Road Map for Tax Reform

The Taxation of Savings and Investment

A statement by the Economic Council of Canada
1987

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This Statement reflects the views of the Members of the Economic Council of Canada; however, dissenting comments by Dian Cohen, Diane Bellemare, Kalmen Kaplansky, Chaviva Hosek, and Raymond Koskie appear at the end of the document.

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Foreword

The Council's research project on taxation is the most ambitious study of the tax system undertaken outside the federal Department of Finance since that of the Carter Royal Commission in the 1960s. In the course of our work, we have drawn on some of the best minds in Canada – leaders in academic research, our own staff, and tax practitioners. Yet taxation is such a massive subject that the Council was compelled to choose between digging deep on a focused set of issues or using the same resources to address a wider range of topics. The Council chose, in 1983, to focus on the taxation of income derived from savings and investment. We have therefore extended the boundaries of our knowledge of the way in which the tax system interacts with decisions to save and invest. The list of discussion papers and research studies in Appendix A bears witness to the depth of the work we have completed. An integrative research report will be published in the spring of 1987. This Statement summarizes the policy advice that Council members have distilled from that large body of research.

In completing this focused research program, the Council did not address two major questions that are of great interest to some Canadians but which would have required more resources and more time than we had at our disposal. The first of these questions concerns the redistribution of tax burdens across income classes. This gap has caused considerable discomfort to some of the current members of Council. But I wish to emphasize here that, because the redistribution issue was not part of the study, the Council does not propose to alter the present distribution of tax burdens. We simply designed a package that would keep the incidence of taxation as close as possible to what it is now. In short, we leave the redistribution issue to another time and another forum.

The second question that was not addressed in this study is how to eliminate the federal fiscal deficit. That, too, raises a new set of issues. The Council therefore proposes changes that would generate the same amount of total revenue as the existing system.

Setting aside the redistribution and the deficit-reduction issues is a legitimate approach to research in the sense that it enables us to concentrate our attention on the fundamental question of tax structure. How does the tax system affect the efficiency of the Canadian economy and our standard of living? In particular, what is the impact on saving and investment decisions of the total tax system, when all types of taxes (corporate, personal, sales, property, and resource taxes) are taken together? What changes in tax structure are desirable and feasible to increase output and improve our standard of living over time?

In the course of our research, we documented the capricious variations in total tax burdens for various types of investment; we identified the different patterns of saving over the life cycle of an individual, and we found that incomes fluctuate up and down to a surprising degree over a lifetime. We also traced the variation in the responses of individuals to tax rates at different times in their lives. These fresh insights explain why the Council's road map puts forward two main themes for tax reform. On the corporate side, we opt for a broader definition of taxable income, with lower tax rates, but still generating the same amount of revenue. We want to increase the role of business judgment – and decrease the role of the tax system – in selecting investments, which are so important to our future. On the personal side, we also opt for base broadening, but at the same time we propose a longer time horizon for taxation, so that individuals will have more scope for averaging their tax burdens over their lifetime.

The federal government has launched an extensive review of taxation in Canada with a view to introducing major legislative changes in the next year or so. This document is intended to contribute to that review and to the public discussion that will follow. It is our hope that the research results published in the background documents, plus the recommendations in this Statement, will help Canadians to focus on the question of tax structure. The first challenge, in our view, is to get the design of the foundations right. Once that is done, we will be in a better position to deal effectively with the issues of redistribution and deficit reduction.

The project has benefited from the contributions of many individuals. I would like to pay special thanks to the members of the Economic Council and to the tax practitioners who served on the Advisory Committee, as well as the many outside experts who provided guidance to the research team. The Council benefited greatly from their knowledge and experience, and we thank them for the time they gave us.

Judith Maxwell
Chairman

Road Map for Tax Reform

READER'S NOTE

The reader should note that various conventional symbols similar to those used by Statistics Canada have been used in the tables:

.. figures not available
... figures not appropriate or not applicable
-- amount too small to be expressed
- nil or zero
e estimated figures
x data confidential, to meet the secrecy requirements of the Statistics Act.

Details may not add up to totals because of rounding.

The Council's Approach

There is a broad consensus today that the Canadian tax system needs reform. Governments are concerned because the system fails to generate enough revenue despite the relatively high statutory rates of taxation. Citizens are upset because they perceive the system as being too complex and unfair. Businessmen are critical of the complexity, the high statutory tax rates, the uneven tax treatment of different investment projects, and the constant changes being made to the tax system. Economists in general, and members of the Economic Council of Canada in particular, are convinced that taxes as they are now structured are a barrier to efficiency and to higher standards of living because they needlessly distort decisions by investors, savers, consumers, and producers.

There is also a surprising degree of consensus among governments, political parties, and independent observers on the need to broaden the tax base by eliminating tax preferences so that statutory tax rates can be reduced. The consensus does not go so far as agreement on specific measures, however.

Canada's tax system is already a mixture of annual taxes on personal and corporate income, taxes on expenditures, payroll taxes, and taxes on property. It should be noted that Canada relies more than most other OECD countries on sales taxes and other forms of indirect taxes levied on expenditures. There is also special treatment for certain types of assets (owner-occupied housing, pension funds, and RRSPs, for example) that makes the personal tax system somewhat of a hybrid of income and expenditure tax bases. In this Statement, the Council is putting forward a series of recommendations that would broaden tax bases; lower statutory tax rates; tax real, rather than inflated, income; tax equals equally; and move the focus of the personal income tax towards a lifetime-income basis. They would also improve the fairness of the system through a series of measures and provide for closer integration of corporate and personal income taxes.

Our analysis takes account of all levels of government and the major types of taxes on income, sales, and property. The Statement is founded on a three-year research program focused on the taxation of capital income – that is, income derived from saving or investment; this program has generated important new analytical results in several key areas. Some of the associated research is indicated in Appendix A.

Our results show that the current tax system, by impairing the rate of capital formation and encouraging investments in projects that are attractive only because of favourable tax treatment, is preventing the economy from performing at its potential. The main thrust of our recommendations, therefore, is to reduce those efficiency losses and at the same time create a fairer and simpler tax system.

It is important to underline at the outset that our proposals are not intended to change government revenues: revenue gains from widening the tax base would be used to reduce statutory tax rates. The Council acknowledges that deficit reduction is a vital issue; but it is a distinct problem, and to clarify the issue we have tried to focus on improving the structure of the tax system. We believe that governments are caught in a vicious circle. Their tax bases have become badly eroded. Yet the more they try to boost revenue by raising tax rates on such narrow bases, the more the high tax rates accentuate inefficiencies and inequities, and encourage tax avoidance and evasion. Thus the first step towards a more coherent system is to broaden the tax bases and get statutory rates down.

The proposals are also designed, generally, to be distributionally neutral; that is, if adopted, they would not significantly alter the distribution, or the share, of after-tax income going to low-, medium- and high-income Canadians. The Council endorses the concept of reasonable personal-income-tax progressivity. And most members believe that the tax system should provide a mechanism that would enable individuals – particularly those with incomes that vary widely from year to year or during different parts of their lives – to average their incomes for tax purposes over their lifetime, should they so desire.

In the course of our discussions, questions were raised with respect to the tax treatment of savings, as distinct from income that is spent; the appropriateness of a "lifetime- versus annual-income" concept for tax purposes; the willingness of governments, under the pressure of vested interest groups, to leave the rules of the game alone; and, for particular industries and enterprises, the difficulty of making the transition from a tax system that evolved in the 1970s to one that is suitable for the 1990s and beyond. These were searching questions. Not all could be answered with surety. The question of winners and losers from tax reform, for instance, requires an intimate knowledge, not publicly available, of the incomes, assets, liabilities, and tax circumstances of individual Canadians and individual Canadian firms. It also presupposes knowledge of how taxpayers will respond to the change being proposed and what options they might choose. We could claim no such prescience. And while this by itself is no reason for inaction, it did prompt us, in certain key areas, to recommend gradual changes.

Having said that, it must be acknowledged that, while Council tried very hard, it was not able to reach a consensus on all the perspectives or specific recommendations put forward in this document. The principal area upon which Council members were unable to reach agreement was the question of *what* it is that tax policy should achieve. The Council originally undertook this project with a view to looking at changes to the tax system that would enhance its fairness, efficiency, and capacity to raise revenues. Some Council members, however, believe that the tax system should be not only the mechanism by which governments raise revenues but also the means to achieve other policy objectives, such as economic and industrial development goals or specific social-policy objectives such as greater transfers to the poor. (Their views are expressed on page 31.) Most Council members believe, however, that past overemphasis on the use of tax-policy initiatives to promote such policy goals have led to the present compromised tax regime.

History of Tax Reform

The history of tax reform in Canada shows that, periodically, it is essential to stand back and assess the whole tax structure. The first major review of the Canadian tax system in its entirety was undertaken by the Rowell-Sirois Commission. The core of its recommendations, which focused on the need for a stronger federal fiscal presence, had substantial influence on the postwar arrangements between the federal and provincial governments that led to a completely revised *Income Tax Act* in 1949.

The 1949 *Income Tax Act* embodied both the personal and the corporate income tax levied by the federal and provincial governments. (Alberta, Ontario, and Quebec have since set up their own corporate income taxes, and Quebec also has its own personal income tax.) The 1949 Act was a clean-up job, aimed at reconciling the massive wartime income tax changes with the postwar realities of federal and provincial fiscal responsibilities. The 1949 reforms focused on income and excluded capital gains. The failure to tax capital gains eventually caused the downfall of the system because it created incentives to avoid taxes through a process called "surplus stripping." Individuals were able to convert ordinary income (wages or dividends, for example) into retained earnings of closely held corporations and then take the income from the corporation as a capital surplus or capital gain.

The federal government tried to block this gap with many complex, and at times arbitrary, amendments to the Act. Eventually, in September 1962, the government appointed a Royal Commission on Taxation (the Carter Commission), which held public hearings in all regions of Canada and submitted its final report in December 1966. The Commission's main conclusion was that an annual personal income tax, broadly defined to include capital gains and other forms of income, offered the best possibility for a fair and reasonable tax system. The family would be the unit of taxation, rather than the individual. The Commission also recommended that the federal government reduce its reliance on corporate and sales taxes. It urged the integration of corporate and personal taxes through a full dividend tax credit, and it would have moved the federal manufacturers' sales tax to the retail level.

In 1969 the government issued a White Paper that generally supported the idea of a comprehensive income-tax base, along with simplified personal-income-tax schedules. It supported full taxation of capital gains, a full credit against taxation of dividends in the personal income tax, and a flat-rate corporate profits tax. The Paper was subsequently the subject of House of Commons and Senate Parliamentary Committee study, culminating in Bill C-259, implemented in January 1972. Among other things, the Bill provided for general income averaging, for only one-half of capital gains to be taxable, and for one's principal residence to be exempt from capital gains; in addition, a partial dividend tax credit was introduced.

In subsequent years the federal government adopted a variety of relatively *ad hoc* tax initiatives. Perhaps most important, it indexed the basic personal exemption and the personal-income-tax-rate brackets in 1974. In 1976 the amounts of contributions to registered pension plans (RPPs) and registered retirement savings plans (RRSPs) were increased.

On the corporate side, various measures were introduced to offset the effects of inflation and to give special treatment to manufacturers and small businesses. The capital-cost-allowance system was also altered a number of times to give special treatment to various forms of investment. The investment tax credit was introduced in 1975 and enhanced a few years later.

Taken in their entirety, the changes introduced in the 1970s echoed the Carter Commission's earlier objective of providing a closer integration of the personal and corporate income taxes and enhancing the role of the personal income tax in the total tax system. But while some of the initial reforms effectively broadened the personal-income-tax base, subsequent deductions and credits tended to compromise the system and move it away from the Carter Commission's original emphasis on fairness and neutrality.

The 1981 federal budget proposed several major changes into the federal tax system, some of which were subsequently dropped by the government. It sought to include as taxable income various benefits not previously taxed, or inadequately taxed, and it reduced the top marginal personal-income-tax rate to 50 per cent. But, unlike earlier revisions, the overall thrust of the changes was seen to be relatively harsh in its treatment of small business and a significant segment of the tax-paying population, and there was strong public resistance to the proposed budgetary measures.

Then, in May 1985, the federal government launched a debate about reform of the corporate income tax, which proposed changes in capital cost allowances, the investment tax credit, and the inventory allowance that would broaden the tax base and reduce the statutory corporate-tax rate by 7 percentage points. (Some of these measures were then partially implemented in the February 1986 budget, although they have not yet been enacted.) The 1985 and 1986 budgets also made important changes to the personal income tax – providing a lifetime exemption of $500,000 for capital gains, a minimum personal income tax, and higher limits on contributions to registered pension plans and registered retirement savings plans.

More recently, in October 1986, the federal Minister of Finance, the Honourable Michael Wilson, provided guidelines for a major reassessment of the federal tax system – not only with respect to the personal and corporate income taxes, but also the manufacturers' sales tax. Any changes at the federal level will have important repercussions for the provinces as well, because of joint or related collection systems.

Trends in Other Countries

Canada is not alone in its search for a more efficient and equitable tax system. Reform has become a major issue in many OECD member countries because of widespread misgivings about high and variable tax rates and narrow tax bases. Indeed, the OECD has had this to say on the matter:

> Governments are not alone in their growing concern over the shortcomings of current tax systems. Public support for tax systems and collection methods, which in some countries has never been very great, has waned in recent years, both because of the rise in average tax rates and because of the systems' growing complexity, itself related to the narrowing of the tax base.... Both theoretical considerations and the prevailing political mood, therefore, tend to support the principle underlying most of the current or prospective tax reforms as originally proposed: a widening of the tax base and, for the personal and corporate income taxes, a lowering of rates, with greater simplicity and greater horizontal equity in the sense that taxpayers of comparable means would come closer to receiving similar treatment.[1]

In 1986, after two years of intensive debate stemming from presidential initiatives that were hailed as introducing "a second American revolution," the U.S. Congress adopted a series of reforms aimed at broadening the tax base and lowering the top marginal rates. The recent federal reforms have reduced the top marginal personal-income-tax rate from 50 to only 28 per cent, with the vast majority of taxpayers subject to a marginal rate of 15 per cent. The statutory corporate-tax rate has been cut from 46 to 34 per cent, with an even lower rate for small business. To finance these cuts in statutory tax rates without changing federal tax revenues, a host of tax preferences have been eliminated, and capital gains are no longer to receive preferential tax treatment.

The United Kingdom, too, has lowered the top marginal tax rates on high personal income and has recently taken steps to reduce discrimination between different types of investment and different forms of financing. It has also reduced its statutory corporate-tax rate from 52 to 35 per cent. Similar "base-broadening" measures are being introduced or considered in a number of other European countries. In 1986, the government of New Zealand replaced its existing structure of commodity taxes with a value-added tax akin to those which are widespread in Europe, and similar indirect tax reforms have aroused considerable discussion in Australia and in Japan. In short, the search for more-efficient and more broadly based tax systems is international.

Canada cannot remain indifferent to these developments, particularly to the changes that have occurred in the United States. In an open economy such as Canada's, an excessively high tax on personal or corporate income could result in an exodus of capital or labour that is highly mobile. At the same time, Canada cannot, and should not, expect to replicate the U.S. changes. The U.S. tax legislation differs substantially from practices in Canada. Canadian governments have traditionally played a larger role in the economy than U.S. governments, particularly in the areas of health, education, social security, and regional development; thus they have proportionately larger revenue requirements for those purposes. These Canadian revenue needs go beyond those which would be yielded by outright adoption of the new U.S. tax rules and rates taken together. If Canadians are to continue to fund the public expenditure programs they now enjoy, the

Canadian rules or rates, or both, will almost inevitably differ from those in the United States.

The Changing Tax Mix

In the search for tax reform, questions arise with respect to not only particular taxes – i.e., income or sales taxes – but possible changes in the *tax mix.* For example, should the share of corporate income taxes in the revenues of government be increased, as is about to occur in the United States as a result of the recent tax changes? Should the share of sales or value-added taxes in total tax revenues be increased, as has occurred in recent years in the United Kingdom and New Zealand? There is also the closely related question of how taxes are to be implemented – *directly*, by means that allow the circumstances of the individual taxpayer to be taken into account; or *indirectly*, by means that do not. One can vary the burden of an income tax according to the taxpayer's characteristics. Commodity or value-added taxes really cannot be "personalized" in this way. This distinction becomes important when one wants to achieve distributional and other objectives through the tax system.

It is also evident that taxes cannot be studied in isolation from each other; they must be viewed as part of an interdependent system of measures. Nor can reform be confined to one level of government within Canada. Property taxation is almost exclusively used as a tax base by local governments; resource taxation, primarily by provincial governments. Both federal and provincial governments share jurisdiction in the fields of corporate and personal income taxes.

The tax mix has changed dramatically over time. In 1985, the total tax revenues collected by the federal, provincial, and local governments amounted to $158.3 billion, or 33.2 per cent of gross domestic product (GDP). (Investment and other nontax income added $50.6 billion – or 10.6 per cent of GDP – to combined government revenues.) Chart 1 groups the taxes under seven main headings. It shows that in 1985, personal income tax accounted for the largest single share of the total revenue raised, followed by sales and excise taxes, and social insurance and other payroll taxes. Property tax, corporate income tax, and resource taxes each provided less than 10 per cent of total tax revenue.

It was not always so. A generation ago, sales and excise taxes were the most important source of revenue, followed by corporate income tax. Personal income tax was in third place. Social insurance and other payroll taxes were much less significant than they are now, and resource taxes were negligible. Clearly there have been major shifts in the way that Canadians have financed the services supplied by government over time.

Table 1 shows the absolute magnitude of the tax revenues, by level of government. Personal income tax, sales and excise taxes, social insurance and other payroll taxes, and corporate income tax are the most important sources of revenue for the federal government; personal income tax, sales and excise taxes, and resource taxes play the biggest role in provincial finances; and property tax is by far the major source of local tax revenues. Of course, not all provincial and local revenues come from taxes. Almost one-quarter of provincial revenues are cash transfers from the federal government, and about one-half of local revenues are transfers from the provinces.

Appendix B contains a brief description of the main types of taxes dealt with in this Statement.

What Are the Problems?

Criteria for a Sound Tax Regime

To judge the weaknesses of the current system and to set objectives for reform, we need criteria that will ensure a good tax system. The criteria that we employ are those of efficiency, fairness, simplicity, stability over time, and government accountability in a democratic society. These criteria are not necessarily mutually exclusive; their application therefore calls for balance and compromise.

