UK actively supports the OECD's work to develop international standards for transparency and exchange of information in national tax systems, which help counter cross-border tax evasion and avoidance. Importantly, this work has encompassed a programme of outreach – through the OECD's Global Forum – to expand co-operation to a wider group of countries, particularly in the developing world. The G20 has recently been discussing this very issue and Ministers are expected, at their meeting later this month, publicly to support OECD standards on exchange of information and transparency.

The UK has welcomed the opportunity of enhanced co-operation with the US, Canada and Australia through the newly formed Joint International Tax Shelter Information Centre, which has just started operating here in Washington. A joint strategy, coupled with increased collaboration and co-ordination of information access between our countries, will be a great help to our national aims of tackling avoidance.

Tax avoidance is not the only challenge however. The increasing ease of movement in capital, goods, services and people around the world requires co-operation between Governments to reduce double taxation, provide certainty for taxpayers and ensure that they pay the right amount of tax to the right jurisdiction. The UK has an extensive network of bilateral double taxation treaties (covering more than 100 countries), based on the OECD model. And we are working to modernise those treaties in line with changes in the nature of business activity and the global economy. Going forward, the UK will continue to work to ensure effective international co-operation on tax issues.

But, in closing, let me just return for a moment to restate the fundamental points that guide us in the international dimension.

We are committed and will continue to press for the creation of a level playing field on international taxation issues and for the adoption of clear international standards of transparency and exchange of information.

We reject and will continue to resist narrow, inflexible and protectionist policies and we will reach out to encourage developing countries to become increasingly engaged in tax policy debates and the search for effective long-term solutions.

We see tax competition not simply as an inevitable outcome of growing global integration, but as a positive force that we must actively encourage. It drives reform, encourages efficiency and rewards those countries that develop sound economic policies and create flexibility.

We believe that pursuing competitiveness and fairness within our domestic framework and in the international arena will provide the kind of climate that will empower our businesses in an ever more competitive world.

I commend that to you as an objective to which can all aspire.

Thank you

[applause]

Facilitator: Moving a little further East here.

Vadim Grishin: It's a real pleasure and honor to stay here with you. I've been asked to share with you some observations about the Russian tax reform. And I believe that it can be interesting for this highly professional audience.

In recent years Russia has faced the challenge of creating a competitive tax system to support the structural growth of the Russian economy. Our reconstruction strategy was to establish a tax system that would be fair, unoppressive, transparent and clear to taxpayers. We have succeeded in accomplishing some of this task. We have failed to do some other things for a variety of reasons and some are yet to be done. However, it can be said now that the tax reforms on the way over the last few years have brought significant changes in the tax system structure to greatly improve the investment climate and Russia's economy growth in recent years.

As you can see by the end of 2003 the Russian economy showed stable growth – growth domestic product growth by 7.5%. Household income grew by 40.2%. Capital investment increased by 12.5%. Russian's economic indicators compares with other emerging market countries are very positive. There is no doubt that the main driver of the positive macro economics and stable tax revenues is oil prices – 60% of Russia's exports come from oil, gas and similar products. The other main factor is an undervalued local currency. These two factors lead to large trade surplus.

In the last two years the tax administration in Russia has improved by far. Budget surplus reached 3% of GDP, while the external debt burden has significantly decreased. Budget revenues have historically proved to be very dependent on oil prices, thus on this slide you can see a functional dependence of budget revenues from increasing oil prices.

Extra budget revenues are accumulated in the specially created Stabilization Fund. The Stabilization Fund was recently established separately from the budget as a source for budget fund increases – debt, buy-backs strategy infrastructure projects. However, once it hits $500 billion rubles, approximately $70.5 billion the surplus can be used for other purposes if agreed by the Parliament. We expect this fund will reach 500 billion rubles by the end of this year.

The Stabilization Fund is formed directly from oil taxes. And oil priced at $20 per barrel of euros and more. Money from this fund can be invested in foreign 3-A instruments only.

Today the tax system of Russia includes 16 taxes. Most of them are federal taxes, which are collectible on the whole territory of Russia as well as for special tax regimes. There are three original taxes: corporate property tax, transport tax and gambling tax. There are four local taxes. Tax revenues from federal taxes, generally from the federal budget, however, profits tax and personal income tax, also called regulated taxes, distributed proportionately between local, regional and federal budgets.

