The Eric John Hanson Memorial Lecture Series
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28 November 1997

Taxation and Social Policy

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Foreword

The Eric John Hanson Memorial Lecture Series recognizes the many contributions made by Dr. Eric Hanson to the University of Alberta and to the wider community. Eric Hanson taught at the University of Alberta from 1946 to 1975. He was Head of the Department of Political Economy in from 1957 to 1964, and was instrumental in building our department. Many have benefitted from his dedicated *efforts* and his wisdom.

The ninth Eric J. Hanson Memorial Lecture, "Taxation and Social Policy," was delivered by Richard M. Bird on Friday, November 28, 1997. Richard Bird is Professor of Economics and Director of the International Centre for Tax Studies at the University of Toronto. Professor Bird is an international authority on taxation and public economics. He is currently on the editorial boards of three journals, a member of several international committees including the Universities-National Bureau of Research Committee on Taxation, Resources and Economic Development, and is associated with seven research institutes in four countries. He lists among his selected publications 24 books on topics in Canadian and international public finance.

Early in his career, Richard Bird worked on international programs centred at Columbia and Harvard universities and for the International Monetary Fund. He has been active in international work ever since. His expertise has been called upon frequently by the IMF, the World Bank and various other United Nations organizations, the Organization for Economic Development and Cooperation, and by a host of countries around the world. In addition, Bird has advised many provinces and territories, departments and commissions in Canada.

Richard Bird is a graduate of King's College and Dalhousie University in Halifax and obtained his PhD from Columbia University in 1961.

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Previous Lectures

Inaugural Dr John Whalley, University of Western Ontario
Tax Reform Options for Canada

Lecture II John W Crow, Governor, Bank of Canada
The Work* of *Canadian Monetary Policy

Lecture III Dr Cliff Walsh, Australian National University
The Political Economy* of *Economic Advice

Lecture IV Dr Jozef **MM** Ritzen, Erasmus University, Rotterdam
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Government and Job Training

Lecture V Dr David Foot, University of Toronto
Demography, Dependency, and Deficits:
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Lecture VI Dr Thomas E Kierans, President and CEO, CD Howe Institute
Le Defi quebecois/The Quebec Challenge

Lecture VII Arthur Kroeger, distinguished Federal civil servant (retired), now
Chancellor of Carleton University
Governments and the "Jobs" Issue

Lecture VIII Mrs Judith Maxwell, President
Canadian Policy Research Networks, Ottawa
The Social Dimensions* of *Economic Growth

TAXATION AND SOCIAL POLICY

by Richard M. Bird

It is an honour to be here today to give the Eric John Hanson Memorial Lecture. When I first began to be interested in public policy, one of the earliest studies I read was a report by Eric Hanson on that perennial theme of Canadian political debate, the fiscal needs of the provinces. [1] Tempting as it was to tackle this subject again, however, I have chosen instead to follow up Judith Maxwell's 1996 Hanson Lecture on the social dimensions of economic growth[2] by offering some thoughts on the general subject of taxation and social policy.[3]

The potential reach of this topic clearly exceeds my grasp, however, so my next problem was to decide how to approach it. A public lecture may at times be an appropriate occasion to recapitulate and re-emphasize some aspect of the wisdom of the ages. Alternatively, it may provide an opportunity to explain and expound to a wider audience new ideas at the frontier of the discipline. Unfortunately, since there seems to be a shortage of both wisdom and well-developed new thinking on my chosen subject, all I have to offer today is a series of observations on various actual and potential linkages between taxation and social policy. My aim is less to reveal answers than to raise questions.

Specifically, I shall raise three major questions. First, if taxes decline, is social policy adversely affected? That is, are the level of taxation and the quantity and quality of social policy closely related? My tentative answer, contrary to much recent discussion in Canada, is that there is no necessary linkage between the level of taxation and the level and quality of social services delivered through the public sector.

Whether or not I carry you with me on this first point is basically irrelevant with respect to the second question I wish to explore, concerning the interactions between the taxes we levy and the outcomes which are the concern of social policy. Whatever the level of taxation, exactly how we choose to collect it and to relate it, explicitly or implicitly, to such social policies as those relating to children and the elderly will affect families, the distribution of income, the work decision, education, health, and many other social dimensions of life. On the

[1] Eric J. Hanson, *Fiscal Needs of the Canadian Provinces* (Toronto: Canadian Tax Foundation, 1963).

[2] Judith Maxwell, *Social Dimensions of Economic Growth,* The Eric John Hanson Memorial Lecture Series, Volume VIII, January 25,1996 (Edmonton: Department of Economics, University of Alberta, 1996)

[3] I shall not discuss the many important federal-provincial dimensions of this subject, on which see Thomas J. Courchene, *Social Canada in the Millennium* (Toronto: *CD.* Howe Institute, 1994).

whole, although there is still much that we do not understand about these relationships, my general argument is that both tax and social policy could be improved if we thought more often about both sides of these linkages when developing either tax or social policy.

Finally, a third possible way of linking taxation and social policy is by taxing such "bads" as smoking and drinking. Attractive and obvious as this approach may appear to many, I shall suggest that on the whole there is little to be gained, and perhaps much to be lost, by attempting to legislate good behaviour through the tax code.

The level of Taxation

Let me turn now to the first of my questions, namely, to tax or not to tax? This question and its connection with social policy has come to the fore in Canada recently in these days of, so we are told, emerging "fiscal dividends." Should governments that are apparently about to experience the rare pleasure of collecting more money than they are currently spending, cut taxes or spend more?[4]

Most who favour spending increases appear to support expanded spending on social policies of various sorts, whether to restore our allegedly eroded "social capital" or simply to reverse the cuts of the last few deficit-fighting years.[5] Many who take this position would seem to agree with John Kenneth Galbraith's argument of 40 years ago that even a bad tax may be good if it is spent by a good government on good things.[6] Moreover, they seem to be in the fortunate position of knowing just what those "good things" are -- more health care, more child care, more spending on education, more supportive social services for the unfortunate, and in general more redistributive policies.

[4] I shall abstract from the question of retiring debt (which can be viewed as reducing future rather than present taxes).

[5] Although in fact total government expenditure had not declined in absolute terms as of the end of 1996, expenditure on goods and services did decline slightly after 1994, and as a percent of GDP total expenditure declined sharply from 49 percent in 1992 to **44** percent in 1996. At the federal level, the main reductions were in expenditures on employment insurance and transfers to other levels of government. Cuts in expenditure on goods and services and on transfers to persons were much more marked at the provincial level and were significantly passed through to local governments (including schools) and hospitals. See the useful presentation and summary in David B. Perry, "The End in Sight: Deficit Reduction in the 1990s," *Canadian Tax Journal,* 45 (1997), 853-75.

