BUSINESS COUNCIL ON NATIONAL ISSUES

TAXATION POLICY REFORM
AND THE NATIONAL AGENDA

OTTAWA
OCTOBER 1986

THE BUSINESS COUNCIL ON NATIONAL ISSUES

As the senior voice of business in Canada, the Business Council is the means by which leaders have chosen to contribute personally to the development of public policy and to the shaping of national priorities.

Its members are the chief executive officers of 150 leading Canadian corporations. With about 1.5 million employees, these companies administer over $700 billion in assets and generate more than $250 billion in revenues.

The Council is a non-partisan organization with a fourfold focus -- to help build a strong national and international economy, progressive social policies, healthy political institutions, and a more secure Canada.

POLICY COMMITTEE

Chairman **David M. Culver**	**Alcan Aluminium Limited**
President **Thomas P. d'Aquino**	**Business Council on National Issues**
John D. Allan	Stelco Inc.
John Anderson	Westcoast Transmission Company Limited
Charles F. Baird	Inco Limited
Michel F. Bélanger	National Bank of Canada
Rodrigue J. Bilodeau	Honeywell Limited
Claude Castonguay	The Laurentian Group Corporation
D. Steele Curry	Revelstoke Companies Limited
A. Jean de Grandpré	Bell Canada Enterprises Inc.
James L. Dunlap	Texaco Canada Inc.
John F. Fraser	Federal Industries Limited
Rowland C. Frazee	Honourary Chairman
Charles H. Hantho	C-I-L Inc.
Kenneth W. Harrigan	Ford Motor Company of Canada, Limited
Gerald R. Heffernan	Co-Steel Inc.
E. Sydney Jackson	The Manufacturers Life Insurance Company
R. Jack Lawrence	Burns Fry Limited
Ronald N. Mannix	Manalta Coal Ltd.
C. Edward Medland	Wood Gundy Inc.
J. Edward Newall	Du Pont Canada Inc.
Alfred Powis	Noranda Inc.
Cedric E. Ritchie	Bank of Nova Scotia
Thomas H. Savage	ITT Canada Limited
C. Richard Sharpe	Sears Canada Inc.
James H. Smith	Domtar Inc.
William W. Stinson	Canadian Pacific Limited

TASK FORCE ON TAXATION POLICY

1985/1986

Chairman	
Gerald R. Heffernan	**Co-Steel Inc.**
Vice Chairman	
James H. Smith	**Domtar Inc.**
J. Christopher Barron	Cassels Blaikie & Co. Limited
William R.C. Blundell	Canadian General Electric Company Limited
Michael A. Cornelissen	Royal Trustco Limited
Pierre Lortie	Provigo Inc.
Giles R. Meikle	Deloitte Haskins & Sells
J. Dean Muncaster	Company Director
John H. Panabaker	Mutual Life of Canada
Paul Paré	Imasco Limited
Morris A. Perlis	American Express Canada Inc.
Roger W.F. Phillips	IPSCO Inc.
C. Douglas Reekie	CAE Industries Ltd.
Thomas H. Savage	ITT Canada Limited

TAXATION POLICY REFORM AND THE NATIONAL AGENDA

In early September of this year, the Business Council on National Issues published a paper entitled Economic Priorities and the National Agenda. In that paper, the Council argued that three initiatives must succeed if Canada is to maximize its economic potential: the drive to bring order to our public finances must be accelerated, comprehensive tax reform must begin, and further trade liberalization between Canada and its major trading partners must be achieved.

In this second paper entitled Taxation Policy Reform and the National Agenda, the chief executive officers that make up the Business Council on National Issues offer more detailed views on the critically important issue of how Canada's system of taxation can be improved to meet the goals of fairness, simplicity, and efficiency.

This discussion paper summarizes the views contained in a report of the Business Council Task Force on Taxation Policy. The Task Force, composed of Business Council members, met frequently during an eighteen-month period, and arrived at its conclusions following extensive consultations with a wide variety of interested parties in both the private and public sectors.

The discussion and conclusions contained in this paper are the product of roundtable exchanges involving Council members directly. While expert advice was sought in the course of the study, great care was taken to ensure that the outcome reflected the practical concerns and the direct experience of the business leaders involved.

This paper encompasses a set of principles and a group of proposals that are meant to be considered as a whole. The Council endorses the package, but not necessarily any single conclusion out of context. We stress that this is a discussion paper only and that the Council's views may evolve further and encompass new areas as the debate unfolds.

The Business Council offers these views to government and to the public at this time hopeful that they will lead to a better understanding of the issues involved, and to a broadly-based consensus upon which our elected representatives can act in the national interest.