This slide shows the taxes we've abolished over the last five years. Of course many of them were expensive to administer. Turnover taxes have been abolished after lengthy and heated debate. Sales tax is now a thing of the past. These taxes formed the bulk of regional and local budgets tax revenues.

The most important taxes are the following: federal taxes, profit tax, value-added tax, personal income tax, excise, natural resources extraction tax. These five taxes are contributing almost 90% of all tax revenues in Russia. Of course the custom duties are not officially includes in the list of taxes collectible by the Tax Authorities. Also unified social tax is a direct contribution to the pension, medical and social state non-budget funds and is not included in the official tax statistics.

As you can see there is a consistent trend in our tax policy over the last few years. The most important and collectible taxes are no longer distributed among the federal, regional and local budgets. Thus VAT, excises, and natural resources extraction tax are contributed to the federal budget. We believe that centralizing tax revenues in the federal budget is one of the key points of the success of the Russian tax reform since it helps to finance less developed regions at the expense of the donor regions, like Moscow or St. Petersburg. In Russia almost one half of the regions are underdeveloped.

Now I would like to highlight some general rules of Russia's tax system. Corporation profit tax, which is quite similar to the U.S. corporation tax is applicable to all businesses excluding small businesses subject to simplified tax regime. Generally business-related expenses are tax deductible. Transfer pricing and capitalization rules are not enforced. Corporation profits tax rate is at 24%. From 2005 profits tax accounting will be kept separately from business accounting. That is an indirect tax, which is similar to the European model but with some differences. From 2004 it stands at 80% and will be reduced to 16% from 2006.

This tax makes a large contribution to the Russian budget. Some experts will say that this tax is very easy to collect. This is true, but at the same time, it's difficult to administer, especially when in recent years some taxpayers began to use tax evasion scheme based on artificial tax funds.

Russia plans to resolve this negative situation very soon by introducing a new online VAT filing requirement in the form of an electronic method and procedure for all VAT payers.

This is a huge task, which has to be dealt with in 2006. In which, in our opinion, will have a two-fold effect. On the one hand, resolution of this matter will simplify the relations between the taxpayers and the tax authorities. Large companies involved in a multitude of transactions and with numerous branches submit to the tax authorities tons of printed invoices and it’s practically impossible to examine them.

Thus, with the electronic system, the taxpayers will be simplified. On the other hand, the Tax Authority will get the opportunity, having built a corresponding electronic structure and provided that they get good mathematics support, to analyze in real time the transaction being performed on the market. And, thus, identify the taxpayer subject to specific attention of the Tax Authority from the standpoint of their compliance with the tax law.

Unified social tax is payable by employers. Today the rate is 35.6%, which is rather high for people with lower incomes. The rate goes down to 2% for income higher than 600,000 rubles – this is approximately around $20,000. It has four schedules. Tax revenues are divided into four different portions. For example, for the highest rate at 35.6%, the distribution is the following: 28% goes to the pension, 40% to the Social Security fund, 3.6% to the state medical fund, and a very small portion to the federal budget. There are some privileges for disabled employees and for small northern [sounds like] communities. But, as of 2005, the tax rates will be significantly reduced, as I said before.

Personal income tax is 13% for tax residents and 30% for non-residents. Mineral resource extraction tax varies depending on the type of resource and is imposed on extracted resources. For crude oil the rate is temporarily up to 2007 and is pinned to the price of oil. Before introduction of the MET excise tax was collected from oil and gas.

We have also property tax, so-called asset tax, of 2.2. Excise for alcohol, spirits, tobacco products, luxury cars and petrol, advertising tax of 5% will be cancelled from 2005.

Over the last four years the overall number of taxes has fallen dramatically. In the past there were more than 50 taxes, whereas a new structure of the tax system effective from 2006 or even as soon as 2005 we'll have no more than 15 taxes of different levels. In addition, there will be three special tax treatments in place. They will cover small businesses, production-sharing agreements, and agricultural producers. Indirect taxes such as VAT and excise duties have undergone fundamental changes.