Efficiency and Neutrality

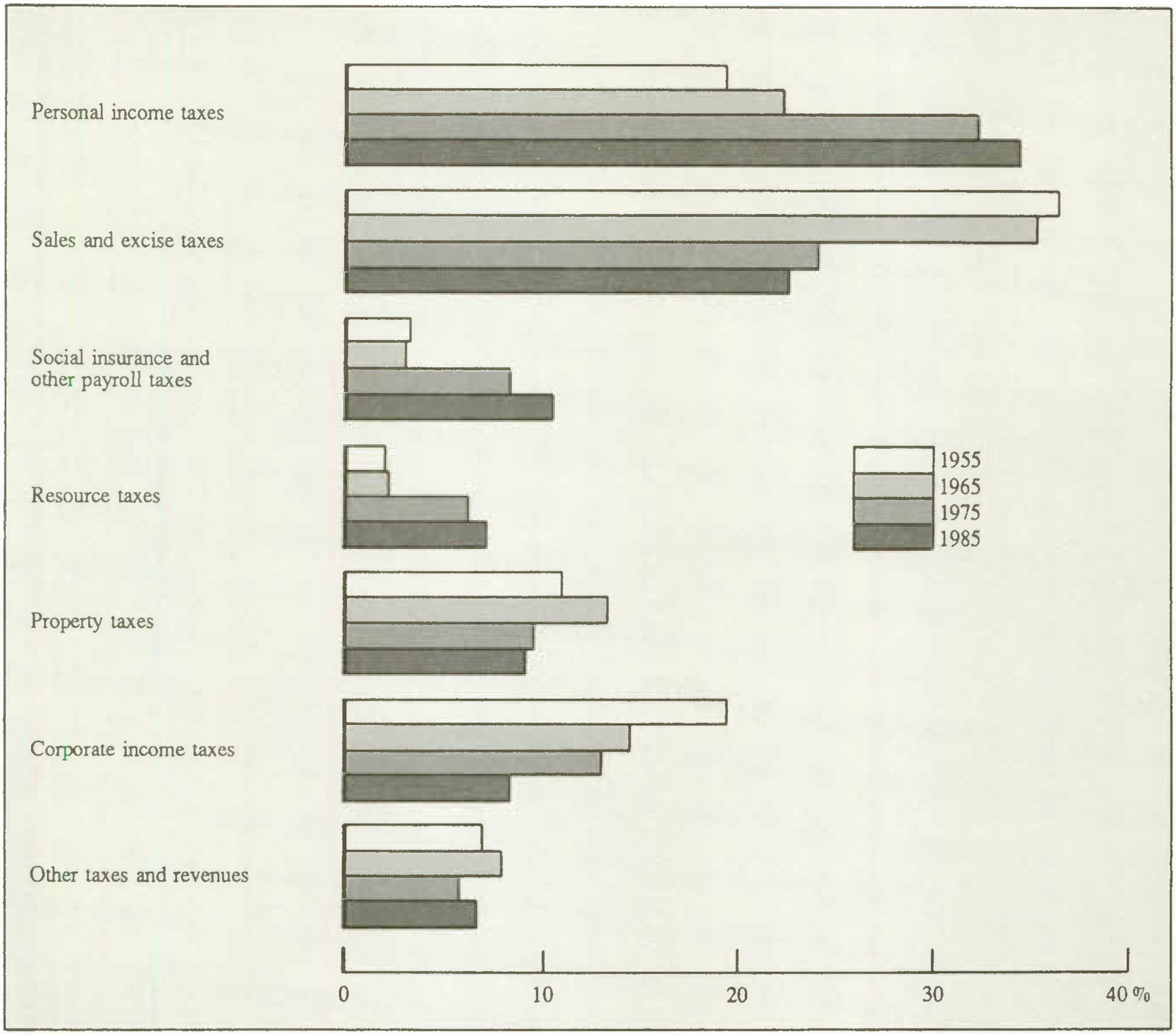
Our definition of efficiency has an important time element. We are concerned with maximizing output and the standard of living, not only currently – with the resources we have at hand – but also in the future, when resources can be expanded. The definition of efficiency at a fixed point in time when resources cannot be expanded is quite simple. We say that output could not be increased by any rearrangement of factors of production. Efficiency in a "dynamic" context – or over time – is a somewhat more complex matter. A working definition here might be that "efficiency is attained when the welfare of any one generation cannot be increased without decreasing that of another generation."

In matters of taxation, is there a principle that, if adhered to, would encourage efficient outcomes? One answer is at hand:

> An ideal tax system would interfere as little as possible with the millions of economic decisions that are made every day, on such matters as what to produce and what to consume, what productive technology to employ, and how to organize and

Chart 1

Sources of Government Revenue (All Levels) as a Proportion of Total,[1] Canada, Selected Years



1 Excluding intergovernmental transfers, investment income (except royalties), and contributions to public service pension plans.
SOURCE Estimates by the Economic Council of Canada, based on data from Statistics Canada.

> finance production. If income is not taxed uniformly and consistently, without regard to its source and its use, economic decisions will be unduly influenced by tax considerations, and the allocation of economic resources will be distorted.[2]

Today's working definition of efficiency embodies this notion of *neutrality*, or of "minimizing interference with economic decisions in otherwise efficient markets."[3]

Our research shows that the Canadian tax system is far from being neutral or even-handed in its treatment of investment. When sales, property, corporate, and personal taxes are all taken into account, effective tax rates on capital income vary enormously, depending on the industry in which an asset is used, the type of asset acquired, the manner in which the investment is financed, and the tax status of investors supplying the funds (see Appendix D).

Table 1

Sources of Government Revenue,[1] by Level of Government, Canada, 1985

	Level of government			All levels
	Federal	Provincial	Local	
	(\$ Millions)			
Personal income tax	32,124	22,443	...	54,567
Sales and excise taxes	16,146	19,916	188	36,250
Social insurance and other payroll taxes	12,800	4,250	...	17,050
Resource taxes	4,179	7,208	...	11,387
Corporate income tax	9,993	3,463	...	13,456
Property tax	...	250	14,480	14,730
Other taxes and revenues	1,454	6,554	2,818	10,826

1 Excluding intergovernmental transfers, investment income (except royalties), and contributions to public service pension plans.
SOURCE Estimates by the Economic Council of Canada, based on data from Statistics Canada.

These variations in tax treatment induce distortions in investment and saving decisions, and the distortions are accentuated by the interaction of inflation with an inadequately indexed tax system. Inflation increases the dispersion in effective tax rates and increases the overall taxation of capital income.

Fairness

Customarily two measures of the fairness of taxes are used: the extent to which equals are treated equally; and the extent to which the burden of taxation is shared between people in different economic circumstances.

The extent to which people in equal situations are treated alike by the tax system – or the criterion of "horizontal equity" – has traditionally been the principal measure of fairness in the tax system and was the principal goal of the Carter Commission. It is also a principal goal of our recommendations.

Concerning the tax treatment of people in different income groups or with different levels of economic resources, the Council endorses the principle of progressivity when taking account of all taxes and transfers as they affect individuals of different means. The mix of proposals to be set out below would not alter the existing pattern in any significant way.

Most calculations of tax incidence have used *annual* data on the distribution of income. But an annual-income distribution that catches people in a "snapshot" or "freeze-frame" view is not necessarily typical of their longer-run experience. We believe that the tax system, wherever possible, should take account of the lifetime income, spending, and savings inclinations of Canadians, and be as neutral as possible in matters that entail choices between present and future consumption.

Simplicity

It is an indication of the complexity of our tax system that just under 40 per cent of federal taxpayers now have their personal-income-tax returns completed by others.[4] Not surprisingly, therefore, complaints about the complexity of the tax system are widespread and important. Canada's tax system is, after all, largely self-administered. Any erosion of taxpayer morale consequently threatens compliance with the system.

Complaints about complexity in the tax system may reflect complaints about complexity in the rate structure or the tax base. There is, in fact, little doubt as to the primary source of the problem here. The problem is that the tax base is not drawn up on a uniform and consistent principle. This encourages taxpayers to attempt to beat the system by arranging their affairs so that essentially similar activities will be taxed at lower, rather than higher, rates. To prevent further erosion of the tax base, the authorities may then introduce legislation to circumscribe these "loopholes," which simply adds more complexity to the tax code.

A classic example of this vicious circle arises from differences in the treatment of capital gains and other income. In the United States, for instance, it has been estimated that as much as one-half of the U.S. tax code in the past has been devoted to limiting the extent to which taxpayers could take advantage of the lower tax rate for long-term capital gains.[5]

Stability

Up until the 1960s, new federal taxes were introduced, or old ones abolished, on 17 different occasions. In the 1970s, there were 55 major changes (involving $100 million or more) in federal taxes *after* the changes emerging from consideration of the Carter Report had been completed.[6] Currently, one tax practitioner alleges that "even in a dull year, we appear to be turning out over 100 pages of amendments to the Income Tax Act."[7]

Decisions on long-lived investments have to be made within the context of existing tax law, and abrupt changes in these laws of the kind indicated can cause economic dislocation and create windfall gains and losses. Frequent changes in tax provisions may also cause capital formation to be lower than it would otherwise be.

Visibility and Accountability

Wherever possible, taxation should be visible and levied with a minimum of administrative discretion. These attributes increase the accountability of government in a democratic society. In Canada, for example, the federal manufacturers' sales tax is largely hidden from the general public, while retail sales taxes, property tax, and personal income tax score high marks on grounds of visibility and accountability.

Shortcomings of the Present System

We argue that the present structure of individual taxes in Canada, as well as their mix, tends to discourage savings and investment, to divert investment choices away from those which are the most economically sound, and to violate some or all of the criteria just described. Consider the principal tax bases.

Personal Income Tax

Just as the personal income tax has become the main source of tax revenue for the federal and provincial governments, so have concerns been raised about its efficiency and fairness, and about the high statutory marginal rates, the incentives to avoid tax, and the breadth of coverage. Under the present system, similar, as well as dissimilar, savings and investment opportunities often bear different tax rates. Articles and books are written on how to defer or avoid paying taxes; tax advisers prosper on this account, and towards the end of each year newspaper advertisements abound with offers of MURBs or other tax-shelter opportunities. In 1983, for example, of over 1 million tax filers with incomes of $40,000 or more, close to 15,000 paid no tax at all, and many others paid very little tax – a situation that violates most public perceptions of fairness and that led to the introduction of an alternative minimum personal income tax in the 1985 federal budget.

An individual can save in many different ways. He or she can purchase corporate stocks and bonds or government debt, deposit funds in savings institutions and mutual funds, contribute to pension funds, or buy a house. Each type of asset will earn a return in the form of interest and dividends, capital gains, or, in the case of owner-occupied housing, an imputed rental income. Currently, each of these returns to savings is taxed differently. This in turn leads to distortions in how the savings are invested.

Moreover, the returns to savings and investment are taxed on a nominal, rather than real, basis. This means that during sustained bouts of inflation, the personal income tax may confiscate the entire income from some investments and lessen government accountability by including hidden tax increases.

Many economists argue, however, that there is a more serious shortcoming with the personal income tax – namely, in its treatment of savings and consumption. The issue becomes more complex when one takes into account the existence of different levels and forms of taxation, and the effects of inflation on the system. Returns on the same invested savings can be taxed at several levels, through the corporate income tax and the personal income tax; if reinvested, the yields can again be taxed, and so on. This, in part, is what the effort to integrate the corporate- and personal-income-tax systems through dividend tax credits is all about – to eliminate double taxation of shareholders. But the upshot is that under an income tax system, the tax treatment of savings – first, as part of income; second, on the subsequent flow of returns – tends to discourage saving and to encourage current consumption. This in turn reduces the amount of savings available for investment and generally raises the cost of capital beyond that which would otherwise prevail.

A third concern has to do with taxing income on an annual basis – a practice that not only encourages current consumption but also distorts the allocation of savings. Savings enable individuals to achieve a stable consumption stream from an irregular flow of current income. In their early earning years, individuals typically save little, or even dissave (borrow). In middle age, they consume less than their current income in order to repay debts and to acquire a stock of financial wealth from which to draw

The Effect of Taxing Savings and Their Returns under an Annual Income Tax

Suppose an individual wished to save for a purchase (worth $100 today) that would be made upon retirement 20 years hence. With an annual rate of inflation of 5 per cent, the purchase price in 20 years would be $265.33. With a nominal interest rate of 8 per cent per annum, the individual could obtain the $265.33 necessary to make that purchase by putting aside $56.93 of *after-tax* income in a savings account today. If, however, the returns to savings are taxed, as under an annual income tax, an individual with a 30 per cent tax rate would have to set aside $89.23 of *after-tax* income today in order to have the $265.33 in 20 years' time. Thus, under an annual income tax, it would cost the individual $32.30 more in forgone present consumption to obtain the same amount in 20 years than it would under a lifetime-income tax system. In our example, the treatment of savings under an annual income tax amounts to an additional excise tax of 56.7 per cent on future consumption.

The effective tax rates on future consumption implied by an annual-income tax system for different statutory income-tax rates and dates of consumption are presented in the table below. The figures in the table show that the effective additional tax rate on future consumption increases with the period of time considered and, furthermore, at an increasing rate. The table also reveals how much more punitive is the taxation of savings and its returns when inflation is higher – 10 per cent, in the example – even though the real annual return to saving stays unchanged at 3 per cent.

Effective Tax Rate on Future Consumption Implied by an Annual Income Tax: Two Examples

	Time of consumption (years)			
	1	10	20	30
	(Per cent)			
Income tax rate (%):				
Case A				
0	0	0	0	0
10	0.7	7.7	16.0	25.0
20	1.5	16.1	34.8	56.2
30	2.3	25.2	56.7	96.2
40	3.1	35.1	82.5	146.5
50	3.8	45.8	112.7	210.3
Case B				
0	0	0	0	0
10	1.2	12.3	26.0	41.5
20	2.4	26.2	59.3	101.0
30	3.6	42.1	101.9	186.8
40	4.8	60.2	156.6	311.0
50	6.1	80.8	227.0	491.4

Case A – Real interest rate = 3 per cent; inflation rate = 5 per cent; and nominal interest rate = 8 per cent.
Case B – Real interest rate = 3 per cent; inflation rate = 10 per cent; and nominal interest rate = 13 per cent.
SOURCE Economic Council of Canada.

later, to finance their retirement consumption. They may also save to cover future periods of unstable income – when earnings are forgone to allow time to bear children, upgrade professional skills, or bridge a period of job search – or to transfer wealth by leaving bequests. Whatever the motive, to the extent that savings finance future consumption, the taxing of savings by an annual income tax discourages future consumption relative to current consumption. This effect may be compared to an extra tax on future consumption that varies with the marginal tax rate, the nominal interest rate, the inflation rate, and how far into the future consumption is delayed (see box). In short, because of the tax treatment of savings, individual consumption decisions over time are distorted. For the population as a whole, the amount of savings available for investment is reduced.

Further equity concerns arise because of the variability of income from year to year. Individuals subject to variable incomes, who have to save to smooth out their consumption patterns, are treated less favourably than others who have the same total income over the period but have much more regular income patterns. Variable incomes are a fact of life for a sizeable proportion of the population, and it is hard to see why they should be treated less favourably than other similarly situated individuals who have smoother income patterns.

These criticisms having been made, the personal income tax remains the most progressive, direct, visible, and appropriate tax by which to finance a large segment of government activity. The thrust of our later recommendations will be directed at addressing the shortcomings of the system, while retaining its strengths.

Corporate Income Tax

The corporate income tax is riddled with a variety of tax credits, allowances, and deductions. Despite its relatively high statutory rate, the tax base has been reduced by concessions intended to promote certain types of investment and to offset the effects of inflation. The result, as we observed above, is that some activities are taxed much more heavily than others.

In any recent given year, about one-half of all corporations paid no tax at all. In some cases, this was because a corporation had experienced real losses. In other cases, it was due to the provisions of the corporate-income-tax legislation and to the competence of accountants and legal experts. Such departures from an even-handed or neutral tax system divert capital resources from their most productive uses – that is, those with the highest rates of return before taxes – into activities that are less productive but yield greater after-tax returns because of the preferential tax treatment they enjoy. After all, to the corporation a dollar saved in taxes is worth just as much as a dollar earned from productive activity. Needless to say, Canadians do not come out ahead if investments that are losers on the basis of business judgment are promoted to winners by the tax system. Viewed another way, the productivity of capital in the economy is effectively lowered and, with it, output and income levels.

Not surprisingly, therefore, the burden of taxes on existing capital among industries, and even on firms within the same industry, is very uneven. For example, in 1983 the *average* effective corporate tax rate – i.e., the ratio of taxes paid to book profits – ranged from 8.7 per cent in the storage industry to 43.4 per cent in the construction industry (see Chart 2). These variations in tax burden are due to the existence of different tax allowances, credits, and deductions, and to the fact that statutory corporate-tax rates themselves vary by industry and according to the size of the corporation.

The wide dispersion in marginal effective total tax rates on income from investments can be attributed largely to the provisions of the corporate tax. A comparison of Charts 3 and 4 indicates that the corporate income tax is responsible for most of the variation, even though it accounts for only a small proportion of the overall marginal effective tax rate applying to returns from new investments. The principal corporate-tax provisions responsible for this dispersion have been the investment tax credit (now being phased out), accelerated depreciation allowances for machinery, and the unfavourable tax treatment afforded equity-financed investments compared with debt-financed investments. These tax provisions favour firms and industries that are highly leveraged and that invest relatively heavily in machinery. Other disparities in marginal effective tax rates are caused by the preferential statutory tax rates that apply to firms engaged in manufacturing and processing, as well as to small businesses; differences in statutory tax rates between provinces; and the inappropriate integration of corporate and personal income taxes.

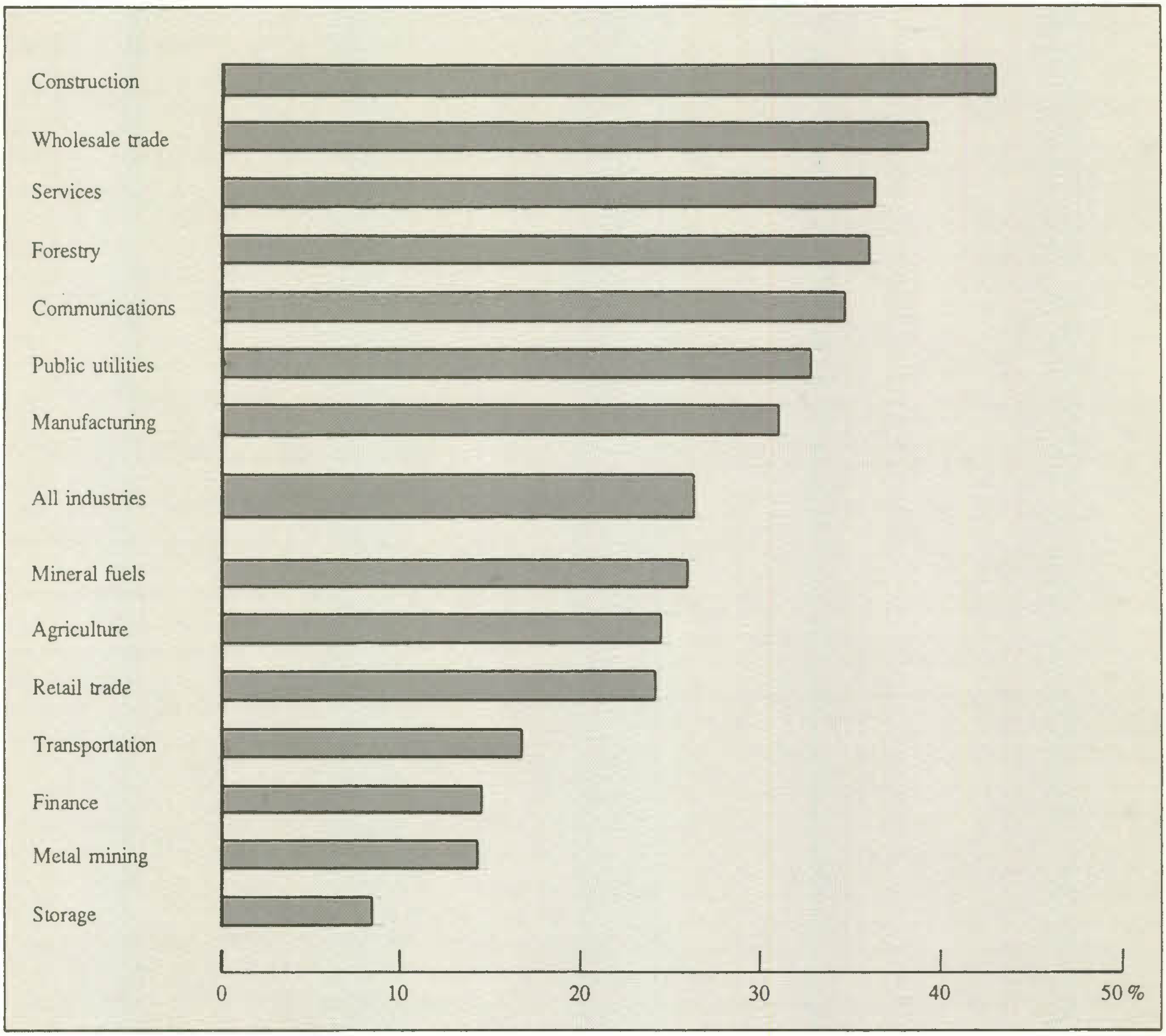
In combination with the tax system, inflation can cut deeply into corporate cash flow. For example, during the period 1977-81, it has been estimated that inflation reduced the current net cash flows of all nonfinancial industries by approximately 25 per cent.[8] *Ad hoc* tax-policy responses designed to alleviate this situation, in turn, contributed to the dispersion in marginal effective tax rates that we have described.