David M. Culver
David M. Culver
Chairman

G.R. Heffernan
Gerald R. Heffernan
Chairman
Task Force on
Taxation Policy

Thomas P. d'Aquino
Thomas P. d'Aquino
President and
Chief Executive Officer

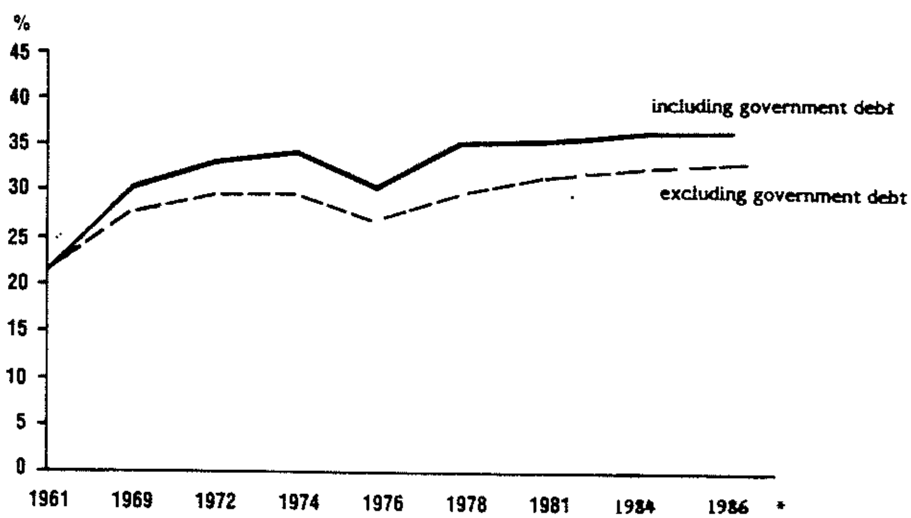
THE CASE FOR TAXATION POLICY REFORM

The Business Council believes that comprehensive reform of Canada's taxation policies is an urgent priority. Why is it important?

To begin with, many fear that the present tax system is having an adverse effect on job creation and, ultimately, on our standard of living. It is seen to distort and complicate investment and economic decision-making by individuals and by businesses, thereby inhibiting Canada's economic growth. The federal government recognized this problem early in its mandate. In its 1984 Agenda paper, the current tax system was identified as an obstacle to growth, and reform of the tax system was seen as an important dimension of economic renewal.

Many Canadians are disturbed by their growing tax burden. From 1961 to 1986 the total federal and provincial taxes paid by the average family grew from 22% to over 32% of its income. If budget deficits -- the value of programs and services not currently paid for -- are included, this tax rate grew by more than one-and-a-half times to nearly 36%.

The Average Canadian Family's Total Tax Rate



Source: Michael Walker and Sally Pipes, Tax Facts 5: The Canadian Consumer Index and You (Vancouver: Fraser Institute, 1986) p. 57.

* Estimate

Some argue that the taxation system has failed because it has not yielded enough revenue to finance government operations and programs, particularly at the federal level. The resulting deficits will be a drag on the economy for many more years. Also, the system's inefficiencies adversely affect the economy because, for example, existing taxes take more from taxpayers than they add to government coffers. Recent studies in the United States show that in the 1970s, the marginal cost to the economy of collecting one extra dollar in their progressive tax system was between $1.50 and $1.70.

Lastly, the world context cannot be ignored. Tax reform initiatives are under study or taking place throughout the industrialized world. If Canada's tax rates and systems fall increasingly out of line with those of its competitors, most notably the United States, the consequences would be harmful to our employment and prosperity.

In this respect, it is useful to note the burden of taxation in other developed countries. In the early 1980s taxes accounted for about 35% of Canadian Gross Domestic Product compared with 30.5% in the United States and 27.2% in Japan. Although Canada ranks near the middle among countries of the Organization for Economic Co-operation and Development (OECD) in relative tax burden, it is worrisome that our two largest trading partners have significantly lower burdens.

These are a few of the reasons why Canada's uncompetitive tax climate poses serious risks for its medium-sized, open economy and why tax reform must be carried out soon and on a comprehensive basis.

THE BUSINESS COUNCIL'S PROPOSALS

This paper outlines the Business Council's views on a national taxation policy framework and the general tax policies that will best serve the public interest and allow Canadians to prosper in an increasingly competitive world.

Canada has a large and expensive public sector. Like many Canadians, the Business Council is of the view that the overall tax burden that has grown up to support current levels of public sector expenditure is excessive. While this issue is important it is deliberately not addressed in these proposals. We do address, however, an issue that we believe lies at the heart of the tax policy reform debate -- how to pay for government programs and services with the least damage to growth and job creation. Our suggestions are designed to be "revenue neutral" -- in other words, if implemented as a package, they would not reduce or increase total tax revenues.

Four Main Elements

The package of reforms proposed in this paper centres on four main elements:

- **The tax base should be broadened.** Existing tax incentives and exemptions should be cut back so as to let a freer market allocate resources more efficiently.