Radical changes were made to profit tax, with its current rate of 24% and almost complete abolishment of privileges. Taxation of natural resources has seen changes in terms of production and utilization. A new tax on corporate property has been imposed. That's some progress so far, however, quite a lot of issues remain to be tackled.

Reform is in progress and quite a lot of changes come into effect from January 1, 2005. This is the next stage of reform. A water tax will be introduced. Parliament will soon approve a state duty in its new chapter of the tax code. And we believe that it will come into effect from the 1st of January. This is a very important stage of tax reform, since it will complete a task that has been on the agenda over the last 10 or 15 years namely. To fully realize a constitutional principle that everyone should pay a statutory rate of taxes. And that the amount of the state duty for most items will be reduced compared with the current ones.

This year we expect to finalize the rules for determining customs value, which is of great important to tax on imported goods. And issues of custom fees paid for custom's clearance, escort and storage of goods will be addressed. In this area we will abandon the practice of charging a duty currently paid for such fees for customs clearance.

We will switch to capital rates that, in principle, correspond to the cost of the service provided by customs authorities. There will be some increase in tax rates applicable to mineral production, both oil and gas effective from the 1st January of the next year. We expect profit tax rules to be substantially improved this year.

We propose that Parliament should also make a number of decisions concerning convergence of tax and business accounts. They should provide taxpayers with the greater freedom when it comes to determining various costs. We intend to introduce another set of changes from 2006. A new land tax based on the values of land and an individual property tax provided that the work on large-scale assessment of housing is completed by that time. In 2006 we'll see very important changes in VAT. A number of radical changes are in store – reducing the rate to 16% with simultaneous abolishment of the current preferential rate for some classes of goods, as well as resolving issues related to capital investment and forced a reform of VAT to exporters.

These problems have been discussed over the last few years. And I think that we will be ready to start solving them from 2006. The procedure for VAT reforms to exporters and other taxpayers who use the zero rate is most likely to change from the commission's procedure for the reformed to a declaratory one. We also expect to switch to the VAT escrow method from 2006 instead of the current two methods: cash and accrual.

I would like to highlight another important factor. We assume that in the coming years the tax burden will continue to decrease. Normal tax rates will be lower as well. This is an important element of a competitive economy and a competitive tax system. Recently we have reduced the tax burden at the rate of 1% point of GDP a year and this will continue for the near future. However, a lower tax burden, taken alone, is not sufficient and the latest government cabinet meeting showed that the issue of tax administration, tax control takes priority.

It's this issue of the government to focus on the complete tax reform. This is quite understandable – having fixed low taxes the government is entitled to demand that these taxes are paid in full. As lower taxes taken alone are not sufficient to make taxpayers meet their obligation in full.

Russia and other countries share issues, including those related to criminal developments in the tax sphere which requires principal decisions. Without this, without improvement of tax administration and tax control we cannot expect any competitive conditions on the market. It's clear that those who do not pay taxes have a clear advantage compared with those who meet their tax obligation in full. To streamline this fear is not so much the fiscal task of the government, as an important element of a sound economic environment, attractive investment climate and this is what taxpayers have been highlighting recently.

Now I would like to share some conclusions. Adam Smith says that a deferred tax system is based on progress of rates doesn't work in Russia. Low flat rates were better. Before cutting the personal income tax we understood that the real household income is growing but peak revenues and most of the declared income reached only the minimal peak rate of 12%. Where the maximum peak rate of 30% was used by four or six percent of taxpayers.

Thus, we made a compromise by adding one percent to the low-income scale and introducing a flat 13% tax. This provides more revenues than collecting 30% from those four or six percent of taxpayers or enforcing declaration procedures. We also believe that establishing the flat rate of 30% encourages middle class and rich people to declare their incomes.

Another reason for this radical change was that the application of the maximum peak rate of 30% together with social tax of 38.5%, enforced in the late '90s, to declare 100 rubles burdened an employer for an additional six to 8.5 rubles.