Current Sales Taxes

Most observers agree that the federal sales tax, which accounts for about 14 per cent of federal tax revenue, has serious deficiencies. The manufacturers' sales tax (MST) is closer to a selective excise tax than a general sales tax, since 61 per cent of its yield is drawn from only six commodities. The MST base is the price at which a domestic manufacturer sells his product – or, in the case of imports, the duty-paid value, exclusive of transport costs to the Canadian border. The MST base excludes both services and trade margins, so it captures, in all, perhaps only about 30 per cent of the value of household consumption. The base also exempts exports; certain

Chart 2

Average Corporate Tax Rates for Selected Industries, Canada, 1983



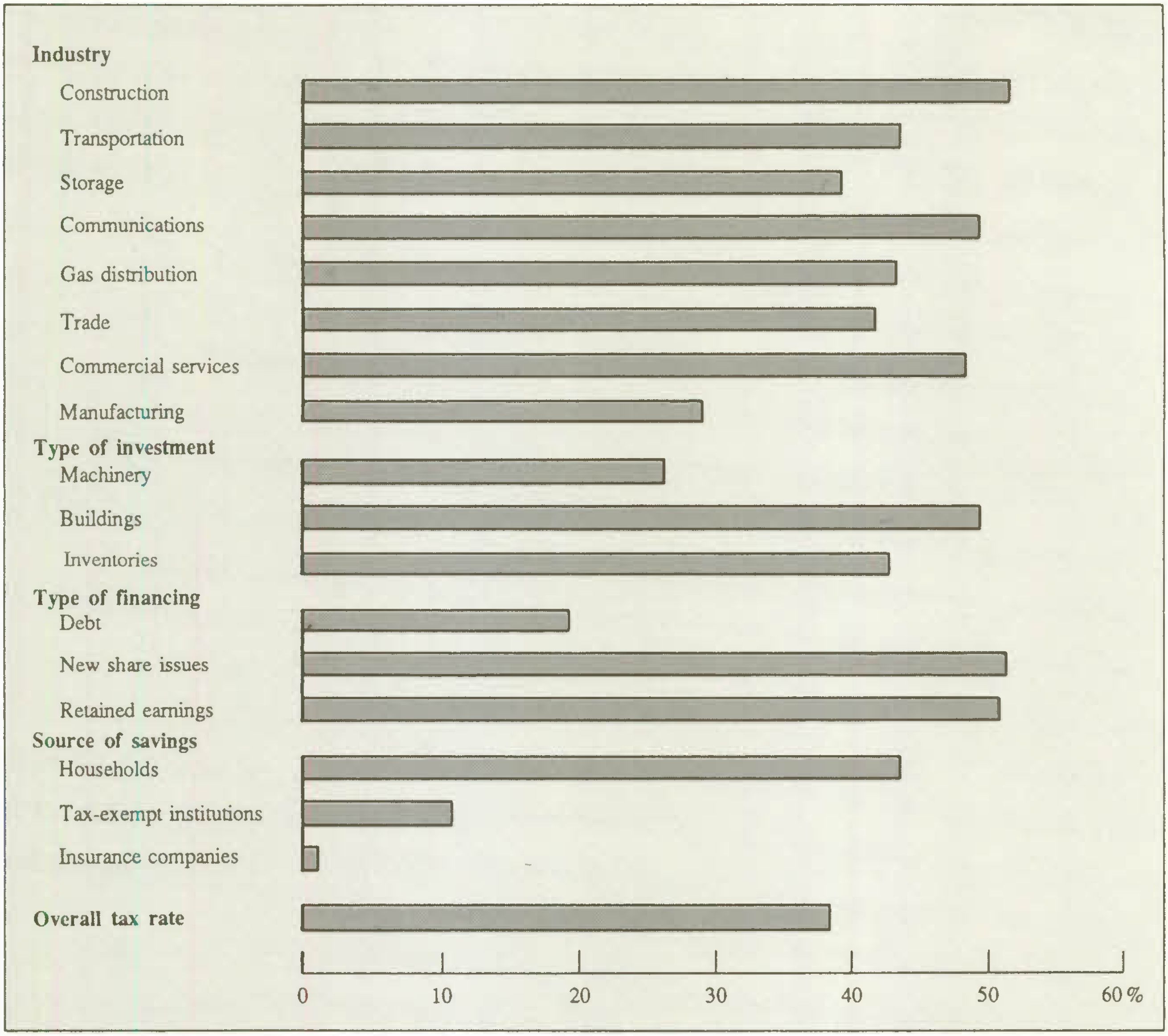
SOURCE Estimates by the Economic Council of Canada, based on data from Statistics Canada, *Corporation Taxation Statistics*, Cat. 61-208, 1983, Table 2.

necessities, such as food, clothing, footwear, and drugs; and most producers' goods, except building materials, office equipment, and some transport equipment.

For most items, the current nominal MST rate is 12 per cent; for construction materials and building equipment, however, it is 8 per cent, and for alcoholic beverages and tobacco products, 15 per cent. The inclusion of construction materials and equipment in the MST base in 1963 was a significant departure from the principle of either taxing consumption or taxing value added in production only once. In addition, both the MST and most provincial sales taxes apply to manufacturing output that is used in other production processes, including items such as office equipment, various materials, and fuels.[9] In fact, the combined federal and provincial sales taxes are really three taxes rolled into one: a tax on some consumption, an additional tax on production or value added, and a separate tax on the use of investment capital. These taxes correspond to the three distinct bases shown in Table 2. The table indicates that only about one-half of federal-sales-tax collections originate in domestic consumer purchases. The remainder are

Chart 3

Marginal Effective Total Tax Rates[1] on Corporate Investment Income, Canada, 1985



1 The "marginal effective tax rate" is the rate of tax payable as a percentage of the pre-tax rate of return on a prospective investment whose returns are just enough to cover its costs. The "marginal effective total tax rate" encompasses business property taxes, sales taxes levied on purchases of capital inputs, corporate income taxes and personal income taxes.

SOURCE Appendix D, column 1.

accounted for by business purchases of investment goods and intermediate products.

Overall, federal and provincial sales taxes add 3 to 4 percentage points to the marginal effective tax rates faced by new investment projects. They do have a tendency, however, to moderate the variation across industries attributable to the corporate tax. This is so, largely because sales taxes weigh more heavily on depreciable assets than they do on other business assets, whereas the reverse is true of corporate income taxes.

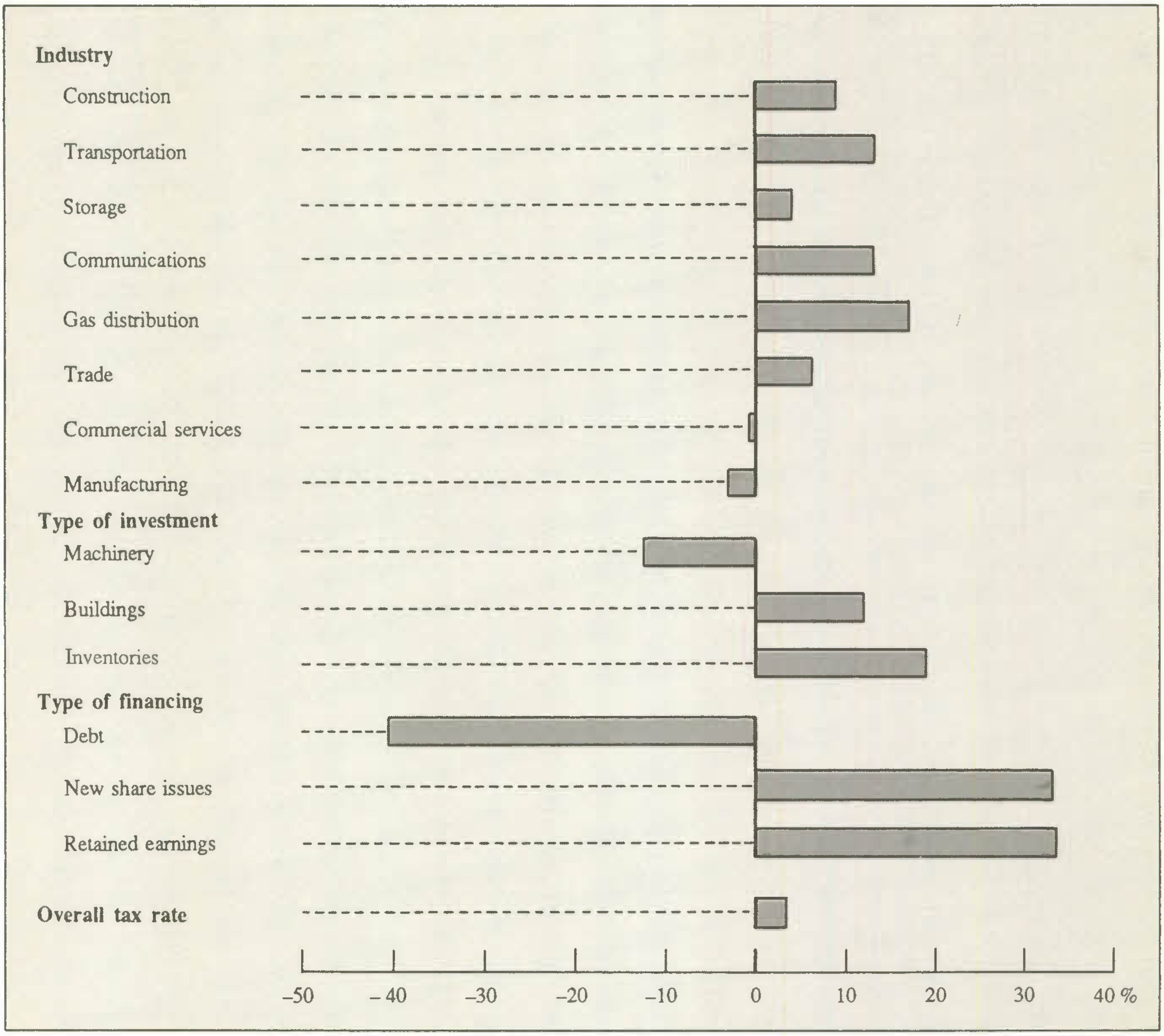
A further problem with existing sales taxes is that while there is a clear intent to exempt exports, and a mechanism for tax refunds is in place, this mechanism fails to remove all hidden sales taxes embodied in Canadian export prices.

Resource Taxes

In the resource sector the achievement of tax neutrality faces a number of unique problems; and the issue must be

Chart 4

Marginal Effective Corporate Tax Rates[1] on Corporate Investment Income, Canada, 1985



1 The "marginal effective tax rate" is the rate of tax payable as a percentage of the pre-tax rate of return on a prospective investment whose returns are just enough to cover its costs. The "marginal effective corporate tax rate" encompasses corporate income taxes only.
SOURCE Appendix D, column 5.

viewed against the backdrop of a 13-year-long, three-way struggle among federal and provincial governments and the industries over resource revenues and the control of resource development. We have previously described the fiscal tribulations of the energy industries (*Connections*, 1985, Chapters 2 and 3; and *Changing Times*, 1986, Chapter 5). We are, however, also concerned with mining in this Statement. Recall here that the first oil price shock, in 1973, was preceded by a boom in other commodity prices and that the mining industries had to contend with some of the same fiscal exactions later imposed on the oil and gas industries.

A difficulty in discussing the taxation of income generated by resource industries is the need to disentangle tax measures from fiscal measures related to resource management and to collection of the rents due to resource-owning provinces. It is important to distinguish between a tax system and a royalty system, and to keep the objectives of one from getting in the way of the other.

Table 2

Federal- and Provincial-Sales-Tax Bases, Canada, 1980

	Contribution to sales tax revenue	
	Federal	Provincial
	(Per cent)	
Tax base		
Consumer expenditure	51.2	65.2
Investment	13.3	8.0
Intermediate inputs	35.5	26.8
Total	100.0	100.0

SOURCE C-Y. Kuo, T. C. McGirr, and S. N. Poddar, "On measuring the effective federal and provincial sales tax rates in Canada," Canada, Department of Finance, Tax Policy and Legislation Branch, October 1985 (unpublished).

The issue is complicated by the taxation of the resource industries by two levels of government, and by the very large role that resource revenues play in some provincial budgets (e.g., in Alberta and, to a lesser degree, Saskatchewan). There is no doubt, however, that marginal effective tax rates vary widely across different resource industries. A conspicuous offender in this respect was the federal government, with its decision in 1974 to disallow deductions of royalty and mining taxes from taxable income and to replace those deductions with a partial federal resource allowance.

Property Tax

Property taxes, both residential and nonresidential, provide the single, most important source of revenue for local governments. As most businessmen know, not only are commercial and industrial properties typically assessed at a higher proportion of market value than residential properties; they frequently pay a higher statutory rate of tax on this higher assessment. The end result is that in some cities nonresidential property pays an effective tax rate that is three times as high as that of residential properties.

We were somewhat surprised to find that the property tax accounts for more of the overall marginal effective tax rate on a new investment than does either the corporate tax or commodity taxes. According to our calculations, the property tax adds about 4.5 percentage points to the marginal effective tax rate on new investment projects. It is also applied unevenly across different industries. In fact, the same two industries (construction and commercial services) that are worst hit by sales taxes are also the most affected by the property tax. The fact that the property tax has different effects on different industries should not be too surprising, because by its very nature it taxes buildings more than machinery or inventories. Moreover, assessment and tax practices vary, not only from one province to another but frequently from one municipality to another – and there are more than 4,000 municipalities.

Summary

We have found that the personal-income-tax system, alone and in combination with the corporate income tax, acts as a deterrent to individual savings and investment, and distorts the flows of savings into areas that are often not the most efficient. An annual personal income tax also favours present consumption over future consumption. This has serious efficiency implications. At the individual level, it distorts one's planning of consumption through time. At the aggregate level, it leads to an underaccumulation of capital in the economy. Through time, this translates into lower output, wages, and consumption levels than those attainable under a more neutral tax system.

Moreover, the different personal-income-tax treatment accorded to the yields on different types of savings distorts personal savings and investment decisions. These nonneutralities turn economic losers into tax winners. They also encourage taxpayers (firms, as well as individuals) to devote real resources to the discovery of ways to convert one type of income into another (e.g., dividends into capital gains) in order to minimize their tax liabilities, which in turn creates the need for further legal constraints to prevent tax avoidance. This leads to an unnecessarily complex and constantly changing tax system entailing real costs for firms, individuals, and the tax authorities. Its instability is demonstrated by the fact that over 300 pages of amendments to federal-income-tax legislation were added to the books in 1986 alone.

But other taxes introduce their own distortions. The provisions of the corporate-income-tax system, with its relatively high statutory rates and variety of tax allowances, credits, and deductions, are responsible for most of the variation in marginal effective tax rates on new investment. The federal manufacturers' sales tax also introduces major distortions in that it is applied very unevenly, with the majority of goods and services being taxed at zero rates while a few are taxed at 12 per cent. Variations in the amounts and incidence of provincial sales taxes also take their toll. And local property taxes are an even greater burden on new investment, varying widely from municipality to municipality and hitting land- and building-intensive business activities the hardest.

Taking all of these taxes into account and viewing them from the perspective of an individual contemplating the undertaking of new investments, the variation in the marginal effective total tax rate is enormous. Appendix D shows the marginal effective total tax rates on income from new investments, depending on the industry, asset, mode of finance, and tax status of the investors, each taken individually. But in combination, taking the extreme cases, marginal effective tax rates could be as much as 102 per cent or as little as –78 per cent.[10] The latter, of course, constitutes an effective subsidy.

In the resource sector there is no question that there is a very wide dispersion of tax treatment – with the situation made more complex by royalty arrangements; exploration, development, and processing allowances; and the competing claims and responsibilities of the federal and provincial governments. All told, these variations and distortions in the taxes levied on savings and investment exact a heavy toll in terms of Canada's productivity performance. Can they be modified in ways that will encourage more-efficient business decisions and increased prosperity?

What Kind of Tax Reform?

Canadians want – and are entitled to – a tax system that shares the burden of taxes fairly; promotes, rather than obstructs, job creation and the attainment of higher living standards for all groups in society; is as simple and stable as is compatible with a complex economy; and promotes responsible government. The Council has seen its job as that of considering how the reform of taxation of *savings and investment* can advance those goals. We believe that many of the principal complaints about the inefficiency, inequity, instability, and complexity in our tax system arise from its treatment of savings and investment. The principal reason for the focus of our study, however, is our belief that it is the taxation of savings and investment that plays a key role in the determination of present and future output, and living standards.

Possible Directions

Personal Income Tax

A question that is often asked is: Why not just clean up the current system and move towards an annual income tax, as was done recently in the United States? In other words, attempt to get a wider, more even-handed tax base in an annual-income-tax system. In theory, it is certainly possible to attain even-handed treatment of different types of saving or investment under an annual income tax. But consider what some of the implications of such a shift would be. First, for neutrality, there would have to be accrual accounting for capital gains. Capital gains would have to be computed and taxed each year – whether they were realized or not – and not just upon the sale of the asset. Otherwise, assets earning capital gains would be favoured over those which do not. Second, for any asset whose returns were in kind (such as owner-occupied housing), imputed returns would have to be calculated annually and taxed. Otherwise, assets earning imputed returns would be favoured over those earning monetary returns. There is a similar problem with respect to the funds of defined-benefit pension plans. It would be extremely complex and expensive to tax the returns on the value of an individual's pension rights on an accrual basis. Third, capital income would have to be indexed so as to tax only the real part of interest, dividends, rents, and capital gains.

It is readily apparent that to achieve neutrality under an annual income tax, severe complexity and a high degree of arbitrariness in rules on imputation would result. It is just as apparent that the so-called comprehensive annual-income-tax reform in the United States accepts the non-neutralities outlined above as inevitable. In fact, no tax system on an annual-income base fully addresses these departures from neutrality; nor could it.

It appears sensible to us to consider the economic power of individuals on the basis of their lifetime incomes, since over that period of time most of the consequences of their decisions to spend or save will wash out. On a lifetime basis the distribution of individual earnings is much more uniform, with about half the disparities that show up in annual data. In part, this results from the good years being averaged with the bad over a lifetime, but much of the variation in annual data also has to do with age, with both young and old being disproportionately represented among the low-income groups in annual-income distributions.

If the financial circumstances of individuals are considered on a lifetime basis, then the appropriate rate for taxes levied annually will not necessarily bear a direct relation to a person's current income. The tax system would have to provide an averaging mechanism. Individuals normally use savings to smooth out their consumption patterns over their lifetime; as taxpayers, they could attain a large measure of do-it-yourself averaging under a combined system that allowed savings to be held in both unregistered and registered forms. Taxes on savings accumulated in a registered asset would be deferred until they are withdrawn. Individuals could then smooth their tax liabilities over time by altering the mix of registered and unregistered assets that they hold.

In Canada we have already moved in that direction. The treatment of owner-occupied housing, together with the provisions for holding registered savings in the form of RRSPs and RPPs, make the present system a mixed one, which, with modifications and a more complete integration of the corporate and personal tax system, could come close to a lifetime-income tax system. Not only would such a tax system be more fair; it would also generate more savings and more domestic investment.

A lifetime-income tax has as its objective the removal of the non-neutralities in the tax base associated with the current income tax, not the avoidance of tax on income received by an individual during his or her lifetime. Thus consideration must be given to the treatment of savings or investment upon the death of the holder to ensure that income is taxed – if not during the lifetime of the individual, then upon death.[11]

In this respect the current tax system already contains the mechanisms that would permit the attainment of a lifetime-income tax. For registered accounts, deregistration and taxation as income upon death is in accord with lifetime principles. Apart from the obligatory deregistration at age 71, the only feature that moves the tax away from a lifetime-income base is the tax-free rollover provision between spouses, which we regard as reasonable. For nonregistered assets in general, the present system, which taxes all monetary returns generated by the assets – including the deemed realization of capital gains upon death – is consistent with a lifetime principle. But deductions for capital income, like the $1,000 deduction for interest and dividends under the current system, could allow some income during a lifetime to escape taxation. The measures needed to prevent this leakage, while still allowing for the deductions, would be complex and would involve unacceptably high administrative and compliance costs. The workable compromise is to limit the size of any such deduction, as is now done.

