TAXATION POLICY REFORM IN CANADA

A Report of the Task Force on Taxation Policy
of the Business Council on National Issues

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TABLE OF CONTENTS

Page

SUMMARY OF RECOMMENDATIONS i

INTRODUCTION

- Outline of Paper 2
- An Overview of the Tax System 4
- A Failing Tax System 12
- A Shared Tax System 14
- The Need for Change 15

Chapter 1 A POLICY FRAMEWORK FOR TAX REFORM 17

- Basic Principles 18
- Design Features 22

Chapter 2 PERSONAL AND CORPORATE INCOME TAX POLICIES 32

- **The Personal and Corporate Income Tax Systems: Key Issues** 34

- **The Tax Base** 36
  - **A. The Personal Tax Base** 36
  - Tax Expenditures and the Integrity of the Tax Base 37
  - Treatment of Capital Gains 40
  - **B. The Corporate Tax Base** 41
  - The Integrity of the Base 42
  - Capital Cost Allowances 43
  - Treatment of Losses 44
  - **C. Integration of the Personal and Corporate Tax Systems** 46

- **Tax Rate Structures** 47
  - The Effects of Past Rate Reductions 48
  - Tax Changes in the United States 49
  - Proposals for Canada 50

- **Other Issues** 52
  - Adjusting for Inflation 53
  - The Taxation of Irregular Income Flows 54
  - Improving Tax Compliance 54
  - The Tax and Transfer Systems 55

Page

Chapter 3 TRANSACTION TAXES 56

- Transaction Taxes: Federal and Provincial Sales Taxes 57

- Toward a New Comprehensive Transaction Tax 60

CONCLUSIONS 64

APPENDICES 1. COMPARISON OF PERSONAL TAX BASES 66

2. COMPARISON OF CORPORATE TAX BASES 70

3. SUMMARY OF TAX REFORM PROPOSALS IN THE UNITED STATES 76

4. THE EFFECTS OF TAX RATE REDUCTIONS IN THE UNITED STATES AND CANADA 80

FOOTNOTES 85

SUMMARY OF MAJOR RECOMMENDATIONS Page

Introduction

o Outline of the Paper

- Tax policy changes should be made against the backdrop of a clear, coherent policy framework that sets forth key assumptions and objectives which then guide individual policy choices and decisions. 2

- Our policy recommendations are part of a package which taken together are designed to be "revenue-neutral" -- raising neither more nor less revenue than the present tax system. 3

- This package of suggested reforms contains four principal elements:

  (i) income tax rates for individuals and for corporations should be significantly reduced, providing tax savings to virtually all Canadians but with particular emphasis on cutting the higher marginal rates endured by both the top-bracket taxpayers and low-income Canadians. 3

  (ii) as marginal tax rates are lowered, the personal and corporate income tax bases should be broadened; 4

  (iii) there should be a full harmonization of the corporate and personal income tax systems; 4

  (iv) greater reliance should be placed on transaction taxes to raise government revenues. 4

Chapter 1 A Policy Framework for Tax Reform

o Fundamental Principles

1. **The primary purpose of the tax system should be to raise the revenues necessary** to finance the provision of public services for the people of Canada. 18

2. **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. 19

3. **The Canadian tax system must remain internationally compatible and competitive** in order to promote greater economic efficiency and growth. 20

4. **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. 21

o Design Features

1. **The tax system should be stable and based upon an integrated and cohesive policy framework.** 23

2. **The tax system should be balanced** and avoid excessive reliance on any one area of taxation. 23

3. **The burden of taxation should be shifted away from income and towards expenditure.** 24

4. **There should not be "double taxation".** The total tax paid on a particular income stream should not vary solely as a result of the manner in which the income is earned and flows to its ultimate owner. 25

5. **The tax system should be designed to eliminate hidden taxes,** so as to reduce the inevitable distortions they create in the economy, and to let people know how much tax they are paying. 27

6. **The tax system should be designed to be administratively efficient and consistently applied** in order to facilitate public understanding and compliance. 27

7. **The base of taxation should be broad and comprehensive** with the minimum number of special incentives, exemptions, deductions, concessions and credits so as to avoid costly distortions in the economy and ensure that taxpayers and firms in similar circumstances face similar tax liabilities. 28

8. **Personal income taxation should be progressive, but top marginal tax rates should be kept as low as possible.** Marginal rates should not be allowed to increase so steeply, or to reach such high levels, as to impair individual initiative, risk-taking, productivity improvement and capital formation. 29

9. **The corporate tax rate should be roughly equivalent to the top rate of personal income tax.** This is required to achieve an efficient integration of the personal and corporate tax systems and to contribute to simplicity and the avoidance of abuse. 30

10. **The tax system should not penalize taxpayers, nor provide the government with windfall gains as a result of inflation.** 30

11. **Neither the corporate nor the personal tax system should penalize those receiving irregular or varying income flows.** 31

12. **There should be the closest possible co-ordination of the tax policies of the federal and provincial governments.** 31

Chapter 2 Personal and Corporate Income Tax Policies

A. The Personal Tax Base

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. 37

o Tax Expenditures and the Integrity of the Tax Base

- The entire panoply of tax exemptions, deductions, shelters, concessions, and incentives, should be reviewed to determine whether they are producing benefits sufficient to justify their costs and if the delivery mechanisms currently being used are the most appropriate. Tax measures which do not meet these criteria should be eliminated or phased out. 38

- The method of delivering tax expenditures should be examined to ensure that effective progressivity and cost effectiveness are built into the system through capping benefits, imposing fixed percentage tax credits, or utilizing "clawback" mechanisms. 38

- Generally, the delivery of government relief and incentive programs should be divorced from the system of taxation. To the greatest extent possible, the tax system should be neutral -- it should not selectively influence economic decisions or behaviour. However, it must be accepted that in some instances tax credits or other relief can be an effective and equitable means to providing benefits to well defined groups, primarily for social policy reasons. 39

o Treatment of Capital Gains

- The Business Council supports the important objectives of encouraging entrepreneurship and risk-taking which the federal government is attempting to achieve with the $500,000 lifetime capital gains exemption. However, with the implementation of the more fundamental reforms we are urging and subject to allowing for inflation adjustments to the cost base of assets, in the long term 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. 40

B. The Corporate Tax Base

- Corporate taxes should continue to be assessed on the basis of income but with significant restructuring of the present system. 42

o Integrity of the Base

- Reform of the corporate tax system should aim to achieve increased neutrality -- it should not selectively influence economic decision-making -- and encourage business to rely more on market forces. 42

- Many existing exemptions, deductions, concessions, incentives and credits in the corporate tax system should be removed or cut back, and greater equality should be maintained in the application of others. 42

- The achievement of neutrality, together with other policies recommended in this report, will help to attain the necessary goal of ensuring that our major industries operate within a tax environment which allows them to be competitive with Canada's major trading partners. 42

- A concerted effort should be made by the federal and provincial governments to rationalize the taxation systems applicable to resource industries. Such a tax framework should continue to recognize the special high costs and risks associated with resource exploration and development, and at the same time should reduce the distortions now caused by taxes and royalties levied on gross revenues. 43

o Capital Cost Allowances

- To the extent that existing distortions are removed from the tax system and corporate rates are significantly reduced, it may be possible to modify the system of capital cost allowances to make certain that its rates conform somewhat more closely to actual rates of capital consumption, recognizing that a degree of accelerated allowance is required to partially offset inflation, technological obsolescence, and higher Canadian capital costs. In addition, the system of capital cost allowances should be changed so that the same set of rates apply to all industries in order to be more equitable in encouraging investments throughout the private sector. 43

o Treatment of Losses and Corporate Reorganizations

- In order to reduce the present bias of the tax system against risk-taking, there should be an expansion of corporate "loss flow through" provisions so that losses can be transferred among members of a corporate group. 44

- 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. 45

- Small incorporated businesses should be permitted the option of being treated as partnerships for tax purposes, thus allowing both income and losses to flow directly through to shareholders. 45

C. **Integration of the Personal and Corporate Tax Systems**

- The total tax paid on income earned through the operations of a corporation should not exceed that which would have to be paid if the same income were earned directly by an individual. 46

- Income that is subject to tax at the corporate level should give rise to a full offsetting credit for such taxes paid when the income (dividends) is passed on to shareholders. 46

o Tax Rate Structures

- The cornerstone of sound tax reform is a general lowering of tax rates and an expansion of the tax bases for both individuals and corporations. 47

- The maximum income tax rates under the personal and corporate tax systems should be essentially equal and the personal and corporate tax systems should be integrated to the greatest extent possible. 47

- To be equitable, personal income taxation should continue to be progressive, i.e. the average rate of taxation should rise with income, but the rate structure should be moderated to provide relief to all Canadian taxpayers. 47

- Ideally, the top personal income tax rate should not exceed 35%, including both federal and provincial portions of the tax. 51

- Recognizing that the proposed changes could cause a modest increase in the rate of tax on retained earnings for small Canadian-controlled private companies, more favourable treatment should be accorded during a transition period to the retained earnings of such corporations up to a maximum annual amount. 51

Other Issues

o Adjusting for Inflation

- The preferred way to deal with inflation in the area of personal income taxation is to index tax brackets and exemptions to recognize the loss in the purchasing power of money. There should also be an appropriate recognition of the impact of inflation on corporate taxable income. However, with relatively low rates of inflation, ad hoc measures are probably sufficient. 53

o The Taxation of Irregular Income Flows

- The personal tax system should be neutral as to the timing of the receipt of income. An efficient income-averaging system should be implemented. 54

o Improving Tax Compliance

- Tax compliance and the smooth functioning of the revenue system should be improved. This would follow from the implementation of the package of reforms advocated in this paper. 54

o The Tax and Transfer Systems

- A system is needed in which social assistance recipients are encouraged to earn additional income and to join the official labour market. This may involve measures to lower the implicit marginal tax rate such individuals face when they start to earn income by better integrating the tapering-off of support programs with tax rates. 54

Chapter 3 Transaction Taxes

o Toward a New Comprehensive Transaction Tax

- To promote international competitiveness, a transaction tax could replace not only the present federal and provincial sales taxes, but also 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. 60

- A new comprehensive transaction tax should be used to replace any revenue losses resulting from implementing the personal and corporate income tax changes advocated in this paper. 60

- The range of federal and provincial transaction (manufacturers' and retail sales) taxes should be consolidated into one comprehensive and uniform flat rate transaction-based tax. 62

- The tax should be as broadly based as possible applying to virtually all goods and services sold in domestic markets. 63

- The tax should be set at a level which will re-establish a more appropriate balance between the revenues raised from the income and transaction tax systems.

63

- Variations in tax rates based on the class of goods or services should be avoided. 63

- The tax should be based on actual prices and in its final calculation, on selling prices to consumers. This would not preclude the tax from being collected in stages through the production and distribution process, but taxes paid on inputs should be offset against tax owing or immediately refunded. 63

- To avoid having the tax injure those in the lowest income categories, a system of selective tax credits should be implemented. 63

- To enhance Canada's economic efficiency, the tax should be structured so that it does not increase business input costs. 63

- To promote accountability, the tax should be disclosed to those who finally pay it. 63

INTRODUCTION

"Taxes are what we pay for a civilized society."

Oliver Wendell Holmes, Jr.

In recent years citizens have become increasingly frustrated by a tax system which they perceive as burdensome, difficult to understand, and in many respects unfair. At the same time, growing numbers of business people have become aware that the current tax system often undermines entrepreneurship, competitiveness and economic efficiency. Concern with taxation is not unique to Canada. Similar opinions are widely held in the United States, Britain, continental Europe, Australia and New Zealand, and have resulted in changes, or proposals for change, which promise to reform fundamentally many of these taxation systems. Indeed, the United States, Canada's closest economic partner, is currently in the midst of a massive overhaul of its tax rules involving a broader tax base and sharply lower tax rates. This will have major implications for Canadian tax and economic policies.

The Business Council welcomes recent federal government plans for a comprehensive review of the Canadian tax system.[1] Such a searching appraisal is badly needed, and should lead to proposals for reform that command broad support throughout the country. In order to participate constructively in the national debate on tax policy issues, the Business Council decided to establish a Task Force on Taxation Policy in early 1985. The Task Force's mandate was to prepare a taxation policy framework and a set of general policy proposals for Canada. This paper represents the fulfillment of those objectives. **The purpose of the policy framework is not to offer detailed recommendations on every aspect of the tax system, but instead to articulate an integrated set of principles and policy directions against which specific reform proposals can be assessed and evaluated.** In addition, the paper offers a number of general policy recommendations in various areas illustrating the direction we believe the tax system must move in the years ahead if Canada is to maintain or improve its position in the increasingly competitive global economy.

Outline of the Paper

- The introduction describes some of the most important characteristics of, and problems with, the existing Canadian tax system.
- Chapter one provides a general framework for tax reform in Canada, including a discussion of key principles and tax system design features which we believe should be adopted.
- Chapter two focuses on the current personal and corporate income tax systems, and argues for fundamental changes in both -- including lower rates and a broader base -- in accordance with the principles and ideas developed in the preceding chapter.
- Chapter three consists of a brief treatment of the role and desirability of transaction taxes.
- The conclusion presents a few final comments and restates the major policy recommendations.
- Four appendices address technical questions not discussed in detail in the body of the paper.

We wish to make an important point at the outset concerning the linkage between tax policy and the broader subject of fiscal policy and the deficit in

Canada. Changes in taxation policy can have a significant impact on government finances, and thus have obvious implications for fiscal policy and government deficits at both the federal and provincial levels. The policy framework ideas and the more specific policy recommendations put forward in this paper have not been "costed" in a precise way. However, the proposals, taken together, are designed to be "revenue-neutral." In other words, they are not intended to result in a reduction or increase in the total tax receipts of governments.

There are many in Canada, including most of the business community, who believe the overall tax burden facing Canadians is excessive. The Business Council shares this concern. We have a large and expensive public sector whose current costs already significantly exceed aggregate government revenues. While this issue is important it is deliberately not addressed in these proposals. Given this, the vital question becomes how to pay for government programs and services with the least damage to the fundamental elements from which a prosperous, efficient, and flexible economy can be constructed. This is the challenge which lies at the heart of both tax policy reform and this Business Council Task Force Report.

As outlined in the next three chapters, the Business Council supports a major overhaul of the current Canadian tax system. The package of suggested reforms put forward in this paper contains four principal elements.

- **Income tax rates for individuals and for corporations should be significantly reduced, providing tax savings to virtually all Canadians but with particular emphasis on cutting the higher marginal rates endured by both the top-bracket taxpayers and low-income Canadians.**

- At the same time as marginal tax rates are lowered, the personal and corporate income tax bases should be broadened through the reduction or elimination of a large number of existing tax deductions, exemptions, tax shelters and incentives, so as to achieve a more efficient economy and greater potential for all Canadians.

- There should be a full harmonization of the corporate and personal income tax systems to avoid tax-induced unfairnesses and distortions.

- In order to make the tax system as a whole more efficient and to encourage saving and investment that will benefit all Canadians, we should raise a greater portion of government revenues from taxes on transactions and less from taxes on incomes. Even with the present income tax system, some effort should be made to move the tax more towards a consumption base by allowing increased deductions for personal savings.