In Russia an employer is treated as tax agent. This factor made employers adopt great salary schemes. Before cutting the profits tax we calculated that the effective profits tax rate for major economies reach 11% to 17% due to regional tax concessions and narrowest use over the capital investment privilege along to deduct up to 50% of taxable profits. Competing for the low regional profit tax rates to attract taxpayers, many regions had budget deficit because they couldn’t earn enough money to finance necessary vital expenses.

No real capital investment came in some regions. They were still underdeveloped and required federal budget assistance. On the other hand, establishing low or zero rate for original profits, tax portion and for property tax the so-called “unsure tax” were attracted to artificial profits of some companies to the low tax regions – only for tax allocation. And that created unfair taxation for other taxpayers and losses for the Russian budget.

Before cutting VAT we realized that increased consumption gave us an opportunity to cut VAT from 20% to 18%, separate from canceling of the sales tax. However from 2006 we plan to reduce the VAT rate to 16%. But doing this we need to sacrifice a privilege tax rate of 10% collected from food, children clothing, and medication.

This step should definitely push up for some time retail prices for these goods, but taking into account that most poor people will be funded by the state for buying drugs. This temporarily growing in prices will be paid out of the pockets of wealth and middle class people.

Before reducing the unified social tax we understood that the regressive use T-rates from 35.6% to 2%, instead of the flat rate of 38.5% how to jumpstart and develop of non-state social security funds for well paid employees. But for employers with less well paid employees 35.6% is still high, thus, we reduce the maximum tax rate to 26%, plus a descending tax scale for high incomes up to 2%. Our calculation showed that the proposed tax rate could still give enough of operational money to the state social system.

Some concluding remarks. This is really true that centralization of tax revenues and ration on flexible intra-budget mechanisms allowed room for maneuver on deficits or, in short, crisis situations. The second assumption is that by canceling or reducing one tax you should broaden the tax base to new categories of incomes or to reduce most of the privilege incentives. By reducing taxes you have to be sure that everyone is going to observe the tax laws, thus, significant pending to improve tax administration as required.

Unfortunately there is not enough time to discuss all the issues related to Russian tax reforms, but those are the principal wide lines and thank you for your attention. [applause]

Facilitator: Thank you, Mr. Grishin. I was fascinated by the 5% tax on advertising that you're going to be phasing out. I'll move right into our next speaker. Bob Hamilton is assistant deputy minister for tax policy of Canada, please welcome Bob Hamilton.

Bob Hamilton: Okay, thank you, Scott. First of all, I would like to thank you and the organizers of the conference for giving me a chance to come here and talk to you today. It's a fascinating chance to not only listen to the experiences of other countries that we've heard this morning and I look forward to hearing more about what's the U.S. perspective this afternoon. And hopefully in the next 15 minutes or so, I can give you some insights into what we've been doing in Canada and some of the challenges that we face.

First, I wanted to leave a little room to walk through a couple of doors that were left open for me this morning. First off, Jeffrey mentioned that if anybody wants to understand more about what it's like to move to a value-added tax system, we've had some recent experience in Canada and I was involved in that and I would be happy to share any of that with you. But I'll leave that until the questions and answers, except to make two points. One, it was a courageous task for the government to take on and that's code word, I think, for some of you that may know when you go to a Minister and say that we've got a courageous proposal for you he or she usually starts to tremble. We introduced the tax in 1991. The government was replaced in 1993. And otherwise it's been a fantastic success.

[laughter]

A great economic . . . and I guess at a more micro level for those of you who that may be involved in that change should you decide to go through that door, I would say be prepared for an isolated hermit-like existence. Not only will you be working 24 hours a day because it's a massive undertaking, but you will feel isolated from society. It got to the point where I would go to social events and sort of mumble what I did. I'd start – well, I work for the government. Oh, yeah, what part of the government? Well, Department of Finance and we're part of the tax policy.

And finally I'd get down to the Goods and Services Tax and then all hell would break loose and my eyebrows are just growing back. And my family members would actually just lie – they'd say what's Bob doing these days? Oh, we don't know. [laughter] But it's sad. Anyway, it's a fantastic tax and we've had good experience with it from an economic perspective.