The advantages of what is effectively a lifetime-income tax are fivefold. First, it does not discriminate in favour of present consumption. It is thus more efficient than an annual-income-tax system, since it does not distort economic decisions concerning the allocation of consumption through time, and, as a result, the average individual would be better-off over his or her lifetime. Second, it is more equitable than an annual income tax. Individuals with equal command over goods and services would pay equal lifetime taxes, irrespective of their time preferences for consumption or the fluctuations of their income flows. Third, it is a simpler tax because it does not require accrual accounting. Fourth, it treats investment in human capital (i.e., education and training) and physical capital symmetrically. Finally, with registered savings no inflation adjustment of capital income is required.[12]

In the long run, Council research leaves little doubt that a lifetime-income tax would produce additional benefits from a sizeable boost in investment. Since labour would have more buildings and more machinery and equipment with which to work, labour productivity and output would increase. With increased employment opportunities and higher real wages, working Canadians would benefit the most. Estimates of the effects of taxes on output, investment, and growth are among some of the most controversial in economics. Nevertheless, simulations done for the Council suggest that even if Canadians did not increase their savings at all, the adoption of a lifetime-income tax would generate an early increase of 1 per cent in the annual income of the average Canadian.[13] But if Canadians were to respond, as we think they will, by significantly increasing their savings, the beneficial effects of a lifetime-income tax would be even higher. Our simulations suggest that over an extensive period of time it could lead to substantial increases in per capita output and real wages and, in the process, enhance the average Canadian's standard of living by as much as 7 per cent.[14]

Would not a lifetime-income tax system be regressive in its incidence? There is no inherent reason why it should be. The choice of a tax base and the choice of tax rates can be coordinated to obtain any desired distribution of tax burden. Like an annual-income tax, a lifetime-income tax could be made more or less progressive by appropriately choosing the structure of tax rates and personal exemptions.

The Council experimented to determine the effects of a lifetime-income tax, using *current tax rates* for the various income classes. The figures in Table 3 show how a shift to this type of tax would change the tax burden – in short, not very much at all; the average tax burden would be identical, and, if anything, the overall incidence of taxation would be slightly more progressive than it is now.

Corporate Income Tax

From a neutrality standpoint, the most desirable corporate-tax system would be one based on cash flows, defined as the difference between receipts from the sales of goods and services (including the proceeds of selling plant

Table 3

Effect of Shifting to a Personal Lifetime-Income Tax in Canada, by Income Group

	Proportion of lifetime income	
	Present personal income tax	Lifetime-income tax
	(Per cent)	
Income group:		
Lowest tenth	7.3	7.4
Second	11.3	10.6
Third	12.5	12.2
Fourth	13.5	12.7
Fifth	14.5	14.1
Sixth	15.1	14.3
Seventh	15.7	15.8
Eighth	16.7	16.8
Ninth	17.7	18.5
Top tenth	20.5	21.0
Average	15.8	15.8

SOURCE J. Davies and F. St-Hilaire, *Reforming Capital Income Taxation in Canada: Efficiency and Distributional Effects of Alternative Options*, a study prepared for the Economic Council of Canada (forthcoming).

and equipment) and the nonfinancial costs involved in acquiring goods and services. Only realized flows, which are easily observed, enter the tax base; hence, no distinction needs to be made between expenditure on current items (labour, materials, and so on) and expenditure on capital goods. Capital goods are written off immediately for tax purposes. The calculation of financing costs and depreciation, as well as their correction for inflation, is made unnecessary by the immediate write-off. Consequently, a cash-flow corporate tax would be a great deal simpler than alternative methods of calculating taxable profits. Under the cash-flow corporate tax, expenditures on real items can be deducted, but the returns to the suppliers of finance, whether they be shareholders or creditors, cannot. Unlike the present corporate income tax, therefore, no deduction would be permitted for interest payments. Nor would there be any tax credit for shareholders in respect to corporate tax paid on dividends. By taxing cash flows rather than capital income, a cash-flow corporate tax would eliminate the disparities in marginal effective tax rates caused by the existing corporate-tax system.

Despite the attractiveness of a cash-flow corporate tax from a tax-neutrality standpoint, there are, unfortunately, major practical objections to a tax system of this kind. It would not be to Canada's advantage to adopt any tax base that was markedly different from that of its main trading partners – especially its principal source of foreign capital, the United States. This is because the more that Canada's corporate-tax base diverges from its U.S. counterpart, the less likely are Canadian taxes on U.S.-owned businesses to be offset by U.S. tax credits. In particular, the nondeductibility of interest expenses under a cash-flow tax would probably disqualify this tax from foreign tax credits under current U.S. tax law. Under such circumstances, U.S. investment in Canada would be discouraged, unless the Canada-U.S. tax treaty were renegotiated and U.S. tax law was amended to permit U.S. investors to obtain U.S. tax credits for Canadian cash-flow taxes levied on interest paid by corporations.[15]

Foreign countries should have no difficulty recognizing a Canadian cash-flow tax as equivalent to an income tax, for foreign-tax-credit purposes, because the taxes collected under a cash-flow corporate tax would, on average, likely be lower than those collected under Canada's existing corporate income tax. (A cash-flow tax would be levied only on "pure profits," which are less than shareholders' equity income – the base for the present system.) Consequently, the amounts of after-tax income available for repatriation (and taxable abroad) would probably increase were we to adopt a cash-flow corporate tax. But if adoption of such a tax in this country would result in less Canadian tax revenue and a gain for foreign treasuries, why would Canada want to implement such a tax in the first place? Canada should attempt to replace the corporate income tax with a cash-flow tax only if the misallocation of capital caused by distortions inherent in a corporate income tax outweighs the tax-revenue loss to foreign governments. Otherwise, our efforts ought to be confined to making the corporate income tax as neutral as possible with regard to investment decisions and as creditable as possible with respect to foreign tax systems.

Such an objective could be achieved by converting the present corporate income tax into a pure withholding tax on equity income. Unlike the current corporate-tax system, a neutral withholding tax would only permit capital cost allowances that correspond to actual depreciation at replacement cost, and it would also allow replacement-cost accounting for inventory usage. No investment tax credit would be provided. Moreover, to be a pure withholding tax, the corporate tax would have to be fully integrated with the personal tax in order to avoid taxing investment income received by domestic investors twice. Interestingly, the federal government's decision in its 1986 budget[16] to phase out the investment tax credit constitutes a step in the direction of a corporate withholding tax, whereas abolition of the inventory allowance in the same budget involves a move away from such a tax.

Sales Taxes

Sales tax reform – federal and provincial – must aim at a reduction, if not the complete elimination, of the variation in effective tax rates across commodities, and at removal of the tax on inputs. There is an emerging consensus that if a federal-sales-tax presence is to be maintained, only a retail form of the sales tax is worthy of serious consideration. Halfway measures, such as improved administration of the manufacturers' sales tax or its movement to the wholesale level of distribution, have been closely scrutinized and found wanting.

Several ways in which the federal government could move its sales tax to the retail level have been examined, and most were found to be deficient. The alternatives range from the Carter Commission's proposal of "piggy-backing" the federal tax on provincial sales taxes, to the joint federal-provincial administration and collection of sales taxes, to the institution of a separate federal retail sales tax. The only remaining alternative appears to be a federal value-added tax (VAT).

A VAT that does not tax purchases of capital goods or other business inputs is identical to a broadly based retail sales tax. Whereas a retail sales tax bites at the end of a production and distribution chain, a value-added tax nibbles at every link in the chain leading to the final consumer. Like a retail tax, a VAT would be neutral in its treatment of competing, taxed products, but it would probably be better than a retail tax at capturing services in the base and in exempting exports from taxation.

In its February 1986 budget, the federal government announced its intention to introduce a new business transfer tax (BTT) to replace the manufacturers' sales tax (MST) and to finance the repeal of current surtaxes on personal and corporate incomes. Although the full details of the scheme have not yet been revealed, the BTT will most likely be a VAT calculated by the subtraction method.

Under the latter subtraction method, businesses would not calculate their tax liabilities for each separate transaction but, instead, would do an annual or quarterly calculation somewhat similar to an income statement. Purchases of intermediate inputs and capital goods would be deducted from sales. Exports would be excluded from total sales.

Resources Taxes

Some Canadians would impose special burdens on the resource industries. The premise of the 1973 Kierans Report on mining taxation to the province of Manitoba was that the taxation of rents or "windfall gains" arising from resource price increases is no disincentive to mining. In retrospect it may seem rather cruel to speak of such "windfall gains," considering the course of mineral and fuel prices over recent years. Nonetheless, in both good and bad years, rent collection does perform a useful function, which is to direct capital and labour to the best uses of land and mineral resources.

Others would argue for special tax incentives to share costs and risks with those who explore, develop, and extract resources. The purpose of the incentives is usually to steer industry capital in specific directions – for example, from conventional oil production to tar sands, enhanced oil recovery, and the frontiers – or to achieve national objectives, such as self-sufficiency and security of supply.

By granting incentives, the Crown effectively assumes risks and incurs costs that can be justified by the incremental royalties yielded by new resource developments. When that is the intent of non-neutralities, however, it seems best to lodge the incentives and disincentives clearly in royalty systems and to remove them from the tax system. Indeed, this was the thrust of our previous report on energy – that the tax system should be "as neutral as possible with respect to different types of investment and various sources of supply." Also, we found that provinces should be the ones primarily involved with funding special incentives for exploration and development on their own lands.[17] For its part, the federal government should avoid tax measures that effectively negate these provincial incentives. In line with this approach, federal incentives in their entirety would be limited to Canada lands and to activities on provincial lands that involve national objectives, extraordinary technologies, or situations beyond the financial capability of provincial governments.

Property Tax

The application of property taxes varies from country to country, and there is no agreement as to an "ideal" system. In general, this tax is used to finance the local provision of both property-related and people-related goods and services, although many services (police and fire protection, for example) have elements of both. Some would prefer that the property tax be largely restricted to financing services related to property, while people-related benefits would be financed from broader-based taxes levied on the "ability-to-pay" principle.

From this perspective, economic efficiency would be enhanced by restructuring the business property tax to reflect more accurately the benefits received and the cost of delivering those benefits. While such a system might not be more administratively simple than the present system of property assessment and rate determination, neither would it be more complex. Many municipalities have, in fact, been moving more and more in that direction. There has been an increasing use of user fees, lot levies, cash imposts, and special assessments to pay for local goods and services.

And So . . .

Such might be the framework for reform: a personal lifetime-income tax; a neutral corporate-income-tax system, fully integrated with the personal tax; federal and provincial sales taxes uniformly and visibly applied, but excluding capital and other business inputs; greater resource-tax neutrality; and business property taxes linked to services received and costs imparted. How close to these ideals can we expect to come?

Recommendations for Policy Change

Earlier we cited a number of reasons for modifying Canada's taxation of savings and investment. We indicated that such changes should be weighed in light of several criteria, the most important of which were efficiency, fairness, simplicity, and visibility. We believe that the following package of recommendations – 20 in all – meet those tests.

Personal Income Tax

With respect to the personal income tax, the main thrust of the Council's recommendations is to nudge the system further towards a lifetime-income tax. This would do two things: it would enhance efficiency by removing the distortions of the current tax base, both by obtaining greater neutrality in the treatment of different types of savings or investment and by obtaining greater neutrality in the treatment of consumption over time; and it would give taxpayers greater freedom to manage their own affairs so that they would be taxed at a marginal rate corresponding more closely to their lifetime income. In addition, such a system would also be more equitable and simpler in that it would not require accrual accounting.

Capital Gains

The full inclusion of capital gains in taxable income is consistent not only with a more neutral lifetime-income tax base, but also with an annual-income tax base.

It will have a tremendous simplifying effect on a personal lifetime-income tax. While it will still be necessary to identify capital gains, removing the preferential treatment eliminates the tax incentive to convert other income into capital gains. This means that all the complicated tax rules required to limit such activity will vanish. Thus,

1 *We recommend that the $500,000 lifetime exemption for capital gains be phased out. We further recommend that capital gains be included in full in taxable income, with the only exceptions being the continued total exclusion of capital gains on the sale of principal residences and the continuation of the current treatment of family farms. At the same time, capital losses should be allowed full deductibility from other income.*

In advancing this recommendation, one cannot be indifferent to how the corporate sector is taxed on income that gives rise to capital gains. The question of the relative treatment of interest, dividends, and capital gains, and the integration of the corporate and personal taxes will be dealt with in subsequent recommendations.

Lowering the Top Tax Rates

The foregoing recommendation would remove the substantial advantage in the personal-income-tax system that currently favours persons in the higher-income brackets. It would also widen the tax base and open up the possibility of reducing the top marginal rates. Accordingly,

2 *We recommend that the top federal marginal tax rate on personal income be reduced from 34 per cent to 30 per cent and that the 30 per cent rate applicable to the next lower bracket be reduced to 28 per cent.*

Such a reduction would be in line with similar developments elsewhere. It would directly affect roughly 3 per cent of tax filers annually. Our estimates indicate that the rate reductions could be made without exhausting the revenue gains achieved by fully including capital gains within taxable income.

Registered Savings

The main instrument for moving to a lifetime-income tax is registered saving. Registered saving constitutes a convenient do-it-yourself income-averaging device that enables individuals to smooth out their lifetime tax payments and, as such, is justifiable on the grounds of fairness. The present dollar limits on contributions to registered saving plans (RSPs), therefore, have no justification. A rationale for limiting RSP contributions to a percentage of income does exist, however, from a budgetary point of view – if government cash requirements are regarded as important as government surpluses and deficits. In this respect, it may be noted that taxes deferred by contributions to registered savings plans are matched by an equal deferral of government revenue. Therefore, contributions to registered savings plans do not increase a government deficit but certainly reduce cash inflow and increase the current cash requirements of governments. Thus there is a trade-off between savings, growth, and tax equity, on the one hand, and government cash flow, on the other. With this in mind,

3 *We recommend the gradual removal of dollar limits on amounts contributed to registered savings. As circumstances permit, the contribution rate should be increased to a level in the range of 25 to 30 per cent and it should be total income that qualifies for the contribution rather than earnings.*

A contribution rate of 30 per cent is compatible with the minimum tax, regardless of income level. A limit of 30 per cent would also cover most people's year-to-year fluctuations in personal income, as observed in taxation statistics. The purpose of expanding the definition of income that qualifies for contributions, from earnings to total income, is to permit do-it-yourself income averaging for some of the more variable sources, such as equity income.

Nonregistered Savings

Registered treatment is not appropriate for all savings. There must be sufficient scope for saving in nonregistered form, particularly if the assets are used for collateral on subsequent borrowings. Today, the bulk of personal financial wealth is in nonregistered savings.

All things considered, the present $1,000 deduction limit on interest and dividends seems very low, bearing in mind the average individual's need to save in nonregistered form for a down payment on a house, or for other reasons. It would be particularly so, if the income eligible for the deduction were to include capital gains and rental income.

With these considerations in mind,

4 *We recommend that the $1,000 interest and dividend deduction be increased to $2,000 and that taxable capital gains and net rental income be included in the deduction.*

Clearly, with such a limited deduction, there would still be a very substantial amount of nonregistered assets, yielding an income stream that would be subject to income tax annually. The interest paid on money borrowed to acquire these assets would continue to be deductible. It should continue to be the case, then, that such deductions of interest paid on borrowed money also serve to reduce the $2,000 deduction proposed in the recommendation.

Registered Borrowing

Not all taxpayers benefit from registered saving. The number of taxpayers assisted by the tax system can be expanded with the introduction of registered borrowing. Registered borrowing consists of an election by the taxpayer to treat the proceeds of a loan as taxable income, such election earning the taxpayer the right to deduct from future taxable income the interest and amortization payments on the registered loan. This being the reverse of registered saving, it would result in prepaid taxes and an increase in government cash flow. Thus there would be no reason to put dollar limits or percentage limits on registered borrowing. Examples of taxpayers who could benefit from this election include people temporarily leaving the labour force for retraining or women temporarily leaving the labour force to have children. As well as being useful for such taxpayers in general, for students it would put borrowing for investment in "human capital" on the same basis as borrowing for other forms of investment. Thus,

5 *We recommend that provision be made for borrowing on a registered basis.*

We expect that under the system we are proposing there would be a greatly expanded role for registered assets. There would remain, however, assets not suitable for registration and for which the individual capital-income deduction would not be large enough. Such assets should continue to be treated on an annual income base, as they are under the current system.

Indexation

Over the not-too-distant past, high inflation rates created some of the greatest distortions in the tax system because of the lack of full indexation. The lack of full indexation has also meant that government tax revenues increase because of inflation, in addition to any visibly legislated increases.

The lack of any indexation would result in nominal, rather than real, values being taxed. Until very recently, however, the current personal income tax has been, more or less, fully indexed for labour income. The treatment of capital income, on the other hand, has been much more haphazard. Registered savings, by and large, have also been indexed automatically to the same extent as labour income. Nonregistered savings, in contrast, have been generally taxed on nominal, rather than real, returns.

Last year the federal government limited the indexing of the personal income tax to amounts in excess of a 3-per-cent increase in the cost of living. In our view, the government should, as a minimum, restore indexation at the full inflation rate. Indeed,

6 *We recommend that all relevant personal tax brackets, deductions, and exemptions be fully indexed.*

Under such indexing, labour income and all registered savings or investment would once again be fully indexed for inflation, and increased use of registered savings would mean a greater degree of indexing overall. In addition, the value of the deduction for returns from nonregistered savings would not be eroded by inflation. Those assets whose yields would continue to be taxed on an annual-income basis would, however, continue to be affected by inflation. For such assets we are not recommending any indexing. Should inflation once again become a major problem, however, the federal government might wish to consider the reintroduction of indexed security investment plans (ISIPs), but without accrual treatment of returns, for corporate equity.

Corporate Income Tax

We believe it is possible to achieve a much greater degree of tax neutrality by broadening the corporate-income-tax base and cutting statutory tax rates. The Department of Finance has already embarked upon such a course of action as a result of measures contained in the 1986 budget – notably, repeal of the 3-per-cent inventory allowance, phasing-out of the general investment tax credit (ITC), and the concurrent reduction in statutory corporate-tax rates of between 2 and 4 percentage points over the next three years. Such steps are designed to reduce the dispersion in marginal effective tax rates and thereby ensure a greater degree of tax neutrality with respect to investment decisions. Implementation of the following additional or alternative measures would narrow the variation in marginal effective tax rates even further. They involve:

- capital cost allowances that correspond more closely to actual capital costs;
- adjustment of the corporate tax system for inflation;
- lower and more-uniform statutory corporate-tax rates;
- closer integration of the corporate and personal tax systems; and
- greater loss offsetting for tax purposes.

Before discussing the above recommendations in greater detail, some comment is warranted concerning the federal government's decision to repeal the investment tax credit.

The Investment Tax Credit

It is not the investment tax credit *per se* that has caused so much variation in marginal effective tax rates; instead, it is the uneven manner in which it has been applied. The ITC rates vary by type of asset and by industry, as well as by region. Consequently, abolition of the ITC, as proposed by the federal Department of Finance in the 1986 budget, would considerably reduce the degree of dispersion in marginal effective tax rates. Accordingly, we support the federal government's decision to phase out the investment tax credit for all but a few special types of investments. We hasten to add, however, that should a stimulus to aggregate investment be considered desirable at some time in the future, an investment tax credit provided *at the same rate* for all types of capital, including inventories, might be appropriate.

Capital Cost Allowances

Accelerated capital cost allowances (CCAs) enable firms to write off certain investments for tax purposes long before the end of their economic lives. Machinery used in the manufacture and processing of goods (CCA Class 29), for example, can be written off in only three years, even though its economic life is estimated at over 18 years. In contrast, the tax lives of buildings correspond more closely to their economic lives. The current structure of CCAs is therefore a major source of variation in marginal effective tax rates among assets, firms, and industries. In order to reduce such discrepancies considerably and accomplish further base broadening, *7 We recommend that the present system of capital cost allowances, involving broad classes of assets, be retained but that the allowances correspond more closely to actual capital costs, taking into account physical wear and tear and obsolescence. We also recommend that CCAs be adjusted to take into account the current costs of replacing an asset [as described in the next section of this Statement].*

We recognize, of course, that even if the current rate at which certain broad classes of assets are written off for tax purposes is clearly excessive, actual capital costs are extremely difficult to measure for all assets. Hence any major reduction in the degree to which CCAs are accelerated should be implemented only after close consultation with representatives of the tax-accounting profession and the business community.

Adjusting the Corporate Tax for Inflation

In order to mitigate the interaction of inflation with the tax system,[18]

8 We recommend that the corporate tax system continue to make adjustments for inflation.

Ideally, full indexation of the corporate income tax would be accomplished by (a) indexing CCAs to reflect actual replacement cost, (b) restoring the recently abolished inventory allowance at a rate corresponding to inflation; and (c) restricting interest deductions to real, rather than nominal, expenses. While the first two indexation provisions are administratively feasible, confining interest deductibility to real, rather than nominal, expenses would probably encounter difficulties. In particular, such a step would constitute a major divergence from the corporate tax systems of countries investing in Canada and could thus jeopardize the full crediting of Canadian corporate taxes under foreign tax systems. But indexation involves a package deal encompassing all three provisions, not just two out of three.