[6] See John Kenneth Galbraith, *The Affluent Society* (London: Hamish Hamilton, 1958), pp.246-47, where it is argued that even a "bad" sales tax may be justified if it finances a "good" social expenditure.

I like to think my heart is in the right place too. But I am also an economist. Contrary to popular myth, even a card-carrying economist need not be either dismal or hard-hearted, but he or she should be "hard-headed" in the sense of thinking things through. And when I think through many of the propositions one hears about the relation between the level of taxation and social policy, they seem at best unproven and at worst nonsense.

Most who comment on the relation between the level of taxation and social policy seem, for instance, to have an extremely simple production function in mind. More money spent on education, health, or any other "good thing" of which they approve will, they assume, necessarily result in proportionally more education, health, or whatever being produced. This view that "more in" equals "more out" is not only naive: it is demonstrably wrong.

More resources spent on the public health care system, for example, do not automatically result in either more health care or better health care, let alone a more healthy population.[7] Despite the outraged howls of some of my academic colleagues, not to mention the educational profession in general, the social benefits of increased expenditure on education in Canada today are equally unclear. And surely it is clear by now that the huge increase in supposedly redistributive transfers in the postwar period has not been matched by any correspondingly huge decrease in income inequality.a

Surprisingly little is known about the "production function" of most social policy outputs. As a rule, we do not even know whether we are on what may be called the "flat of the curve" -- that is, where the pay-off to spending more on a particular activity is zero -- or perhaps even "over the hill" in the sense that the pay-off may be negative with the result that more expenditure on health

[7] For a good exposition of the fallacious nature of most discussion of this issue, see A.J. Culyer, *Health Care Expenditures in Canada: Myth and Reality; Past and Future* (Toronto: Canadian Tax Foundation, 1988). Health care is of course only one input into the production function of health, and by no means the most important, as memorably demonstrated in Marc Lalonde, *A New Perspective on the Health of Canadians* (Ottawa: Health and Welfare Canada, 1974).

[8] Of course there has been some redistributive effect, and for some groups (the elderly) a significant effect, from public policy initiatives: see, for example, such studies as Francois Vaillancourt, ed., *Income Distribution and Economic Security in Canada* (Toronto: University of Toronto Press, 1985) and G.C. Ruggeri, D. van Wart, and R. Howard, *The Govemment* as *Robin Hood* (Kingston: School of Policy Studies, Queen's University, 1996). But considering the huge growth in government transfers over recent decades, the net impact of public policy on distribution is surprisingly small: see Vito Tanzi and Ludger Schuknecht, "The Growth of Government and the Reform of the State in Industrial Countries," International Monetary Fund Working Paper 95/130, Washington, 1995.

care or schooling may actually produce less health or education.[9] If we have not yet reached the point of negative returns on the marginal productivity curve, spending more on social policy may indeed produce more output. But it by no means follows that such spending will have a higher marginal pay-off to society than would, say, a reduction in the GST or the income tax. Such matters can be resolved only by analysis, not assertion.

In any case, the pay-off to additional spending on, say, education may vary widely depending upon whether the additional funding goes to pre-schools, physical education, adult retraining, or advanced studies in molecular genetics. Opinions as to the relative social value of such alternatives, whether held by experts or people in general, are a poor substitute for adequate knowledge as a basis for making rational allocative decisions. Health care similarly encompasses everything from organ transplants to emergency room care to screening for breast or prostate cancer and an infinite variety of other possibilities. The probability that the marginal benefit of an additional dollar spent on each of the many activities included within such broad categories as health and education will be equal can safely be asserted to be zero. Indeed, within each social policy area, the internal allocation of funds is likely to be as important in determining how much socially-valued output is generated as is the total amount of funding devoted to the area.

What is the significance of such arguments in a time of expenditure cuts, whether motivated by more or less well-founded fears of deficits or even, to utter words that appear to be "politically incorrect" in many academic circles these days, by a desire to cut taxes? Just as we cannot say very precisely or convincingly what the effects of increased expenditure on social policy might be on social policy outputs, we also cannot say much about the presumed deleterious effects of cuts in expenditures. With respect to health expenditure in Ontario, for example, Peter Coyte has recently argued that "in the absence of evidence from clinical and economic evaluations demonstrating that current patterns of practice are appropriate, effective, and, also, cost-effective, it is unclear why we continue to allocate more than 30% of the provincial budget to services without detailed evidence of service cost-effectiveness."[10]

Health care systems everywhere have an insatiable appetite for resources, and it is by no means beyond the realm of possibility that we are already spending too much and not too little on health even from the narrow perspective of improving the health status of the population, let alone from a broader perspective concerned with general social well-being. At present, however,

[9] As was famously asserted by Ivan Illich some years ago in such works as *Medical Nemesis: The Expropriation of Health* (London: Caldar & Soyars, 1975).

[10] Peter C. Coyte, "An Assessment of the Health Policies of the Harris Government," Paper presented to symposium organized by the Centre for Study of State and Market, University of Toronto, October 10,1997, p. 2.

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potential trade-offs even within the health care sector, let alone between health and other social policy expenditures are seldom discussed analytically, still less the possibility of broader trade-offs with the effects of the level and structure of taxation on social well-being.

Tax Resistance and Social Policy

Whatever one thinks of such arguments, I suggest that it is almost certainly true that we can and should do much better in spending our social policy resources, almost regardless of the amount we have to spend. Indeed, I shall go further and suggest that at least some of the current pressure for tax reduction may have originated from a basically correct perception on the part of many citizens that they have, on average, been paying more in the form of taxes and getting less in the way of services they value.[11]

Many have argued in recent years that the *economic* cost of taxation has increased owing to globalization pressures.[12] While such pressures may indeed have affected the structure of taxation, making it more difficult, for instance, to raise taxes on corporations, it is not clear they have as yet had any significant effect on the tolerable level of total taxation. Indeed, I suggest a better case can be made that the marginal *political* cost of increased taxation has risen significantly since the hey-day of social policy expansion in the 1960s and 1970s, both because taxes hurt more and expenditures are valued less.[13]

From 1985 to 1995, for example, total government revenues rose from 40.0 to 43.8 percent of GDP, with 84 percent of this increase in taxation taking the highly visible form of higher personal income taxes, and another 11 percent of the increase being accounted for by almost equally visible property taxes.[14] Over a decade during which real disposable personal income barely increased,

[11] For an earlier sketch of this argument (and a slightly less rough attempt to quantify it), see Richard M. Bird, "Closing the Scissors, or The Real Public Sector has Two Sides," *National Tax Journal,* 35 (December 1982), 477-81.

[12] Indeed, to some extent I have done so myself: see Richard M. Bird and Charles E. McLure, "The Personal Income Tax in an Interdependent World," in Sijbren Cnossen and Richard M. Bird, eds., *The Personal Income Tax* (Amsterdam: Elsevier, 1990).