The second thing is just to say we had a little discussion at the end of the previous session about small versus large economies and different perspectives. It's interesting to be here with large economies. I mean we are part of the G-7 and we certainly think of ourselves as large economies and certainly have a lot of scope to have different tax policies and different social policies as well from our neighbors to the south and from other countries. A lot of sovereignty flexibility there but there's no doubt, being just north of the United States we can't help but be influenced and feel some times like a small economy in terms of the types of the pressures that are placed us.

And I'm speaking here only of the tax world, but it applies more broadly, of changes that happen here. Indeed, the changes that we saw in 1986 and our tax reform were very much -- at least in part – driven by events that happened here in the U.S. The tax reforms here led to an increased, a catalyst, if you like, for the changes that took place in Canada.

Similarly, as we stood right now looking forward, interesting to see what might be happening in the U.S. on the tax front and it will at least be a factor to be considered in the Canadian context. So whether I should have been on the previous panel or this panel I guess it's not 100% clear, but I'm glad to be on this one.

Let me just quickly – and I will try to respect the time – so I'm going to go through this material relatively quickly but I'm happy to talk at the question period or afterwards about particular aspects. I want to do four things. Just a quick background on what the Canadian tax system looks like from a macro level.

I want to talk about the fiscal and economic context because I think that's an important of what we've been up to in Canada and what will shape where we go forward and talk a bit about what our recent federal tax experience. It wasn't a tax reform, if I can use that term, like we saw in the '80s. But it's been a significant change in the tax system and I'll spend a few minutes on that, and that at the end I'd like to talk about some of the challenges and directions, some of which we've heard already. A couple might be a little bit different and a slightly different perspective on it.

Okay, so our level and mix. Now Jeffrey showed you the OECD table, so I won't spend a lot of time on this but it is useful background just to know what we're dealing with for some of the remarks I'm going to make. You can see that we're slightly below the OECD average in terms of total tax revenues. If you looked at that same chart in the early 1990s, you would have seen us right about the OECD average so we have seen a decline since those years in terms of the amount of tax revenue that we're taking relative to the size of the economy.

Looking at the next one is really what's the mix like in Canada? And, again, not too much surprising I don't think in terms of the mix of taxes we have -- fairly heavy reliance on income taxes, the personal and corporate. And I think one of the most important things and the reason I wanted to include this slide is up in the top right corner. We get our total revenues – about $350 billion, about half from the federal government and about half from provincial governments, so the provincial governments play an important role in the tax system in Canada.

We have a fairly integrated system – a lot of harmonization through our tax collection agreements but there are definitely differences. And the point that was made earlier that it's important to have all governments rowing in the same direction to really achieve an objective I think is one that applies in Canada and I'll talk about that in a moment. And the provinces are in virtually every tax base that's there so that's what we have in Canada by way of sort of a macro picture.

And with that bit of context what I'd like to turn to now and spend a few minutes on is the fiscal and economic. Not just to brag about what we've done in Canada, although we are fairly proud of it on the fiscal front, but because I think it's important to understand the tax policy's role in this.

I mean I work at the Department of Finance and tax policy is one part of that department. But the fiscal and economic environment not only shapes what we can do from a tax policy perspective but also our tax policies help determine what that fiscal and economic environment is going to look like.

So I very much see it as an integrated whole and I think if you look at the picture over the last decade I think it's important to keep the two of them together and perhaps to help understand why we put so much importance into this. If you look into about the mid-1990s you had a situation with a Mexican peso crisis. You had a prominent here in the U.S. declaring that Canada was on the verge of becoming a third world country. Now you can debate the accuracy and validity of that statement but just the fact of having it out there obviously caught people's attention and, in fact, I think was a catalyst for some of the changes that came forward. We had high deficits and prior to that the debt was growing.

Following that period, from the 1995 budget forward there was a commitment to getting the fiscal house in order and I think this chart shows you how we basically reduced the deficits. And in the 1970s period we've run a constant set of surpluses since then of varying size.

In fact, I was just at the Finance Committee earlier this week with the Minister where he presented the economic update going forward. And the major criticism right now is that the surpluses you're projecting are massive. You're deceiving the Canadian public – I mean we're basically having a debate about the bad side of running surpluses and it's kind of an interesting position to see given where we might have been 20 years ago. But we have had some success in actually staying in a surplus position and that fiscal environment I think has allowed us to do a number of things.