- **Income tax rates should be cut for persons and corporations.** This will help save taxes for many Canadians, with particular emphasis on cutting the marginal rates at the top and for low income individuals.

- **The personal and corporate income tax systems should be better integrated.** This should minimize economic distortions and prevent unfairness and abuse.

- **Greater reliance should be placed on transaction or expenditure taxes.** This would make the tax system more efficient and encourage saving and investment.

All tax policy changes proposed by the Council in this paper are based on a coherent policy framework that sets forth key assumptions and objectives to guide individual policy choices and decisions.

A GENERAL FRAMEWORK FOR TAX REFORM

Basic Principles

The Business Council believes that tax reform should be based on the following principles:

1. **The prime purpose of the tax system should be to raise revenues to finance public services.** In contrast, the current system is saddled

with too many other tasks including promoting growth, stimulating employment, redistributing income, and fostering regional and sectoral development. It cannot perform all of these tasks well.

2. **The tax system must not distort the normal working of market forces in determining rewards and in allocating resources.** A more neutral tax system, allowing greater scope for the freer exercise of market forces and individual efforts, would be more effective in promoting growth, job creation and business development.

3. **The Canadian tax system must be compatible and competitive with the systems of our international trading partners.** In an increasingly global economy, our tax system must not put Canada at a competitive disadvantage nor must it cause skilled Canadians to move abroad to find more comfortable tax climates.

4. **Canada's tax system must respond to the needs of society and must treat people fairly. It must foster a climate of freedom and incentive where each Canadian has the maximum opportunity to develop and prosper.**

Design of Tax Reform

The Business Council believes that a reformed tax system should incorporate the following features:

1. **It should be stable and based upon an integrated and cohesive policy framework.** Public confidence would be promoted, personal and business planning would be less disrupted, and tinkering with the system would be reduced.

2. **It should be balanced and avoid excessive reliance on any one area of taxation.** The imposition of any tax inevitably leads to distortions as taxpayers adjust their behaviour to minimize their tax burdens. Taxation should be spread across a broad range of taxes, goods and services, with each revenue source taxed at moderate rates.

3. **The burden of taxation should be shifted away from income and towards expenditure.** Taxing income leads to distortions and a loss of incentive, reducing the levels of saving, investment and effort. By contrast, taxing expenditures minimizes these effects and would help productivity and competitiveness by encouraging investment.

4. **"Double taxation" of corporate income -- first taxing corporations and then the dividends they pay to individuals -- should be eliminated. The total tax paid should not be determined solely as a result of how income is earned or flows to its ultimate owner.** The tax burden eventually falls on individuals because corporate taxes are effectively passed on through higher prices, lower wages, or a lower return on investment. Taxing businesses as if they were disassociated from the economy only hides the tax burden and reduces governments' accountability.

5. **Hidden taxes should be eliminated.** They raise production costs and make Canadian producers less competitive with foreign businesses both at home and abroad. Also, the public should be able to identify the taxes they pay and how they pay them.

6. **Our tax system should be simpler and consistent so Canadians can understand it and comply with it more easily.** Complexity contributes to tax avoidance and evasion. Uncertainty hampers economic decision-making.

7. **The base of Canada's tax system should be broadened and the whole range of special incentives, exemptions, deductions, concessions and credits should be cut back.** This will help avoid costly distortions in the economy and will ensure that taxpayers and firms in similar circumstances face similar tax burdens.

8. **The personal income tax system should be progressive, with the top marginal tax rates as low as possible.** High or quickly rising marginal rates dampen personal initiative and risk-taking while impairing productivity and capital formation. They also encourage tax avoidance and the use of tax shelters that are often not in the public interest, socially or economically.

9. **The corporate tax rate should be roughly equivalent to the top rate of personal income tax.** This will go a long way to achieving an appropriate integration of the personal and corporate tax systems and contribute to simplicity and avoidance of abuse.

10. **The tax system should not penalize taxpayers by giving the government windfall gains as a result of inflation.**

11. **The corporate and personal tax systems should not penalize taxpayers whose income rises and falls over the years.**

12. **The federal and the provincial governments should coordinate their tax policies as closely as possible and make tax reform a cooperative effort.**

PERSONAL AND CORPORATE INCOME TAX REFORM

These principles suggest that the current tax system must be modified substantially to further the goals of economic efficiency, competitiveness, fairness and simplicity.

Steps to achieve these changes should begin with a review of the fundamentals of taxation -- the tax base and the rate of taxation. The following sections of this paper concentrate on examining the rates and bases of three principle tax mechanisms: personal income taxes, corporate income taxes, and transaction taxes. Several other important tax areas are also discussed but in less detail.