[13] The concept of marginal political cost is developed in Walter Hettich and Stanley L. Winer, "Economic and Political Foundations of Tax Structure," *American Economic Review,* 78 (1988),701-12, and applied to Canada in W. Irwin Gillespie, *Tax, Borrow and Spend: Financing Federal Spending in Canada, 1867-1990* (Ottawa: Carleton University Press, 1991).

[14] Calculated from Perry, *op.cit.* in note 5, pp. 857-58, and Karin Treff and David B. Perry, 1996 *Finances of the Nation* (Toronto: Canadian Tax Foundation, 1997), p. A:3.

the burden of personal income taxes increased by almost 40 percent. [15] Most taxpayers definitely felt they were paying more.

But what were they getting for their money? Although total government spending rose slightly from 1985 to 1995 (from 46.8 to 47.9 percent of GDP), expenditure excluding debt service actually fell from 37.5 to 34.0 percent. Social expenditures -- those on health, education, and social services -- nonetheless rose slightly (from 19.5 to 21.0 percent of GDP) over this period, but almost all of this increase (80 percent) was on social services. On average, a dollar's worth of income taxes in 1985 "bought" $1.15 in health and education services. By 1994, however, the same dollar purchased only $1.06 in such services.16 Rough and arbitrary as such comparisons may be, they suggest that many citizens may indeed have been correct in feeling they were getting less for their money, especially if they did not place much value on many of the increased social services, for reasons I shall discuss later.

Whatever weight one places on such speculative calculations, it is clear that to understand the growth and structure of government both sides of the budget -- expenditures and taxes -- must be taken into account. [17] If taxes rise quickly, automatically, and virtually invisibly as in the golden days of the 1960s, expenditure on everything and anything is likely to rise equally quickly and painlessly. If taxes slow down and even decline in relative terms, expenditures must fall sooner or later. Similarly, if tax increases can be tied, however loosely, to generally desired expenditure outcomes, such increases are more likely to be accepted.[18] On the other hand, if all that taxpayers see for their

[15] From 1985 to 1994, disposable personal income (deflated by the implicit index for personal consumption expenditure) rose by only 3.1 percent; over the same period, personal income taxes increased by 39.6 percent in absolute terms, or from 13.5 to 16.1 percent of personal income: calculated from Department of Finance, *Economic Reference Tables August* 1995 (Ottawa, 1995), Tables 1, 4,13, and 46.

[16] For further discussion of this approach, see Bird, *op. cit.* in note 11. The figures in the text were calculated from various data in the sources cited in the previous two notes. Real per capita expenditures on health and education (deflated by the implicit index for government consumption expenditure) increased by 17.8 percent from 1985 to 1994. This component of the "full" income (arbitrarily defined to include equal per capita shares of these expenditures as equivalent to final consumption) of Canadians thus rose over this period from 13.7 to 15.4 percent. However, income taxes over the same period rose from 11.9 to 14.5 percent in terms of the same income base.

[17] See Richard M. Bird, "Tax Structure and the Growth of Government," in Lorraine Eden, ed., *Retrospectives on Public Finance* (Durham: Duke University Press, 1991).

[18] Dwight R. Lee, "Overcoming Taxpayer Resistance by Taxing Choice and Earmarking Revenues," in William F. Shughart II, ed., *Taxing Choice* (New Brunswick, N.J.: Transaction Publishers, 1997). Such symbolic (or notional)

increased taxes are increased expenditures that they value relatively little, resistances to tax increases and the desire for tax reductions may strengthen.

Two Types of Redistribution

Perhaps the most critical issues shaping politically sustainable decisions about social policy relate to redistribution. Redistribution means that some gain and some lose: the usual idea, of course, is that the poor should gain and the non-poor should lose. Many commentators have recently emphasized the need to retain and reinforce what may be called "social cohesion" or "social capital" through such means as providing more adequate income support to the poor in these difficult times. Such methods of achieving this goal as more effectively "targeting" the benefits of a fixed (or even declining) social policy budget on the poor have not only been advocated but already to a significant extent been implemented in Canada. In a democratic society dominated by the non-poor, however, any redistributive objective can be achieved by any method only if the non-poor majority support it. Why should they do so?

Two distinct reasons come to mind. The first is because they think it is the right thing to do. The second is because they think it is in their own interests to do SO.[19] Each of these factors may play some role in explaining both some recent and prospective future developments in Canadian social policy and in particular some aspects of its increasingly important entanglement with tax policy.

Some redistributional policies may be supported simply because they accord with broadly-shared social perceptions of what is "right." With respect to taxes, for example, we have a mildly redistributive system largely owing to the importance of the personal income tax.[20] Experience around the world for the last few decades suggests that, despite the extensive popular and academic criticism to which it has been subjected, at least mildly progressive personal income taxes are likely to remain important, largely because people think it is

earmarking is explored in the Canadian context in Wayne R. Thirsk and Richard M. Bird, "Earmarked Taxes in Ontario: Solution or Problem?" in Allan M. Maslove, ed., *Taxing and Spending: Issues of Process* (Toronto: University of Toronto Press, 1994).

[19] A third reason may be that no one quite understands what is going on anyway -- a perfectly understandable result given the present state of social policy in areas such as the treatment of the family. A less kindly interpretation of some of this confusion might be that the policy-making elite is trying, as it were, to slide something past the populace to achieve certain goals that may not be widely accepted (poverty relief) by attaching them to other goals that are (risk reduction). Further exploration of such Machiavellian maneuvering is, however, beyond the scope of this paper.

[20] See Ruggeri, Van Wart, and Howard, *op.cit.* in note 8, p.90.

only fair that those who have more should contribute a larger share to financing government activities.[21]

Similarly, on the expenditure side, there appears to be a continuing strong consensus in Canada that no one should be permitted to fall below some minimum standard of living. More specifically, no one should be denied access to certain social services (notably health) for reasons of poverty. The existence and especially the design of many social policies may thus be understood at least in part in terms of what might perhaps be called the "humanitarian" objective of alleviating some of the worst effects of poverty. **In** contrast, the "egalitarian" objective of reducing income inequalities as such has never been very evident in Canadian social policy.[22]

If the humanitarian objective were all that there was to the redistribution system, however, our present extensive set of social policies would make little sense. The most efficient way to provide income support to the poor would be through some variant of Milton Friedman's "negative income tax,"[23] perhaps supplemented by limited income-conditioned access to certain public services such as health and education which may perhaps be considered to provide some "spillover" benefits for society as a whole or to be justified in some other way.