The next chart just basically shows – I mean even if you just don't look at Canada but look more broadly that you see relative to the other G-7 countries we're the only one that is running a surplus in this environment. So, again, that is something that we feel quite good about and our tax policy changes have been taking place within that context.

Just very quickly a couple of other slides. We do still have a fairly significant debt but, again, we're taking that debt burden down relative to our partners abroad. And we have established a target of moving towards 25% debt to GDP ratio at the federal level within 10 years. And these figures I'm showing you here are total federal plus provincial – it's always something we have to keep in mind in Canada. Are we looking at federal or total and these are total numbers.

Now just quickly on this slide because I focused on the fiscal side of things just from the economic perspective. You don't just do this to have good fiscal charts but we've also seen good economic performance over the last number of years, whether it's employment growth – you can see where we are: labor productivity, standard of living. If you look at the 1997 period until now there have been a lot of successes on the economic front. And, as I'll come to in a second, it's helped shape . . . it's been driven, well, not driven but a factor has been what we've done on the tax side and it's also shaped what we've done on the tax side. And so we're in an environment now where we'd like to keep this picture rosy going forward. And how do we stay out of a deficit position and continue to pay down debt and accomplish all of the other goals that the government has?

So let me situate federal tax policy in that context – what have we done in recent years. And it's interesting for a couple of reasons. One, is I think it tells us it's interesting to try and explain what's happened there but it's also, perhaps, a good predictor of what we should be trying to do going forward. The first is that we established a plan, a multi-year plan going forward and we phased in the changes as we could afford them. In other words, we preserved the fiscal picture as best we could while still trying to reduce taxes.

And the changes we've had over the last five years have been tax reductions. Certainly we lowered taxes for low and middle income Canadians.

First, a large part of the package was directed towards that and that's not only politically a necessary step but also from an economic perspective. We do have some difficulties in that area and it was necessary to reduce the burden. And then finally we looked at areas where we could reduce taxes where we could get the biggest economic bang for the buck. In a time of limited resources we didn't have a lot of excess money to spend. If we wanted to stay on this fiscal position, where could we put the tax cuts where they would do us the best good and I'll talk in a moment about that.

So, as I said, in 2000 we introduced a five-year plan. A hundred billion dollars, $84 billion U.S. tax reduction over five years, so it wasn't all done at once. It was phased in as we could afford it. Three-quarters of those cuts went to individuals and I talked a little bit about why that's important. And corporate tax rate reductions, which tried to establish a Canadian advantage as we call it in the corporate tax area. We were able to do further reductions in 2003 and 2004 and my hope is going forward we'll be able to continue this path, again, within our fiscal constraints. So what was the five-year plan?

Basically on the personal tax side – I won't explain these but we did restore full indexation of good structural changes as far as we were concerned. We reduced marginal tax rates for all income levels. We increased the Canada Child Tax Benefit and an important part of the government's platform was increasing the benefits for Canadians with children. It's called a tax benefit – it doesn't actually run through the tax system but whatever. And we reduced taxes on capital gains again as other countries have done, trying to look at ways to stimulate investment risk-taking and we increased the tax shelter savings opportunities. We recognized that the taxation of savings does have economic impacts and we looked for ways to try and increase those where possible. The main reason I put these on is there is a little bit of something for a number of different groups in this, and this package represented about three-quarters of the reductions over the five-year period.

Perhaps more interestingly from some perspectives is what we did on the corporate tax side. We reduced the general rate from 28% to 21%, so our statutory rate came down. And we also made some improvements to the resource sector, which brought their rate down to 21% and made some other changes. So we were left with an uniformed tax rate for large businesses at 21%, eliminating some of the special rates that had been in place for manufacturing, etc. And we think that was a good change to bring a low rate to all our sectors, and I’ll show you in a minute why we thought that low rate was important.

We also eliminated capital taxes. We had been relying fairly heavily on capital taxes in Canada and they will be phased out by 2008. And, again, all of these changes were coming in and, in fact, this is the last year of that phase-in period for most of these changes.