The cornerstone of Canadian taxation is the income tax system. Increasingly, the federal government and the provinces have come to rely on direct taxation -- primarily taxes levied on personal and corporate income. By 1985, more than 60% of the revenue of these two levels of government came from this source, making it a priority area for reform initiatives.

1. THE PERSONAL TAX BASE

The first question facing tax reformers is, what tax base should be applied to individuals -- income or expenditure? In other words, should governments collect tax when taxpayers earn revenue or when they spend it? In Canada we have basically an income system with some features of the expenditure system.

Those who favour the income base of taxation argue that it taxes by "ability to pay" and so treats taxpayers fairly and equitably. However, it also taxes savings doubly -- people pay tax not just when they first earn, but also when the income they save pays them a return. This creates a disincentive to save and invest.

Supporters of the expenditure base of taxation argue that it reflects what people take or remove from society in an economic sense. According to this view, Canadians would pay tax only on what they spend for personal consumption. By not "double taxing" savings, as happens with an income base, more Canadians would save and invest. The economy would perform better and generate more national wealth and jobs.

The Macdonald Commission recommended that we consider shifting the personal tax system from an "income" to an "expenditure" base. The Business Council favours some shift toward expenditure -- first, by means of greater use of deferred savings plans similar to the present Registered Retirement Savings Programs, (RRSPs) but with more investment options; and second, by an increased emphasis on transaction taxes.

Major disruptions and costly adjustments would arise, however, if the federal government suddenly switched tax bases. For example, those making large "lumpy" purchases such as a home would suffer a sudden heavy tax increase. Also, the young and the elderly, who tend to spend more of their current earnings, would need offsetting tax adjustments. In addition, a mechanism would be needed to combat the incentive for people to live in Canada while earning income, and then at retirement to move to a country with low consumption taxes.

Accordingly, we conclude that

- **The base of the direct tax system should continue to be "income," but there should be a significant shift in the balance toward "expenditure" taxes.**

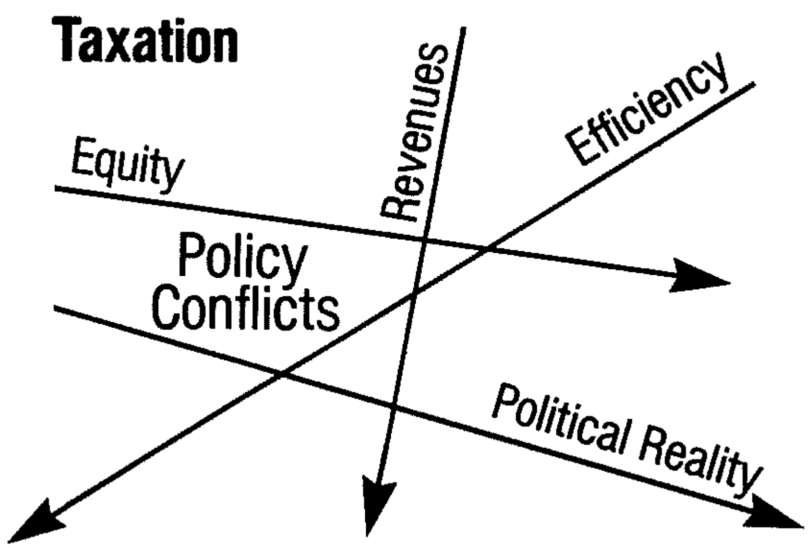
- **There should be increased reliance on transaction taxes.**

- **There should be greater use of deferred savings plans similar in nature to RRSPs. However, the plans should give savers more flexibility with regard to investment options.**

Tax Expenditures and the Tax Base

Determining which tax base to use is only half of the job. One must then decide how many items or activities will be exempt from taxation. Each exemption narrows the remaining tax base. This creates a need for higher tax rates to bring in the same amount of revenue from the narrower base. It also leads to increased complexity as attempts are made to have products and services redefined to qualify for exempt status.

The House of Commons Standing Committee on Finance and Economic Affairs recently noted that the government is making increasing use of "tax expenditures." (This concept is based on tax revenue foregone to serve social and economic purposes.)



Reliance on tax expenditures is frequently the result of governments using the tax system to advance social and economic goals apart from the immediate need to raise revenue. The more they pursue diverse policy goals, the more the tax system becomes complicated and works at cross purposes. We believe that governments, where possible, should avoid the use of such incentives. They lead to growing distortions and cause taxpayers to base decisions not on market realities but on putting off or avoiding taxation.

Another problem of tax expenditures is that they may be manifestly unfair. In a personal income tax system based on high marginal rates, greater dollar benefits go to higher income taxpayers than to those with lower incomes. It is possible to overcome these regressive effects by delivering tax expenditure programs more carefully. For example, benefits could be "capped" at a low maximum rate. Alternately, "fixed rate" tax credits could be used where everyone benefits by the same percentage. Or more "clawback" techniques could be employed such as those used with the Child Tax Credit, where the value of the credit is reduced as income rises.