A more viable method of indexing the corporate income tax proposed by the Ontario Committee on Inflation Accounting[19] would be to continue to permit nominal interest deductibility but to adjust CCAs and the inventory allowance for the degree of non-equity financing. The result would be that whereas an entirely equity-based company would receive CCAs reflecting true economic depreciation, with complete indexation as well as the full inventory allowance, a company that uses debt financing would have the indexation component of CCAs and the inventory allowance reduced by the current proportion of non-equity financing.

Unfortunately, indexation of the corporate tax along the lines suggested above would greatly increase the complexity of the tax system and is therefore perhaps not worth undertaking as long as the inflation rate remains relatively low. Under such circumstances,

9 We recommend that discretionary measures be implemented involving slightly accelerated CCAs and an inventory allowance, all taking into account the business sector's overall debt/equity position, as long as inflation remains below 5 per cent annually.

For example, since roughly 60 per cent of corporate investment is equity-financed, the appropriate rate for an inventory allowance would be 60 per cent of the annual inflation rate. If the latter were 5 per cent, then a 3-per-cent inventory allowance would be required.

While indexation of the tax system may not be viewed as a matter of much urgency with the inflation rate currently hovering around 4 per cent annually, there is no guarantee that further inflationary pressure will not arise in the near future. The current mess in which we find the corporate tax system is partly due to the liberalization of CCAs and the enhancement of the investment tax credit introduced during the 1970s and early 1980s in an effort to counteract the adverse impact of inflation on corporate cash flows. To avoid repeating past mistakes, indexation of the corporate tax system should be considered a desirable medium-term objective. It ought to be viewed as an insurance policy against the damaging ramifications of a renewed outbreak of inflation. Adjusting to inflation accounting for tax purposes is, of course, easier, the lower the rate of inflation. Thus now is the time to act on indexation, while inflation is relatively low. Therefore,

10 We recommend that the federal government introduce immediate indexation, or at least prepare a contingency indexation scheme that could be implemented should inflation exceed a threshold of 5 per cent for a prolonged period of time. In this regard, the indexation scheme proposed by the Ontario Committee on Inflation Accounting ought to be considered.

Part of the variance in marginal effective tax rates is due to the preferential statutory tax rates that apply to companies involved in manufacturing and processing, as well as to small businesses. Hence, in conjunction with measures to broaden the corporate-income-tax base, steps ought to be taken to ensure that statutory corporate-tax rates are more uniform.

This could be achieved by abolishing the manufacturing and processing deduction and reducing the basic federal tax rate so as to ensure that the manufacturing sector will be faced with statutory rates that are no higher than at present. Similarly, any drop in basic statutory corporate-tax rates could be accompanied by a corresponding reduction in the small-business deduction in order to ensure that the statutory corporate-tax rates applied to small businesses would be no less than the present rates. (Note that we are not suggesting that provincial statutory rates be brought into line with each other, since these tax rates tend to reflect the level of public services provided within each province.) Accordingly,

11 *We recommend that statutory corporate-income-tax rates be lowered and rendered more uniform across industries and types of activities. More precisely, we recommend that the special rate for manufacturing and processing be abolished, and we suggest a standard tax rate of 33-1/3 per cent, 8-1/3 percentage points of which would be abated to the provinces. In the case of private Canadian-controlled companies, however, we recommend that the first $200,000 of active business income be taxed at the rate of 25 per cent, again allowing an abatement of 8-1/3 percentage points to the provinces.*

The foregoing rates can be compared with those applicable to large and small businesses in 1986. As shown in Table 4, for large manufacturing and non-manufacturing companies, the rates are 40 and 46 per cent, respectively, assuming that 10 percentage points of the tax rate are abated to the provinces. In the case of small manufacturing and nonmanufacturing firms, the statutory tax rates are 20 and 25 per cent, respectively, again allowing for 10 percentage points to be abated to the provinces.

Our suggested rates can also be compared with those which are expected to apply to large and small businesses in 1989, once the measures announced in the 1986 federal budget have been fully implemented. For large manufacturing and nonmanufacturing companies, the rates will be 36 and 43 per cent, respectively, assuming that provinces account for 10 percentage points of the tax rate. The statutory tax rates will be 18 and 23 per cent, respectively, in the case of small manufacturing and nonmanufacturing firms.

Integrating Corporate and Personal Income Taxes

With regard to the overall taxation of income from corporate investment, the degree of integration with respect to corporate and personal income taxes achieved by the former 50-per-cent dividend tax credit was excessive (except in the case of large tax-paying corporations) and therefore unduly expensive.[20] We therefore endorse the

Table 4

Actual and Proposed Statutory Corporate-Income-Tax Rates for Canada (Federal and Provincial Combined)

		Rate proposed by:		
	1986 rate[1]	Department of Finance (1986)[1]	BCNI[2]	Economic Council (1987)[3]
		(Per cent)		
Large business	46	43	35	33.3
Small business	25	23	35	25.0
Large manufacturing business	40	36	35	33.3
Small manufacturing business	20	18	35	25.0

1 Includes an abatement to the provinces of 10 percentage points.
2 Includes an abatement to the provinces.
3 Includes an abatement to the provinces of 8-1/3 percentage points.
SOURCE Canada, Department of Finance, *Budget Papers* (Ottawa: Finance, February 1986), p. 28; and Business Council on National Issues, *Tax Policy Reform in Canada*, A Report of the Task Force on Taxation Policy (Ottawa: BCNI, October 1986).

reduction of the dividend tax credit to 33-1/3 per cent – that is, 25 per cent of grossed-up dividends – while noting that it might well be adjusted in future to reflect any significant changes in average (federal plus provincial) corporate tax rates.

A dividend tax credit of 33-1/3 per cent, combined with the full taxation of capital gains upon realization as in recommendation 1 above, would also restore the balance in the taxation of dividends and capital gains achieved prior to the introduction of the lifetime capital-gains exemption in 1985.[21]

Under the present corporate tax, the preferential treatment of interest compared with equity costs is mitigated by the fact that interest is subject to personal tax upon receipt by households. On the other hand, dividends are eligible for the dividend tax credit, while taxes on capital gains are postponed until the latter are realized and then levied at half the personal rate, or not at all. When earned inside an RRSP or by a pension fund, however, interest is nontaxable, and dividends are not eligible for credits. Thus dividends earned on RRSP and registered-pension-fund investments do not receive any relief for corporate income taxes paid. As a result, RRSP holders and pension funds tend to favour debt investment relative to equity investment. This bias against equity investment will be cause for even greater concern if the existing limits on contributions to RRSPs are relaxed still further, as proposed.

The dividend tax credit could, of course, be extended to cover income from RRSP (and pension) funds. This would result in equal tax treatment of interest and dividend income, and would thereby eliminate the discrimination against investments financed by new shares. But that would still not remove the bias against income from RRSP investments received in the form of capital gains, which discourages the financing of investments with retained earnings.

The latter situation could be avoided, however, if accumulated capital gains on the common shares of Canadian public corporations held in registered savings plans were deemed to be dividends and, as such, qualified for the dividend tax credit. Accordingly,

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12 We recommend the creation of a separate "capital component" within registered savings plans, consisting of both net capital gains and dividends received from listed common shares of taxable Canadian corporations. Upon withdrawal from a registered plan, the capital component would be grossed up by a factor of 1-1/3 for personal tax purposes, and this grossed-up amount would then be eligible for the dividend tax credit of 33-1/3 per cent.

Extension of the dividend tax credit to registered savings along the foregoing lines would remove the existing tax-induced bias against the investment of registered savings in common shares.

Loss Offsetting

An additional shortcoming of the present corporate-tax system has been that a large proportion of firms cannot take full advantage of all the tax allowances for which they qualify. From 1977 to 1981, for example, almost half of all investment was undertaken by companies that were rarely able to use their capital cost allowances, investment tax credits, and other deductions; in 1981, more than half of all corporations had no tax liability whatsoever.[22] Although unused tax losses can, of course, be carried forward (or backward), the period over which losses can be spread is limited. Moreover, the present value of these tax allowances is reduced by the fact that firms must forgo interest on losses carried forward.

In our view the most effective and acceptable approach to implementing loss offsetting for tax purposes would be to allow firms to carry losses forward indefinitely. Moreover, tax losses should be carried forward not simply at their nominal value, as at present, but marked up by an interest factor to allow for the fact that non-tax-paying firms have to wait to get the benefit of the tax allowances. Accordingly,

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13 We recommend the unlimited carry-forward of losses for tax purposes – with interest – subject to appropriate tax-avoidance rules.

Such a provision would be especially beneficial to new, small, or undiversified businesses, or firms that reinvest a relatively large proportion of their income. Unlimited loss carry-forward would reduce the possibility of fraudulent claims for losses, since firms would not be able to claim losses until they had taxable income.

The foregoing recommendations concerning the corporate-income-tax system could be implemented within three or four years. For instance, the present general investment tax credits of 7 and 10 per cent are to be reduced by the federal government to 5 and 7 per cent, respectively, in 1987; and both are scheduled to be reduced to 3 per cent in 1988 and repealed entirely in 1989. Our recommended capital cost allowances, as well as the proposed cuts in statutory corporate-tax rates, could be phased in over a similar period of time. By contrast, the recommended extension of the dividend tax credit to registered savings plans and the unlimited carry-forward (with interest) of losses for tax purposes could be put into effect immediately.

Sales Taxes

A broadly based, uniform value-added tax (VAT) that would replace the manufacturers' sales tax could remove both the intertemporal and the intersectoral misallocations of capital, characteristic of the existing tax. The proposed business transfer tax (BTT) – a VAT under another name – promises to place federal indirect taxation on a much more efficient footing, provided that it is imposed on a broad base and at a single rate.

14 We support replacement of the existing federal sales tax with a new one that effectively exempts business inputs, such as a value-added, or business transfer, tax.

The result would be improved if provincial sales taxes were also removed from business inputs and capital goods. Therefore, to reap the full efficiency gain from sales tax reform,

15 We recommend the removal of capital goods from the base of provincial sales taxes as well.

We recognize that considerable effort is already being made to avoid imposing sales taxes on business inputs. But it is often difficult to tell at the point of sale whether a good is for business or personal use; thus some tax on capital goods is almost inevitable under a traditional sales tax. Should one or more provinces decide to apply the same VAT or BTT methods employed federally to remove inputs from the tax base completely, the administration and compliance costs of these taxes could be reduced by combining the efforts of both levels of government. Therefore,

16 We recommend that both levels of government discuss simultaneous reform of their indirect tax systems.

It remains to be seen how comprehensive the BTT will be and how it will apply to various items of consumption. Difficulties can be expected in the cases of housing services, financial services, hospital and educational services, and consumption by nonprofit institutions and government. Some of these might be exempted; others, zero-rated. Simply exempting some institutions would deprive them of a mechanism by which to obtain relief from taxes paid on their inputs. Zero-rating brings the supplier into the circle of licensed vendors and confers on him the right to deduct inputs.

The foreign experience with value-added taxes indicates that their administrative and compliance problems rise dramatically when they are imposed at nonuniform rates. The same can be said of the business transfer tax. The latter has, however, the additional disadvantage that if it is imposed at different rates at various points in the production and distribution chain, it becomes difficult to remove fully the burden of these taxes from exports or any other zero-rated goods and services. Therefore,

17 We recommend that any new tax, such as a business transfer tax, be at uniform rates, with as few exemptions of consumption goods and services as possible, and that it be visible at the point of sale.

We are also concerned about the hidden nature of this new tax and would like to see the tax either invoiced separately or at least posted at the cash register. Invoicing or posting would, however, provide misleading information unless a uniform rate were applied at all stages of production and distribution.

Only about a third of domestic consumer expenditure is now burdened with the MST, at a typical rate of 12 per cent. Broadening the base of the federal sales tax would make it possible to reduce this tax rate, increase federal revenues, or both.

While recognizing that a new BTT would have to raise at least as much revenue as the old MST, the revenue from this source should not be increased without careful consideration. Increasing BTT revenue tilts the tax system away from a lifetime-income tax towards a consumption tax and raises questions of fairness. Concerns about interregional equity arise even without increasing the revenue from this source.

A BTT would raise the price that people pay for consumption goods. For low-income persons who cannot save, there would be a clear-cut increase in the cost of living. While some low-income persons are shielded from such increases to the extent that they receive indexed transfer payments, others are not well shielded. For low-income persons, therefore, indexed transfers should be supplemented by sales tax credits, which should not be implicitly taxed back by other welfare programs.

18 We recommend that if a uniform value-added tax or business transfer tax is adopted, it be accompanied by an appropriate personal-income-tax credit available to taxpayers with incomes below a stipulated threshold.

While the BTT is unquestionably a substantial improvement over the MST, the Council is not convinced that the BTT is a suitable tax base for generating substantial increases in federal tax revenue, now or over time. The BTT has a number of shortcomings in terms of equity and of regional and international implications. First, the tax credit recommended above would offset the higher cost of living associated with the BTT only for those families below a certain threshold. We have no means of easing the burden on families or individuals who are above that threshold. Second, interregional redistributions could result from the substitution of BTT revenue for income-tax revenue, and from the extension of the federal sales tax to transport services. Transport services are currently not subject to federal sales tax. Their inclusion in the base of a BTT would affect the well-being and development of regions and industries where transport costs are a major component of consumer prices. Similarly, increasing the flat rate of a BTT in order to reduce personal or corporate income taxes would help high-income, but hurt low-income, regions. Third, this last change would lower the taxes on nonresident investment in Canada, putting a larger tax burden on residents.

Some members would support an increase in BTT revenues well in excess of those obtained through the current manufacturers' sales tax in order to finance cuts in personal tax rates. Others would not, for the reasons noted above. Moreover, we have provided a means of financing reductions in marginal tax rates through the recommendations that call for full taxation of capital gains and accompanying changes to the corporate-income-tax system.

Resource Taxes

Deductions of exploration and development costs by both the mining and oil industries, the remaining earned depletion allowances, and the processing allowances made for mining industries are the principal factors responsible for the negative marginal effective corporate-tax rates enjoyed by those two industries in the past. The exploration process can be compared to industrial research and development. The deduction of exploration expenses from taxable income can thus be considered very similar to the deduction of research and development by other industries. Other special tax incentives, such as depletion allowances, can have some disadvantages; either they get reflected in higher bonus bids, and thus fail to remain with taxpayers, or they interfere with provincial resource management.

The analysis of corporate-income taxation uncovered a large variation in tax rates across industries and firms. In the mining sector, some of this variation is caused by provincial processing allowances. To increase the neutrality of the tax system with respect to resource firms and resource development,

19 We recommend the gradual withdrawal of the remaining (federal) earned depletion allowances and (provincial) processing allowances.

This recommendation affects mostly the mining industries and would be offset in part by a general reduction in federal tax rates. Reductions in provincial mining taxes to offset the withdrawal of processing allowances would also be appropriate. Given the current state of markets for the products of mines, earned depletion and processing allowances could be phased out gradually. Unused depletion allowances should be grandfathered and granted the benefit of the recommended interest on losses carried forward.

The federal resource allowance, in lieu of deductions of royalties and mining taxes paid, is capable of distorting royalty systems. It increases the effective cost to resource companies of royalties and other resource rents that exceed the federal allowance, and it reduces the after-tax cost of those rents which fall short of the allowance. In this way, the federal allowance creates distortions among oil, gas, and mining industries. The federal allowance, by not following this pattern of variation, modifies the differences in after-tax royalties among wells. Thus it is impossible to say that the royalty system achieves an efficient allocation of costs and risks among provincial landowners and private-sector resource companies. The best solution to this problem is a return to the system that was in force from 1917 to 1973, whereby provincial royalties were fully deductible from taxable income (mining taxes became deductible in 1946).

This problem was addressed before by Council, in a publication entitled *Connections*;[23] yet it remains unresolved. Pending a solution, considerable improvement could be made by disallowing, for federal-income-tax purposes, a percentage of provincial royalties, mining taxes, and other resource payments in excess of the federal resource allowance, while allowing the deduction of lesser royalties and mining taxes. Provision could be made for this percentage to vary with economic circumstances.[24]

Property Tax

Our research found that municipal property taxes have an important impact on the effective tax rates on new investments in Canada. In fact, property taxes on businesses are a more important component of such effective tax rates on new investment than either corporate taxes or sales taxes on capital inputs. They also vary quite substantially, depending on each municipality's priorities, assessment practices, and tax rates. We also found that, in general, businesses pay a greater proportion of municipal property taxes than do individual residents, effectively cross-subsidizing services to residential property and the community at large. Many economists and independent observers find this situation to be objectionable.

On the other hand, discriminatory taxing of businesses is a long-standing practice. The whole exercise of municipalities competing for business investment is rooted in the belief that business assessment produces a profit that can be used to keep the residential rates down. Any major shift in the system towards easing the burden for business could involve a complete realignment of the property tax system, the division of revenue and expenditures between provincial and local governments, and the intergovernmental transfer system.

20 *We recommend that where they now do so, provincial governments continue to impose provincial standards for property assessments and that all provinces, in collaboration with their municipalities, review the municipal financial responsibilities borne by businesses and residents to ensure that there is a reasonable sharing of taxes and benefits.*

We are reluctant to go further than this, since we have not engaged in the kind of comprehensive study of municipal fiscal management that would permit more specific advice.

Conclusions

In developing these recommendations we have been guided by the belief that tax reform, particularly reform of taxes that affect savings and investment, should address three principal issues: the definition of the appropriate base for each tax, the breadth of the tax bases chosen, and the mix of taxes used to meet government's revenue needs.

We note that different countries and governments have taken different approaches to these questions in recent years. The federal government in the United States has chosen to reform its tax system by broadening the base of an annual income tax, with no integration of corporate and personal income taxes and no adjustments for the effects of inflation on capital income. By way of contrast, many other industrial countries are broadening the base of their income tax systems, while moving to greater integration of their corporate- and personal-tax systems. Many of these same countries have also shifted the mix in their tax systems to increase the share of revenues obtained by transaction or consumption taxes.

The federal government in Canada is also currently proposing, or implementing, a number of reforms – such as broadening the base of the corporate income tax and increasing the share of this tax in overall federal revenues, enlarging the share of sales or consumption taxes in the overall tax mix, and increasing the amounts of registered savings allowed under the personal-income-tax system.

Scope of Our Enquiry

We have imposed two restrictions on our enquiry that are particularly important: revenue neutrality and distributional neutrality. The first restriction simply means we have assumed that it is not our business to change the total amount of government revenue in the process of tax reform. This does not mean, of course, that we are indifferent to the current goal of deficit reduction. We are of the opinion, however, that tax increases to cut the deficit would be more economically sound and more politically acceptable if carried out on a suitably reformed tax base.

Nor have we seen it as our goal to change the distribution of income that results from our present tax system. Goals concerning the distribution of income are inevitably divisive. Our approach has been to seek tax arrangements that would increase the size of the total social pie and to leave discussion of the appropriate division of this pie to wider debate in the political process as a whole.

We have also stressed that our enquiry has not been restricted to one level of government or to any particular type of tax on savings and investment. Indeed, we find that there are many interactions between taxes on savings and investment, so that such taxation must be treated as an interconnected system. For these reasons, we are opposed to piecemeal reform of the taxation of savings and investment. For instance, we have found that it would be desirable to remove sales taxes from investment goods and services. We note that both federal and provincial governments add about the same burden to taxes on investments by levying sales taxes on capital goods; thus reform by both levels of government is desirable.

A Proper Balance

Governments are continually tinkering with the tax systems within their jurisdictions – usually in the name of reform. In a democratic society this is perhaps inevitable, given the plethora of vested-interest groups lobbying for tax relief. But every now and then there comes a time to stand back and take stock, and now is just such a time.

This having been said, it must be recognized that matters of taxation cannot be isolated from matters of public spending. For governments that are accountable to their electorates, they are twin sides of the same coin. Governments have a responsibility to exercise prudent and positive fiscal restraint. This applies to policies that raise revenues, as well as those which spend them. By the same token, reforms to the revenue side of the equation should not be interpreted as substitutes for reforms needed on the expenditure side. Changes to the tax laws to encourage personal savings, for instance, do not remove the need for pension reform.

Equally, concerns about economic efficiency and social justice cannot be separated into compartmentalized boxes. The recommendations we have outlined, if adopted, represent a balance of concerns for economic efficiency and growth, on the one hand, and for fairness and even-handedness, on the other. We have been conscious that the more competitive and stronger the economy, the greater the opportunity for individuals to prosper. But there must be a proper sharing. The drive for economic efficiency must not be at the cost of increased social or regional tensions.