And finally we said we needed to align our tax depreciation rates, again, coming to some more structural aspect. Could we try and get those rates in line with useful [indiscernible] – not accelerate them but look for a way to make sure they’re keeping up with developments out in the economy.

This chart is actually quite instructive in terms of what was driving us on the corporate tax side. You can see on the left side where, if we compare ourselves to the U.S. and, again, we compare ourselves to a lot of countries but obviously the U.S. is an important benchmark for us in terms of the integration of our economies. We had a statutory tax rate much higher than the U.S. when we started this exercise. And we are driving towards this year of having an advantage of 2.3 percentage points on the statutory rate and we think that’s important.

It’s true that taxes don’t drive everything and it’s true that the statutory rate is not the end of the story in tax terms but it is an important indicator. It’s important in terms of where income and expenses take place. And we just think that establishing a rate at a lower level than in the U.S. was an important benchmark for us.

Going forward the dynamics will change and there will be some external forces and we’ll have to keep that in mind but that was an important part of it.

Now that’s sort of where we’ve been. We established in 2000 a five-year plan and phased it in as we could afford it and tried to look for the biggest economic bang for the buck. Let me just talk very briefly about three or four things that I think will drive us going forward. And, as I say, there’s some commonality between what I’m going to say and what you’ve heard from some of the other speakers.

First off, I think to maintain the downward trend in personal taxes. The first point on here is really just to say that that’s all going to have to be done within the context of the fiscal discipline that we’ve established for ourselves. I don’t think that the current Finance Minister wants to be the first to go back into deficit again so I think that we do need to keep that fiscal picture in mind but we need to bring personal tax rates down.

And the next two bullets – I'll just say that there are different sort of problem areas or things you might do at different points in the spectrum. At the low end we do have some issues that we have deal with effective marginal tax rates for those individuals, that is where the tax and benefit or tax and transfer systems interact. By virtue of targeting our taxes in those areas we've established claw-back [sounds like] ranges and we have some very high marginal tax rates in those circumstances. Some of that is due to things we do federally. Some of it is due to things that happen at the provincial level, but where every they happen you can actually some very high marginal tax rates. We need to think about that.

Unfortunately, we have been thinking about it and the answers are not easy. But I think one solution is to try and take the personal tax rates down at that level or find other ways to reduce the burden, so that's one place where we need to do some thinking and hopefully make some progress. The second is at the upper end of the income scale where, you know, our ability to attract and retain highly-skilled workers, entrepreneurs is going to be affected – not the only factor but affected by the tax rates in Canada.

We right now have a significant tax disadvantage, if I can put it that way if I compare it to the U.S. Our rates at the highest income levels are higher than they are here. And, again, that becomes a factor, maybe not a driving factor, but a factor in terms of our ability to attract these executive and skilled labor entrepreneurs.

And I think the taxation of income from savings . . . we have sheltered tax savings vehicles in Canada and a lot of the savings in Canada is run through these tax-sheltered vehicles. But still, relative to other countries as we look around, we still think we double tax a significant percentage of savings and we should be looking for ways to improve that taxation going forward.

The second point - and this is quite an important one – folks on labor to enhance productivity. Taxation is a means not an end and we're really ultimately trying to find ways to improve standards of living and productivity in the economy. Where can we put the new tax reductions in so they will give us the biggest bang for the buck? I just throw this chart up because its some work we have done in finance using a general equilibrium model, which I'd be prepared to talk about.

Just a couple of comments on it. It really tries to address the question of where would be the best place to focus a tax reduction. And what comparisons – if you had had $100 tax reduction, what would be the welfare gain or the effect on the wellbeing of the economy. And just in broad strokes -- I mean what it shows you is, if you can make a change in the area of taxation of capital income for persons (on the left side) or the sales taxes that apply on business inputs, you can actually achieve a 1.3 to 1 ratio of benefits here.

Just as a caveat, I wouldn't focus on the particular numbers themselves, as opposed to the relativity. If you go over to just before the dotted line and you see consumption taxes, you see that a reduction in those consumption taxes gives you relatively less economic benefit because they're more efficient taxes. They appear as value-added tax and would not distort decision-making in the economy very much and so, therefore, reducing it gives you relatively less benefit. And in between you have things like corporate tax rate reductions on the right side and we look at the changes.