In his most recent report, the Auditor General of Canada states that tax expenditures make the tax system "less able to provide equity, efficiency and simplicity." We agree with this observation. Overall, tax expenditures reduce the smooth working of our economy and on balance are not in the public interest. Many were designed to achieve objectives that are now obsolete or of questionable validity. By sharply cutting their number we can still meet most policy objectives outside the tax system, for example, by making direct payments.

Accordingly, we conclude that

- **The government should review the whole range of tax exemptions, deductions, shelters, concessions, and incentives. Tax measures should be phased out that do not provide sufficient benefits to justify their costs in terms of lost revenue.**

- **Innovative ways to deliver personal tax expenditures that make the system more progressive and cost effective should be examined.**

- Generally, support and incentive programs should be divorced from the tax systems. As far as possible, the impact of the tax system should be neutral. It should not selectively influence our economic decisions or behaviour. However, in certain cases, tax credits can fairly and effectively give relief to well-defined groups. A good example would be the Child Tax Credit.

The Treatment of Capital Gains

One tax expenditure which narrows the personal tax base is the $500,000 lifetime capital gains exemption. Our conclusions on this measure are as follows.

- The Business Council supports the important objectives the federal government is attempting to achieve with the $500,000 lifetime capital gains exemption. We too believe it is important to provide a clear signal that government policy favours personal investment and risk-taking. In the longer term, however, if government implements the broad changes we are proposing, and subject to a provision allowing for inflation adjustment to the cost base of assets, serious consideration should be given to phasing out the existing capital gains exemption and including capital gains in the tax base as normal income.

2. THE CORPORATE TAX BASE

If the first fundamental question for tax reformers is what base should be used to tax individuals, the second is what base should be used to tax corporations. As with individuals, Canada presently taxes corporations using an "income base." Over the years other methods have been proposed, most notably "cash flow." Under this method corporations would be assessed on their net cash flow. Proponents assert that it would promote investment and economic growth. Taxpayers would be able to write off all capital expenditures in the year they invest, avoiding any penalty on acquiring capital assets and any distortion caused by inflation, but would not be allowed to deduct their interest expense.

However, moving to a new tax base would bring a number of serious disadvantages. For example, tax revenues to governments would vary greatly;

firms currently with high debts would be put in great difficulty; complex transitional rules would be required; and since Canada would be the only country using the base, foreign investment would probably decline.

Accordingly, we conclude that

- **Canada should continue to base corporate taxes on income, but significantly modify the present system as outlined in the following sections of this paper.**

Tax Expenditure and the Tax Base

Having determined the appropriate tax base for corporations, one must next decide what exemptions (tax expenditures) would be permitted.

The principal objective of corporate tax reform should be to improve the efficiency of Canadian business so as to provide benefits to all Canadians. This can be best achieved by encouraging business to rely on market forces, not government incentives. Thus in principle the tax base should be broad and uniform, equalizing effective tax rates for different investments, activities and industry sectors. In other words, it should strive for neutrality. This would allocate resources more effectively, improve economic efficiency, and help our industries compete in the global economy.

Accordingly, we conclude that

- **In reforming the existing corporate tax system, the aim should be to achieve greater neutrality.**

- **Government should remove or cut back many existing exemptions, deductions, concessions, incentives and credits in the corporate tax system.**

- **By achieving a neutral tax system and other goals recommended in this report, business will be encouraged to rely on market forces, not government incentives.**

- **Governments should make concerted efforts to rationalize resource industry taxation. They should recognize the high costs and risks associated with resource exploration and development. At the same time,**

they should reduce distortions caused by taxes and royalties levied on gross revenue.

Capital Cost Allowances

A key element when considering the corporate tax system is how capital consumption should be recognized. The present system of capital cost allowances has served the Canadian economy reasonably well. It has provided some measure of incentive to invest during a tax era marked by disincentives such as sales taxes on capital spending, and the failure to index depreciation allowances to inflation.

As a general rule, governments should also ensure that our overall tax regime does not place heavier tax burdens on our citizens and corporations than those faced by our major trading partners. This will help Canadian industries -- which generally are more capital intensive and have higher capital costs -- to compete more effectively in the international arena.

Accordingly, we conclude that

- **Some modification of the present system of capital cost allowances may be possible. To the extent that the government reduces corporate rates and removes disincentives from the tax system, it may be possible to provide maximum permitted deductions that more closely conform to actual rates of capital consumption. However, the tax system must retain a degree of accelerated allowances to offset inflation and to maintain Canadian industry's competitiveness. It must also recognize that business investments frequently become obsolete long before they are physically worn out. In addition, the system of capital cost allowances should ensure that the same set of rates applies to all industries in order to more equitably encourage investments throughout the private sector.**

Treatment of Losses

Just as the fair recognition of capital consumption through capital cost allowances is part of the calculation of the costs of doing business, so is the equitable treatment of losses important to the health of many corporate groups. However, since we lack an adequate system of "loss flow through," a corporate group of profitable and unprofitable corporations may pay tax on an aggregate amount that exceeds its combined net taxable income. This creates a strong bias against risk-taking.