Most importantly, we believe that all tax policy changes should be made against the backdrop of a clear, coherent policy framework that sets forth key assumptions and objectives to guide individual policy choices and decisions.

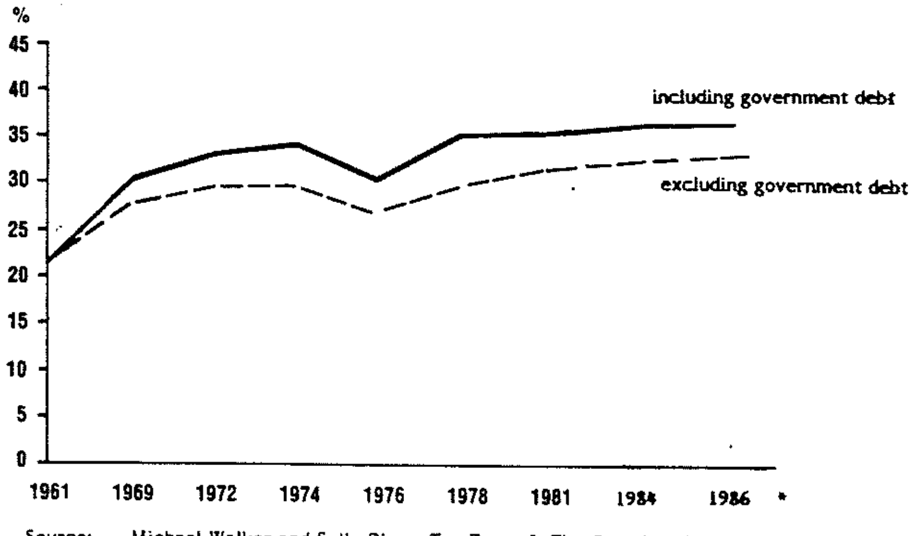
An Overview of the Tax System

Over the past two decades, Canadians have witnessed a substantial increase in their total tax burden. From 1961 to 1986 the average family's combined total federal and provincial tax rate increased from 22% to over 32%[2] as shown in Chart 1 on page 5. During the same period, the proportion of Gross National

Product (GNP) accounted for by the government sector rose from less than 31% to nearly 48%. The increasing difference between what government spent and what it collected in taxes was accounted for in part by increases in direct charges for goods and services provided by government, but mainly by rising deficits. Since deficits can be regarded as a form of deferred taxation,[3] they should be included in any measure of the long-term tax burden borne by Canadians. Making this adjustment, the average Canadian family's total tax rate grew by more than one-and-a-half times from 1961 to 1986 from 22% to nearly 36%[4] as indicated in Chart 1. Even this figure underestimates the real burden imposed by governments on individuals, since it does not reflect fully the economic costs of the misallocation of resources and effort inherent in our present tax and regulatory structures.

CHART 1

The Average Canadian Family's Total Tax Rate



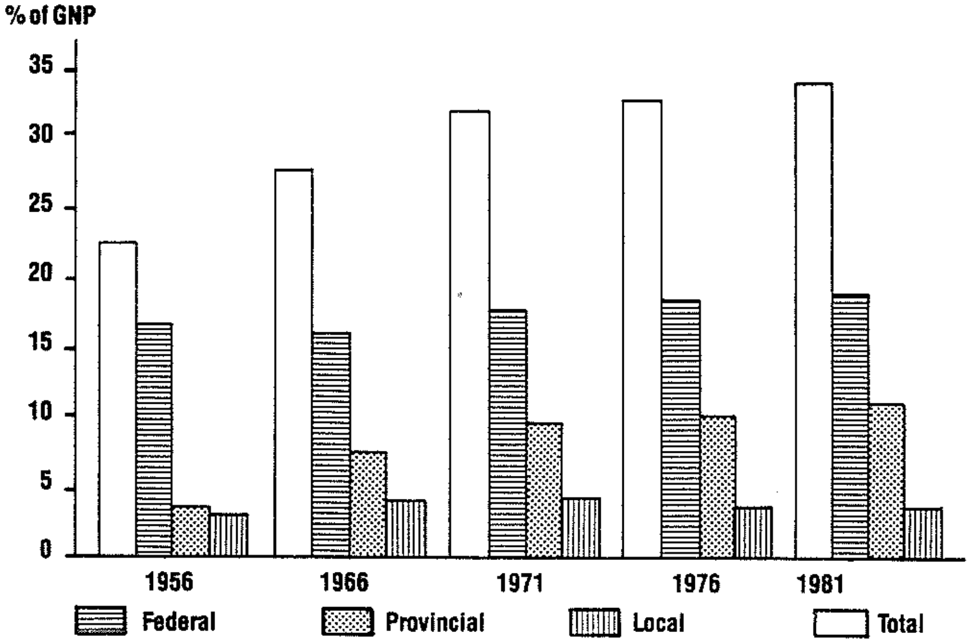
Source: Michael Walker and Sally Pipes, Tax Facts 5: The Canadian Consumer Index and You (Vancouver: Fraser Institute, 1986) p. 57.

* Estimate

Chart 2 summarizes the growth of taxes in Canada between 1956 and 1981. By the early 1980s, taxes accounted for one-third of GNP, with government deficits amounting to approximately another 10% by the time the 1981-82 recession took hold. The federal government's tax revenues as a proportion of GNP have risen modestly since the 1950s, while local government revenues have remained basically flat. The sharpest increase has been in provincial government taxes, which more than tripled as a share of GNP. This development was associated with expanding government provision of education and health services, both of which lie mainly within provincial jurisdiction (although the national government is also involved in funding programs in these areas) and with changes in tax rental and sharing agreements. These changes led participating provinces to impose their own taxes directly instead of receiving a portion of federal taxes, as under the previous rental arrangements. However, in most cases the federal government continued to administer the collection.

CHART 2

Total Taxes by Level of Government as a Share of GNP

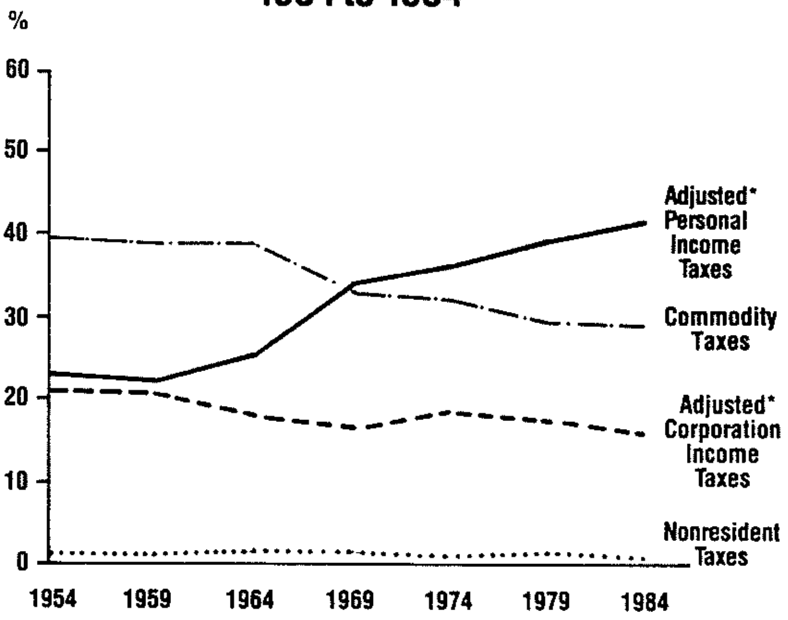


Source: Robin Boadway and Harry Kitchen, Canadian Tax Policy, 2nd Edition (Toronto: Canadian Tax Foundation, 1984), p.2.

Chart 3 shows the extent to which all governments have relied on just a few taxes for a large proportion of their tax revenues. Note, in particular, the increasing contribution from personal income tax which has become the biggest single revenue source. Although corporate income tax has contributed a smaller percentage of all taxes over this period, it would be incorrect to assume that corporations are not carrying a substantial burden of taxation.

CHART 3

Major Taxes as a Percentage of All Taxes (all levels of government) 1954 to 1984



Source: Statistics Canada, National Income and Expenditure Accounts, Catalogue nos. 13-531, 13-201, and 13-001 (various issues).

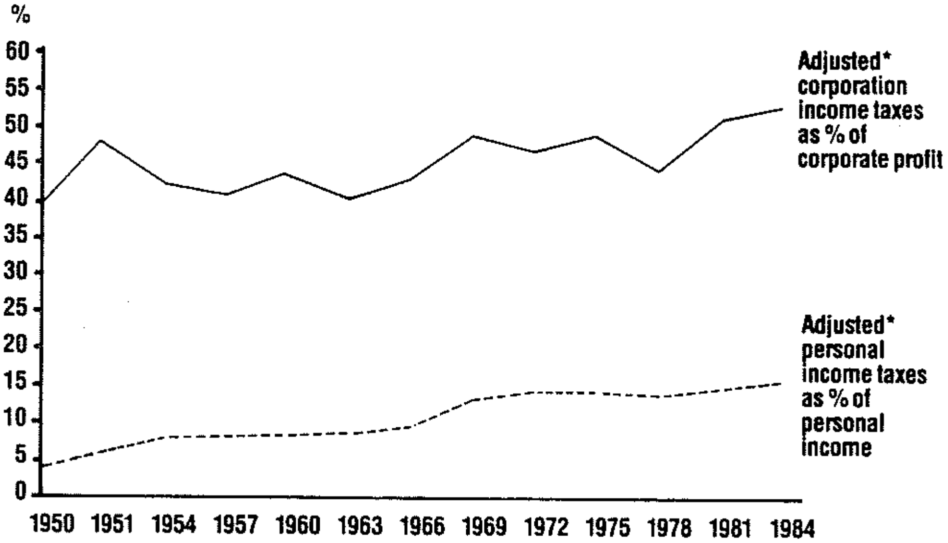
*Personal income taxes include C.P.P., U.I., and Q.P.P.

*Corporation income taxes include C.P.P., U.I., and Q.P.P., and exclude P.G.R.T. and I.O.R.T. on petroleum companies

As indicated in Chart 4, in 1984 corporations paid 53% of their profits in income taxes -- adjusted to include unemployment insurance levies (U.I.) and Canada and Québec Pension Plan Contributions (C.P.P. and Q.P.P.) -- while individuals paid 15% of their income in personal incomes taxes -- similarly adjusted to include U.I., C.P.P, and Q.P.P. payments. Corporations tended to pay a gradually increasing percentage of tax from 1950 to 1984, rising from 40% to 53%. During the same period, personal income taxes remained at a significantly lower level but rose even faster as a proportion of income, from below 5% to 15%. There are two principal reasons for the apparent contradiction between corporations paying ever larger shares of their income in tax (more than four times the share paid by individuals) yet accounting for a decreasing percentage of all taxes, and conversely, for personal income taxes accounting for dramatically larger proportions of total tax.

CHART 4

Personal Income and Corporate Profits and the Relationship Between Taxes and Tax Bases 1950-1984



Source: Statistics Canada, National Income and Expenditure Accounts, Catalogue nos. 13-531, 13-201, and 13-001 (various issues) as cited in David B. Perry, "Fiscal Figures", Canadian Tax Journal, Vol. 34, No. 2, (March – April 1986).

*Personal income taxes include C.P.P., U.I., and Q.P.P.

*Corporation income taxes include C.P.P., U.I., and Q.P.P., and exclude P.G.R.T. and I.O.R.T. on petroleum companies

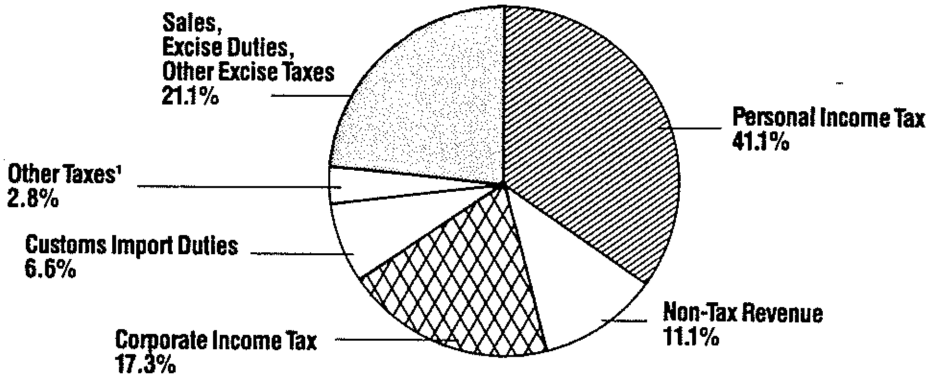
The first explanation is that while personal income increased rapidly as a proportion of GNP, from 77% in 1950 to 86% in 1984, corporate income fell from 14% of GNP to somewhat over 9%, with a low of just under 6% in 1982. The second reason is that personal taxes are derived from a progressive rate schedule, thus the rising personal incomes yielded disproportionately higher increases in tax revenues. On the other hand, corporate income is taxed at a flat rate and produced tax revenues proportionate to corporate income.[5]

Taking the federal government alone, personal and corporate income taxes combined have provided well over half of total revenues. Chart 5 on page 10 compares the sources of federal revenue in 1970 and 1985. Once again, the biggest increase has been in personal income tax.