It's not to say that this kind of thing is the only factor by any stretch of the imagination. Obviously, tax policy is shaped by fairness, administration and many other considerations, but it does give us an indication that if we are looking at efficiency it tells you a little bit about where the relativities may lie. So we find that it's quite an interesting piece of work. And I think it's consistent with other analytic work like that that's going on.

The third point – strengthen the corporate tax advantage. As I said, we put a lot of stock in focusing our limited resources in an area where we could take our statutory tax rate down. As others have pointed out today, we’re only going to see more economic integration internationally, probably only going to see corporate tax rates move in one direction or stay stable down. So all of the pressures that we see and have talked about this morning are going to continue.

How do we in Canada have to react to that? I think we heard earlier it’s not a . . . you don’t reform the tax system and wash your hands and go home. It’s a continual process and we’re going to have to keep our eye on this and try to decide what we need to do within the context of our environment.

The last point I’d point on there is marginal effective tax rates. It’s only just to say that we know that the statutory tax rate is important but it’s not the only factor. And while we have a statutory tax rate advantage if you look at us relative to the U.S. If you look at marginal tax rates, which are a more comprehensive measure of how the tax system is affecting investment decisions, we actually are at a disadvantage because of things like CCA rates and other aspects of the tax system. So going forward we have to take that into account as we modify our tax system. But I still think the statutory tax rates are an interesting trigger point for us.

Finally, and this is getting a little bit more micro and I’ve got limited time available -- addressing evolving business structures and instruments. And I guess this applies in all areas of policy but it certainly does in the tax area. And I just want to use a specific example to demonstrate what I think is a more general point. We're seeing out there new structures developing, new instruments and, as I say that's not limited to the tax area. And they are creating policy challenges. I've used the example of flow-through vehicles here just because it's something that we're paying increasing attention to in Canada. Whether you have trusts, partnerships, whatever you might call them these vehicles that are setup in the tax system to flow through income are getting more innovative, a little bit more difficult to fit into the classic system that we have.

And I think it raises some real challenges in terms of trying to figure out how you design your tax policies to ensure that you've got an efficient and fair system. How do you best integrate corporate and personal taxes in an environment where you've got these other business structures that aren't really fitting quite nicely into the corporate structure? And I just listed in terms of the key considerations, again, how do you do it in a way that doesn't distort economic decisions and have tax start driving behavior? How do you do it in a way that preserves your revenues – obviously a concern to people where I come from?

Third, how do you deal with the fairness of the tax system? And I think we've had a couple of good discussions of that this morning.

People have to have confidence that the tax system is fair and has integrity and if they've got these vehicles and whether it's an international vehicle or whether it's something at home like one of these. You've got to make sure that you're convinced and you can convince the public that actually the right amount of tax is being collected in the right place and you are stemming avoidance opportunities.

And I guess finally on this I put compliance and enforcement and it applies to this but it also applies more broadly. And it's really just to emphasize a point that's been made earlier. I'm all for tax simplification. I think it's naïve to say, well, it's easy to simplify the tax system. I think you have to disentangle it and understand who are you simplifying it for and in what area and try to take it on at a more micro level.

But at some point in developing the tax code you really have to ask yourself have we got a tax system that people understand and can comply with? Have you got a tax system that we can administer? Sometimes we can get wrapped up in developing policies and trying to take into account every nuance or possibility and end up with something that really neither we fully understand, certainly the taxpayer doesn't fully understand how to comply with and our partners at Revenue Canada don't really know how to administer.

I don't know how you get from here to there because the transition is difficult. But one point is, I think, paying a little bit more attention as we develop policies. Putting them through that simplification lens and saying are there some ways we can get some rough justice here that gets us most of the way but leaves us with something that we can comprehend and explain to people and they can deal with.

So that I think continues to be a challenge for us because the economy is only to get more complicated and there is only going to be more special cases that we need to take account of and that's going to be a challenge for us. With that I think I'll close and be happy to take any questions. Thank you.