At present, some corporate groups are able to use complex and costly mechanisms to offset gains and losses between corporate entities. This is most practical with wholly-owned subsidiaries. However, many other businesses cannot benefit in this way because of legal impediments requiring them to operate subsidiaries as separate entities, or because of practical considerations relating to minority interests.

Accordingly, we conclude that

- **To reduce the present bias of the tax system against risk-taking, government should expand corporate "loss flow through" provisions so that losses can be spread among members of a corporate group.**

- **Careful consideration must be given to how to meet provincial concerns that expanded loss flow through mechanisms might result in changes in provincial tax revenues.**

3. INTEGRATION OF THE PERSONAL AND CORPORATE TAX SYSTEMS

Earlier we determined that corporations and individuals should both be taxed in large part on the basis of income. We must now consider the degree to which the two systems should be harmonized. Canada taxes corporate income twice -- first at the level of the company itself, and again when it is realized by shareholders in the form of dividends or capital gains from the sale of stocks. It is widely recognized that this system is unfair and distorts the economy and that there should be better integration of the corporate and personal tax systems.

One alternative is to remove all corporate taxation and capture the tax revenues when the financial benefits are received by individuals. However, the Business Council believes there are sound reasons to continue taxing income in the hands of corporations. These include: ensuring that a fair amount of tax is collected from foreign shareholders; the efficiency of a corporate system as a "withholding tax" -- collecting and holding a share of profits from corporations, rather than pursuing individual shareholders for their portions of the corporate gain; and preventing tax avoidance.

On the other hand, there are no persuasive reasons why income earned through corporations should be taxed more heavily than income earned through unincorporated business enterprises. Yet the former are subject to "double taxation" while the latter are taxed only at the personal level.

Accordingly, we conclude that

- **Total tax on corporate income should not exceed the tax which would have to be paid if an individual had earned the same income directly.**

- **Income subject to corporate tax should give rise to a full offsetting credit for the taxes paid on such profit when the income is passed on to shareholders in the form of dividends.**

Tax Rate Structures

Previously we identified two fundamental elements -- the base and the rates -- as central to the discussion of any tax. Having examined the question of the base it is now necessary to consider the structure of tax rates. In our view, sound tax reform requires both lowering personal and corporate rates and expanding tax bases. To preserve neutrality and take away incentives to shift income from one form to another, the two systems should be integrated and maximum rates under both should be essentially equal. These changes will give all Canadians a greater incentive to work, save and invest.

Presently, rapidly rising rates are applied in the higher tax brackets. Then, as we have seen, the base is narrowed with numerous exemptions, deductions, incentives, concessions, credits and other tax shelters. Highly progressive marginal rates lead to great demand for more of these special tax considerations. Evidence shows that as the top marginal rate rises above 30%, the incentives to escape taxation increase rapidly.

High marginal tax rates lead to complexity, raise questions of fairness, stifle the efficiency of our economy, restrain economic growth, and diminish the size of the tax base. They trigger growth in the underground economy, encourage individuals to spend time and money solely on trying to avoid tax liabilities, and channel investment into unproductive "tax shelters."

Accordingly, we conclude that

- To stimulate effort and initiative by all Canadians, the federal and provincial governments should move to a general lowering of tax rates while putting in place an expanded tax base for both persons and corporations.

- To make the tax system work smoothly and fairly, the maximum income tax rates under the personal and corporate tax systems should be essentially equal. The two systems should be integrated to the greatest extent possible.

- To be fair, the average personal tax rate should continue to rise with income, as it does now. We agree that higher-income individuals should pay a higher proportion of their income in tax than do those with less income. But tax rates should be reduced across the board to provide relief and incentive for all Canadian taxpayers. Any potential loss in revenue should be made up by broadening the tax base and increasing consumption taxes. In the long run, any losses would be more than offset by greater government revenues due to growth in the economy.

- Ideally, the top personal income tax rate should not exceed 35%, including both federal and provincial portions of the tax.

The Effects of Past Rate Reductions

Past tax changes in the United States and Canada show that when governments cut high marginal tax rates, they harvested significant increases both in income reported and total tax collected from individuals. The evidence is that by reducing the top rates, government can make many tax shelters less "profitable." Much previously sheltered income can be lured back into the tax system, and more taxpayers induced to realize gains on appreciated assets. Over the long term, lower rates will create positive incentives to save, work and invest.