In this connection, I should perhaps emphasize that, quite apart from any concern for the poor, some public support of many superficially "soft" social policies may in fact be justified fully in hard economic terms.[24] Redistributional policies that, for example, deliver better pre- and post-natal care and early childhood support to poor families, like policies that deliver direct income support to families with children in school, make it more likely that children will succeed in school, and a more educated populace may to some extent be associated with a higher rate of economic growth.[25]

[21] See Richard M. Bird and Sjibren Cnossen, "Introduction and Summary," in Cnossen and Bird, *op. cit.* in note 12.

[22] Three decades of further exposure to Canadian public policy has not provided any evidence that would lead me to alter much the views on this subject first expressed in Richard M. Bird, *The Growth* of *Govemment Spending in Canada* (Toronto: Canadian Tax Foundation, 1970), pp. 163-64.

[23] See Milton Friedman, *Capitalism and Freedom* (Chicago: University of Chicago Press, 1962).

[24] For one example, see the discussion of income distribution in Richard M. Bird, *Charging for Public Services* (Toronto: Canadian Tax Foundation, 1976), chap. 15.

[25] Lorraine Dearden and Alexandra Heath, "Income Support and Staying in School: What can we learn from Australia's AUSTUDY Experiment?" *Fiscal Studies,* 17 (November 1996),1-30.

More broadly, not only educational and training policies but also properly-designed income support that makes it easier for people to change jobs may constitute an essential part of the arsenal of fiscal instruments needed to cope with change in the modern world.[26] Such social policies may be productive in the narrowest economic terms and may even be indispensable components of a sustainable modern social and economic system. Globalization pressures tend to accentuate income inequalities, and the resulting political consequences may, unless adequately offset by such policies, lead to a retreat to more "closed", if poorer, economies in the interests of social peace.[27]

In addition to such policies, humanitarian motives might perhaps lead us to provide some restricted general fiscal support to privately-chosen charitable activities through the tax system, as indeed we do.[28] But that would be about it. Neither "free" provision of most health and education services nor large virtually "universal" transfer programs such as the GAS/GIS or many aspects of the employment insurance system can be explained on such grounds. To the extent their aim is poverty alleviation, such policies could surely be much more effectively targeted than they have been in the past.

The importance of such broad redistributive social policy programs can perhaps best be explained in terms of a quite different objective of social policy -- not to help the poor, but rather to insure the non-poor against risk. As countries grow richer, they tend to spend relatively more on risk-mitigating transfer programs. Such public risk-reducing expenditures may grow in importance because potential losses may grow more than proportionately to income -- for example, because they are related to wealth[29] -- or because of the

[26] See Richard M. Bird et al., *Industrial Policy in Ontario* (Toronto: Ontario Economic Council, 1986).

[27] For a recent review of the evidence, see Jeffrey G. Williamson, "Globalization and Inequality: Past and Present," *World Bank Research Observer,* 12 (August 1997), 117-36. Another way of making a similar point might be in terms of the argument in Mancur Olson, *The Rise and Decline of Nations* (New Haven: Yale University Press, 1982) with respect to the tendency of richer countries to, in effect, search for the political "quiet life" by catering more and more to specific interest groups, up to the point of choking economic growth.

[28] See Kimberly Scharf, Ben Cherniavsky, and Roy Hogg, *Tax Incentives for Charities in Canada,* CPRN Working Paper No. CPRN 03 (Ottawa: Renouf Publishing for Canadian Policy Research Networks Inc., 1997)

[29] Shantayanan Devarajan and Jeffrey S. Hammer, "Public Expenditures and Risk Reduction," Development Research Group, World Bank, October 1997. This assumes, plausibly, that wealth rises faster than income and holds even with declining absolute risk aversion (but constant relative risk aversion).

increasing comparative advantage of social insurance -- for example, as a result of the loosening of informal community and family ties. [30]

Everyone is afraid of becoming ill, many of us have or hope to have children who will have to be educated, more and more of us are afraid of losing our jobs, some of us are concerned with looking after elderly family members, and most of us hope to live long enough to become elderly ourselves. Health care, education, employment insurance, and retirement income are thus social policy areas of direct and personal interest to most Canadians. Redistribution from the well to the sick, from the employed to the temporarily unemployed, and from workers to retirees can thus largely be understood and justified in terms of, as it were, ourselves helping ourselves.

Of course, given the well-known market failures arising from such informational problems as adverse selection and moral hazard, public intervention in such insurance schemes may often be justified on efficiency grounds. [31] But such arguments do not necessarily justify large public expenditures to mitigate risk, let alone full public provision of such services. For my present purposes, however, it suffices to note that the political support base for programs which in some sense may be seen as benefiting everyone directly is likely to be much wider than that for programs targeted more narrowly on poverty relief.

The Tax-Transfer System

Against this general background, let me now turn to some more specific questions with respect to the relation between the structure of taxes and the structure of expenditures. I shall consider two aspects of this linkage. The first concerns the role of tax policy in delivering social policy. The second relates again to the question of targeting social policy expenditures.32

[30] See the nice exposition along these lines in John Burbidge, *Social Security in Canada: An Economic Appraisal* (Toronto: Canadian Tax Foundation, 1987), chap. 2.

[31] "Adverse selection" arises because people presumably know if they are "bad" risks, but an insurance company would not, with the result that if it would set its premiums at average risks for the population, only higher-than-average risk people would purchase insurance and the company would soon go broke. "Moral hazard" arises because once people have insurance they may not be as careful as they would otherwise be to avoid risky activity, with the result that insurance companies which cannot enforce good behaviour would soon be out of business. Neither of these problems vanishes with public insurance, of course, but they may, for various reasons, be more manageable. For an accessible discussion, see Nicholas Barr, *The Economics of the Welfare State* (London: Weidenfeld and Nicolson, 1987), chap.5.

[32] A third aspect that could be considered, pricing in the social policy area, in a sense ties the other two together, but this is not discussed here: see Richard M. Bird and Thomas Tsiopoulos, "User Charges for Public Services: Potentials and Problems," *Canadian Tax Journal,* 45 (1997), 25-86

First, as the millennium approaches, the tax base-broadening and low-rate philosophy of tax reform in the 1980s should, I think, give way to a new set of policy responses.[33] Taxation should not be viewed, as in the accepted approach, solely as an instrument to raise revenue in the most efficient, fair and simple way. Instead, tax policy should be seen in a wider context as one element of the set of "governing instruments" used to affect economic and social behaviourfor better or for worse.[34]

As we have all learned in recent years, for example, since the most important public expenditures are on the components of the "welfare state" -- health, education, and social assistance -- expenditure restraint necessarily implies the "reform" of social policy. The aim of such social policy reform has often been conceived to be both to control costs and to target assistance more accurately to lower-income individuals. Tax policy has an important role to play in such an exercise, both in a positive and a negative sense.