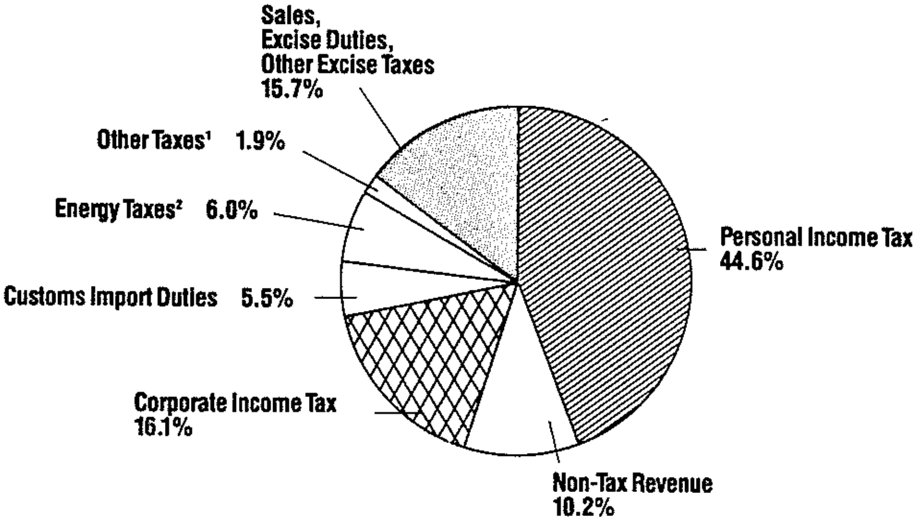
It is also interesting to consider briefly the relative burden of taxation in Canada and other developed industrial countries. Comparing the total tax burden, Canada ranks near the middle among the countries of the Organization for Economic Co-operation and Development (OECD). In the early 1980s taxes (inclusive of social security charges) accounted for about 35% of Canada's gross domestic product. In several Western European countries the comparable figure is considerably higher, which indicates that Canadians are by no means the most heavily taxed people in the industrialized world. However, it is worrisome to note that Canada's two largest trading partners impose smaller total tax burdens on their economies than does Canada: in the same period taxes accounted for 30.5% of gross domestic produce in the United States and 27.2% in Japan. This is illustrated in Chart 6 on page 11, which also shows that Canada has a higher level of government deficit to GNP than any of our major trading partners. While such an aggregate measure of taxation does not in itself provide an adequate basis for determining a country's international economic competitiveness, it does provide a rough

CHART 5

Tax and Non-Tax Revenue as a Share of Federal Revenue (per cent of federal revenue) 1970



1985



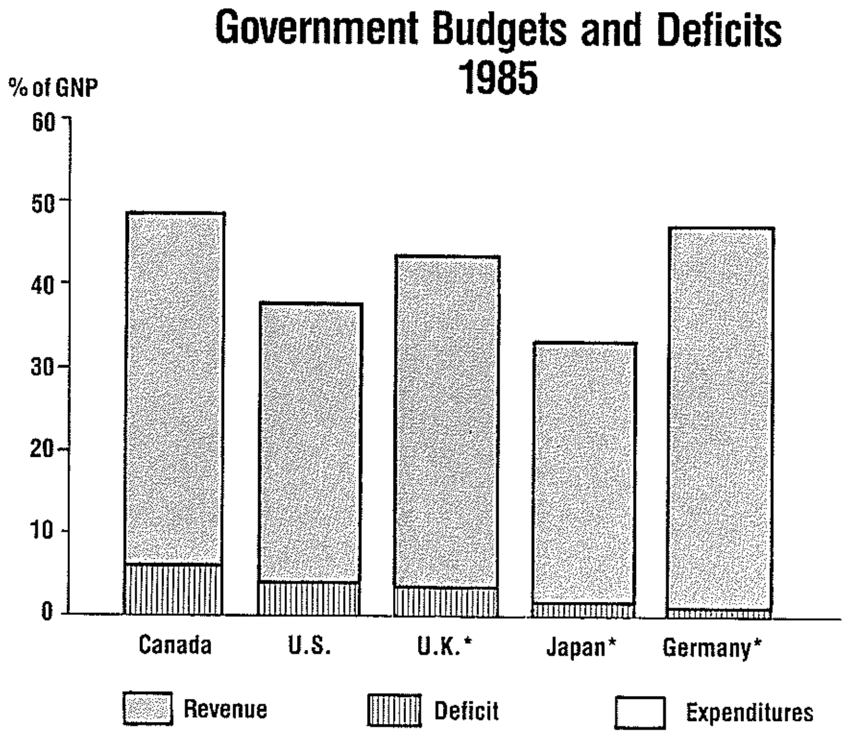
Notes:

[1] Includes non-resident taxes (1970 = 2.0%, 1985 = 1.6%) and estate taxes (1970 = 0.8%, 1985 = 0%)
[2] Energy taxes = PGRT + IORT + gasoline excise + oil export charge

Source: The National Finances 1971-72, Canadian Tax Foundation p.22
The National Finances 1984-85, Canadian Tax Foundation p.81

indication of the burden being imposed on the economy through public sector taxation. It should also be recognized that Canada raises a larger portion of its tax revenues through direct taxes on income and less through direct transaction taxes on consumption than do many western European countries. As discussed later, this situation has implications for the international competitiveness of Canadian industry.

CHART 6



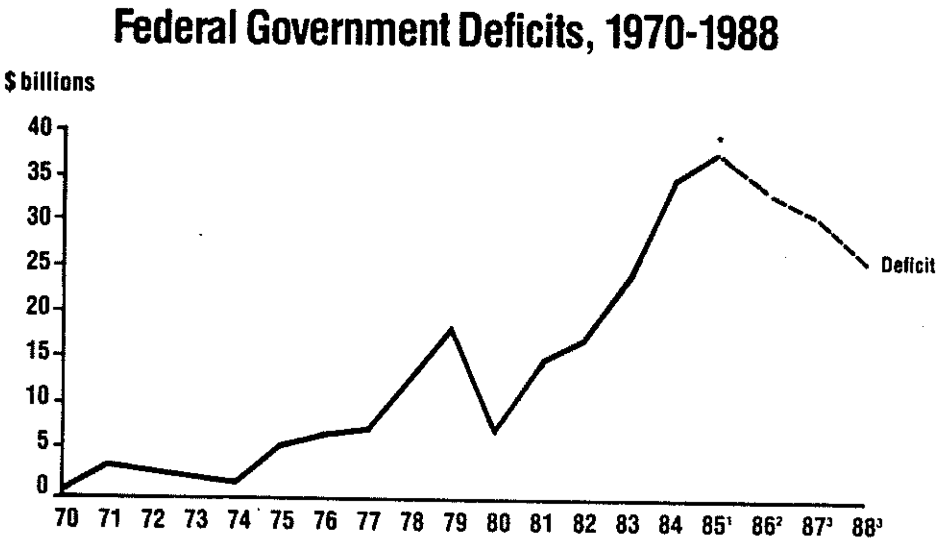
*Estimates based upon partial data

Source: Econoscope, The Royal Bank of Canada, May 1986, p.5

A Failing Tax System

High taxes and large government deficits raise issues concerning the size and role of government in society. They also indicate that our tax structure has failed in its primary purpose of raising sufficient revenue to finance the operations of government. Chart 7 clearly shows the acceleration of this failure in the first half of the 1980s. The projected improvement for the latter half remains to be achieved. The present substantial deficits of governments,

CHART 7



*Fiscal projections for 1986-88 incorporate certain accounting changes recommended by the Auditor General, and are not entirely consistent with earlier data

Source: Economic Review, April 1985 Department of Finance, Canada. p.128

Federal Budget, 1986, Department of Finance, Canada, The Fiscal Plan

[1] Actual [2] Preliminary estimate [3] Forecast

together with the growing complexity of the tax system, mean that the true cost burden of government has become hidden and its distribution arbitrary and unclear. There is a saying that "an old tax is a good tax," the thought being that old taxes have worked their way into the structure of the economy and those affected have made the appropriate adjustments in their behaviour and expectations. But some of Canada's old taxes are not good taxes. Indeed, there is growing evidence that many of our existing taxes take more -- directly and indirectly -- out of the pockets of taxpayers than they add to the coffers of government, in large part because they impair economic efficiency.

For example, studies of the income tax system in the United States conducted by Edgar Browning[6] and John Shoven[7] have concluded that during the 1970s, the marginal cost to the economy of collecting one extra dollar via the U.S. progressive income tax system was between $1.50 and $1.70. A more recent study reported that to provide a grant to the less well-off two-fifths of the population would involve a loss to the economy of $3.50 for every dollar redistributed.[8] In other words, in order to provide a needy person with $1.00 of assistance, people had to be taxed at least $3.50, considering both direct and indirect costs. Another example is Canada's ever-rising federal manufacturers' sales tax, which has harmed the competitive position of Canadian industry and, as a result, reduced employment opportunities for many Canadians.[9]

It is impossible to know exactly all the consequences of high levels of taxation. However, it is clear that rising income taxes pose serious risks for a medium-sized, open economy such as Canada's, particularly since tax rates are already high in relation to some of our competitors and our economy is facing unprecedented competitive challenges.

A Shared Tax System

It is a fundamental aspect of the Canadian tax structure that it is made up of taxes that are the responsibility of not only the federal government, but of the provinces and municipalities also. Indeed, the provinces and municipalities in the aggregate account for approximately one-half of the total tax revenue collected in Canada, and are responsible for spending more than one-half of all government expenditures. Canada, far more than our major trading partners such as the United States, the United Kingdom and Japan, has a shared, decentralized tax system.

It follows that the provinces and the municipalities have important roles to play in the reform and restructuring of the overall tax system. The provinces largely rely upon the federal government to define the appropriate base for the personal and corporate tax systems, and therefore have a legitimate and immediate interest in any changes that would have an impact on that base. More fundamentally, the provinces, and through them the municipalities, also need to be actively consulted with respect to other important changes in the system, changes which could have both direct and indirect effects on the position of these other levels of government. We believe that this dialogue can be pursued most usefully in the context of an overall policy framework.

The provinces, along with the federal government, must recognize their particular responsibilities to help Canada achieve a more rational and competitive tax system. For example, the provinces must not regard the expanded income base suggested for both individuals and corporations as a means of increasing their aggregate tax revenues. Instead, they should agree to reduce their tax rates, in parallel with the reduction in federal tax rates, as long as the integrity of their revenue base is maintained -- perhaps through mutually agreed-upon federal guarantees. In addition, the provincial and municipal governments should demonstrate their leadership by examining their antiquated systems of real estate assessment and taxation, and their hidden taxes on business inputs that raise the costs, and reduce the competitiveness, of Canadian industry. On the other hand the federal government must demonstrate leadership with respect to reforming at least personal and corporate income taxes, as well as transaction taxes.

The Need for Change

It is vital to recognize that the problems in our present tax system are not merely matters affecting business and those individuals who are well off. These problems have an impact on all Canadians, both directly through the unfairness and perverseness of our present tax structure and, more importantly, indirectly through its reduction in economic growth, job creation, and personal opportunities. The situation requires a new and comprehensive reappraisal of our entire tax structure. The Business Council therefore supports the decision of the Minister of Finance to undertake a review of the entire federal tax structure. We call upon the provinces and other levels of government in Canada to become involved in this process to enable a thorough review to be undertaken of the entire tax structure. We recognize that it is neither possible nor desirable to achieve a total overhaul of our tax system in a short period of time, but we do believe that a comprehensive review, rather than a continuation of ad hoc and piecemeal adjustments, is required so that future changes in our tax system, accompanied by appropriate transitional measures, can be put in place as part of the rationalization of the entire system. Such a comprehensive review is also the only means of reconciling the divergent interests of different groups. It is necessary to demonstrate to those who would lose as a result of particular changes that, through the total package of reforms, they would gain more than they lost.

Chapter 1 A POLICY FRAMEWORK FOR TAX REFORM

> "To tax and to please, no more than to love and be wise, is not given to man."
>
> Edmund Burke

Tax systems, and even more so, tax changes, are complex. This is the result of trying to achieve specific results by applying imprecise tools in a dynamic and only partially understood environment. Not surprisingly, frequently there are unexpected results, while simple ideas often become bogged down in quagmires of complicated rules.

Some of the difficulties inherent in the process could be alleviated by adopting a long-term perspective on the tax system. This chapter outlines the fundamental principles and key design features which the Business Council believes should provide the central policy framework against which proposed improvements to Canada's system of taxation should be measured. In the following chapters these principles, design features, and their implications will be described more fully, together with a more detailed discussion of the rationale for their recommendation and the general policy proposals which flow from them.

Basic Principles

Four fundamental principles should form the foundation for taxation in Canada.

1. **The primary purpose of the tax system should be to raise the revenues necessary to finance the provision of public services for the people of Canada.**

In contrast to this principle, Canada's current tax system is being asked to perform many tasks simultaneously. Besides raising revenue, it is expected to promote economic growth, stimulate employment, foster sectoral development, encourage specific types of investment and activity, reduce regional economic disparities and redistribute income from high- to low-income individuals. The inevitable result is that it performs none of these tasks well.

The solution is to refocus the tax system on its original purpose: the raising of revenue necessary to finance the provision of public services for the people of Canada. Accordingly, other government objectives should be pursued primarily through direct expenditures. However, programs that are broad in application, that dispense small benefits to each recipient, and for which objective criteria (such as income) determine the selection, can be efficiently delivered through the tax system (for example Child Tax Credits). Were the tax system restructured to conform to the above direct expenditure principle, it could be greatly simplified. In addition, through the more visible, direct financing and delivery of government services and programs, the public would have a much better appreciation of the costs and value of the services they were receiving, and political accountability would be enhanced.

2. **The tax system must avoid distorting the normal functioning of market forces in determining rewards for entrepreneurship and work, and in allocating resources within the economy.**

There is increasing concern about the inefficiency of using the tax systems to direct and stimulate economic activity. Selective use of taxation in place of market forces has created inefficiencies, resulted in less dynamic economies, and led to a lower standard of living for many Canadians than would be possible with an efficient tax system.

Among the distortions induced by the present Canadian tax system are: a bias against risk investment, resource misallocations due to the incomplete recognition of inflation, the encouragement of debt financing over equity, the biasing of investment towards particular industries, the favouring of foreign competitors through discrimination in the commodity tax system, and a bias against high cost resource production by taxing production rather than profits.

> "In its broadest form, then, the tax system has a powerful influence on the allocation of resources in our society, and on the extent to which these resources are produced and consumed. This Commission considers it important that the disincentives inherent in the tax system be replaced with measures that will encourage the efficient allocation of productive resources and the adoption of new processes, products and services. In our view, such measures are necessary components of any industrial policy that will enable Canada to meet its strategic objectives. Tax measures, however, are extremely

> complex and sensitive, demanding a great deal of analysis and consultation before policy changes are formally presented in Parliament."
>
> Report, Royal Commission on the Economic Union and Development Prospects for Canada, (Macdonald Commission), Ottawa: Supply and Services, 1985, Volume 2, page 209.

These and other detrimental results have contributed to the less-than-optimum performance of the Canadian economy thereby diminishing the opportunities for all Canadians. A more neutral tax system, one allowing greater scope for the exercise of individual effort and market forces, would be more effective in promoting growth and job creation and the development of both large and small businesses.

3. **The Canadian tax system must strive to be internationally compatible and competitive in order to promote greater economic efficiency, competitiveness and growth.**

Canadian society is characterized by a higher level of government expenditure -- as a percent of GNP -- than, for example, is the United States. This means that Canadians must also accept a generally higher level of taxation. However, it is essential that this be imposed in such a way as to result in the least possible disadvantage to our economy. Under our present tax system this is not the case. An increasingly competitive world economic environment, and the absolute necessity for Canadian producers and entrepreneurs to participate aggressively in world markets, demands that this be corrected. In the interests of all Canadians, the corporate tax system must be internationally compatible and competitive, so as to provide employment opportunities to our growing workforce. Equally, the personal tax system must be adjusted to allow Canada to attract and retain highly skilled and mobile individuals.

These imperatives take on an added urgency in view of the tax reforms now being proposed and implemented abroad. In particular, in the United States pending changes could strengthen the competitiveness of that country, and offer inducements to the most highly skilled members of our labour force to relocate there. Given this environment, Canada cannot afford to retain an outmoded tax system, characterized by high tax rates, a myriad of special exemptions, deductions, concessions, incentives and credits, as well as hidden taxes on business costs which impair competitiveness and impose unnecessary burdens on individuals and businesses.

4. **The tax system must be fair and socially responsive, and promote an environment in which individual Canadians can enjoy the maximum opportunity and incentive to develop and prosper.**

"Fairness" is in large part a subjective concept, but in a discussion of taxation it has particular characteristics which are commonly accepted. The Business Council believes that it is fair for individuals in similar circumstances to pay similar amounts of tax (horizontal equity). We also believe that it is fair for individuals who earn more to pay more tax -- not just in absolute terms but in relative terms as well, i.e. a greater percentage of income (vertical equity). However, apart from these more common characteristics of "fairness," there is also the concern that every Canadian has the right to have the opportunity to make the most of his or her own life. In this sense, a tax system which retards the growth and development of the economy must be seen to be unfair in the fundamental sense that it denies opportunity. The Canadian tax system can and should be reformed so that it both conforms to our standards of fairness and at the same time expands opportunity.