In short, the evidence suggests that lowering marginal tax rates could lead to high-bracket taxpayers reporting more income and paying more tax.

Tax Changes in the United States

Tax rates in Canada must be set with an eye to the international environment. The most prominent factor is the recent set of tax reforms in the United States. There, after accounting for clawback mechanisms, the top effective marginal rate at the federal level will be in the range of 28% to 33% for individuals, and 34% for corporations. (State taxes typically can add about 5% more). If Canada's top marginal rates and overall income tax burden stay significantly higher, we risk not being able to compete. We also risk driving numerous skilled and productive Canadians out of the country.

Small Business

Small incorporated businesses make important contributions to Canada's economic development and to employment, but they suffer special disadvantages in raising equity capital. While our proposals for a single flat corporate tax may mean an increase in tax for some of these companies, there are compensating factors in our package to help the operators of small businesses. For example, the effective tax rate paid by most small business owners should drop, since their maximum personal income tax rate would be cut to 35%. We have also proposed a fully compensating dividend tax credit mechanism that would eliminate double taxation.

Accordingly, we conclude that

- **Government should permit small, incorporated businesses the option of being treated like partnerships for tax purposes. This would allow both the income and the losses of such companies to flow directly through to shareholders, thus promoting investment, risk-taking, and investment.**

- **Our proposals may cause a modest rise in the rate of tax on undistributed corporate income for small Canadian-controlled private companies. We advise giving such corporations more favourable treatment for their retained earnings, up to a maximum annual amount during a transitional period.**

4. OTHER ISSUES

A number of other important issues -- not related to tax rates or the base -- need to be considered.

Adjusting for Inflation

Inflation can seriously affect the tax system, both for businesses and individuals. A recent Brookings Institute study, commenting on conditions in the United States, notes that:

> Among the most serious defects of the tax system are those that arise from its interaction with inflation. If a tax system is based on values unadjusted for inflation, it produces inequity ... But it also causes inefficiency by distorting economic decisions; and it adds to complexity by promoting transactions either to escape, or to capitalize on, the effects of inflation.

For individuals, inflation can give rise to the well-known problem of "bracket creep." As inflation drives up nominal income, it pushes people into higher tax brackets even though their real income has not changed. In the case of some low-income households, it can actually move them from a non-taxpaying to a taxpaying position.

Accordingly, we conclude that

- **In the long run, indexing personal tax brackets and exemptions is the fair way to deal with losses in the purchasing power of people's money.**

- **With regard to corporate taxable income, the impact of inflation should be taken into account. However, with present low levels of inflation, this can probably be achieved best with appropriate ad hoc measures rather than wholesale indexing of the system.**

The Taxation of Irregular Income Flows

The amount of personal tax liability should not vary as a result of the timing of revenues earned. There should be no tax penalty, as there is at present, on people whose income rises and falls.

Accordingly, we conclude that

- **The personal tax system should be neutral as to when a taxpayer receives income. Government should put in place an efficient income-averaging system.**

Improving Tax Compliance

High rates, complex tax provisions, and an obsolete system of transaction taxes tend to promote activity in the "underground economy." An improved system would induce people to comply with the rules and make it easier for revenue authorities to enforce tax statutes.

Accordingly, we conclude that

- **Government should target those who now illegally evade paying their appropriate tax. We believe that better compliance will follow if the federal government puts in place the package of reforms we advocate in this paper.**

The Tax and Transfer System

High marginal tax rates also have adverse effects on the poor. Social assistance recipients can face implicit marginal tax rates in excess of 100%. So-called "tax back" arrangements for social assistance programs cut payments as earnings increase. In some cases they can result in recipients' losing more through taxes, lost support payments and benefits-in-kind than they earn in extra income. This dramatically reduces incentives to seek entry into the official labour market and promotes involvement in the underground economy.

Accordingly, we conclude that

- **Methods of lowering the high implicit marginal tax rates many social assistance recipients face when they start to earn income must be examined. They should be provided with positive incentives to join the labour market.**

A Shared Tax System: Harmonizing Federal and Provincial Taxes

The Business Council recognizes that comprehensive tax reform requires not only improved tax policies at the federal level but also the involvement of the provinces. Far more than countries such as the United States, the United Kingdom and Japan, who are our major trading partners, we operate with a shared, decentralized tax system. This is clearly indicated by the fact that our provinces and municipalities receive about half of all tax revenue collected, while the income tax base for individuals and corporations is largely defined by the federal government.

This structure requires us to concentrate more on harmonizing our tax regimes. For example, having a generally agreed definition of income is crucial to encourage businesses to operate across provincial boundaries, while a cornerstone of our tax reform proposals -- a maximum personal and corporate income tax rate of 35% -- is unachievable without the cooperation of the provinces.