On the positive side, Canada already delivers a variety of social policies indirectly through the tax system in the form of so-called "tax expenditures" or reductions in taxes for socially-favoured uses of income. In 1994, for example, as much as $16.5 billion was "spent" by the federal government alone in this way on social policy, broadly conceived, compared to some $71.2 billion in direct social policy expenditures.[35]

Many of these tax reliefs have been criticized as "upside-down welfare" in the sense that much of the relief goes, by definition, to those whose income is high enough for them to pay tax. In part in response to such criticisms, many of these provisions were changed from deductions to credits in 1987, and

[33] This argument follows that in Richard M. Bird and Jack M. Mintz, "Future Developments in Tax Policy," *Federal Law Review,* 22 (No.3, 1994),402-13.

[34] See Michael J. Trebilcock et ai., *The Choice of Governing Instrument* (Ottawa: Economic Council of Canada, 1982).

[35] The expenditure figure is for 1994-95, from Treff and Perry, *op. cit.* in note 14, p. A:6. The "tax expenditure" figure is calculated from information in *Government of Canada Tax Expenditures* 1997 (Ottawa: Department of Finance, 1997), Tables 1-3. This figure -- which is of course subject to the usual strictures about the imprecision of such aggregates (see *ibid.,* p.15) -- is the sum of estimated tax expenditures for health, education, charities, welfare, child care, family support, employment insurance, and retirement under the personal income tax, the corporate income tax, and the GST. (Note that G.C. Ruggeri and C. Vincent, "Tax Expenditures and Tax Preferences in the Personal Income Tax System of Selected OECD Countries: A Suggested Classification," Department of Finance Working Paper 97-07, October 1997, classify the important RRSP/RPP deductions as preferences for saving rather than "tax expenditures" for retirement as is done here.)

suggestions for more moves in this direction, notably by changing the present deductions for retirement saving to credits, are not uncommon.36 Understandable as such arguments may be, however, I suggest that they suffer from two basic problems. First, they do not pay sufficient attention to the legitimate concerns of tax policy. And second, they may undermine the very redistributive policies that their advocates are concerned to strengthen. I shall return to both these points.

With respect to the negative use of the tax system to implement social policy, for some years we have imposed so-called "clawbacks" (or supplementary surtaxes) in addition to the normal income tax on such transfer payments as old age security benefits and unemployment insurance.[37] A similar approach of, in effect, limiting the benefits of subsidized public services to lower-income persons could obviously be used with respect to other social expenditures such as health care and post-secondary education, and indeed proposals along these lines have been made in the past.[38]

For the two reasons I mentioned a moment ago, however, it is far from clear that this approach should be extended. Indeed, it is not at all certain that what we have done in this direction to date really makes much sense. The existing clawbacks have already resulted in the introduction of a mishmash of "family" concepts, income concepts, and rate scales in the income tax to the point where it is not clear anyone quite knows what is going on.[39] Moreover, overly

[36] See, for example, Courchene, *Op*. cit. in note 3, p. 76.

[37] Canadians over 65 years of age received in 1996 a basic old age security (OAS) pension of $4746.24 per year. This pension was subject not only to the normal income tax but also to a special tax equal to 15 percent of family (not individual) net income in excess of $53,215 up to a maximum of the benefits received. Effective in 1996, this surtax was withheld directly from OAS payments rather than "clawed back" at next year's tax filing. (The new Seniors Benefit program extends this special taxation even further, but is not discussed here.) A similar "clawback" at a rate of 30 percent of income in excess of a threshold of $65,910 (in 1996) is applied to recipients of unemployment insurance benefits, up to a maximum of benefits received.

[38] See, on health, Ontario Economic Council, *Health: Issues and Alternatives* (Toronto, 1976) and M.L. Barer, R.G. Evans, and G.L. Stoddart, *Controlling Health Costs by Direct Charges to Patients: Snare or Delusion?* (Toronto: Ontario Economic Council, 1979), and, on post-secondary education, David AA Stager, *Focus on Fees: Alternative Policies for University Tuition Fees* (Toronto: Council of Ontario Universities, 1989).

[39] In addition, further clawbacks are implicitly and explicitly imposed on recipients of welfare, who thus face high -- often very high -- marginal tax rates on any income they may earn. See Ken Battle and Sherri Torjman, "The Welfare Wall: An Analysis of the WelfarefTax System in Ontario," in Allan M. Maslove, ed., *Taxation and the Distribution of Income* (Toronto: University of Toronto Press, 1994).

successful "targeting" of benefits may reduce the level of political support for certain public programs below the critical minimum needed for sustainability.

Consider for example the current treatment of children in the Canadian tax-transfer system. The Child Tax Benefit introduced in 1993 replaced three earlier programs -- a family allowance, a non-refundable income tax credit for dependent children, and a refundable child tax credit targeted to lower-income families.[40] The credit for dependent children had itself been introduced only in 1987 to replace an earlier long-standing tax exemption for dependents. Both of these changes were clearly motivated in part by the aim of improving targeting in the sense of directing more of the (direct and indirect) social expenditure in support of children to children in poor families.[41] How well did this policy succeed in this aim, and at what cost?

While, as is all too usual with respect to social policy in Canada, the complexity of the recent reform of the Child Tax Benefit means that the first part of this question is surprisingly difficult to answer, it appears that the answer may be "not too well."[42] As for the second part of the question, there would appear to be three important "public policy" costs associated with this attempt to develop a more targeted social policy.

[40] As of 1997, the maximum benefit is $1,020 per year per child (plus supplements of $75 for the third and subsequent children and $213 for children under seven). The benefit is non-taxable but is reduced by 25 percent of child-care expenses claimed and in addition by 5 percent (2.5 percent for one-child families) of family net income over $25,921. In addition, the CTB includes a "working income supplement" which is now also paid on a per child basis ($500 for the first child, $405 for the second, and $330 for each subsequent child). This supplement is phased in at annual family earnings of $3,750 up to a maximum of $10,000 and then is reduced for those with net family income over $20,921 by rates ranging from 12.1 percent for one-child families up to 26.8 percent for families with three or more children. Further -- and no doubt equally complicated -- changes are promised for 1998.

[41] I shall not discuss the continuing child care expense deduction. Although some social policy advocates would apparently like to fold the estimated $305 million (in 1994, compared to $5.2 billion for the child tax benefit in that year) of tax relief arising from this deduction into the social policy basket, I agree with the Department of Finance *(op. cit.* in note 34, p. 66) that this deduction simply recognizes some of the costs of earning taxable income and is therefore properly deducted in determining taxable income.

[42] See the analysis in Frances Woolley, Arndt Vermaeten, and Judith Madill, "Ending Universality: The Case of Child Benefits," *Canadian Public Policy, 22* (March 1996), which concludes that the greatest gains in disposable income were experienced by families in the $40,000-$50,000 range (p.37)." A similarly unenthusiastic appraisal from a different perspective may be found in Shelley Phipps, "Canadian Child Benefits: Behavioural Consequences and Income Adequacy," *Canadian Public Policy,* 21 (March 1995), 20-30.