> "The tax system is one of the most important determinants of economic growth over the longer term. When the Royal Commission on Taxation (the Carter Commission) reported in 1966, one of the foremost goals of policy analysts was the establishment of a tax system that was equitable in its treatment of different groups. While equity remains an important goal, tax specialists now stress the need for a system that is calculated to encourage economic efficiency."
>
> Report, Royal Commission on the Economic Union and Development Prospects for Canada, (Macdonald Commission), Ottawa: Supply and Services, 1985, Volume 2, page 206.

Design Features

Consistent with these principles, the Business Council believes that a reformed tax system should incorporate a number of important design features.

1. **The tax system should be stable and based upon an integrated and cohesive policy framework.**

Stability of the tax system is required to promote public confidence and to minimize disruptions in personal and corporate financial planning. To enjoy stability, any reformed structure must have the support of a broad political consensus. This reduces the risk of major revision in the event of changes in the political tide. Without such a consensus, and the resulting confidence it instils, investment, economic growth and opportunity will suffer. For these reasons, changes to the tax system should be based on a widely accepted set of fundamental principles and should be derived from a cohesive policy framework. Generally, implementation should then proceed in an incremental fashion -- with appropriate transitional provisions. However, occasionally it may be necessary to implement more comprehensive changes, for example in response to dramatic shifts in the tax structures of Canada's major trading competitors. In these rare instances where a major realignment of the system is required, it is even more critical that the changes be derived from a cohesive policy framework. Such a well-founded process promotes stability and reduces the tendency towards continual tinkering and rebalancing of the tax system in response to the demands of competing special interests.

2. **The tax system should be balanced and avoid excessive reliance on any one area of taxation.**

The imposition of any particular tax inevitably leads to distortions in the allocation of resources as persons adjust their behaviour to minimize the incidence of the tax. Heavy reliance on a particular revenue source inevitably means that the rates of taxation in that area will be high. This in turn increases the tax-induced distortion of economic behaviour. In order to minimize such distortions, and reduce excessive pressures towards tax avoidance, it is wise to spread taxation across a broad range of revenue sources and activities, and to tax each such revenue source at moderate rates.

3. The burden of taxation should be shifted away from income and towards expenditure.

Just as the taxation of a particular activity distorts the allocation of resources, so too does the taxation of income in itself lead to distortions and a loss of incentive. In some respects, income can be considered as a reflection of one's economic contribution to society. Expenditure often reflects what one removes. In economic terms, the taxation of income tends to drive a "wedge" between the amount firms pay for labour and capital and the return received by the providers of these resources.[10] This "wedge" tends to reduce the levels of saving, investment and activity in the economy. By contrast, taxation of expenditures minimizes such effects [11] and permits the economy to accumulate capital and improve living standards more effectively.

In the present and foreseeable world trading environment, it is crucial that Canada improve its productivity and competitiveness. To accomplish this, market-driven investment must be encouraged. This implies a need to shift the balance of taxation away from income and towards expenditure.

4. **There should not be "double taxation." The total tax paid on a particular income stream should not vary solely as a result of the manner in which the income is earned and flows to its ultimate owner.**

Fairness dictates that income be subjected to a single integrated tax regime between the time it is generated and the time that it becomes available for expenditure. This does not mean that there cannot be a tax on "income" and a separate tax on "consumption" transactions -- only that the tax system should not impose additional taxation on an income stream merely because of its form. In other words, the total tax paid on a particular income stream should not vary solely as a result of the manner in which the stream flows to its ultimate owners and the tax is collected. This "double taxation" issue arises particularly in the taxation of corporate income.

In reality, the burden of any tax ultimately falls on the individual, not on organizations, corporations or things. Corporations and organizations pass on tax burdens to individuals in various ways: to consumers of products or services through higher prices, to the suppliers of labour through lower wages and salaries, or to the suppliers of capital through lower rates of return. Taxing businesses or corporations as if they were isolated entities, disassociated from the economy and the general public, only disguises who bears the ultimate tax burden and tends to reduce political accountability.[12]

> "All taxes are ultimately borne by people through the reduction in the command over goods and services for personal use. Taxes can, of course, be collected not only from people but also from corporations, trusts, and

> cooperatives. But organizations such as these cannot bear taxes. It is the people who work for, sell to, buy from, or are members, beneficiaries, or owners of these legal entities who are made better off or worse off by taxes.
>
> Report, Royal Commission on Taxation, Ottawa: Queen's Printers, 1966, Volume 1, Intro. page 7.

The issue arises when shareholders receive income in the form of dividends from corporations. In a non-distorting, efficient tax system, the same total amount of tax should be collected on profits regardless of whether the individual earned the income directly, or whether a corporation was interposed between the business activity and the receipt of income in the form of dividends.

This is not to say that corporate income should be untaxed until distributed to shareholders. A corporate tax ensures that foreign owners of corporations located in Canada pay their fair share before withdrawing profits. It is also effective in preventing the tax avoidance that occurs when there is an unnecessary buildup of non-reinvested retained earnings within a firm. However, these considerations must not be allowed to hide the fact that the corporate tax is another mechanism for taxing individuals. As such, any corporate tax burden borne by the individual must be equitably acknowledged within the overall taxation framework.

Additionally, as discussed in greater detail later in the paper, sensitivity to international competitive pressures is required when setting corporate tax rates. Canadian business cannot be expected to compete effectively in world markets if they are put in the position of suffering the disadvantage of excessive tax burdens.

5. **The tax system should be designed to eliminate hidden taxes, so as to reduce the inevitable distortions that they create in the economy, and to let people know how much tax they are paying.**

Hidden taxes on business should be eliminated since they raise domestic production costs, resulting in a misallocation of resources within our economy and less-than-optimum output. Canada has a very high level of such taxes, including transaction taxes on business inputs, capital taxes, extra layers of real estate taxes, and other business levies. These place Canadian producers at a competitive disadvantage with foreign businesses and reduce production and jobs in Canada. Furthermore, we believe that hidden taxation in general should be eliminated. Taxation should be "up front" and "above board." It should not be hidden in the prices of goods and services, nor should it be hidden by way of inflation or deficits -- which transfer the burden of taxation onto future generations. To the greatest extent possible, the public should be able to identify clearly what taxes they are paying and how they are paying them.

6. **The tax system should be designed to be administratively efficient and consistently applied to facilitate public understanding and compliance.**

The excessively growing complexity of the tax system has raised serious concerns among individuals and the business community. It is imposing unnecessary costs on taxpayers from the perspectives of both compliance and administration. Complexity, coupled with frequent modifications, leads to uncertainty as to the application and incidence of taxation. Such uncertainty impedes business decision-making, economic growth and job creation. Complexity also increases the potential and incentive for tax avoidance and evasion, adding further to the costs of administration and to public suspicion that actual tax burdens are not being shared fairly.

Much can be done to simplify the existing tax regime by basing it on sound principles rather than perceived expediency. This is essential if the system is to fulfill efficiently and fairly its prime function: raising the revenues necessary to finance the provision of public services to the people of Canada.

7. **The base of taxation should be broad and comprehensive with the minimum number of special incentives, exemptions, deductions, concessions and credits so as to avoid costly distortions in the economy and ensure that taxpayers in similar circumstances face similar tax liabilities.**

It is essential for the tax system to be founded on a broad and comprehensive base with the minimum possible number of selective exemptions, deductions, concessions, incentives and/or credits. This will ensure that the tax burden is, and is seen to be, equitably distributed, that individuals and firms in similar circumstances face similar tax liabilities, that the system is kept reasonably simple and comprehensible, and that tax rates are kept at the lowest level possible.

Heavy use of selective adjustments imposes different rates of tax on different investments or activities; this in turn distorts economic decision-making, reduces the level of economic efficiency and competitiveness, and results in a less-than-optimum allocation of resources. A more neutral tax system, which avoids the use of selective adjustments, has the opposite effects and also promotes public confidence that all are paying their fair share and enhances compliance. These conditions apply throughout the tax system to personal and corporate income taxes, as well as to transaction taxes.

8. **Personal income taxation should be progressive, but top marginal tax rates should be kept as low as possible. Marginal rates should not be allowed to increase so steeply, or to reach such high levels, as to impair individual initiative, risk-taking, productivity improvement and capital formation.**

The Business Council believes that it is fair for individuals who earn more to bear a heavier tax burden, both absolutely and relatively. This implies that tax rates should increase with increases in income. However, it is important to recognize the negative effects which sharply rising "marginal" tax rates[13] can have on the incentives to work, save and invest, as well as the incentive they create for tax avoidance and evasion. Rising marginal tax rates magnify the size of tax "wedges" between private and social rates of return as income increases, causing individuals to alter their behaviour in often undesirable ways. Lower marginal tax rates minimize tax-induced distortions in economic decision-making.

It is not necessary to have sharply rising "marginal" tax rates in order to achieve a reasonable degree of progressivity. All that is required is that the "average" rates of tax paid increase with income. A moderation of tax rates through all brackets, together with sharply lower top rates, will achieve this by ensuring that the tax base is broad and comprehensive with few exemptions, deductions, concessions and "tax shelter" incentives.

9. The corporate tax rate should be roughly equivalent to the top rate of personal income tax.

There are several reasons why it is appropriate to tax income in the hands of corporations. However, to prevent abuse and to enhance simplicity, the total tax paid on income earned through the operations of a corporation should not exceed the tax to be paid if the same income were earned directly by an individual. This can be achieved only if the personal and corporate tax systems are integrated. It can be achieved efficiently only if the rate of corporate tax and the top rate of personal tax are roughly equivalent.

10. The tax system should not penalize taxpayers, nor provide the government with windfall gains, as a result of inflation.

Inflation is itself a form of hidden taxation. To improve accountability, and maintain the overall fairness of the tax system, it is important that governments not receive substantial additional tax revenues from inflation-induced distortions in the tax system. If inflation returns to abnormally high levels, it would be necessary to undertake a thorough "indexation" of the entire tax system to adjust all aspects of taxation for the falling purchasing power of the currency. At very low rates of inflation, it should be possible to allow for an appropriate recognition of inflation through specific ad hoc adjustments without introducing the complexities and costs of full indexation.

11. Neither the corporate nor the personal tax system should penalize those receiving irregular or varying income flows.

The tax system should be neutral as to the timing of the receipt of income over the lifetime of the taxpayer. This means that the amount of a person's tax liability should not be based on the timing of the receipt of taxable revenues. Our recommendation for dealing with this issue is to ensure that the tax system includes mechanisms for allowing irregular income flows to be averaged over appropriate periods.[14]

12. There should be the closest possible co-ordination of the tax policies of the federal and provincial governments.

The federal tax system cannot be viewed in isolation from those of the provinces and municipalities, nor can the tax system as a whole be made more efficient and equitable unless it is co-ordinated with other broad government policies that impact on business decisions, economic growth and employment. The aggregate of all taxes influences economic activity. The federal government has a leadership role to play in the area of personal and corporate tax, but a worthwhile reform of our system will require the active participation of all governments. Thus, it is vital for changes in tax policy to be arrived at on a basis that involves the co-operation of federal and provincial governments.

Chapter 2 PERSONAL AND CORPORATE INCOME TAX POLICIES

The previous chapter establishes a general policy framework that can be used to evaluate current tax policies and suggest changes in three main areas of taxation -- personal income tax, corporate taxation, and transaction taxes. The first two of these are treated in this chapter while a discussion of the quite separate issues relating to transaction taxes is deferred until the next chapter. The background documents and studies on tax policy released by the federal government over the past 18 months have largely focused on corporate taxation. Most of the actual changes made to tax policy have also been in this area. The issues and proposals explored in the next two chapters go considerably beyond the corporate sector. We believe it is desirable to bring forward for discussion wide-ranging reform proposals affecting all types of taxation based on a coherent policy framework as developed in the first chapter of this paper. Based on ample previous experience, we have concluded that incremental, ad hoc changes made without reference to any overall policy framework do not serve the public interest well.

The policy framework outlined earlier suggests that a number of important modifications should be made to the tax system to further the goals of economic efficiency, competitiveness, fairness and simplicity. In broad terms, our proposals would, if acted upon, shift the focus of taxation in Canada away from income -- normally reflecting one's economic contribution to the economy -- towards expenditure -- reflecting what one removes. The approach taken in this paper would also result in a broadening of the personal and corporate tax bases, both of which have been steadily eroded in recent years through the proliferation of special incentives, deductions, and exemptions that collectively fall under the general heading of "tax expenditures."[15] Because they narrow the tax base, tax expenditures necessitate higher tax rates to raise the same amount of revenue. Further, and as recently noted by the House Standing Committee on Finance and Economic Affairs, the increasing use of tax expenditures has greatly complicated the tax system and led to growing distortions and inefficiencies in economic behaviour on the part of taxpayers.[16] The tax reform strategy advocated in this paper thus consists of four principal components:

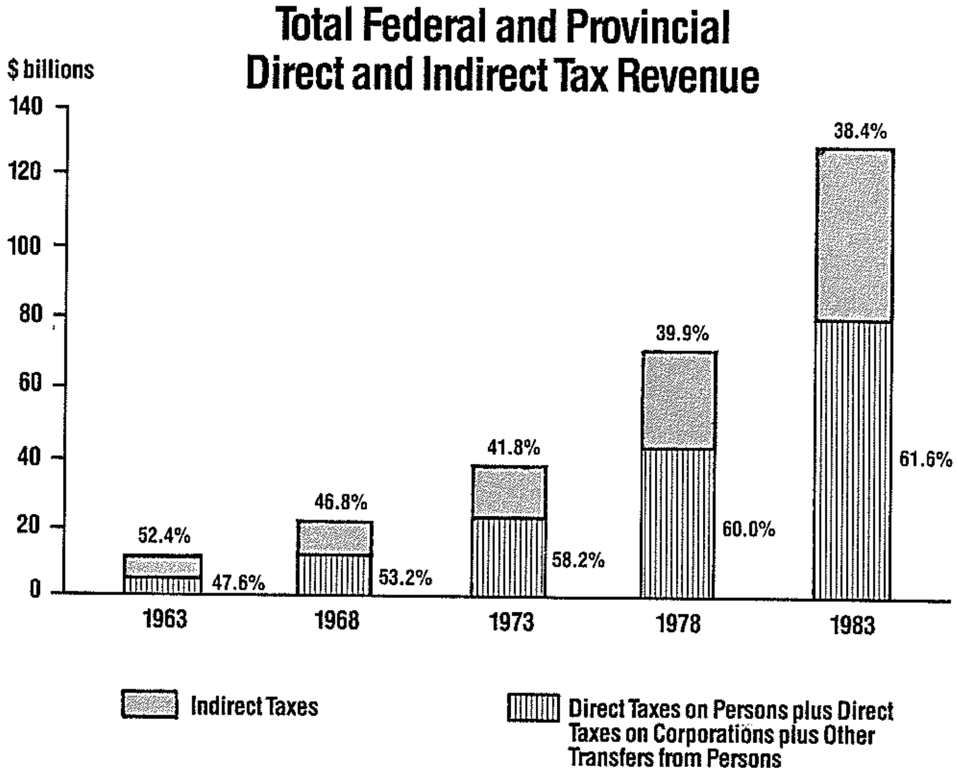
- lower income tax rates;
- broadening the tax base by phasing out or limiting existing tax expenditures;
- improved integration of the corporate and personal tax systems to contribute to efficiency and avoid abuse; and
- greater reliance on expenditure- or consumption-oriented taxes to raise the revenues needed to fund the extensive array of public sector activities and programs maintained in Canada.