The Proposed Tax Mix

Taxes are ultimately borne by individual people – not corporations or other businesses. As the personal income tax is both the most important direct tax and the main source of tax revenue for federal and provincial governments, our recommendations in this regard are central to any comprehensive reform of the manner in which investment income is taxed.

The Council has taken the approach that the revenue gains from full taxation of capital gains should be used to reduce marginal tax rates and to remove elements of the tax system that discourage saving. The Council is aiming here for greater simplicity (it is no longer necessary to devote pages and pages of the tax code to limiting the conversion of other income into capital gains) and for greater efficiency (through less tax avoidance, more efficient use of savings, and less disincentive to save). At the same time, we have placed limits on the contributions to registered savings plans to minimize the adverse effects on the cash flow of governments, and we have retained the minimum tax to ensure that the proposals do not create excessive tax relief for the well-to-do.

The recommendations pertain to two distinct forms of saving, both of which will encourage new investment and growth:

- registered savings, which postpone taxation until the income is withdrawn from the plan (as a result of recommendation 12, equity investments would be eligible for the dividend tax credit); and

- nonregistered savings, which would be treated as they are now except that the tax deduction accorded to interest and dividends would be increased to a limit of $2,000 and broadened to include capital gains and net rentals from property.

The proposals would provide Canadians with much more scope to "save for a rainy day" and for old age by averaging their incomes over time. This, we feel, is particularly appropriate for a future in which we foresee increasing pressure on Canadians to change jobs frequently, to re-educate themselves periodically, and to prepare themselves for longer and healthier retirements. Through a combination of registered pensions, registered saving, and registered borrowing, the tax system would encourage taxpayers to be much more self-reliant than they can be under a system that taxes on the basis of annual income.

Our recommendations are intended to tax all lifetime income by requiring that registered savings be deregistered and taxable before or upon the death of the taxpayer, subject only to a rollover to spouses, as exists today. A consumption tax would go further and would exempt bequests and gifts to others from the tax base. The Council considered and specifically rejected such consumption-tax treatment.

Our recommendations are also distributionally neutral. Low- and medium-income Canadians would face no higher tax rates than they do today; those below a stipulated threshold would have a tax credit to offset the impact of a business transfer tax or a value-added tax uniformly applied; and all would share in enhanced access to registered savings. Moreover, all Canadians would be able to share in the growth of income that would occur under a more neutral tax structure.

As for the present corporate-income tax, we have essentially proposed broadening the tax base and cutting statutory tax rates while maintaining the corporate-income-tax share of total tax revenue at the current level. Such a change in the corporate-tax structure would cause shifts in the tax burden on both existing and future investments. The size and the direction of the impact will depend on the industry, the asset mix, and the debt/equity ratio of each company. The changes must therefore be made with appropriate consultation; but we wish to emphasize that the biggest change – a deceleration in capital cost allowances – would be countered to a considerable extent by the reduction in statutory rates.

Our recommendations go further than base broadening and rate reductions, however, in suggesting that the corporate-income-tax base should correspond more closely to real income, not nominal income. Past experience has taught us that an unindexed corporate-income-tax system is accident-prone. An indexed corporate tax ought to be viewed as an insurance policy that is necessary to ensure that any renewed outbreak of inflation will not, once again, seriously distort investment decisions or provoke the kind of *ad hoc* tinkering with the tax system that occurred in the 1970s.

Such a combined strategy would reduce the role of the corporate tax as a tool to influence the allocation of investment and would transform it into a withholding tax, which would then be adjusted properly for inflation and integrated with the personal-tax system. While such a tax system would still fall short of the ideal, it would be a great deal better than what we have now, especially if such measures are combined with the recommended changes in personal, sales, and resource taxation.

Reform of the federal sales tax is overdue. Various reform possibilities have been discussed over the years, and the federal government is examining the possibility of replacing its sales tax with a new business transfer tax.

We support replacement of the federal sales tax with a business transfer tax or equivalent value-added tax on consumption. And while recognizing that provincial-sales-tax legislation already goes some way in that direction, additional improvement would be made by exempting investment goods from provincial sales taxes. We also take the view that the new federal business transfer tax (on value added) should be imposed at a uniform rate, with as few exemptions of consumption goods and services as possible, so that the tax will be visible and simple. Visibility could also be increased by quotation of the tax at the point of sale.

At the minimum, it could be expected that the revenues raised by a new business transfer tax would replace those secured by the present federal sales taxes. Beyond that, it could generate additional revenues, enabling the federal government to lower other tax rates or reduce the federal deficit. On the other hand, a BTT, uniformly applied, is a flat tax on consumption. To use this source of revenue as a substitute for a progressive income tax, without compensating personal-income-tax credits, would be a regressive move – affecting individuals and regions with low incomes. Moreover, unduly high consumption taxes could provide incentives to Canadians, especially retired Canadians, to spend their money abroad, where sales taxes are lower or nonexistent.

While the opinions of Council members differ as to the future role of a BTT or VAT, in general the Council does not think that the share of transactions or sales taxes in the total revenue of governments should increase.

Resource industries pay taxes and are subject to tax provisions that no other industry in Canada faces. In analysing them, one has to separate those which are desirable elements of provincial royalty systems from other tax provisions.

The measures we have proposed – gradually phasing out (federal) earned depletion allowances and (provincial) processing allowances – would affect mainly mining companies. The effect would be offset by the recommended reduction in corporate-income-tax rates. Given the current state of most mineral markets, unused depletion allowances should be grandfathered and should benefit from our recommended proposal to allow losses to be carried forward with interest. With respect to the resource allowance, there should be a return to full deductibility of royalties and mining taxes. Failing that, some progress could be made by disallowing only a fraction of royalty deductions in excess of the current allowance.

Finally, we observed that the property tax accounts for more of the overall marginal effective tax rate on a new investment than either the corporate tax or sales taxes. We also observed that most municipal governments tax commercial and industrial property more heavily than residential property. But given the complexities of provincial and municipal financial arrangements and the fact that the property tax is the single most important revenue source for municipalities, the Council chose to recommend further study of these problems by the governments themselves.

The Gains to Be Made

The prime focus of this Statement has been on how the *structure* of Canadian taxation might be modified so as to achieve more effectively a number of longer-run goals, most notably the more efficient allocation of resources and hence a higher overall standard of living. Tax policy in this sense is not an appropriate instrument for the attainment of short-run macroeconomic objectives, such as providing an immediate stimulus to employment or lessening inflation. For such immediate objectives, what is more important is the mix of fiscal policy – the setting of tax rates and government-expenditure levels – and of monetary policy.

That having been said, a responsible government would have to consider whether structural changes to a tax system could possibly involve major disturbances to the economy, no matter how great the potential long-term gain. To determine whether there would be adverse effects from its proposals, the Council simulated the overall impact of the type of changes proposed here, using its CANDIDE model. On the basis of what could be considered rather harsh or unfavourable assumptions, the results of our simulations suggested very strongly that major changes could be made in the current personal- and corporate-tax systems with no significantly adverse consequences.

The CANDIDE model cannot capture the longer-run favourable impacts of our proposals on savings and, in turn, on either domestic or net foreign investment (exports minus imports). Nonetheless, it does indicate the potential for substantial gains in efficiency as a result of the better allocation of resources. Specifically, it showed that greater efficiency would maintain the existing level of GNP with a lower level of investment by increasing the productivity of that investment. Over the longer run, although there could be some debate over the absolute size of the increase in savings once Canadians responded to the new structure of taxes that we recommend, there is no doubt but that the result would be an increase in output – an increase that, in turn, would allow for reductions in tax rates but yet keep the government deficit on a declining growth path.

Comparisons with U.S. Tax Reform

The tax reform recommended in this Statement has much in common with the tax reforms being undertaken, or proposed, in the United States, Canada, and other countries. For example, many countries – including Canada and the United States – are broadening the base of the corporate income tax by stripping out incentives and lowering statutory tax rates. The intent of all of these reforms is to increase the role of business judgment – and decrease the role of the tax system – in the selection of investments. We would go further in insisting that real, rather than inflated, corporate income is what should be taxed.

In another important respect – the integration of business and personal taxes – recent U.S. tax legislation differs substantially from past practice in Canada, the trend in other industrial countries, and the recommendations in this Statement. The United States is one of the few OECD countries that has not moved to reduce double taxation of corporate shareholders by integrating personal and corporate taxes. Indeed, the recent U.S. tax legislation removes the last vestige of integration in their tax system. We do not think the U.S. example should be followed in this respect; indeed, our proposals would increase the integration of personal and corporate income taxes in Canada.

On the side of personal taxation, our recommended shift towards a personal lifetime-income tax, through greater use of registered saving, contrasts with the recent move in the United States to curtail the deductibility of saving and thereby confine the personal-tax base to annual rather than lifetime income. Our proposals are similar to U.S. legislation in insisting that capital gains be taxed like other income, with appropriate offsetting changes in tax rates to maintain distributional neutrality.

The recommended changes should not adversely affect Canada's attractiveness for investment or highly skilled labour. Indeed, the reverse may well be true. Our recommendations are not intended to increase the overall tax burden on corporate investment income. In the aggregate, the revenues raised by a broader-based corporate income tax would not change very much, and sales taxes would no longer be levied on capital inputs; therefore, business would likely pay lower taxes on investment income. By contrast, in the United States the revenues raised by corporate income taxes are expected to increase by 22 per cent over the next five years, to finance a personal tax cut of 5 per cent. This increase in corporate taxes will obviously make investment in Canada more attractive.

Moreover, it is clear that the burden of increased U.S. corporate taxes must eventually be borne by people; in taxation, as in the rest of economics, there is no such thing as a free lunch. While the long-run incidence of corporate income taxes is not altogether clear, there is a widespread presumption that in the short run at least, the burden of increased corporate income taxes in the United States will fall on shareholders. Compared with our proposals, therefore, recent U.S. tax legislation will increase the burden of taxation on capital income in the short run and have uncertain effects in the long run.

And Globally?

Finally, by achieving a more efficient allocation of investment, and thus higher productivity throughout the economy, our package of recommendations would enhance Canada's overall competitiveness from an international standpoint. Such a strategy is in direct contrast to the existing one, which attempts – through tax allowances or exemptions – to maintain or improve the international competitiveness of selected industries *at the expense of productivity* in the economy as a whole. The important message is that if the tax system can contribute to attaining efficiency in the allocation of our resources, our competitive position in the world economy will most certainly be enhanced.

Dissenting Comments

Dian Cohen

I believe that this Statement makes a useful and provocative contribution to the current discussions on tax reform. Its insights and recommendations deserve serious study. However, the idea of taxing incomes on a lifetime, rather than an annual, basis – while interesting in some sort of "ideal" context – seems to me to be impractical and at odds with the political and economic realities of our time.

Diane Bellemare, Kalmen Kaplansky, and Chaviva Hosek

Taxation and fiscal issues are, by their very nature, divisive. Everyone, it is said, wants to benefit from government expenditures; yet no one wants to pay the bill. Nevertheless, tax reforms have occurred, and are occurring, in other countries with a relative degree of consensus, as demonstrated as recently as this year in the United States and in Sweden in 1982. The experience of other countries shows that it is possible to proceed with a tax reform that is well accepted by the public at large. The foundations of a politically acceptable tax reform lie in widely shared concepts of justice and equity. People accept paying bills that they consider fair; otherwise, they will be tempted to evade them. In light of this elementary principle of political economy, we have to express important reservations on the main thrust of this Council's Statement and on its precise recommendations regarding personal, corporate, and sales taxes.

Where we part company with our colleagues is on the role of the tax system and the criteria for reform. The report focuses solely on how the tax system affects investment returns and savings decisions. But its approach is based on a narrow and, in our view, erroneous concept of efficiency that totally ignores matters of distributional justice, ability to pay, or public consensus. The Statement argues that the present tax system is "impairing the rate of capital formation and encouraging investments in projects that are attractive only because of favourable tax treatment." But what it proposes would alter the very nature of Canada's fiscal system in ways that, we believe, would be neither revenue-neutral nor distributionally neutral. Because the concepts of justice and fairness put forward in the Statement are not widely accepted, the recommendations would be unlikely to create a consensus in Canada. Moreover, we think that if implemented they could be detrimental to Canada's economic performance.

To be politically acceptable, tax reform has to be based on accepted values. In this regard, the document fails to present a wide discussion of the concepts of equity and justice. The fairness criterion put forward in the Council's Statement is one based on a lifetime horizon. In other words, it is based on the premise that "annual ability to pay" is not an important equity criterion; consequently, the document supposes that it is not important that individuals with the same annual income pay the same amount of taxes. It *proposes* that individuals pay taxes on that part of income that is spent or not put into a registered savings plan; it *supposes* that the individuals who save will be taxed later in life when the proceeds of their savings are eventually spent. What is critical is that over their entire lifetime, those individuals with the same income *ought to* pay the same amount of taxes. But a lifetime is a large horizon. Nobody will be able to ascertain, or verify, that equity over a lifetime has been respected.

We believe that the fiscal system should contain a formula for the averaging of income over a period of years in order not to penalize those whose incomes fluctuate significantly. But we are concerned that exempting all registered savings, and taxing only income that is spent during a lifetime, is in fact a consumption tax that favours those who can afford to save. Over some periods of time it is likely to increase inequalities in income and wealth. One could design examples on paper to show that a tax based on spent income is equitable over life; however, most of the time what happens on paper and what happens in real life turn out to be two completely different things. Compare, for example, the pension promised on paper at the beginning of an average individual's working life with the pension he or she actually receives, and one would have to admit that it is impossible to plan over a whole life.

We believe that for most Canadians a fair fiscal system is one based on the concept of annual ability to pay. It was the concept adopted in Canada in 1972, and it is the concept that was adhered to in recent U.S. reform. In this regard, because a consumption tax, or a tax based on lifetime income spent, would enlarge horizontal inequality and lead to situations where people with the same annual income would not pay the same amount of taxes, we think Canadians would, and should, reject it outright. Indeed, if implemented we believe that a tax "reform" along these lines could prompt many Canadians to question the fairness and legitimacy of their governments.

One of the main arguments for the proposed changes presented in this Statement is that the actual system taxes savings more than once, consequently discouraging savings and investment. We consider the proposition to be fallacious. The argument is based on the idea that because individuals pay tax on all income and pay tax on income generated by their savings, the net rate of return – or the rate of return after tax – is not equal to the market rate. Our reaction to this argument is "So what?" There is nothing ethical or moral that requires that the rate of return on savings after tax be equal to the market rate of return, especially in those years when nominal and real interest rates are very high.

This document presents us with the value judgment that the fiscal system must not discourage savings mainly on the pretext of efficiency through time. We disagree. The ultimate purpose of the fiscal system is not to increase savings but, rather, to provide a fair distribution of the costs of public expenditures. In the process, as we recognize, it must not impede economic growth.

Besides, Canada does not have a savings problem. On the contrary, a major element impeding the growth of the Canadian economy is the fact that aggregate demand is not strong enough. The stimulation of saving can only depress aggregate demand and generate more unemployment. The Council Statement supposes, as does the CANDIDE model, that the increased savings will immediately generate an increase in investment. This argument is not well founded. Investors invest when and where they know they can sell the proceeds of their investments. Actually, in Canada, investments are not constrained by savings; there are plenty of idle financial, physical, and human resources. Because of this, a fiscal system that pursues as its main objective an increase in savings can only increase unemployment and be detrimental to the growth of the Canadian economy.

For these reasons, we do not approve of those recommendations which would enlarge the personal tax system from one based on annual income to one based on consumption over a lifetime. In particular, we are strongly opposed to recommendation 3, which, by increasing the amounts in registered savings, would lead to a deterioration in horizontal equity.

We are not opposed in principle to a reform of the sales tax through the introduction of a business transfer tax, which would enlarge the tax base to include services and could permit a decrease in the actual tax rate. However, despite the claims in the Statement, we suspect that the proposed changes in personal and corporate income tax (especially recommendations 3, 4, 5, 11, 12, and 13) will decrease government revenues and put pressure on the federal government to raise the forgone revenues through an increase in the business-transfer-tax rate. Indeed, if the government is inclined to raise additional revenues through increases in the BTT rate, one can reasonably fear inflationary pressures. Such a change in the structure of the fiscal mix, even though accompanied by a personal tax credit to low-income taxpayers, would be to the detriment of the average taxpayer, who will have to support the burden of the reform.

Overall, then, it is hard to believe that the Council's proposals, if adopted, would be revenue-neutral and distributionally neutral or would generate the major growth benefits claimed in the Statement.

Finally, in spite of our opposition to the basic thrust of this Council Statement, we share the view that tax reform is needed. Our system is far too complex. The fiscal base has eroded through time, and in its present form it gives rise to too many inequities. We believe, however, that true reform must take into account the principle of "ability to pay in a given tax year." We also recognize that, at the end of the line, revenues must finance vital services, as well as income transfers to individuals and regions – the expenditure side of the public coin. Canadians expect their elected governments to fulfil public responsibilities. In this respect, there is no such a thing as a free lunch.

Raymond Koskie

I have had the opportunity to read the Dissent of my colleagues Diane Bellemare, Kalmen Kaplansky, and Chaviva Hosek, with which I am fully in agreement; however, I wish to add certain additional comments.

A broad consensus has emerged in Canada – and indeed internationally – that the tax arrangements developed over the past decades are in need of reform. The momentum for tax reform is spurred largely by the public's perception that the existing tax system in *unfair*. Tax reform proposals must meet this concern. They must redress the unfairness in the system in a way that is responsible and in a manner that contributes to both the *equity* and the *growth* of the Canadian economy. There can be no doubt that this is an awesome task. Nevertheless, we must come to grips with the issues – and the sooner, the better. Although the Council states that:

> the main thrust of our recommendations therefore is to reduce these efficiency losses and at the same time create a fairer and simpler tax system,

in my respectful view, the Statement makes very little headway towards satisfying those objectives.

The roots of the public's discontent with Canada's tax system are many, and they run deep. Each particular class of taxpayer has its own grievances against the peculiar ways in which taxes are levied upon it. Any consideration of tax reform must consider the grievances of not only the wealthy, high-income, and corporate taxpayers; it must also consider the broader grievances of *ordinary Canadians*, who, without doubt, shoulder the largest share of the tax burden. Unfortunately, the Statement focuses largely on issues of concern to Canada's corporations and its wealthier and higher-income earners.

Canadian wage earners are keenly aware of the taxes that are deducted from their pay cheques. These are deducted from pay cheques as night follows day, and with little allowance for special circumstances. Ordinary Canadians do not hire tax planners; nor can they benefit from the various tax-saving or deferral schemes. They are wary that their tax dollars are taking the place of taxes that a large group of wealthy Canadians are able to avoid, for one reason or another.

These persons therefore have good reason to be concerned about the fairness of the present tax system. Canadian corporations have enjoyed many favourable tax arrangements to reduce their tax costs and effectively shift the tax burden onto others. The Council recommends eliminating certain of these special allowances; but, on the other hand, it proposes to use the new corporate-tax revenues to reduce the corporate-tax rate. No consideration is given to the possibility of using those revenues *to reduce the tax burden on ordinary Canadians*, as the recent U.S. tax amendments are attempting to do. Similarly, the Council proposes eliminating the earned depletion allowance, and the provincial processing allowances, for companies active in the resource industry but does not consider how the additional tax revenue generated by these changes should be used.

The Council also ignores basic fairness considerations in its proposals for the reform of the *personal-income-tax system*. It recognizes that the capital gains exemption of $500,000, as well as the favourable tax treatment given to capital gains, generally serves no economic purpose and is unfair; but, once again, while the Council recommends taxing capital gains as any other income and eliminating the capital gains deduction of $500,000, it proposes to use the extra tax revenues from these changes not to reduce taxes for all Canadians, but only to reduce the tax rates for the highest-income earners. No consideration is given to the best use of the extra tax revenue to be gained from the taxation of capital gains; the Council seems content to take money from the left pockets of wealthy taxpayers only to put it in their right pockets.

The Council has recommended a "lifetime-income tax," which essentially is a tax on the *consumption expenditures of individuals throughout their lifetime*. Most taxpayers will be unfamiliar with the term "lifetime-income tax." The Statement's emphasis of this term somewhat blurs that which is really intended – namely, a tax on consumed income. This somewhat radical concept is clearly *regressive*, in that it ignores the taxpayer's ability to pay. In response to the question of whether or not this concept would change the tax burden, the Council states:

> . . . not very much at all . . . .