First, from a tax perspective the attempt to improve the vertical equity of the tax-transfer system by, in effect, treating children in poor families better by treating children in rich families worse has clearly reduced the horizontal equity of the tax system.[43] Two non-poor families with the same income, one of which has three children and one with none, are now assumed to have exactly the same taxable capacity. As Jonathan Kesselman has said, this approach makes Canada almost unique in the world in treating the costs of raising children "".as simply consumer outlays like the childless family's choice to purchase a fancy boat."44

Secondly, quite apart from its effects on equity, the Child Tax Benefit, like most of the various partial "integration" and claw-back schemes with which the Canadian tax-transfer system has become encumbered in recent years, results in an erratic and confusing set of marginal tax rates, income concepts and tax unit concepts. Canada's pioneering use of refundable tax credits as a means of delivering targeted welfare benefits may have much to be said for it, but one result has been the creation of what might be called a "classified" income tax -- one in which the applicable tax rate on a dollar of additional income depends upon into which "class" the recipient falls with respect to a variety of factors including family status, size of individual income, size of family income, and source of income (such as Child Tax Benefit, Employment Insurance, or Seniors Benefit). We have come a long way indeed from the Carter Commission's ideal of a comprehensive personal income tax, let alone from what now seems the relative simplicity of the 1971 Income Tax Act. It is by no means obvious that all this change constitutes progress.

Finally, while those who gain from the Child Tax Benefit may not be as closely targeted as one might at first think, the losers, as with the new Seniors Benefit, are all too clear. In the case of the Child Tax Benefit, higher-income families with children in effect end up paying higher taxes so that lower-income families with children can receive higher benefits. Why a family with $100,000 in income and two children should pay higher taxes for this purpose, while a family with the same income and no children does not, simply defies rational explanation from either a social policy or a tax policy perspective. Moreover, from a political economy perspective I suggest that such clear segregation, let alone the creation of direct opposition, between the interests of the poor and the not-so-poor runs the risk of reducing public support for families in general.

[43] See James B. Davies, "The Tax Treatment of the Family," in Richard M. Bird and Jack M. Mintz, eds., *Taxation to 2000 and Beyond* (Toronto: Canadian Tax Foundation, 1992).

[44] Jonathan R. Kesselman, "The Child Tax Benefit: Simple, Fair, Responsive?" *Canadian Public Policy,* 19 (June 1993), 117.

Guidelines for Reform

A first basic guideline in reforming either taxes or transfers is that tax policy and the array of transfer and expenditure policies we call social policy must be considered together, rather than separately, if government is to achieve its policy objectives efficiently and effectively. In the best of all worlds, focusing both on the need to be more efficient in expenditure and on the restoration of some integrity to the fundamental concepts of the tax system might result in a better integration than at present exists of the tax and transfer systems. As an example, in some respects the partial integration of social insurance contributions and the personal income tax in the Netherlands may prove to be a path worth further exploration in Canada.45

This approach, however, implicitly views public policy as being designed and implemented by a benevolent dictator, concerned only to maximize social welfare -- and able to tell when success is achieved in this aim. In reality, a second basic guideline for policy reform is that public policy is produced not by the dreams of well-intentioned technocrats but rather only when it is adopted through the political process. From this perspective, as I suggested earlier, overconcentration on more effectively targeting social programs on the poor may undercut the essential political support for such programs.

This point may be illustrated by considering an interesting line of argument recently suggested as explaining to some extent the rather inefficient ways in which such social policies as general welfare assistance are currently provided.46 The key aspect of this approach is that some characteristics critically relevant to redistributive policy -- for example, the ability to work -- are private information, that is, known to the persons concerned but not to the public authorities. The prevalence of free (or well below-cost) public provision of health and education services, for example, may to some extent be explained by the extent to which such public provision results both in more consumption of such services by lower-income persons and to a certain extent in "self-selection" by the better-off out of the system. Indeed, this approach implies that it should be in the interest of those who favour more redistributive policy to encourage the rich to opt out of public services. On the contrary, however, most strong advocates of social policy seem very much against the

[45] See Hendrik Elle Koning and Dirk Witteveen, "Netherlands," in Joseph A. Pechman, ed., *World Tax Refonn : A Progress Report* (Washington: Brookings Institution, 1988), at p. 175, for details. Basically, since 1990 the personal income tax and the payroll taxes supporting the social insurance system have been combined into one tax with an identical base, although the separate identity of the two parts is maintained. A similar partial integration of income and payroll taxes, although only for the employees' contribution, exists in Denmark and Norway.

[46] A useful brief overview of this approach is Robin Boadway, "Economic Theory Dictates a Rethinking of Policy," *Policy Options,* September 1997, pp. 12-16.

creation of so-called "two-tier" public services, whether in health or education.47 How can one explain this apparently irrational opposition to "opting-out"?

One reason may of course be that those who take this position simply accept equal provision as a primary policy goal, irrespective of the level of such provision. But another reason, I suggest, may also simply be that economic theory alone is inevitably an inadequate guide to appropriate public policy. No "benevolent dictator" determines policy. Instead, only those policies for which a sufficient coalition of support can be built will be implemented. From this broader political economy perspective, permitting the better-off to exit from public services may reduce both the level and the quality of such services. The level may fall because there will no longer be majority support for maintaining expenditures; and the quality may also fall owing to the removal of the more articulate and often better informed consumers.48

A similar comment may be made with respect to the argument that redistributive services can be delivered more effectively --- that is, be better targeted -- by such means as restricting access to services to those with certain characteristics that are considered to be correlated to the desired target clientele. An example might be delivering welfare assistance through the agency of social services rather than in the form of a negative income tax. The argument is that social workers may be regarded as gathering the information necessary to distinguish the various categories of need such as disability and employability.49 Coupled with the self-selection inherent in subjecting oneself to such an administrative process, it may well be that such a system is a more cost-effective way of delivering services to those to whom society really wishes to redistribute.

Targeting and Compensation

Though reminiscent of the Elizabethan Poor Law of 1601 with its emphasis on aiding only the "deserving poor", this argument to some extent rings true with anyone who has watched the development of Canadian welfare policy over the years, with its repeated attempts to draw the line between those who "should" be aided and those who should not, between those whose plight is no fault of their own and those who should, in society's view, be able to look out for themselves.[50] With respect to programs intended primarily for poverty

[47] For a clear example, see E.M. Hall, *Canada's National-Provincial Health Program for the 1980's* (Ottawa: Department of Health and Welfare, 1980).

[48] See Albert O. Hirschman, *Exit, Voice and Loyalty* (Cambridge: Harvard University Press, 1970).