The remainder of the present chapter is principally concerned with the issues raised under the first three headings, namely the tax rate, the tax base and integration.

The Personal and Corporate Income Tax Systems: Key Issues

As shown in Chart 8, during approximately the past two decades the federal and provincial governments together have come to rely more heavily on direct taxes which are essentially taxes levied on income. In recent years this trend has been holding steady with 60.5% of total federal and provincial tax revenue deriving from direct taxation in 1985.

CHART 8



Source: Informetrica Ltd., National Forecast service Data Base (Ottawa, 1986).

Income taxes comprise the central element of the tax system, and therefore should be the main focus of efforts to achieve significant tax reform. There is growing concern in Canada and in several other advanced industrial countries regarding the structure and impact of existing personal and corporate income tax systems.[17] Several key questions are:

- What should be the base upon which income taxes are levied?
- What is the appropriate structure of tax rates to be applied to this base?
- How should the effects of inflation on tax liabilities be dealt with?
- How should the effects of the timing of income receipts on tax liabilities be addressed?
- How should the often perverse and regressive interactions between the personal tax and transfer systems be handled through the tax system?

The first two of these questions are treated here in some detail; the other three, being more technical, are discussed only briefly.

The Tax Base

A. The Personal Tax Base

The tax base issue centres on the choice between taxing "income" or "expenditures." Should personal tax be imposed at the time revenue is earned or at the time it is spent? The current tax system contains features of both approaches, although it is primarily an income-based system. Proponents of the income base argue that income is a measure of "ability to pay" and is therefore the most equitable alternative. Supporters of the expenditure base argue that expenditure frequently reflects that which one removes from society, and an expenditure base would encourage saving, investment, and the expansion of economic development and national wealth.[18]

> "There appears to be merit to building on recent changes that moved personal income tax in the direction of a personal consumption tax...."
>
> Report, Royal Commission on the Economic Union and Development Prospects for Canada (Macdonald Commission), Ottawa: Supply and Services, 1985, Volume 3, page 428.

Theoretically, it would be possible to shift the personal tax system totally from an "income" to an "expenditure" base. The Macdonald Royal Commission recommended consideration of such an approach, and, as a partial step in this direction,[19] the Business Council favours the introduction of a comprehensive transaction tax (as discussed in the next chapter) which would shift the tax burden towards expenditure. If the direct (income) tax base was itself converted suddenly to an expenditure base, significant disruptions would be inevitable. Moreover, to adopt a pure expenditure base would require not only that all amounts saved be deductible, but that all amounts borrowed be added to taxable revenue. This could create serious problems for individuals making major purchases, such as housing and durable goods. Suddenly changing to an expenditure base would also dramatically alter the distribution of tax burdens across generations of Canadians due to the different saving and consumption patterns characteristic of the various generational groupings.[20]

In light of these considerations, we believe that the base of the direct tax system should continue to be "income." However, we also believe that contribution limits on amounts saved in deferred savings plans, similar in concept to RRSPs, should be increased. This would help shift the tax structure more towards a consumption base. Provisions should also be made for carrying forward unused deductions to such plans along the lines recently proposed by the government.[21] In addition, there should be greater flexibility with regard to the types of investment options open to such plan holders.

Tax Expenditures and The Integrity of the Tax Base

One of the major problems with the current personal income tax system is the presence of numerous special deductions, exemptions, concessions and incentives. They erode the tax base, necessitate higher marginal tax rates, distort the "neutrality" of the tax system by causing investors to allocate their savings in ways which do not reflect market realities, and prompt questions about the overall fairness of the tax system. Concern about the effects of tax avoidance mechanisms on the perceived fairness of the tax system was a key factor behind the government's decision to introduce the "alternative minimum tax" in the February 1986 Budget.

Many tax expenditures were created to pursue policy objectives which are now of questionable validity, or ones which could better be achieved outside the tax system through the use of direct expenditure programs. The entire panoply of tax exemptions, deductions, concessions, incentives, credits, and tax shelters generally[22] should be thoroughly reviewed to determine: first, whether they are producing benefits to taxpayers sufficient to justify their costs in terms of lost tax revenue; and second, if the benefits outweigh the costs, whether the current delivery mechanism is the most appropriate. If a tax measure cannot be justified under these criteria, it should be eliminated or phased out.

The manner in which many tax deductions, exemptions or expenditures are delivered is a cause for concern. Currently, most take the form of deductions or exemptions. Due to the effects of rising marginal tax rates, greater dollar benefits go to higher-income taxpayers than to those with lower incomes. This raises questions of both equity and efficiency in the distribution of such tax expenditures. There are various ways to address this problem. First, the dollar value of an exemption or deduction could be capped, as is the case with the current $500 "employment expense deduction" and the $1,000 "investment income exemption." Second, an exemption or deduction could be converted to a "fixed rate" tax credit where the benefit is the same percentage of the expenditure for all taxpayers. Third, a combination of the first and second options could be adopted imposing a fixed percentage tax credit subject to a maximum dollar amount. For example, a 20% credit could be given up to a maximum amount of $500. Finally, an exemption or deduction could be converted to a fixed percentage tax credit subject to a "clawback" with the value of the tax credit reducing as income rises (as is the case with the current Child Tax Credit).

As one moves from a straight deduction/exemption to a tax credit with a "clawback," the effective progressivity of the tax system is increased and the effective "cost" of such programs reduced. Thus, in this way, changes in the method benefits are conferred through the tax system could be used as a mechanism to maintain a desired level of effective progressivity while, at the same time, facilitating a reduction in marginal tax rates.

How these alternative mechanisms for delivering "benefits" through the tax system apply to various income levels is illustrated in Table 1 on page 39. It is assumed that taxpayers have some expenditure or deduction which is recognized or encouraged through the tax system. For purposes of illustration, the amount of the expenditure or deduction is taken to be $3,000 per taxpayer. The "clawback" example (column E) assumes that the full credit is received up to a taxable income of $20,000, and is then reduced to zero by a taxable income of $30,000.

We believe that, as a general principle, it would be preferable if the delivery of government programs was divorced from the tax system in favour of selective direct expenditures designed to ensure that benefits went only to those in need. To the extent that the tax system continues to be used as a delivery mechanism, the impact should be made neutral in that it should not selectively influence economic decisions or behaviour. We recognize, however, that in some instances tax credits can be an effective and equitable way to provide benefits to well-defined groups. The current federal Child Tax Credit is a noteworthy example.

TABLE 1: **Benefits to Taxpayers from Different Tax Preference Delivery Vehicles with an Expenditure/Deduction of $3,000**

(A)	(B)	(C)	(D)	(E) *
BENEFIT TO A TAXPAYER IN THE:	MAXIMUM $1,000 CAP	FIXED RATE OF 20% TAX CREDIT	FIXED RATE OF 20% TO A MAX. OF $500	FIXED RATE OF 20% WITH "CLAWBACK"
20% BRACKET (TAXABLE INCOME FROM $12,380 TO $17,232)	$ 600	$600	$500	$600
50% BRACKET (TAXABLE INCOME GREATER THAN $59,424)	$1,000	$600	$500	$ 0

* Column E is based on a full credit being granted up to a taxable income of $20,000, and reduced to no credit by a taxable income of $30,000.

The Treatment of Capital Gains

The treatment of capital gains should be addressed in any discussion of the personal tax base. The Business Council supports the important objectives which 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, entrepreneurship, and risk-taking. However, we suggest that in the longer term these objectives could be attained with greater efficiency and fairness through the more fundamental reforms we are urging in this paper, reforms which would provide a fairer and more efficient treatment of all savings and investment. Should the broad changes we are proposing be implemented, and subject to a provision allowing for inflation adjustment to the cost base of assets, serious consideration could then be given to the phasing-out of the existing capital gains exemption and to the inclusion of capital gains in the tax base as normal income.

B. The Corporate Tax Base

As with personal taxation, present corporate taxation rests upon an income base with numerous modifications. Over the years a number of alternative bases have been proposed including "business expenditures" and, more recently, "cash flow." Under a business expenditures base the net business costs incurred by a company would be taxed instead of its profits. A cash flow base, which is often associated with an expenditure base at the personal level,[23] would result in taxing corporations on the basis of their net cash flow -- i.e. the difference between total revenues and total costs including the full net cash cost of capital expenditures.[24]

Proponents of a net business cost base argue that such a tax would stimulate efficiency and cost consciousness and eliminate the distortions caused by taxing profits at the corporate level. Alternately, those who support a cash flow base assert that it would promote investment and economic growth since all capital expenditures could be written off for tax purposes in the year in which an investment was made, thus avoiding any penalty on the acquisition of capital assets. However, moving to either base for corporate taxation could bring a number of disadvantages. For example, no other country employs such systems. If Canada were to adopt either approach, it would create difficulties in our relationships with international trading partners and with the availability of foreign tax credits to investors abroad. Further, under either approach, tax revenues to governments would tend to be highly variable. With a cash flow base, interest expense would not be deductible, putting firms currently in a high debt position in great difficulty. For these and other reasons we believe that corporate taxes should continue to be assessed on the basis of income, but that the present system should be restructured.

The Integrity of the Base

Reform of the corporate tax system should have as its principal objective improving the efficiency of Canadian business so as to provide benefits to all Canadians. We believe the way to achieve this goal is through a more neutral tax system that encourages business to rely on market forces, not government incentives. Neutrality in this context refers to equal tax treatment for all types of investment: in principle, one form of investment should not be given preference over another. As with the proposed changes to the personal tax system, we believe that many existing exemptions, deductions, concessions, incentives and credits in the corporate tax system should be removed or cut back, and greater equality should be achieved in the application of others. The objective would be to equalize effective tax rates for different investments and activities in order to improve resource allocation and economic efficiency. This goal of neutrality would contribute towards the essential condition that Canada's industries operate within a tax environment which allows them to be competitive with our major trading partners. The federal government has already begun to move towards what is regarded as a more neutral system through its elimination of the investment tax credit and inventory allowance, while also slightly lowering corporate income tax rates. Unfortunately, these changes have not been made in the context of a broad reform of our system that would reduce or eliminate other tax policies that hamper business efficiency and competitiveness, and result in differential treatment of investment.

Canada's resource industries present special problems in the application of a uniform corporate tax structure, primarily due to the existence of substantial provincial royalties and other resource-specific forms of taxation. A concerted and co-operative effort should be made by governments to rationalize the taxation systems applicable to the resource industries in order to include those industries in a stable, integrated corporate tax framework. Such a framework should continue to recognize the special issues related to the high initial costs and risks associated with resource exploration and development, through allowing producers to recover a significant portion of their capital costs before full taxation of resource profits commences. At the same time, the system should seek to reduce the distortions now caused by taxes and royalties levied on gross revenues or on other bases other than net income.

Capital Cost Allowances

The present system of capital cost allowances has served the Canadian economy reasonably well. It has provided some measure of incentive for business investment within the context of an overall tax system that has contained many disincentives for investment, such as sales taxes on business capital spending and the failure to index depreciation deductions for the effects of inflation.

To the extent that these distortions are removed from the tax system and corporate rates are reduced as recommended later in this paper, it may be possible to modify somewhat the system of capital cost allowances to provide maximum permitted deductions which more closely conform to actual rates of capital consumption. The system must, however, retain a degree of accelerated allowances as an offset to inflation and, to recognize that, with today's fast-paced technological change, 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 apply to all industries in order to more equitably encourage investments throughout the private sector.

As well, the capital cost allowance system must be designed so that the overall environment for Canadian industries is competitive with our major trading partners. This will require a comparison of the impact of the foreign and domestic tax systems as well as an appreciation of the generally greater capital intensity and higher cost of capital for industries in Canada. In this regard, it is noted that while the major tax changes in the United States eliminated many so-called "business preferences," they did not result in any sharp cut back of depreciation allowances on most industrial machinery.

Treatment of Losses

In order to reduce the present bias of the tax system against risk-taking, there should be an expansion of corporate "loss flow through" provisions so that losses can be transferred among members of a corporate group. The present lack of such a system means that a corporate group comprising profitable and unprofitable corporations can be forced to pay tax on an aggregate amount which exceeds its combined net taxable income. This would not be the case if the corporate group was permitted to offset gains and losses.

At present, mechanisms exist which allow the transfer of losses in certain circumstances between corporations, with such transfers being most practical in situations involving wholly owned subsidiaries. However, the existing situation is inequitable because some corporations are prevented from taking advantage of such transfers due to legal impediments -- such as those requiring certain types of businesses to be carried on as separate entities -- or practical considerations relating to minority interests. Meanwhile, other corporate groups, without such restrictions, may enter into complex, and sometimes costly, transactions to allow the transfer of losses and deductions between corporations in the group.[25] The interprovincial revenue aspects of the needed changes in this area will require special consideration. Provincial concerns about potential declines in their tax revenues will need to be allayed.

Similarly, small, incorporated businesses should be allowed the option of being treated as partnerships for tax purposes along the lines of sub-chapter S in the United States Internal Revenue Code. This would allow both income and losses of such companies to flow directly through to shareholders.[26] The impact of this proposal on small business is discussed in greater detail later in this paper.

C. Integration of the Personal and Corporate Tax Systems

Under current Canadian tax law, income originating within corporations is in effect taxed twice -- first at the level of the enterprise itself, and then when it is realized by shareholders in the form of dividends or capital gains from the sale of stocks.[27] This situation is widely recognized to result in inequitable and anomalous treatment.[28] There are no persuasive reasons why income earned by corporations should be taxed more heavily than income earned by unincorporated business enterprises. Yet the former are subject to "double taxation," while in the case of the latter, the income is taxed at the personal level only. As part of the tax reform advocated in this paper, the total tax paid on income earned through the operations of a corporation should not exceed that which would have to be paid if the same income were earned directly by an individual.

As noted earlier, there are sound reasons why it is appropriate to continue to tax income in the hands of corporations. These include such considerations as the efficiency of corporate withholding compared with direct attribution of income to shareholders, ensuring that foreign shareholders pay their fair share of tax, and preventing tax avoidance which can result from the undue buildup of non-reinvested earnings within a firm. However, income that is subject to tax at the corporate level should give rise to a full offsetting credit for the taxes paid on such profits when the income is passed on to shareholders in the form of dividends. This can be achieved only if the personal and corporate tax systems are integrated; it can occur efficiently only if the top rate of personal tax is close to the standard rate of corporate tax.