Surely, if the Council is as concerned about "equity" or "fairness" as it suggests, then why does it recommend a tax measure that makes no attempt to shift the tax burden from lower-income earners to the substantial group of high-income earners who pay little, if any, tax? So much, then, for the Council's attempt at a "fair" tax system.

The Council theorizes – with, in my view, unsupported optimism – that this consumption tax will result in greater savings and a "sizeable boost in investment," with the further result that:

> Since labour would have more buildings and more machinery and equipment with which to work, labour productivity and output would increase. With increased employment opportunities and higher real wages, working Canadians would benefit the most.

These conclusions, however, totally ignore the commonly held view that Canadians are already among the world's highest savers. This therefore begs the question: Do we need more savings? Furthermore, how do we know that the additional savings will be invested as the Council anticipates? It is interesting to observe the comments of William Mulholland, Chairman of the Bank of Montreal, in a recent interview with Maclean's Magazine, when he described the problem thusly:

> It's sick. The world's monetary system is *flooded with liquidity*, but it ain't being productively employed the way it used to be. People are finding it cheaper making money with money than to make better goods or new products, or to bring in new resources. Sooner or later that's going to exact a very, very serious toll. It's scary. [Emphasis added.]

The Council's Statement leaves a large gap by not recommending incentives to encourage savers to invest their money in Canada's industry, assuming that there is a need for this type of investment.

Conspicuous by their absence are any data in support of the so-called need for "more buildings and more machinery and equipment" and of the perceived "increased employment opportunities and higher real wages." What the Statement fails to recognize and deal with is that one of our many economic problems is to persuade people, both within and beyond Canada, to spend more on Canadian goods. We must make every effort to *stimulate demand* for our goods. The imposition of a consumption tax will only serve to depress this demand, which surely is an undesirable result. In short, then, there is – in my respectful opinion – very little, if any, basis in support of the concept of a consumption tax.

The proposals in the Statement do not realistically meet the need for tax reform in Canada. Tax reform demands hard answers to hard questions, and the Council has refrained from either asking or answering those questions. If the Council proposes to maintain the current division of the tax burden between the business and the personal sectors, then we need to know the economic justification for maintaining the status quo. We also need to know how the division of the tax burden affects the level of aggregate demand, and consequently the level of economic growth, in Canada. If the Council is proposing to lower corporate tax rates to attract new investment to Canada, then we need evidence that lower tax rates are the most effective way to encourage investment in this country. Serious study must be given to these alternative ways of encouraging investment in Canada before Canada's corporations are offered significant reductions in their tax rates.

The Council's recommendation that taxpayers be allowed to deduct up to 25 to 30 per cent of their income as contributions towards registered savings plans is a seriously regressive step. This proposal will be of benefit principally to higher-income Canadians with significant amounts of money in excess of their needs. Families earning the average family income in Canada simply cannot afford to set aside much, if any, of their income in savings, and therefore cannot take advantage of this deduction. This proposal will allow wealthy Canadians large deductions and will further allow them to defer taxes on all income earned by their savings while in the registered savings plan. So, while ordinary wage earners will be paying taxes on each and every pay cheque, upper-income Canadians who are able to save significant amounts of money will be afforded large deductions and will be permitted, under the Council's proposal, to defer taxes on the interest, dividends, and capital gains accruing to such savings as long as the income accrues to the registered savings plan. This proposal is grossly unfair. It will have the effect of removing significant amounts of savings by wealthy Canadians from the current tax base and will therefore further shift the current tax burden onto ordinary Canadians.

The Council has advanced no persuasive reason for such a generous allowance to higher-income earners. It offers no evidence that the Canadian economy requires more savings and less consumption; nor does it consider any alternative mechanisms for promoting savings in the Canadian economy. The Council does suggest that it is concerned about the "double taxation" of savings. The current tax system, however, does not double-tax savings. It taxes earnings that are derived from every discrete productive activity. Income generated by one productive activity is taxed, and the taxpayer is left with some income to divide between consumption and savings. When those savings are invested, they are invested in another productive activity, which generates its own flow of income, which attracts its tax. This is not a true double taxation; it is simply the taxation of two entirely different productive activities.

With respect to sales taxes, the Council recognizes that these taxes, including the proposed business transfer tax, are regressive and recommends that the federal government not rely on the business transfer tax or any other sales tax for an increased share of its revenues. This proposal is a reasonable one, as it recognizes that sales taxes fall on all Canadians, without regard to their ability to pay. In order to minimize the most unfair aspects of sales taxes, the basic necessities of life should be exempted from its scope. Thus the proposed business transfer tax should not apply to food, shelter, clothing, or medical supplies. Otherwise, this tax burden will no doubt be passed on to consumers in the form of yet higher prices for these essential commodities.

Canadians are also concerned about the appropriate scope of other important deductions, such as educational, medical, and child care expenses (particularly with the growing number of single working parents raising children), and employment expense deductions. These deductions do not cover the *real costs* of these expenses. These individuals are entitled to ask why businesses are entitled to deduct the full amounts of their costs, but wage earners are strictly limited in the amounts of educational, medical, child care, and employment expenses that they can deduct from income. These concerns deserve the study and attention that the Council has devoted to other taxation problems.

Finally, Canadians are legitimately concerned about the widespread use of tax planners by wealthy personal and corporate taxpayers to achieve tax reductions and tax deferrals. Background studies are urgently needed of the range of tax-planning techniques used in Canada and their effect upon the economy. As well, the possibility of reforming the *Income Tax Act* to prohibit transactions that are designed to reduce taxes and that are not for any business purpose should be seriously examined. Both the United States and the United Kingdom have placed restrictions on the abilities of high-income earners and corporate taxpayers to avoid their fair share of taxes by sophisticated arrangements that are expressly intended to reduce, or defer, taxes and that are not justified from a commercial point of view.

In summation, then, not only is the thrust of the Statement aimed in the wrong direction, but it is also clear that certain vital aspects of our taxation system and economy have not been adequately considered, if at all. These serious deficiencies can only serve to detract from the credibility of the Council's effort to produce a consensus in such a sensitive area.

In my view, the subject of tax reform must be approached *cautiously* and with a *sensitivity* to the concerns and needs of *all taxpayers*, both individuals and companies. In this regard, I agree with the warning of Robert Brown, Vice-Chairman of Price Waterhouse, Chartered Accountants, who, in commenting upon the federal government's attempt to reform the tax system, stated recently:

> Indeed, the whole tax reform review package must be labelled "dangerous – handle with care." [He later cautioned:] We are in danger of embarking on fundamental tax reform in Canada without adequate preparation and consultation. (The Globe and Mail, November 25, 1986.)

Appendixes

Appendix A

Studies Prepared for the Economic Council on the Taxation of Savings and Investment

Androkovich, R., M. J. Daly, and F. Naqib. "The impact of RRSPs on capital accumulation with progressive personal taxes." Discussion Paper 309, Economic Council of Canada. Ottawa, June 1986.

Bartholdy, J., J. Mintz, and G. Fisher. "Taxation and the financial policy of firms: Theory and empirical applications to Canada." Economic Council of Canada, Ottawa (forthcoming).

Bird, R. M., and D.J.S. Brean. "The interjurisdictional allocation of income and the unitary taxation debate." Discussion Paper 304, Economic Council of Canada. Ottawa, May 1986.

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Appendix B

The Present Tax Structure

Personal Income Tax

Most personal income tax is levied on wages and salaries. As such, the tax is straightforward and usually collected at source. But individuals also derive considerable investment income from a variety of sources, some of which is taxable (nonregistered savings) and some of which is nontaxable (registered savings) until the point of deregistration.

The federal personal-income-tax system has a graduated rate structure, with a basic exemption and a current top marginal statutory rate of 34 per cent. The 1986 federal budget added a surtax to the basic rate structure. In 1987 and subsequent years, the surtax will be 3 per cent for all individuals. All of the provinces except Quebec, which has its own personal-income-tax system, express their tax rates as a percentage of the basic federal tax. The provincial rates vary, with the consequence that the maximum combined federal and provincial statutory rates range from 52.5 per cent in the Yukon Territory to 60.3 per cent in Quebec.

Under the present personal-tax system in Canada, the basic exemptions and tax brackets are partially indexed to the consumer price index. Since 1986, the rate of tax indexation is the rate of growth of the consumer price index in excess of 3 per cent.

Capital income is taxed at several levels. Initially, profits originating at the corporate level are subject to tax. Profits after taxes are then either distributed as dividends or retained by the firm to finance investment. The dividends, therefore, will have already been taxed at the corporate level. To tax them again at the personal level would constitute double taxation. The Canadian tax system seeks to reduce the burden of double taxation through a dividend gross-up and tax-credit scheme. But the integration of the dividend income is incomplete. The higher the tax bracket of the individual taxpayer, the greater the degree of underintegration. The 1986 budget's reduction of both the gross-up and the credit to 33-1/3 per cent has made the integration of dividends from large corporations even less complete. At the same time, however, the credit reduction has simplified the integration of the personal and corporate incomes of shareholders in Canadian-controlled private corporations.

Undistributed profits generally increase the value of a firm and of its shares, thus creating a capital gain for the holders of the shares. Since the undistributed profits have already been taxed at the corporate level, taxing the capital gain at the personal level may constitute double taxation, depending on a number of circumstances. The 1985 federal budget provided for a cumulative lifetime tax exemption for capital gains to a limit of $500,000, to be phased in between 1985 and 1990. This measure, if retained, will probably exempt most taxpayers from capital-gains taxation, provided that Canada avoids major inflation in the future.

A very substantial portion of personal saving in Canada is channeled into investment through tax-exempt instruments such as registered pension plans and registered retirement savings plans. In 1983, contributions to RPPs and RRSPs amounted to at least $9.1 billion – about 23 per cent of total personal savings ($39 billion). The personal-tax statutes limit a taxpayer's total annual contributions to RRSPs and RPPs. The 1985 budget limited contributions for 1986 to 18 per cent of earned income, up to a maximum of $7,500. This amount will grow to $15,500 in 1990 and be indexed to the average wage thereafter.

Contributions to RPPs and RRSPs are deductible from taxable income in the year of contribution, and withdrawals are taxable. Thus contributions to an RPP or RRSP result in a deferral of taxes. If the taxpayer will be in a lower tax bracket when he retires than he was when he contributed to the RPP or RRSP, then his use of those instruments will reduce the discounted value of his/her total tax liability. The RPP and RRSP provisions amount, in other words, to a method of lifetime income averaging that, in a system of progressive personal-income-tax rates, reduces the lifetime tax burden of the individual. The present system, however, taxes interest income received through RRSPs and RPPs more lightly than it taxes equity income received in the same way – an arrangement that is, of course, contrary to the ideal of a neutral comprehensive income tax. The difference in treatment arises from two facts. First, no credit is given for corporate income taxes that is comparable to the personal dividend tax credit. Second, capital gains accumulated by a plan are taxed in full when withdrawn.

Under a progressive income tax system, a person whose taxable income varies widely from year to year but averages up to $20,000 per year will pay considerably more in personal income taxes than a person whose income is $20,000 in each of the years. Elimination of inequities of this kind will require the provision of some method of income averaging. The present Canadian personal-tax system provides two important income-averaging mechanisms. Farmers and fishermen, who are particularly vulnerable to fluctuations in income, have for many years been allowed to average their incomes over periods of five consecutive years. Forward averaging, which is available to all taxpayers, was introduced in 1982 and replaced the previously existing general averaging. Few taxpayers, however, use this rather complicated option; it is of greatest value to artists, writers, professional athletes, and others with very unstable incomes.

Various allowances, deductions, and tax credits provided by the personal-income-tax system have made it possible for some tax filers to pay little or no tax. In 1983, for example, of over 1 million tax filers with incomes of $40,000 or more, close to 15,000 (or 1.5 per cent) paid no tax at all, and many others paid very little. Much of this is a statistical illusion created by the reporting of gross income without deducting all of the expenses incurred to earn the gross amount. Nevertheless, the situation is one that violates most public perceptions of fairness. Accordingly, since January 1, 1986, a minimum tax has been in force.

If the minimum tax is greater than the regular income-tax liability, the difference is paid as an alternative minimum tax for the year. The minimum tax liability can be used as a credit in future years, when the taxpayer's regular tax liability exceeds his alternative minimum-tax liability.

Corporate Income Tax

The federal *Income Tax Act* taxes all corporations on their income. There are two kinds of business income: active income, and nonactive income. Active business income arises from the production activity of a firm's employees, and nonactive income arises from investments made by the firm. We shall concentrate here on active business income, which is the difference between the revenues and costs of the firm, as defined by the *Income Tax Act*.

The statutory basic federal corporate-income-tax rate presently stands at 46 per cent. This rate, however, is merely the point of departure for what is, in fact, a fairly complex schedule of rates. Thus the basic rate is abated by 10 percentage points to make room for provincial corporate-income taxes. The provincial rates range from 5.5 to 16 per cent. The provincial corporate-income-tax bases for Quebec, Ontario, and Alberta differ somewhat from the federal base, but the differences are minor. In 1986, large corporations were liable to a 5-per-cent surtax, as well as the basic federal tax rate. This surtax was replaced on January 1, 1987, by a 3-per-cent surtax on all corporate income. The statutory basic federal rate will drop by 1 percentage point annually in 1987, 1988, and 1989, beginning on July 1, 1987.

A special, low federal tax rate of 40 per cent, also subject to a 10-percentage-point abatement, applies to corporate income from manufacturing and processing.

The federal small-business deduction allows Canadian-controlled private corporations a reduced rate of taxation on the first $200,000 in annual income from active business in Canada. The deduction reduces the federal tax rate, before the 10-percentage-point abatement, to 25 per cent for private nonmanufacturing corporations and to 20 per cent for private manufacturing corporations. By July 1, 1989, these rates will fall to 23 and 18 per cent, respectively. The provincial rates for nonmanufacturing firms range from 10.5 per cent in Ontario to zero in New Brunswick; those for manufacturing firms range from 10.5 per cent in Ontario to zero in New Brunswick and in Saskatchewan.

The calculation of taxable income permits the deduction from revenue of the costs of capital consumption or depreciation. Tax depreciation is often considerably faster than economic, or even book, depreciation – a circumstance that can have significant consequences for a firm's tax liability.

Because it postpones the tax, accelerated depreciation is equivalent to an interest-free loan by the government to a firm, effectively reducing its tax rate. The value of this incentive increases with the tax rate, the capital-cost-allowance rate, and the economic life of the asset. The tax benefit shows up on company books as a deferred-tax liability.

In general, tax depreciation, which is based on the acquisition price of an asset, is more accelerated for machinery than it is for buildings. For example, manufacturing equipment, oil and water storage tanks, power-operated lift equipment, and electrical operating equipment can be written off in only three years, even though the estimated economic life of assets in that class is over 18 years. The economic life of most buildings is about 40 years. Land and inventories are classified as nondepreciating assets and thus do not qualify for capital consumption allowances.

The smooth operation of business requires that firms hold stocks of raw materials and intermediate goods before they are used or sold. The *Income Tax Act* values these inventories on a first-in-first-out (FIFO) basis. This arrangement causes few problems in times of price stability. In inflationary times, however, the replacement price of inventory may be considerably higher than its original acquisition price. Thus the difference between the sale price and the acquisition price contains an illusory profit, which the current statute subjects to tax. In order to mitigate the distorting effect of inflation, the 1977 federal budget introduced a 3-per-cent inventory allowance; the 1986 budget revoked that measure.

The corporate tax being a tax on equity income, firms can deduct their interest costs from corporate income. The double taxation alluded to earlier is thus restricted to equity income. This arrangement favours the use of debt financing, since the tax burden on debt-financed capital is imposed only once, not twice. In periods of inflation, the incentive to use debt financing is greater, since under inflation the tax-deductible interest on debt constitutes a partial repayment of the real principal of the debt. It is impossible to say categorically whether firms gain enough from the tax treatment of interest in inflationary periods to compensate them adequately for the effects on the (accelerated) depreciation allowances, based on acquisition cost, and the inventory allowance. The balance will vary from industry to industry and from firm to firm.

The investment tax credit was introduced in 1975, with the aim of stimulating investment; and the legislation has since been repeatedly modified and extended. The investment-tax-credit rate varies with the CCA class of investment good and the location of the investment. Slow-growth areas enjoy special high investment-tax-credit rates; the highest rate – 60 per cent of the amount invested – applies to investments in Cape Breton. The basis of the capital consumption allowance is reduced by the value of the investment tax credit. The 1986 budget speech announced the phasing-out of the general investment tax credit, starting in 1987. The investment tax credits for slow-growth regions will remain in force.

Corporations need profits in order to take full advantage of the various statutory deductions, allowances, and tax credits available under the corporate-tax system. A lack of profits can be particularly serious for small, rapidly growing corporations that often lack the degree of diversification necessary to enable them to use all available deductions and credits. In the six-year period 1977-82, only 34.5 per cent of all Canadian corporations paid taxes in at least five of the six years; 22.5 per cent paid taxes in three or four years; and 43 per cent paid taxes in fewer than three years.[25] Although tax losses can be carried forward seven years or back three years (indefinitely in the case of resource industries), this provision offers, at best, only limited relief to the loss-making corporation. Deferral of deductions is the reverse of the deferral of taxes under accelerated depreciation: in carrying losses forward, a corporation is, in effect, making an interest-free loan to the government.

The federal government has introduced a variety of measures designed to help loss-making corporations transfer their surplus allowances and credits to corporations or individuals who can set them against taxable income.

The preceding discussion demonstrates that the tax burden can vary greatly from one firm or investment project to another. The statutory tax rate depends on the nature of the industry and the size of the corporation. The investment tax credit varies with accelerated depreciation, which in turn varies with the CCA class of the asset. For that matter, the tax-reducing value of accelerated depreciation itself depends on the statutory tax rate and declines if the tax rate is reduced. Tax burdens are also affected by profitablity. A corporation has to postpone or forgo the advantages of tax deductions and credits in any year in which it suffers a loss and has no taxable income. It is not surprising, in the circumstances, to find that average effective corporate-income-tax rates vary widely from industry to industry. Chart 2 averages out effective tax rates, by industry, in 1983. The chart shows rates ranging from 8.7 to 43.4 per cent. Needless to say, it shows only that effective tax rates can be very variable; the chart does not show the current distribution of tax burdens across industries.

Commodity Taxes

Commodity taxes are levied by both the federal government and the provinces. The federal government levies the manufacturers' sales tax, excise taxes and duties on alcohol and tobacco, a gasoline tax, and import duties. About one-half of the federal commodity-tax revenue comes from the MST; one-quarter, from import duties. The federal government collected $16.1 billion in commodity taxes in 1985.

The MST base is the selling price of all goods produced in Canada or imported into Canada. Many products are exempt from the MST. While producers' goods are exempt, their definition is somewhat arbitrary, and many investment goods (e.g., computers, office machines, and passenger cars) are subject to the tax. Until recently, the MST rate was 7 per cent for construction materials and 11 per cent for most other commodities. The 1986 budget raised these rates by 1 percentage point.

The most important provincial commodity taxes are taxes on retail sales, motive fuels, and tobacco. Provincial sales- and excise-tax collections amounted to $19.9 billion in 1985. Every province except Alberta imposes a tax based on retail sales. The list of commodities exempted from the tax differs from province to province. Sales tax rates vary from 5 per cent in Saskatchewan to 12 per cent in Newfoundland.

Like the MST, provincial retail sales taxes apply to some investment goods. Moreover, the burden of the provincial sales taxes on investment goods varies considerably from industry to industry, as does the burden of the MST. Total sales taxes on investment goods are by no means insignificant: they amounted to about $1.75 billion in 1981, of which 54 per cent was federal revenue and 46 per cent provincial revenue.

Taxation of the Resource Industries

Resource revenues are subject to not only federal and provincial taxes on corporate income but also provincial and territorial mining taxes, royalties, and other levies designed to capture economic rent.

Federal Measures

The *Income Tax Act* includes a number of provisions that apply only to taxation of the resource sector. One such provision is the disallowance of deductions of royalties, provincial mining taxes, and other payments for resources. A related provision is the resource allowance, which is an incomplete offset for the disallowance of royalty and other deductions. The resource allowance permits a firm to deduct about 25 per cent of its resource profits before it deducts allowances for exploration and development expenses, earned depletion, and interest.