[49] See Robin Boadway, Nicolas Marceau, and Motohiro Sato, "An Agency Model of Welfare and Disability Assistance," Queen's University, May 1997.

[50] See Colin J. Hindle, "Negative Income Tax and Canadian Welfare Policy," Unpublished M.Phil. essay, University of Toronto, 1969.

alleviation, Canadians indeed appear to want targeting, at least in the sense of ensuring minimal inclusion in the welfare system of those who should not be there. For other important redistributive programs, however, such as those related to children, the elderly, and the health sector, it is much less clear that even the best targeting system -- indeed, perhaps especially the best targeting system -- will survive the ultimate test of political acceptability.

This question has become more important now that we have the ability to administer targeted benefits fairly effectively through impersonal, and largely invisible, accounting systems.[51] The visible stigma of singling out the poor as "second-class" citizens has lost most of its force, as indeed demonstrated by the general public acceptance to date of such income-conditioned targeting as the Child Tax Benefit and the Seniors Benefit. Nonetheless, further development of such narrowly targeted social policy reforms may prove neither popular nor even feasible unless the majority who now benefit from universal programs are also given some immediate and visible benefits such as tax relief for the private provision of equivalent services.

To the extent social policy becomes more effective in targeting benefits to the poor, rather than making them universally available to all, some compensating offset to middle-class losers may thus be required to ensure continued political support for the whole social policy package. One way to achieve this aim may be by providing increased tax relief for what the Carter Commission called "non-discretionary expenditures"[52] -- particularly those related to such prominent social policy objectives as child welfare, education, and health. Unless this is done, the tax-transfer system may come increasingly to be perceived as unfair in the sense that non-low-income individuals who incur special living costs -- for example, owing to physical disability or supporting four children -- are worse off than those with similar incomes who do not incur these

51Two examples may be offered: First, complementing the universal pension system (OAS) described in note 37, Canada has a supplementary Guaranteed Income System (GIS) -- in effect a "negative income tax" for the elderly which insures (in 1996) a minimum annual income of $11,280 for a single person over 65 and $14,688 for a couple both over 65. The GIS is paid out monthly with the OAS payment, with the amount paid being based entirely on information in the previous year's income tax return: about 40 percent of pensioners get such supplementary payments. Second, several systems have been suggested that could identify who is eligible for how much subsidy on what without the "stigma" problem: see the early discussion in Marjorie Wilcox and Selma J. Mushkin, "Public Pricing and Family Income: Problems of Eligibility Standards," in Selma J. Mushkin, ed., *Public Prices for Public Products* (Washington: The Urban Institute, 1972), p. 395, and the earlier discussion of pricing health policies at note 38. The increasing use of "smart cards" would appear to make such systems increasingly workable.

52See Royal Commission on Taxation, *Report* (Ottawa: Queen's Printer, 1966), vol. 1.

costs.[53] A similar development may well occur with respect to such educational costs as tuition, as education is increasingly perceived as a needed tool for one's children to secure a job and hence a satisfactory lifestyle in this rapidly changing world.

In some social policy areas, the budgetary choice now facing us may not be "all" (universality) or "nothing" (nothing) but "targeting" or "nothing." But to make even targeted social programs possible, some sops (tax reliefs) to the middle class may prove politically necessary. In any case, as I suggested earlier, in at least some instances a good efficiency and equity case can be made for tax relief (partial subsidy) for some private substitutes for publicly-subsidized services. For example, contrary to the arguments made by some to reduce tax-assistance to savings for retirement, such provisions might perhaps be extended to allow taxpayers to save for expenditures on training and education. Moreover, contrary to the reforms of the 1980s, in which tax deductions were turned into tax credits and hence made less remunerative for middle and upper income taxpayers, the future may see a return to deductions for non-discretionary expenditures related to such items as disability and medical costs which are in part subsidized under universal programs -- and perhaps even for children who are now supported only through income-conditioned targeted programs.

To sum up this somewhat scattered argument, tax policy can and should be used like any other policy instrument to respond to evolving economic and political circumstances. Tax "neutrality," the Holy Grail of many tax reformers in recent years, should be replaced by an approach that treats taxation as just one of a broad set of public policies attempting to secure particular objectives. Along these lines, for example, the personal income tax may perhaps be revised to encourage training and education by allowing more deduction of monetary outlays for such purposes.

In addition, as has already occurred with respect to transfers for both children and the elderly -- although one hopes more comprehensibly and with more attention to maintaining the integrity of the tax system as a means of fairly financing government -- the personal income tax may continue to be explicitly or implicitly integrated with the transfer system and used to deliver targeted social assistance. If so, however, there may also be increased pressure for, as it were, "compensatory" recognition of the costs incurred by taxpayers to purchase similar services themselves. Strict egalitarians may not like this outcome, but those concerned with maintaining political support for policies aiding the poor should, I suggest, take a more positive attitude to the introduction of such differentiation into Canadian social policy.

53For an example of this line of argument, see Michael Krashinsky, *User Charges in the Social Services: An Economic Theory of Need and Inability* (Toronto: University of Toronto Press, 1981), at p.28.

Much discussion of social policy confuses three different questions: the appropriate treatment of similar people with different incomes, the appropriate treatment of people with the same income but differing in other policy-relevant characteristics, and the likelihood that preferences for particular services are not strictly related to either income or other characteristics. Forcing everyone to consume the same bundle of services makes sense only under the extremely improbable circumstances that everyone has exactly the same tastes or the paternalistic (father knows best) approach that everyone should eat exactly the same amount of spinach. Even when a sound efficiency or equity case can be made that everyone should have equal access to a given level and quality of a service such as health care, additional strong assumptions are required to justify forbidding anyone to consume more than that amount. From this perspective, it might perhaps be suggested that Canada has been able to go as far as it has with its essentially "one size fits all" health service in large part because of the easy access for the wealthy discontented to the very different American system.[54]

Governments are inherently redistributive. But not all redistribution is equal, and the efficiency of a particular mode of social policy must be assessed both in terms of the motivation for such redistribution and the need to build sufficient political support for its implementation. From this perspective, I have argued that two quite distinct types of social policy may be distinguished.

The first type is one with respect to which most people think they may someday benefit -- health, education, old age pensions. Reducing income variance in the face of such eventualities is clearly a highly-valued function of government and one for which we as a society have demonstrated considerable willingness to pay. Such policies are most supported when their reach is the broadest and they can be justified in terms of self-interest or, more speciously, as "rights." The poor are likely to get "enough" with respect to such services only when the not-so-poor also think they too get enough, and one way to achieve this, if budgetary constraints lead to increasingly targeted direct programs, may be by more explicit joint consideration of tax and expenditure policy, perhaps along the lines suggested above.