The Business Council appreciates that serious questions arise with regard to the exact nature and amount of dividend tax credits. Specifically, should these be based on the average tax rate, or should they be restricted to the actual amount of tax paid by a particular corporation? However, these problems would be less significant with the adoption of the proposals concerning the corporate tax base (which would bring the base more into line with accounting income), as well as those concerning lower personal and corporate tax rates as discussed in the following pages.

Tax Rate Structures

The cornerstones of sound tax reform are a lowering of both personal and corporate tax rates and an expansion of their tax bases. But in order to preserve neutrality in the taxation of income earned in different ways, and to avoid creating incentives for the shifting of income from one form to another, it is important that the maximum income tax rates under the corporate and personal tax systems be essentially equal, and that in general the corporate and personal tax systems be integrated to the greatest extent possible.

To be equitable, however, personal income taxation should continue to be progressive so that the average rate of taxation should rise with income. The current personal tax system achieves this by applying highly progressive marginal tax rates to a tax base narrowed by numerous exemptions, deductions, incentives, concessions, credits and other tax shelters. We believe that this structure is fundamentally unsound. Highly progressive marginal rates give rise to great pressures for special tax concessions and lead to tax avoidance and evasion. For these reasons, high marginal tax rates inevitably cause complexity and raise questions of fairness; they also reduce incentives to work, save and invest. Overall, such a structure damages the efficiency and competitiveness of the economy.[29]

There is some evidence that as the top marginal rate rises above 30%, the incentives to avoid, or even evade, taxes increase rapidly. There is little doubt that top marginal tax rates in excess of 50% create strong incentives to avoid taxes. High marginal tax rates have negative effects on economic growth, and thus on the ultimate size of the tax base. They stimulate the growth of the underground economy. They encourage individuals to spend increasing amounts of time and money in non-productive ways trying to avoid the resulting tax liabilities.[30] And they deprive all Canadians -- not just those at the top of the tax brackets -- of the benefits which a more vigorous and soundly based economy could provide.

Estimates of the adverse effects of high marginal rates have been made for the United States, Sweden, and elsewhere. Some studies have concluded that the cost of raising one additional dollar of tax revenue through the respective income tax systems was between $1.50 and $3.50 in the United States and between $3 and $7 in Sweden.[31] While those and other estimates must be viewed with caution, the general conclusion is that the use of the tax system to redistribute income is costly to the economy and hence to the ability to support growth in jobs and living standards.

The Effects of Past Rate Reductions

In addition to evidence concerning the overall economic costs associated with high marginal tax rates there is evidence of specific beneficial effects flowing from their reduction.[32] (For details, consult Appendix 4.) In both the United States[33] and Canada,[34] reductions in top marginal rates resulted in significant increases in income reported and in total tax collected from upper-income individuals. However, reductions in the middle and lower income ranges in the

United States and elsewhere have resulted in large losses of revenue. The short-term explanation is to be found in the fact that the reduction in top rates suddenly made a great many tax shelters "unprofitable" and lured back into the tax system a substantial amount of previously untaxed or sheltered income. Over the longer term, additional benefits should result from the positive incentives of lower marginal tax rates for purposes of saving, investment and individual effort. In short, these data suggest that if the objective is to increase the percent of total taxes paid by upper-income individuals, this can be achieved best by lowering top marginal tax rates.

Finally, it is worth noting that high marginal tax rates are not only of concern to Canadians with high incomes but also to those with low incomes. This results from the combined effect of the income tax system withdrawing income through taxation with "tax back" arrangements applying to most social assistance programs whereby payments are reduced as earnings increase. Because of these features, social assistance recipients often face marginal rates of 100% or more on earned income. This removes any incentive for these individuals to try to improve their situation by moving into the official labour force and also creates incentives for them to sell their services in the underground economy.

Tax Changes in the United States

This is a logical point to note the radical reform of the personal and corporate income tax systems in the United States that are now being introduced. The changes, while complex, will essentially result in substantially lower personal and corporate income tax rates, but with a broadened tax base and a more neutral tax system, one that seeks to provide less government direction of investment.[35]

Under these tax changes, the top marginal federal income tax rate in the United States for individuals will be reduced to 28% by 1988 (33% in certain bands of income), representing the lowest personal tax rates in over 50 years. The standard federal corporate tax rate is also to be reduced, to 34%. (Of course, in comparing U.S. tax rates with the combined federal and provincial tax rates in Canada, account must be taken of the net impact of state income taxes, which typically add up to a further 5% of tax to the U.S. federal rates.)

In the future, the fact that the top combined federal and provincial marginal rates in Canada will be substantially higher than corresponding rates in the United States could lead Canada to face an outflow of highly skilled and productive individuals, a loss of capital and enterprise, and a deterioration in the competitiveness of certain industries.[36] Given the close proximity and large importance of the U.S. market to our economy, a major disparity of this sort cannot be allowed to continue.

Proposals for Canada

The Business Council strongly believes that there should be a significant moderation in personal tax rates across the board with a sharp reduction in the maximum rates of tax in both the personal and corporate income tax systems. Such a change would provide for a reduction in income tax burdens, on this account alone, to all individual taxpayers, as well as a corresponding reduction in corporate tax rates. The substantial revenue cost arising from such reductions in rates would be met, in part, by an extension of the corporate and personal tax base as recommended elsewhere in this paper, and in part through a shift of a portion of the total tax burden from direct taxes to indirect (transaction) taxes.

More specifically, we recommend that, ideally, the top personal tax rate should not exceed 35% including both federal and provincial portions of the tax. Some moderation in tax rates below this level should also be introduced. Furthermore, to ensure a proper integration of the personal and corporate tax systems and to provide for simplification in the avoidance of abuse, a single corporate tax rate roughly equivalent to this top personal rate should also be adopted.[37]

The single, flat corporate tax rate advocated here implies an increase in the tax rate currently applicable to a portion (the first $200,000 of taxable income) of incorporated Canadian-controlled small businesses, as this income is now eligible for a special lower rate of corporate tax. However, there are a number of compensating factors which would make the overall system advantageous to small business. First, an election to permit small business corporations to flow deductions and losses through to their shareholders' incomes would allow the owners of such companies a total integration of their corporate and personal tax structures. Not only would this avoid any possibility of "double taxation" of income from corporate sources flowing through to the shareholders of such companies, but the ability to flow through deductions and losses would grant immediate relief to the shareholders for such items, thereby reducing business risks and improving their ability to raise capital. Second, under our proposals, the top personal rate would be reduced from the current 50% to 60% to about 35%. This would reduce the effective tax rate paid by most owner-operators of small businesses. Third, we are proposing a dividend tax credit mechanism which would fully reflect corporate taxes paid, thus eliminating the possibility of double taxation of income for those small, privately held corporations that do not select the flow-through treatment of their income and losses. Under the current tax system, as revised in the February 1986 budget, even relatively modest-sized corporations with fluctuating incomes, as well as larger corporations, can be placed in a position where their shareholders will not receive full credit for all of the corporate tax they are required to pay.

Despite these factors, the Business Council recognizes that the changes proposed could cause a modest increase in the rate of tax on retained earnings in Canadian-controlled private companies. Because such businesses do suffer disadvantages in raising equity capital and because of the traditional support given to this important part of our economy, more favourable treatment should be accorded, during a transition period, to the earnings of such companies retained in the corporation up to a maximum annual amount. By way of comparison, the recent tax changes proposed in the United States provide special treatment for small businesses in the form of reduced tax rates (15% and 25%) up to a taxable income level of $75,000. The benefits of these lower rates are then "clawed back" as income increases to $350,000, such that after this amount a corporation pays 34% on its total income.

Other Issues

Three additional issues deserve consideration in connection with the tax reform strategy outlined in this paper: the impact of inflation on the tax system; the taxation of irregular income flows; and the relationship between the tax and income transfer systems in Canada. Each is briefly discussed below.

Adjusting for Inflation

The impact of inflation on the tax system is widely recognized to be a serious problem, both for business and for individuals. As noted in a recent Brookings Institute study:

> "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 will mismeasure real economic depreciation, inventory costs, capital gains, and interest income and expense. This systematic mismeasurement of taxable income 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."[38]

In the case of business, the failure to adjust the tax system to recognize inflation results in an understatement of the deductions for depreciation and inventory, and an overstatement of income for tax purposes.[39] In the case of individuals, the failure of the tax system to take inflation into account has many adverse affects. As a dramatic example, consider that without inflation adjustment, an individual in a 50% tax bracket, facing 10% inflation and 12% interest rates, must put aside $3.40 now to save $1.00 of real, after-tax funds available to him 30 years from now.

Further, inflation causes the well-known problem of "bracket-creep" for individuals whereby inflation-driven increases in a person's nominal income pushes him or her into a higher tax bracket -- or, in the case of some low-income households -- may move them from a non-taxpaying to a taxpaying position.[40] The preferred way to deal with this problem is to index tax brackets and exemptions so as to recognize the loss in the purchasing power of money. This policy was introduced in Canada in the mid-1970s, although full indexation was suspended in 1985.

With respect to the taxation of business profits, recognition of the impact of inflation on the determination of taxable income should also be given. However, with relatively low rates of inflation, this probably can be achieved best through appropriate, ad hoc measures rather than through a wholesale and, of necessity, complex effort to index the entire system of determining business income.

The Taxation of Irregular Income Flows

Ideally, the personal tax system should be completely neutral as to the timing of the receipt of income. That is, personal tax liabilities should not vary solely as a result of the timing of revenues earned. If the impact of the direct tax system falls more on expenditure through the use of registered savings plans, then this problem becomes less serious since such savings are non-taxable until they are withdrawn for consumption purposes.[41] But, as long as the system continues to be based on "income," it should incorporate an efficient, income-averaging method in order to take irregular flows into account.

Improving Tax Compliance

We believe that the measures advocated in this paper would improve tax compliance and the smooth functioning of the revenue system. First of all, the tax system would be, and be perceived to be, fairer to all Canadians with a more rational distribution of burdens. Secondly, the tax system would rest on understandable basic principles, and with a considerable simplification in its application due to such measures as: a simpler rate structure, the elimination of many often complex incentives and special treatments, and the reform of the antiquated system of transaction taxes. Such an improved system should therefore encourage a greater degree of compliance on the part of taxpayers, and should also make easier the job of the revenue authorities in enforcing our statutes fairly, and in reducing the scope of the "underground economy."

The Tax and Transfer Systems

A final issue concerns the interaction between the tax system and the current system of income transfers to individuals. As noted above, many social assistance recipients face implicit marginal tax rates of 100% on additional income. This problem of perverse disincentives has been examined by the Business Council's Task Force on Social Policy which will be releasing a major report on social policy reform in the near future.[42] Briefly stated, a system is needed in which social assistance recipients are encouraged to earn additional income and to join the official labour market. This may involve measures to lower the implicit marginal tax rates they face when they start to earn income through integrating the tapering-off of support programs with tax rates.

Chapter 3 TRANSACTION TAXES

As noted previously, in recent decades an increasing proportion of total federal and provincial tax revenue has been raised through direct taxes and a decreasing share through indirect taxes (sales and excise taxes, customs duties, and other transaction taxes). This change has shifted the burden of taxation away from expenditure and towards income, and imposed a gradually widening wedge between the return earned by a firm and that received by investors, thus increasing the real rate of return required to justify investment outlays. Income taxes tend to bias personal financial decisions towards current consumption. Because of this, they discourage investment, saving and entrepreneurship. Over time, such a tendency will diminish the prospects for job creation, productivity gains, and overall competitiveness in the economy. To deal with this problem, a more careful balance must be struck between the taxation of income and the taxation of expenditure (or consumption).

If all Canadians are to enjoy the best possible opportunities in the years ahead, investment must be encouraged and ways found to pay for the country's large, expensive public sector that are more conducive to economic growth and improved competitiveness than current tax policies. In our view, this can be partially accomplished by restoring a more equal balance between the revenue demands placed on the direct (income) and indirect (expenditure or consumption) tax systems. In the process, it would be desirable to move towards an integrated, simple and comprehensive tax in each area. For these reasons, we favour a more integrated personal and corporate income tax system, as discussed in the previous chapter, as well as a single, comprehensive tax on expenditures or transactions. The latter is the subject of the remainder of this chapter.

Transaction Taxes: Federal and Provincial Sales Taxes

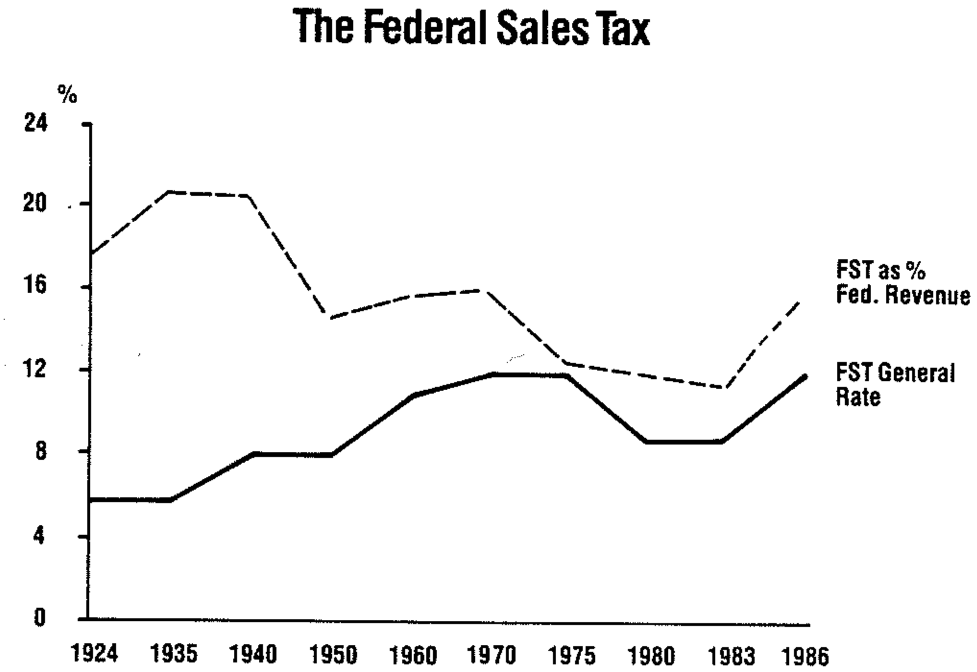
The federal government and the provinces employ a mix of complex and overlapping transaction taxes. Some of them are obsolete and their overall impact can be perverse. At the national level, the present federal sales tax is widely recognized as harmful to our economy and to domestic production and employment.[43] It is a tax which discriminates against domestic producers, and in favour of imported goods, in at least two principal ways:

- The tax on imported goods is levied on "duty paid value" at the time of importation, whereas the corresponding tax on domestically produced goods is frequently imposed at a later trade level, and therefore on a higher value.

- Almost half of the revenue from the present federal sales tax is levied on business costs, thereby increasing the cost of domestic production over those of foreign producers who are not subject to such an obsolete and outmoded tax.