Cooperation does not require complete uniformity of tax systems. In some areas such as pensions or stock savings plans, there can be considerable flexibility. However, in preparing for tax reform, several important issues will have to be addressed including: provincial discretion to tailor tax policies to local circumstances, ensuring stable government revenues, and promoting regional economies.

One significant area of taxation where inter-governmental cooperation would be particularly effective in reducing complexities is in the field of transaction taxes.

TOWARDS A NEW COMPREHENSIVE TRANSACTION TAX

The third major set of taxes in our review -- after personal and corporate income taxes -- are transaction taxes.

Why a Transaction Tax?

In recent decades, Ottawa and the provinces have taken a rising share of total tax revenue by taxing income directly. Less has come from indirect (expenditure) sources such as excise duties and sales taxes.

When income is taxed, people tend to spend rather than save -- because both the income from which savings are made and the return on these savings are taxed. This dampens investment and discourages risk-taking, with the result that we become less efficient and lose jobs.

Ottawa must promote investment at the same time as it finds ways to finance Canada's large and costly public sector, ways that do not stifle growth and leave us unable to compete. In part, we can do this by moving to an integrated and comprehensive tax in each area, and by shifting the weight of taxation more towards expenditure.

Federal and Provincial Sales Taxes

Canada and the provinces employ a mix of complex and overlapping transaction taxes. Some of them are obsolete and their overall impact can be perverse. The Federal Sales Tax has been called "a fiscal relic of the 1920s." At the national level, the tax clearly damages domestic production and employment. It frequently discriminates against domestic producers by taxing them more than foreign ones. It therefore raises Canadian production costs and dampens market efficiency.

In addition, the consumer is not readily aware of the Federal Sales Tax. In contrast with provincial retail sales taxes, it is a "hidden tax." Complicated and costly to administer, it is often based on subjective notional values. Exemptions include a wide variety of items, such as foods, prescriptions and most services. Definitions of exemptions can be complex and questionable.

Accordingly, we conclude that

- **Canada should adopt a new comprehensive and more effective transaction tax. In the longer term, this should replace not only the present federal and provincial sales taxes, but could also replace a multitude of other indirect taxes which add to business costs -- such as business property taxes, capital taxes, and perhaps even premiums for workers' compensation and unemployment insurance.**

- **This new full scale transaction tax should replace any revenue losses resulting from the personal and corporate income tax changes advocated in this paper.**

- An ideal transaction tax should combine the whole range of federal and provincial transaction (manufacturers' and retail sales) taxes into one transaction tax with a flat rate. This would require consultation and agreement between the federal and provincial governments.
- The tax should be as broadly based as possible, applying to virtually all goods and services sold in domestic markets.
- The tax should be set at a level which will re-establish a more appropriate balance between revenues raised from the income and transaction tax system.
- There should be no variations in tax rates based on classes of goods or services.
- The tax should be based on actual prices and, in its final calculation, on selling prices to consumers. If it is collected in stages during production and distribution, it should be fully offset against the tax on sales or immediately refunded to the business.
- To insulate low-income Canadians from the higher tax burden resulting from expanded transaction taxes, there should be a selective tax credit system in place.
- To enhance Canada's economic efficiency, the tax should be structured so that it does not increase business input costs.
- To promote accountability, the government should disclose the real amount of tax to those who bear the final cost.

CONCLUSIONS

The Canadian tax system is deeply flawed. Developed over decades in an ad hoc manner, the tax system cannot meet many of the key objectives assigned to it. The time has come for a major overhaul.

The Business Council believes that the overhaul will be assisted by the principles presented in this paper. From these we developed a reform strategy which we urge the federal and provincial governments to consider adopting. We recommend that governments lower marginal tax rates, broaden the tax base, integrate the corporate and personal income tax systems, and shift the burden of taxation from income to expenditure. In addition, our tax system must be kept compatible and competitive with those of our major trading partners, especially the United States.

Our proposals are part of a revenue-neutral policy framework. They are, as we believe tax reform must be, part of a package with costs in one area carefully balanced against benefits elsewhere. Many of our proposals are not designed to stand alone. Therefore our recommendations should be considered only within the context of our total reform package.

The challenge of tax reform in Canada must be to strive for the betterment of individual Canadians. This can be done by creating a sounder, market-driven economy with more incentives for risk taking and effort and increased opportunities for employment and growth.

We are pleased to note that the Business Council's views and conclusions are largely consistent with the guidelines tabled in the House of Commons by the Minister of Finance on October 23, 1986. The Minister has given Canadians an unequivocal signal of his resolve to proceed with comprehensive tax reform. We hope that this initiative will move forward in an atmosphere of dispassionate and constructive debate. The final outcome must be a system that has the respect and confidence of Canadians -- a system that combines the virtues of fairness with those of efficiency.