The resource allowance reduces the amount that firms can claim under the earned depletion allowance, which allows mining companies to deduct from taxable income up to 25 per cent of net income. The earned depletion allowance, unlike the resource allowance, has to be obtained by incurring eligible expenses (exploration and development expenses and the cost of acquiring machinery and equipment). Unclaimed exploration and development expenses and earned depletion can be carried forward indefinitely. By contrast, non-resource industries can carry forward unclaimed deductions and allowances for only seven years.

A number of capital-consumption-allowance classes are particular to the resource sector; the rates range from 30 to 100 per cent. Resource firms can also claim the investment tax credit at rates that depend on the CCA class and location of the investment; these rates range from 7 to 20 per cent.

Some provisions of the federal income tax are specific to the oil and gas sector. The Western Accord, signed in March 1985 by the federal government and the western oil-producing provinces, and the new frontier energy policy of October 1985 dismantled most of the taxes and incentives introduced under the National Energy Program. Petroleum incentive payments, which replaced depletion allowances, were terminated in March 1986 (outstanding commitments will be "grandfathered" until the end of 1987). They have been replaced by two credits: (1) a royalty credit of 25 per cent of exploration costs of $5 million or less per well incurred in the frontier regions (this credit can be claimed against royalties otherwise payable in the region); and (2) a partially (40 per cent) refundable 25 per cent exploration tax credit, which is applicable across Canada to exploration expenses in excess of $5 million per well.

Provincial Measures

A resource firm's taxable income for federal-income-tax purposes is also subject to provincial income taxes at effective rates that vary, by province, from 8 to 11 per cent. Quite apart from corporate income taxes, the provinces also levy various special taxes and royalties on rents from provincially owned resources.

Mining taxes vary substantially from province to province. Ontario assesses taxable income from mining at graduated rates: average rates range from zero to 22 per cent; marginal rates, from zero to 30 per cent. Quebec levies mining taxes at a rate of 18 per cent of profits but allows a credit of $90,000 that can be carried forward to subsequent years.

Manitoba and British Columbia levy mining taxes at rates of 18 and 17.5 per cent of taxable income, respectively. In British Columbia, however, no tax is payable on the first $50,000 of income. Those types of allowances, which can be claimed in both Ontario and Quebec, can also be claimed in Manitoba and British Columbia.

New Brunswick levies a two-tier mining tax composed of a 2 per cent royalty and a 16 per cent tax on profits in excess of $100,000. Newfoundland imposes an effective 16-per-cent tax on mining revenues. Saskatchewan levies a uranium royalty on a graduated basis and a potash reserve tax that is negotiated with the firm. The Territories collect graduated-scale royalties, which are computed after deducting some costs.

In the 1960s and early 1970s, the provinces collected oil and gas royalties of between 12.5 and 16.7 per cent of the value of production. In 1974 the producing provinces introduced sliding-scale royalties, which resulted in marginal royalties of 40 to 50 per cent for old oil and gas, and 30 to 40 per cent for new oil and gas. Average royalty rates are now around 13 per cent.

Property Tax

The property tax is the primary independent source of revenue for municipalities. In recent years, the tax has provided about 40 per cent of total municipal revenue in Canada, including transfers from provincial governments. The significance of the property tax should not be underestimated: in 1985 it yielded $14.7 billion in revenue, or 9.3 per cent of the revenue received by all levels of government. In 1980, about 45 per cent of property taxes was paid by owners for owner-occupied housing; the rest, by industry.

The property-tax rate is determined by two factors: the amount of municipal expenses that will not be financed from other sources, and the assessed value of the local tax base. The tax base is the assessed value of the various property classes, which normally include industrial and commercial property, single and multiple residential property, farmland, and unimproved land. Property owned by government or by educational or religious institutions is exempt from the tax. In some provinces, the tax base for business properties may include machinery and equipment.

The basis of property assessment in most jurisdictions is capital value. The assessed value of a property for tax purposes is generally much less than its market value. According to surveys undertaken in 1978, residential real property was assessed, on average, at 20 to 30 per cent of market value; commercial real property, at 20 to 50 per cent; and industrial property, at 50 per cent.

The property-tax system is complex, since both provincial governments and municipal governments administer the tax. Besides the 10 provincial governments, there are more than 4,700 municipal bodies in Canada. In most cases, assessment has been centralized at the provincial level, but each municipality is free to determine the tax rate for the properties in its jurisdiction.

In the past, when assessment was the responsibility of the municipality, many local jurisdictions used the property tax as an instrument of industrial policy by underassessing nonresidential property. Some provinces gave special grants to municipalities that had low assessments, providing them with an additional incentive to underassess nonresidential properties. Centralization of assessment at the provincial level, designed to promote some uniformity in assessment practices across jurisdictions, has all but ruled out this use of the property tax. But the methods of assessment and the interval between reassessments still vary from province to province.

Many provinces allow their municipalities to levy a different tax rate on each of the various property categories. For example, commercial and industrial properties are often taxed at a higher statutory rate than residential properties. Total tax liabilities are determined by multiplying the assessed value of the tax base by the statutory tax rate. Because the statutory rates are determined at the local level, average effective property-tax rates (defined as the ratio of actual property taxes paid to the market value of the property) show great variability across municipalities.

Most localities levy not only the nonresidential property tax but also a separate municipal business tax, which is usually paid by the occupant of the property rather than by its owner. In many jurisdictions, the tax is based on the assessed value of real property and is thus simply an extension of the real property tax. Some municipalities, however, use other bases for this tax, including the value of machinery, rental value, square footage of property occupied for business purposes, and storage capacity. The tax is levied in all provinces except Prince Edward Island and is mandatory in Newfoundland, Nova Scotia, New Brunswick, Ontario, and Saskatchewan. The business tax accounted for approximately 5 per cent of local government revenue in 1980.

Appendix C

Reports on Tax Reform in Canada

	Canada, Department of Finance, *Budget Papers*, 1986: Guidelines for Tax Reform	Report by the Business Council on National Issues	Report by the Economic Council of Canada
Objectives of each	To create a tax environment that more effectively encourages productive economic activity and supports social justice. To shape a tax system that meets the national need for a stable source of revenue to finance essential public services.	To prepare a taxation-policy framework and a set of general policy proposals for Canada.	To make a contribution to the federal government's planned proposals on tax reform. The analysis covers all levels of government and all major types of taxes on income, sales, and property.
Criteria for tax reform	Fairness, simplicity and compliance, balance, stability, international competitiveness, economic growth, Canadian priorities, transitional implementation, and consultation.	The tax system must avoid distorting the normal functioning of market forces in determining rewards for entrepreneurship and work, and in allocating resources in the economy. The tax system must be fair and socially responsive, while promoting an environment in which individual Canadians can enjoy the maximum opportunity and incentive to develop and prosper. The tax system should be designed to be administratively efficient, and consistently applied in order to facilitate public understanding and compliance.	The criteria are efficiency, fairness, simplicity, stability over time, and government accountability in a democratic society.
Revenue implications	Reported for each measure.	Revenue-neutral.	Revenue-neutral.
Base for reform	Key part of an agenda for economic renewal founded on	Tax-policy changes should be made against the backdrop of	The principal prospect for improvement in taxation of

	Canada, Department of Finance, *Budget Papers*, 1986: Guidelines for Tax Reform	Report by the Business Council on National Issues	Report by the Economic Council of Canada
	a better framework for growth and an increased self-reliance for Canadians.	a clear, coherent policy framework that sets forth key assumptions and objectives, which then guide individual policy choices and decisions.	savings and investment lies in basing reform on a small set of clear and consistent themes.
Personal income tax			
Tax base	Increase in the personal-income-tax base by the introduction of a federal minimum tax, effective in 1986.	The base of the direct tax system should continue to be "income," but there should be a significant shift towards expenditure through the greater use of deferred savings plans and an increased reliance on transaction taxes.	Lifetime-income tax base.
Progressivity structure	Increased progressivity by the introduction of a refundable sales-tax credit for low-income families and individuals.	Personal income taxation should be progressive, but top marginal rates should be kept as low as possible.	If anything, the overall incidence of taxation would be slightly more progressive with the proposed package than it is now.
Treatment of capital gains		Serious consideration could be given to phasing out the existing capital gains exemption and, instead, including capital gains in the tax base as normal income.	To simplify the tax system and achieve equal treatment of different forms of capital income within and outside registered treatment, capital gains should be included in full in taxable income, with the only exception being the continuation of the total exclusion of capital gains on the sale of principal residences.
Income averaging		The personal tax system should be neutral as to the timing of the receipt of income. An efficient income-averaging system should be implemented.	Implementation of a personal lifetime-income tax would allow broad scope for self-averaging by individual taxpayers.
Inflation adjustment		Indexation of tax brackets and exemptions.	Full indexation of personal tax brackets, deductions, and exemptions.

	Canada, Department of Finance, *Budget Papers*, 1986: Guidelines for Tax Reform	Report by the Business Council on National Issues	Report by the Economic Council of Canada
Corporate tax			
Tax base		Income tax base for now. Cash flow as a base needs further study. Business expenses as a base is not a viable alternative.	Income tax base. Cash flow is not a desirable base when main trading partners have an income base.
Investment tax credit	The general investment tax credits of 7 and 10 per cent, and the 7 per cent credit for transportation and construction will be phased out by 1989. Specific investment tax credits in special areas are unchanged.	Endorse phasing out of the ITC, as per 1986 budget.	Endorse phasing out of the ITC, as per 1986 budget.
Capital cost allowances		CCAs, with some degree of acceleration retained to compensate for inflation.	CCAs, based on economic depreciation with inflation adjustment.
Adjustments for inflation	Retreat from indexation through removal of inventory allowance.	*Ad hoc* inflation adjustment.	*Ad hoc* inflation adjustment with inflation below 5 per cent; full indexation with inflation above 5 per cent.
Statutory corporate-tax rates	In 1989 the planned rate structure will be: Manufacturing business 36% Other business 43% Small manufacturing business 18% Other small businesses 23% Above rates include an abatement to the provinces of 10 percentage points.	Combined federal and provincial rate of 35 per cent for all business.	Large business 33.3% Small business 25% Above rates include an abatement to the provinces of 8.3 percentage points.
Loss offsetting		Expansion of "loss flow-through" provisions transferable among members of a corporate group. Option for small incorporated business of being treated as partnerships for tax purposes.	Unlimited carry-forward of losses for tax purposes, with interest.

	Canada, Department of Finance, *Budget Papers*, 1986: Guidelines for Tax Reform	Report by the Business Council on National Issues	Report by the Economic Council of Canada
Integration of corporate and personal income taxes	Reduced dividend tax credit from 50 per cent to 33.3 per cent, effective 1987.	Full integration by maintaining dividend tax credit at 50 per cent.	Endorse reduction in dividend tax credit to 33.3 per cent.
Indirect taxes			
Tax base	Most federal sales tax rates increased by 1 percentage point. Increase in certain specific excise taxes and duties.	Favours a transaction tax to replace the federal and provincial sales taxes and other taxes. This should not increase business input costs. Transaction tax should have a comprehensive base and uniform rates.	In favour of a BTT or a VAT to replace the MST, with business inputs exempt; as few exemptions of consumption goods and services as possible; uniform rates. Exemption of capital goods from the base of provincial sales taxes.
Property tax			The property-tax burden carried by business should be re-examined.

Appendix D

Marginal Effective Tax Rates,[1] Canada, 1985

	All taxes				Corporate tax (excluding sales and property taxes)	Personal income tax
	Total	Excluding sales taxes	Excluding property taxes	Excluding sales and property taxes		
	(Per cent)					
Industry						
Construction	51.96	43.71	45.08	36.82	9.22	33.28
Transportation	44.00	41.76	38.86	36.63	13.38	28.06
Storage	39.46	37.55	34.41	32.50	4.13	30.65
Communications	49.45	42.41	45.11	38.07	13.25	30.73
Gas distribution	43.78	43.36	40.95	40.53	16.98	28.94
Trade	41.95	39.14	36.66	33.85	6.20	30.76
Commercial services	48.53	35.76	41.36	28.59	–0.48	32.21
Manufacturing	29.26	26.02	25.88	22.64	–2.99	25.66
Asset						
Machinery	26.35	16.03	26.35	16.03	–12.23	26.17
Buildings	49.55	49.55	36.79	36.79	12.29	30.19
Inventories	43.12	43.12	43.12	43.12	19.04	29.74
Mode of finance						
Debt	19.39	14.07	13.94	8.62	–40.59	35.97
New share issues	51.69	48.16	47.97	44.43	33.22	17.70
Retained earnings	51.09	47.36	47.19	43.46	33.39	16.51
Owner						
Households	43.85	39.72	39.56	35.43	4.44	33.88
Tax-exempt institutions	10.94	5.51	5.35	–0.08	–0.08	0.00
Insurance companies	1.38	–4.59	–4.78	–10.75	–8.84	–1.68
Overall tax rate	38.31	33.96	33.80	29.44	3.45	28.13
Tax wedge	3.83	3.40	3.38	2.94	0.34	2.41
Weighted standard deviation	27.32	29.41	26.61	28.06	41.29	19.51

1 The "marginal effective tax rate" is the rate of tax payable as a percentage of the pre-tax rate of return on a prospective investment whose returns are just enough to cover its costs.

SOURCE M. J. Daly, J. Jung, and T. Schweitzer, "Toward a neutral capital income tax system," *Canadian Tax Journal*, Table 8 (forthcoming).

Notes

1 Organisation for Economic Co-operation and Development, *Economic Outlook*, vol. 38 (Paris: OECD, December 1985), p. 8.

2 Charles E. McLure, Jr., "Rationalizing the corporate income tax: The recent U.S. proposals," in Canadian Tax Foundation, Report of Proceedings of the Thirty-Seventh Tax Conference, Quebec City, November 18-20, 1985, p. 6:3.

3 Richard A. Musgrave, and Peggy B. Musgrave, *Public Finance in Theory and Practice*, 4th ed. (New York: McGraw-Hill, 1984), p. 225.

4 Revenue Canada, Letter from Mr. F. H. Hostetter, Director, Statistical Services Division, Ottawa, November 26, 1986.

5 McLure, "The recent U.S. proposals," p. 6:7.

6 Walter Hettich, and Stanley Winer, "Tax reform in an economic model of political choice," a paper prepared for the TRED Conference on the Political Economy of Tax Change, Carleton University, Ottawa, August 1984.

7 R. D. Brown, "International tax planning," *Canadian Tax Journal* 32, no. 3 (May 1984): 564

8 See Glenn P. Jenkins, "The impact of inflation on corporate taxes and the cash flows of business," Economic Council of Canada, Discussion Paper 286, Ottawa, September 1985.

9 Of course, there are administrative reasons for including construction materials and manufactured items in the sales tax base, since it may be nearly impossible to distinguish – at the point of sale – goods sold for business purposes from goods sold for household use.

10 Based on a model used in Michael Daly, Jack Jung, and Thomas Schweitzer, "Towards a neutral capital income tax system," Economic Council of Canada, Ottawa (forthcoming); also published in *Canadian Tax Journal* 34, no. 6 (November-December 1986).

11 It must be emphasized that we are not talking about taxation of net transfers of wealth; that is a separate issue. The repeal of inheritance taxes by the Province of Quebec in a recent budget means that no Canadian jurisdiction now taxes direct wealth transfers. We have not considered any changes to this treatment.

12 With its treatment of registered savings, the lifetime-income tax base in a given year is equal to the difference between the annual-income tax base adjusted for the inflation-induced loss in the purchasing power of all money wealth and the net change in the real wealth of the taxpayer. The change in real net wealth is equal to the change in nominal net wealth, minus the loss in the purchasing power of the outstanding stock of wealth because of inflation. This loss in purchasing power is exactly the inflation adjustment that should be subtracted when calculating the annual-income base adjusted for capital-income indexation. Hence real capital income adjusted for inflation, less the change in real wealth, is equal to capital income not adjusted for inflation, less the change in net nominal wealth; and there is no need to index the capital part of the tax base.

13 R. Boadway, N. Bruce, and C. M. Beach, "Taxation and savings in Canada," Technical Paper, Economic Council of Canada, Ottawa (forthcoming).

14 D. Gauthier, "Taxation and life cycle savings behaviour in a small open economy," Economic Council of Canada, Discussion Paper 306, Ottawa, June 1986.

15 If a large proportion of new investments by subsidiaries of foreign companies operating in Canada is financed out of their Canadian earnings, the disallowance of the deduction for interest expenses under a cash-flow corporate tax may have little impact on foreign investment in Canada.

16 See Canada, Department of Finance, *Budget Papers* (Ottawa: Finance, 1986).

17 Economic Council of Canada, *Connections: An Energy Strategy for the Future* (Ottawa: Supply and Services Canada, 1985), pp. 138 and 143.

18 Capital cost allowances, for tax purposes, are based on historical cost rather than replacement cost. As inflation erodes the real value of these fixed nominal deductions, it tends to increase marginal effective corporate-tax rates on depreciable capital, such as machinery and buildings. In addition, inflation tends to increase the nominal value of inventories. Because

firms must use first-in-first-out (FIFO) inventory accounting for tax purposes, the difference between the current sales price and the cost of having acquired the inventory at some time in the past represents taxable profits. Thus inflation tends to increase nominal taxable profits and, consequently, marginal effective corporate-tax rates. As partial compensation for this phenomenon, firms were formerly permitted a 3-per-cent inventory allowance. This allowance, however, was withdrawn by the February 1986 federal budget.

On the other hand, nominal interest payments effectively contain an element of loan-principal repayment. Inflation tends to raise interest rates and, with them, the deductions of interest, and thereby decreases the corporate taxes paid on debt-financed investments. Hence, as far as businesses are concerned, debt financing provides a shelter against the effects of inflation. At the same time, however, inflation tends to increase nominal interest receipts, resulting in higher personal-tax collections. But the latter tendency does not completely offset the former: the marginal personal-tax rate on interest income, averaged over all investors, is approximately 27 per cent, according to our calculations, whereas statutory corporate-tax rates range from 32.4 to 48.1 per cent. Thus inflation further reduces the overall marginal effective tax rate on investments financed by debt relative to the rate on investments financed by new share issues or retained earnings – a situation that provides additional encouragement to the debt financing of investments.

19 See *Report of the Ontario Committee on Inflation Accounting*, June 1977, pp. 68-71.

20 This is because the 50-per-cent dividend tax credit reflects the presumption that profits distributed in the form of dividends have already been taxed at the corporate level at a rate of at least 33-1/3 per cent. The corporate sector as a whole, however, is taxed at a rate much lower than that (26.5 per cent in 1983, for example), as a result of various tax allowances, credits, and deductions. Since the corporate-tax-reform package that we are proposing is intended to be roughly revenue-neutral as far as corporate income taxes are concerned – so that the overall average corporate-tax rate would not change very much over the long run – it follows that the dividend tax credit should reflect the payment of corporate taxes at a rate that is closer to 25 than 33-1/3 per cent; hence the dividend tax credit should be set at 33-1/3 rather than 50 per cent.

21 For shareholders who typically face a marginal personal-tax rate of 42 per cent, dividend receipts would be taxed at the effective rate of 23 per cent once the dividend tax credit was taken into account, whereas capital gains would be taxed at the effective accrued rate of roughly 26 per cent, assuming a holding period of 10 years for shares. Removal of the difference in effective tax rates on dividends and capital gains would, of course, reduce the differences in marginal effective tax rates on investments financed with new share issues and retained earnings, and thereby eliminate the tax inducement to convert dividends into capital gains. It would also considerably simplify the tax code by obviating the need for large sections of the present income-tax legislation.

22 Canada, Department of Finance, *The Corporate Tax System: A Direction for Change* (Ottawa: Finance, 1985).

23 Economic Council, *Connections*, p. 129.

24 The federal resource allowance is about 25 per cent of gross revenue; thus the federal government could allow the deduction of all provincial royalties, mining taxes, and other currently nondeductive resource payments, up to 25 per cent of gross revenue. The excess of such royalties over 25 per cent would be deductible only in part. The federal resource allowance could then be withdrawn.

25 Some of the frequency of losses can be the result of taxpayer discretion in the timing of CCAs and ITCs allowed by the Canadian *Income Tax Act*. This discretion increases the effectiveness of Canadian tax incentives and reduces the burden of U.S. taxes on Canadian subsidiaries of U.S.-owned corporations.

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