In addition, there is frequent difficulty in determining the value upon which the federal sales tax should be levied. In principle, the tax is based on the price at which a manufacturer would sell goods to a wholesaler. However, with integrated companies the wholesaler is bypassed, and this, together with other transfer pricing activities, has led to the development of often artificial and subjective notional values upon which to base the manufacturers' sales tax. The overall effect of these anomalies is that the tax distorts both production costs and final demand, with consequent damage to market efficiencies. As noted in a recent article, "Canada is now the last remaining industrial nation using this fiscal relic of the 1920s."[44] Chart 9 provides some key data on the evolution of the tax.

CHART 9



Source: Malcolm Gillis, "Federal Sales Taxation: A Survey of Six Decades of Experience, Critiques, and Reform Proposals," Canadian Tax Journal, volume 33 (1985), p.70.

Federal Government Gross General Revenue Expenditure, Statistics Canada, CANSIM.

The federal sales tax is also a "hidden tax": the consumer is not readily aware of its existence when he purchases a product. This is in contrast to the retail sales taxes levied by most provinces. This tax "applies to the selling price of goods sold for final use or consumption unless specifically exempted by law."[45] Exemptions include a wide variety of items, such as food and prescription drugs; most services are also exempt from the tax. Although it is levied on consumers, the retail sales tax is collected by vendors who forward it to their provincial governments. The rate of sales taxation varies across the country, with Alberta standing alone as the only province never to have instituted such a tax (see Table 2).

TABLE 2: Provincial Sales Taxes, 1986

Province	Sales Tax Rate
Alberta	--
Saskatchewan	5%
Manitoba	6%
British Columbia	7%
Ontario	7%
Quebec	9%
Nova Scotia	10%
Prince Edward Island	10%
New Brunswick	11%
Newfoundland	12%

Toward a New Comprehensive Transaction Tax

A comprehensive transaction tax, applying through to the retail level, deserves serious consideration as a possible replacement for many current transaction taxes. Such a tax, designed with an effect similar to a multi-stage value-added tax and applying at each stage of the production-consumption process, could offer significant advantages to domestic producers. It would improve the efficiency of the economy by ensuring that the burden of the tax remained a constant percentage of final selling prices, thus spreading the burden of the tax fairly and efficiently among the consumers of taxed commodities and services and preventing economic distortions. It could also assist in restoring a more equal balance between the taxation of income and expenditure, would reduce the complexity of the present transaction tax system, and would ensure that the public was more fully aware of taxes being imposed.

Ideally, this comprehensive tax would be levied co-operatively by the federal and provincial governments with provision for the provinces to set separate rates for their part of the tax on a destination basis. It could replace not only the present federal and provincial sales taxes, but also a multitude of other indirect taxes which contribute to business costs, such as the business property taxes, capital taxes, and perhaps even premiums for workers' compensation and unemployment insurance, as the present burden of these taxes hampers the ability of Canadian business to remain competitive. We also believe that a new, comprehensive transaction tax should replace revenues that may be required to make up for any overall decrease resulting from implementation of the personal and corporate income tax reductions advocated in the previous chapter.

Because the introduction of a broadly based transaction tax could impose an increased tax burden on lower income Canadians, its introduction should be accompanied by a selective mechanism to compensate low-income individuals for any additional tax burden that they would bear. This compensation could be delivered as a fixed rate, income-dependent credit in the personal income tax system (perhaps similar to that introduced in the February 1986 federal budget).

It should be noted, however, that an individual's total lifetime spending bears a much closer resemblance to his total lifetime income than does his spending in one year to the income of that year. Accordingly, when viewed on a long-term basis, the burden of a broadly based consumption tax is in rough proportion to income. A broadly based consumption tax, in terms of its lifetime incidence, therefore is not markedly regressive. Even in the short term, given the capricious burdens of the present federal manufacturers' sales tax, an appropriately designed broadly based consumption tax should not be significantly more regressive than the present federal sales tax.

The Business Council is aware that the federal government is currently studying the introduction of a comprehensive business transfer tax. In effect, this tax would probably be a modified, value-added tax levied on the balance of revenues over deductible costs, rather than on the transaction-by-transaction basis followed in the value-added taxes adopted in Europe and elsewhere. While full details concerning the contemplated business transfer tax are not yet available, the adoption of such a tax, adjusted to reduce some of the compliance complexities that have plagued somewhat similar taxes abroad, would be a positive step in the reform of the Canadian tax system. It is recognized that this tax will be imposed on businesses in respect of their net value added, and there is no assurance that its burden can be passed on to purchasers in all circumstances. However, final comments on a business transfer tax must be reserved until complete information becomes available.

In view of these considerations, we recommend that the transaction tax policies of both federal and provincial governments be restructured co-operatively along the following lines:

- **To ease the complexities and costs of administration, the present federal and provincial transaction (manufacturers' and retail sales) taxes should be consolidated into a single comprehensive transaction-based tax.**

- **To promote economic efficiency in meeting consumer preferences, individuals should make their own choices on consumption without the distorting effect of variable rates of tax. Thus, the transaction tax should be as broadly based as possible applying to virtually all goods and services sold in domestic markets.**

- **In order to move our present tax structure more towards a tax on consumption rather than a tax on income, this new transaction tax should be set at levels which will re-establish a more appropriate balance between the revenues raised from income and consumption tax systems.**

- To avoid economic distortions and to ease compliance, the tax should apply equally to all goods and services, avoiding variations in rates based on class or style of products.

- To ensure that the ultimate burden of the tax is set as a function of real prices and to avoid distortions which will be inevitable if the tax is imposed anywhere else than on ultimate retail selling prices, the tax should, in its final effect, be based on selling prices to consumers. This would not preclude the tax from being collected in stages through the production and distribution process, as is the case with a value-added or business transfer tax but tax paid on inputs should be fully offset against the tax on sales or immediately refunded to the business.

- To avoid having such a tax injure those in the lowest income categories, a system of selective tax credits should be implemented insulating low-income households from the effect of transaction tax increases.

- To help restore the competitiveness of domestic firms and to enhance Canada's economic efficiency, the tax should be structured so that it does not increase business input costs.

- To provide more accountability to the public, the tax should be disclosed to those who bear its ultimate incidence to the greatest extent possible.

CONCLUSIONS

The tax policy reforms outlined in the previous chapters reflect the view that the Canadian tax system is deeply flawed and in need of a major overhaul. Developed over many years in an ad hoc and often incoherent manner, the tax system does not achieve many of the key objectives which have been assigned to it. It is retarding our long-term economic growth and serving to depress investment; it fails to allow the economy to maximize production of goods and services, and jobs for Canadians; and it does not raise the revenues required to pay for our public services. Above all, the present tax system fails to meet the tests of fairness and efficiency rightly demanded of it by Canadians. For all of these reasons, the Business Council believes that the time for comprehensive tax reform has arrived, and fully supports the recent initiative of the federal government, together with initiatives by other governments, to undertake a fundamental review of our present tax policies.

To sum up our views in this paper, a sound tax system should be unbiased, allowing economic decisions to be made on the basis of market realities rather than tax considerations. Tax reform should aim to achieve substantially reduced marginal tax rates, a broadened tax base and a shift in the incidence of taxation from income to consumption. The Business Council is convinced that changes in these directions will increase economic efficiency, promote international competitiveness, facilitate investment and reduce the current bias against risk-taking, entrepreneurship and effort.

Such a reformed system should improve both the actual and perceived fairness of taxation, not only in terms of the distribution of taxes paid, but also in terms of the opportunity which enhanced economic activity and greater freedom for personal decision-making provides for Canadians to make the most of their lives. Apart from these powerful domestic considerations, Canadian tax policy should be sensitive to the need to keep our system of taxation competitive and compatible with those of our major trading partners, especially the United States.

The Business Council is confident that the tax reforms proposed in the preceding chapters would help to achieve these objectives. These changes are consistent with the fundamental principles and design characteristics outlined at the start of this paper. Because our proposals involve important tax trade-offs and compensating adjustments, they must be viewed as an integrated package. While we realize that any suggestions for change in an area as important as taxation are likely to be subject to intense debate and thus there may be a temptation to adopt only the least controversial elements, we urge that this temptation be resisted. The reform process must be approached from a global perspective and not in a narrow and piecemeal fashion, and with an appreciation that costs or losses to taxpayers in one area are more than offset by benefits in another. Only through taking this broad and long-term view of tax reform can we achieve significant improvements in our tax system and in the well-being of all Canadians.

Appendix 1 - COMPARISON OF PERSONAL TAX BASES

Income and Expenditure Tax Base Defined

In a pure income-based system, all current (accrued) income would be included in gross income for tax purposes. This would include cash income in a year plus many items classified as the equivalent of such income including the accrued capital gains and imputed rent on owner-occupied housing, the value of all employee benefits received, and so on. The current system, while based on income, does not go nearly as far as the theoretical model would suggest. Indeed, not even the recommendations in the Carter Commission report included all forms of accrued and imputed income in the tax base. However, any system largely based on income encourages current consumption at the expense of future consumption, since savings are subject to double taxation. (Savings are taxed first when earned, and then the return to such savings is taxed again.)

A pure expenditure-based system would look very much like the income system from a reporting perspective, except that all forms of saving would be deductible from income for tax purposes, and all forms of dis-saving (borrowing) would be included in income for tax purposes. That is, tax would be levied on income received less amounts saved in the current year plus amounts borrowed in the current year: a taxpayer would therefore -- in general terms -- only pay tax on what he spent on personal consumption. An expenditure-based system is neutral as far as current and future consumption is concerned, and therefore encourages saving and investment, since all current saving is immediately deductible from income before tax. It is generally considered that an expenditure-based system would result in an improvement in economic performance because it would not distort saving and investment decisions.

Discussion of a Pure Expenditure Base

Implementing a pure expenditure base would tend to shift the burden of taxation towards lower-income individuals as well as the young and the elderly, since these groups tend to consume a higher proportion of their incomes than do middle-aged persons and those with upper and upper-middle incomes. The impact on individuals of moving to an expenditure tax is much less substantial when measured on a lifetime basis, although in at least the short to medium term its adverse effects would have to be offset by generous, and complex, transitional provisions. (The effects on lower-income individuals would require measures to at least maintain their current after-tax incomes.) Accordingly, there would be a significant loss of tax revenue to the government in the early years of transition.

There would also be international difficulties in adopting a comprehensive expenditure base if -- as is almost certain -- other industrialized countries remained on an income base. For example, it would be advantageous to live under an expenditure base during one's working life, since saving would be fully tax exempt. However, during retirement it would be beneficial to live, and spend, under an income-based system. This could lead to elaborate attempts to avoid the impact of the expenditure tax in later years of life by moving to another country (e.g. the United States). Such a tax avoidance strategy would be hard to monitor and control and could prove costly in terms of lost tax revenue to governments.

One of the major benefits of an expenditure base is that it would tend to increase the level of saving in the economy by improving the net returns to saving. However, the intended positive effects would not occur if the increase in personal saving and investment was simply offset by an increase in government dis-saving (deficits) brought about by reduced tax revenues resulting from converting the current income tax system to an expenditure base. Another advantage of an expenditure base is that it would greatly reduce the need for adjustments to be made to the tax system for inflation.

Implementing a comprehensive expenditure base would tend to narrow the tax base and would therefore require higher marginal tax rates or a greater increase in transaction tax rates than would be needed under a comprehensive income base. Although these higher marginal tax rates would not have the usual effects on saving and investment behaviour -- because all saving would be deductible from income before tax -- these high rates could still have a negative impact on incentives to work. As a general rule, high marginal rates should be avoided in any well-designed tax system.

A pure expenditure base could require the removal of most special exemptions, deductions, incentives, concessions and credits in order to minimize the narrowing of the tax base. Such changes could have adverse impacts on particular groups of taxpayers who now rely on these features in the tax system and would require appropriate transitional arrangements.

It would be relatively easy to capture many of the benefits of an expenditure-based system while still keeping our present income-base approach by increasing the global limits on deductible contributions to registered savings programs (as we recommend). An advantage of this approach is that it permits the imposition of a limit on the ability of the very wealthy to avoid taxation through saving.

Comparison in Summary

Tax Feature	Broadened Income Base	Pure Expenditure Base
Progressivity available if desired?	Yes	Yes
Effect on Investment	Some distortion, which can be lessened by RRSP-type deductions	Little distortion
Effect on work effort	Moderate	Moderate to good
Understandability	Good	Poor
Simplicity	Moderate to poor	Poor, due to issue of major purchases
Rates	Moderate (less than at present)	Higher
Integration with social support	Possible	More difficult
Transition	Fairly easy	Difficult

Appendix 2 - COMPARISON OF CORPORATE TAX BASES

One goal of the Business Council Task Force on Tax Policy has been to develop a set of proposals which would reduce the biasing of decision-making and thereby improve the economic efficiency of the corporate tax system. This could be achieved in several ways: by removing the distortions now associated with the current "imputed income" based system; by changing the system to one based on "cash flow"; or by converting the system to one based on "net business costs."

An Imputed Income Base Defined

The current corporate tax system is based on net income. Business income is generally defined on an accrual (as opposed to cash) basis. Costs are defined on an imputed basis (when an input is used as opposed to when it is paid for). Because costs are counted on an imputed basis, a distinction must be made between current costs and capital costs. The former can be immediately deducted from income, while the latter must be deducted over time as the asset is used by the firm.

These features of the income tax system mean that appropriate adjustments must be made in a number of areas to achieve neutrality. First, all costs, imputed or direct, must be deducted from income. This gives rise to the problems associated with accounting for the real costs of holding capital assets and inventories; e.g. foregone interest, depreciation due to use or obsolescence, and changes in the price level.

Care must also be taken with income from financial assets to ensure that it is not taxed more than once. This is why, under the present system, intercorporate dividends are not taxable in the hands of the recipient, and there is a dividend tax credit for individuals. Furthermore, adjustments must be allowed to assure that only "real" capital gains are included; i.e. net of inflation.

If all the above types of adjustments were made and the artificial distortions created by the myriad special exemptions, deductions, incentives, concessions and credits were removed, then we could achieve an unbiased corporate income tax system. However, it is clear that the necessary adjustments would be complex and difficult and that the changes to the existing structure would be very substantial indeed.

It is possible to improve on the current situation by staying with an income tax base but making certain critical adjustments. For example, a significant reduction in marginal tax rates coupled with a removal of special exemptions, deductions, credits and so on would be a significant step towards removing bias from the system and ensuring that the returns from different types of investments were taxed on an equal basis. There is a well-thought-out model for this type of change to the income tax system in the form of the "Treasury 1" proposals in the United States and the subsequent modifications proposed by the U.S. Senate Finance Committee in May 1986.

A Cash Flow Base Defined

A tax based on cash flow is equivalent to a tax on "pure profits," where pure profits are defined as returns to a firm in excess of those which would be the minimum required to justify the continuation of business operations. Such a tax base would be defined as the difference between the cash inflows derived from the sale of goods and services and the cash outflows associated with the purchase of current and capital inputs for use in the business (net revenue from real or commercial transactions). Added to this would be an amount to reflect net revenue from financial transactions conducted by the firm.