The second type of social policy relates to those who are, in effect, seen by many as the recipients of public charity -- particularly low-income people on general social assistance. Assuming, as seems plausible, that most citizens do not think such policies have much to do with them personally, policies of this type may perhaps be most readily supported when their reach is narrowest and they can be justified as efficient means of salving the public conscience.

[54] Correctly-designed public programs in such areas as health or education must take into account explicitly interactions with actual or potential private substitutes (Jeffrey S. Hammer, "Economic Analysis for Health Projects," *World Bank Research Observer,* (February 1997)). Markets matter, even when, as to a considerable extent is the case in the social policy area in Canada, they have been suppressed.

Policies that are targeted narrowly to avoid giving "excessive" benefits to "non-deserving" persons may thus be most politically viable, even if the result is that the amounts thus given are too small to provide such persons and their families an adequate chance in life. This may not be ideal, even in strictly economic terms,[55] but it may be the best we can do.

Taxing Choice

Finally, I want to turn briefly to a quite different question -- the potential role of taxation in affecting individual choice and the relation of such effects to social policy. Contrary to popular belief, there are such things as "good" taxes. The best-known example is a so-called Pigovian tax, a tax that improves market efficiency by inducing economic agents to take social costs correctly into account -- while at the same time providing revenue for the state. Although one might expect such "first-best" fiscal instruments to be popular with governments, for the most part they are not with the apparent exception of taxes on smoking and drinking. I shall consider briefly the case for using of taxes to affect personal choices and the case for not using them.

A potentially useful tool in the health policy kit, for example, would seem to be taxes that discourage unhealthy activities. Smoking, like drinking alcoholic beverages, is commonly thought to create adverse external effects. These effects are both real and financial. **It** has been argued, for example, that "second-hand smoke" may kill people; drunk drivers certainly do. In addition, innocent bystanders may also be at financial risk under our public health care system since they must pay for the health care costs incurred by those who abuse their bodies by smoking and drinking. A common rationale often offered in support of such so-called "sin taxes" is thus both to make smokers and drinkers more aware of the real and financial costs of their consumption choices and hence to discourage them from making such choices -- or at least to make them pay for some of the damage if they do make such choices.

Excise taxes on cigarettes and alcoholic beverages may thus be viewed in part as a type of "user" fee. The rates for excise taxes on products with important external effects clearly need to be set with these consequences taken into account, so the policy design issue is to determine whether this fee is set at a rate high enough to reflect these external costs.[56]

A plausible case may thus be made in favour of using taxes to regulate certain private behaviour. Nonetheless, I am skeptical of such arguments for three reasons. First, where we do apply such "regulatory" taxes, there is no apparent relation between the tax rates we set and the policy outcomes we presumably desire. Even taking into account what little we know about the external costs

[55] See, for example, the text discussion at note 25.

[56] For a useful recent discussion of this issue, see Satya Poddar, "Taxation and Regulation," in Bird and Mintz, *op.cit.* in note 43, at pp. 75-77.

arising from secondary smoke, for example, contrary to what many think, there is no conceivable way taxes as high as those we now impose on tobacco can be justified on Pigovian grounds.[57] A more important argument supporting such high taxes is the simple fact that governments can collect a lot of money from people who for the most part seem to be as convinced as the rest of us that they should, so to speak, pay for their sins. Unfortunately, much of the apparent bloom vanishes from this fiscal rose when one realizes that much of this money comes from very poor people. Indeed, tobacco taxes may be the single most regressive element in the Canadian tax system.

A second reason for my skepticism about the regulatory use of taxes is that in fact we do not employ such taxes much or at all even where is an extremely strong case for them. Two examples may suffice: first, we know a lot about the appropriate level and design of alcohol taxation from an efficiency perspective, but there is very little evidence that this knowledge has had much influence on, for example, the relative level of taxation on beer and spirits.[58] Second, although we know even more about the size and nature of the external costs arising from motor vehicle usage, there is little evidence that we have the slightest inclination to impose rational regulatory taxes on private transport59

Finally, a third reason for skepticism about the value of the tax approach to regulating personal behaviour rests on the assumption that we should not prevent informed adults from doing things that are bad for them, so long as they bear the costs of their own foolishness. Life is hard enough without what has been called "the nanny state"[60] sticking its nose in everyone's business through taxing this and subsidizing that in order to get everyone to look after

[57] See especially Jane Gravelle and Dennis Zimmerman, "Cigarette Taxes to Fund Health Care Reform," *National Tax Journal,* 47 (September 1994), 575-90. For related arguments, see W. Kip Viscusi, "Promoting Smokers' Welfare with Responsible Taxation," *National Tax Journal,* 47 (September 1994),547-58, and Andre Raynauld and Jean-Pierre Vidal, "Smokers' Burden on Society: Myth and Reality in Canada," *Canadian Public Policy, 18* (September 1992),300-17.

[58] See, for example, J.A. Johnson, "Comment: The Case of Alcoholic Beverages," in Bird and Mintz (1992), pp. 102-09; Philip J. Cook and Michael J. Moore, "This Tax's for You: The Case for Higher Beer Taxes," *National Tax Journal,* 47 (September 1994), 559-74; and Edmund Crooks, *Alcohol Consumption and Taxation,* Report R34 (London: Institute for Fiscal Studies).

[59] See Bird and Tsiopoulos, *op.cit.* in note 32, at pp 79-80.

[60] William F. Shugart II, "The Economics of the Nanny State," in Shugart, *op. cit.* in note 18.

themselves properly.[61] All in all, it is hard to avoid concluding that hypocrisy plays a bigger role than Hippocrates in determining how heavily we tax specific goods and services. Regulatory arguments may have a limited role in justifying some taxation of activities such as smoking, drinking, and driving, and they should certainly have a larger role than they now do in shaping the precise design of such taxes. But beyond this very limited sphere of action, I see no important place for taxes on choice as an instrument of social policy.

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Conclusion

To sum up this lengthy though very preliminary survey of the broad terrain I have been surveying, my general argument has been that we have probably spent too much time recently worrying about linkages between the size of government and social policy. As I have argued, there is no necessary linkage between the level of taxation and the quantity or quality of social policy. A few of us may also have spent too much time thinking about narrowly "regulatory" taxes. Beyond the traditional externalities argument, the tax system should generally not be used to influence individual choices. But none of us has yet spent enough time thinking about the really important linkages between taxation and social policy -- the linkages that arise from the many ways in which the structure of the revenue system interacts with particular social policies. The two sides of the budget interact in many ways, and we need to take these interactions more explicitly into account than we have usually done in reforming either tax policy or social policy.

[61] At the extreme, as Michael Trebilcock ("Comment: Regulation by Taxation," in Bird and Mintz (1992), p. 101) noted some years ago "".one can imagine extending this approach to fatty foods, motorcycling, white-water rafting, not exercising [by allowing tax deductions for exercise equipment], prostitution, and pornography." This list could obviously be extended.