All revenues generated by the sale of goods, services and assets would be included in the base on receipt. All expenditures -- current and capital -- would be deducted from the base at the time payments were made, but interest might not be allowed as a deduction since all spending is currently deductible. Such a tax base, involving both real (commercial) and financial transactions, can be expressed as follows:

> CASH FLOW BASE = **gains (losses) from "real transactions" (net of the cost of capital expenditures) + interest and dividends received + the value of financial assets sold (debt or equity) - the value of financial assets acquired (debt or equity) .**

Technical arguments can be made which show this formulation of the tax base to be fully "neutral or unbiased" in an economic sense. Further, an important advantage of this system is that inflation does not cause any distortion in burdens since the tax base is always calculated in current dollars. However, since the tax is applied only to a narrow base, the rate applied to a pure cash flow base would probably have to be very high -- perhaps 80% -- to generate equivalent revenue to the current corporate tax system. Further, such a system should include a full offset for the heavy investment associated with start-up situations. This would probably take the form of full refundability of negative tax liabilities, i.e. the tax rate times any negative figure obtained from the tax base calculation.

While a cash flow tax might offer advantages in terms of economic efficiency, it would be a dramatically different tax from that in effect in other countries and would tend to adversely impact investment flows to Canada. Its adoption would require complex transitional rules, and its actual application could be subject to abuse. Revenues from such a tax would be uncertain. While the tax is attractive as a subject for further study, the Business Council cannot urge its immediate adoption.

Net Business Costs

A corporate tax system based upon net business costs would be entirely different from any other proposed tax system. Costs incurred, and not profits earned, would determine the tax paid. Generally, firms would have an incentive to reduce the level of their costs to the absolute minimum, which would lead to greater efficiency. The base of the tax would be quite broad; this would allow tax rates to be appreciably lower than is the case under the current corporate income tax system.

However, such a tax base would have a number of disadvantages. The tax would impose a special burden on new business formations and companies with financial problems, since these new firms would be subject to tax even though they may not be generating any profits. Taxing costs instead of income would tend to accentuate the fluctuations in business profits and losses over the period of a business cycle, although it would tend to stabilize revenue flows to governments. The tax would be out of line with the systems of any of our major trading partners and could create difficulties with regard to foreign tax credits. It would also increase business (after-tax) costs which would tend to adversely affect Canadian exports. Since the system would be dramatically different from the existing corporate tax structure, it could lead to difficult transition costs and to disruptions in business operations. For these reasons, the Business Council does not feel that a tax on net business costs provides a viable alternative to the present system.

Comparison in Summary

Tax Feature	Cash Flow Base	Reformed Broad Income Base	Net Business Cost
Efficiency	Most efficient from economic viewpoint; favours capital investment	Some distortions; much better than present system	Depends on type and credits; VAT type is efficient
Inflation	Inflation does not distort	Requires inflation adjustment	Inflation does not distort
Volatility of tax revenue	Revenue and burden very volatile	Moderate variation	Stable burden (heavier in bad times)
International	Not compatible internationally	Compatible with other countries; reflects trends elsewhere	Not compatible with other countries as main corporate tax
Rates	Higher rates due to smaller base	Lower rates than at present	Depends on base, structure; rate likely low
Transition	Very difficult and lengthy; interest deductibility a major issue	Some difficulties	Difficult
Understandability and simplicity	Reasonable after transition	Reasonable (still involves some significant measurement problems)	Reasonable

Appendix 3 - SUMMARY OF TAX REFORM PROPOSALS IN THE UNITED STATES

Following on the discussion of a number of major proposals for the reform of the United States tax system dating back to 1977 and earlier, the Administration and Congress of the United States have moved to bring forward a major restructuring of the United States tax system over the past year. At the date of writing, these proposals, involving sharply lower tax rates for both United States individuals and corporations but with a broadened tax base, are expected to be passed into law before the end of 1986.

Individuals

- The new law provides substantially lower personal individual tax rates, with the current tax law's 14 rate brackets leading up to a top rate of 50%, being compressed into just two brackets: 15% up to $29,750 of taxable income (joint return) and 28% on the excess. The new rates, to be fully effective in 1988 and partially in effect for 1987 (where a 38.5% top rate will apply) represent the most significant restructuring ever undertaken of the U.S. personal tax system. The reform will bring U.S. personal tax rates down to the lowest levels in over 50 years and to the lowest personal tax structure of any major developed country. (Because of a special "clawback" which recaptures the tax advantages of the lower 15% personal tax rate and personal exemptions for upper income taxpayers, the effective marginal rate of federal tax can reach 33% from about $72,000 to about $200,000 of joint income, varying with circumstances.)

- Increased relief for low-income families is provided through higher standard deductions and personal exemptions. Mortgage interest on a first and second home, and state income taxes remain deductible.

- The amount of deductions claimable by individuals for taxes, interest and other items has been restricted. Interest expense relating to investments is only deductible to the extent of investment income; losses from "passive" investments (including most real estate and tax shelters) cannot be offset against other income; retirement deductions are trimmed; and deductions for other interest and taxes, as well as other items, face new restrictions.

- Estate taxes are retained, and new measures have been introduced to prevent diversion of income to minors and to put penalty taxes on generation-skipping bequests.

Business and Corporations

- The bill provides lower rates for corporations: the standard corporate tax rate is cut from 46% to 34%, effective from July 1, 1987. Lower rates (with a clawback for companies earning more than $100,000) are provided on the first $75,000 of corporate income.

- The investment tax credit, currently ranging from 7% to 10% of the cost of an asset, is repealed, with retroactive effect from January 1, 1986. (Certain carry-overs of investment tax credits are also arbitrarily cut back). The bill also makes changes in depreciation allowances, and in other business investment incentives: the depreciation rates on buildings in particular are sharply reduced, while depreciation on machinery and autos is only slightly affected.

- The legislation contains a substantial number of provisions to restrict tax shelter deductions, reduce special treatment for certain resource income, cut back on accelerated write-offs of expenses and deferrals of income, restrict reserve deductions for banks and completed contract accounting, and so on. The result of this and other changes is a substantial broadening of the tax base for both individuals and corporations.

- Only 80% of business meals and entertainment expenses is to be deductible.

Other

- All capital gains are to be taxed in full as ordinary income and without any special tax expenditures.

- There will be a minimum tax for both individuals and corporations, with the 20% minimum corporate tax being imposed on a base that will (for three years) reflect "book earnings" reported to shareholders.

- A new "branch tax" is to be levied on non-U.S. corporations doing business in the United States through branches.

- The United States foreign tax credit rules are to be tightened, and this, together with the lower corporate tax rates, will make it substantially more difficult for U.S. corporations to get a full credit against U.S. taxes for the foreign taxes paid by their subsidiaries abroad.

- Overall, the new law will reduce the tax bill on individuals by about $120 billion over the next five years and raise corporate taxes by a corresponding amount.

The above provisions are effective at various dates, with most base-broadening rules coming into plan in 1987 or earlier, but rate reductions taking effect during 1987 and 1988. The changes are extremely lengthy and complex and are subject to numerous special rules and technical adjustments.

Appendix 4 - THE EFFECTS OF TAX RATE REDUCTIONS IN THE UNITED STATES AND CANADA

United States

An analysis of United States Internal Revenue Service (IRS) data[46] examined changes in taxpayer behaviour over the period 1981 to 1984 (Table 3). During this period, the "Reagan tax cut" came into effect, reducing the top federal marginal personal tax rate from 70% to 50%. The study found a 60% increase in the number of persons reporting adjusted gross incomes in excess of $1 million between 1983 (when the Reagan tax cuts became fully effective) and 1984, and a 215% increase between 1981 (before the tax cut) and 1984. Over the entire period, income reported by this top bracket group increased from $8 billion to $31.4 billion. Furthermore, under these dramatically lower marginal tax rates, the taxes actually paid by those reporting gross incomes in excess of $1 million increased by some 210%, from $4.9 billion to $15.2 billion. The percentage of total U.S. income tax revenue they paid rose sharply from 1.7% to 5%.

TABLE 3

Taxes Paid by High Income Earners Before and After 1984 U.S. Tax Cuts

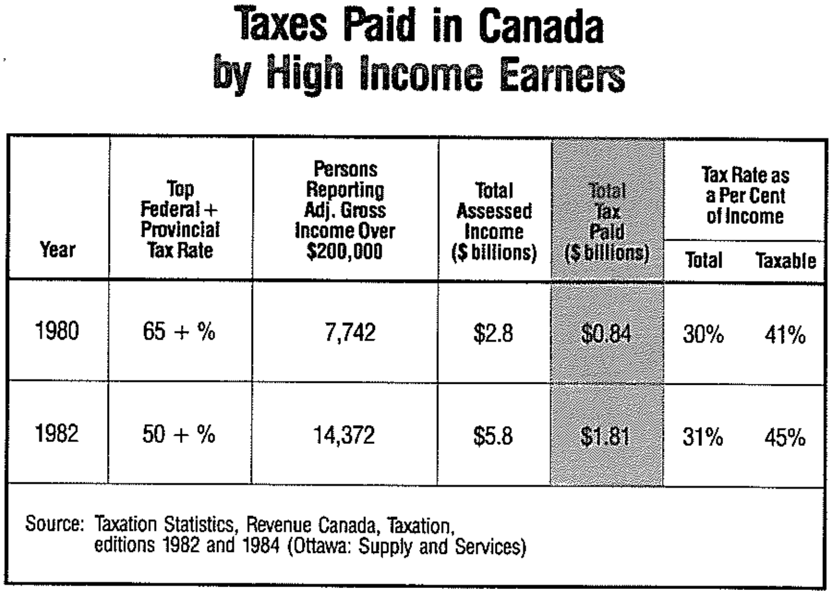
Year	Top Tax Rate	Persons Reporting Income Over $1 Million	Income Reported ($ billions)	Taxes Paid ($ billions)
1981	70%	7,750	$ 8	$ 4.9
1984	50%	16,700	$31	$15.2

Source: Preliminary Analysis of 1984 United States Returns, U.S. Internal Revenue Service, April 1986, as reported in The Detroit News, editorial, April 29, 1986.

The Effects of Rate Reductions in Canada

Similar evidence is available for Canada as illustrated on Table 4. Prior to November 1981, the top combined federal-provincial marginal tax rate averaged around 65% across the country (the top federal rate was 43%). After November 1981, the top federal-provincial rate was reduced to an average of slightly more than 50%. In 1980, 7,742 individuals reported adjusted gross income in excess of $200,000 and paid $838.2 million in tax on $2.8 billion of total assessed income.[47] In 1982, the first year of reduced marginal rates, 14,372 individuals reported adjusted gross income in excess of $200,000 and paid $1.81 billion in tax on $5.8 billion of total assessed income. These figures

TABLE 4



Taxes Paid in Canada by High Income Earners

Year	Top Federal + Provincial Tax Rate	Persons Reporting Adj. Gross Income Over $200,000	Total Assessed Income ($ billions)	Total Tax Paid ($ billions)	Tax Rate as a Per Cent of Income	
					Total	Taxable
1980	65 + %	7,742	$2.8	$0.84	30%	41%
1982	50 + %	14,372	$5.8	$1.81	31%	45%

Source: Taxation Statistics, Revenue Canada, Taxation, editions 1982 and 1984 (Ottawa: Supply and Services) represent an increase of 86% in the number of persons reporting adjusted gross incomes in excess of $200,000, of 116% in the amount of tax they paid, and of 107% in their reported total assessed income in just two years. Recall as well that 1982 was the midpoint of the worst Canadian recession in 50 years.

It is important to note that even though there was an average reduction in the top marginal tax rate of over 20% across the country, the average rate of tax paid by those reporting total assessed income in excess of $200,000 remained virtually unchanged. In 1980, this group paid 30% of its assessed income in federal and provincial taxes compared with 31% in 1982. Similarly, in 1980 this group paid 41.3% of its taxable income (ie. after allowances for exemptions and deductions) in federal and provincial taxes. In 1982 the corresponding figure was actually higher, at 45.1%.

Reduced marginal tax rates have had a similar impact further down the income scale, as seen in Table 5 on page 79. In 1980, a Canadian taxpayer reached the 50% marginal tax bracket at $25,000 of taxable income, or approximately $35,000 of gross assessed income. About 705,000 taxpayers had gross assessed incomes at or above this level in 1980, representing 7.1% of all taxpayers. This group paid $8.8 billion in federal and provincial income tax, which was 30% of total taxes paid in that year. Their average tax rate was 22.6% of total assessed income, and 29.5% of taxable income.

In 1982, after the rate reductions, a Canadian taxpayer reached the 50% marginal tax bracket at $55,000 of taxable income, or approximately $70,000 of gross assessed income. Adjusting for inflation, $35,000 of gross assessed income in 1980 was equivalent to approximately $40,000 in 1982. In 1982, about 893,000 taxpayers had gross assessed incomes in excess of $40,000, representing 8.6% of all taxpayers. They paid $13.4 billion in federal and provincial income taxes, which provided 34.6% of the total tax paid. Their average tax rate was 23.4% of total assessed income, and 30.8% of taxable income. Comparing these figures with those for 1980, it is evident that with lower marginal tax rates, there was an increase in the number of taxpayers in the relevant class, they paid 52% more in total taxes, and they had higher average rates of tax as a percent of both total assessed income and taxable income.

TABLE 5

Effect of Reduced Marginal Tax Rates on Middle Income Earners Canada 1980-1982

Year	Persons with Gross Assessed Income Above		% of All Taxpayers	Tax Paid ($ billions)	% of Total Tax Paid by This Group
	$35,000	$40,000*			
1980	705,000		7.1%	$ 8.8	30.0%
1982		893,000	8.6%	$13.4	34.6%

Source: Taxation Statistics, Revenue Canada, Taxation, editions 1982 and 1984 (Ottawa: Supply and Services)

*Due to inflation, $35,000 in 1980 was approximately equal to $40,000 in 1982

Thus, in both the United States and Canada, reductions in the top marginal tax rates resulted in significant increases in income reported and in total tax collected from upper-income individuals, because of a substantial increase in the number of such taxpayers and these reported earnings.

FOOTNOTES

1. Documents released at the time of the May, 1985 federal budget indicated that the Minister of Finance intended to proceed with a number of tax reform measures. This intention was reiterated at the time of the February, 1986 budget. At the time of writing, the Minister of Finance had not yet released background documents with respect to transaction taxes (e.g. a value-added tax or a business transfer tax). However, on July 18, 1986, he issued a statement indicating that the government intends to consider options for comprehensive tax reform.

2. Michael Walker and Sally Pipes, Tax Facts 5: The Canadian Consumer Tax Index and You (Vancouver: Fraser Institute, 1986), p. 57. The rates shown represent the total tax burden including all forms of federal and provincial taxation.

3. Deficits represent government expenditures which are not matched by current tax receipts. Where borrowed funds are used to finance current government operating expenditures or consumption, the deficits represent deferred taxation, in that future taxes must be higher than would otherwise have been necessary in order to repay these borrowings as they come due. See Phillip Cagan, "Financing the Deficit, Interest Rates, and Monetary Policy," in Phillip Cagan, ed., Essays in Contemporary Economic Problems: The Economy in Deficit (Washington: American Enterprise Institute, 1985).

4. Walker and Pipes, op.cit., p. 57.

5. David B. Perry, "Fiscal Figures," Canadian Tax Journal, Volume 34, No. 2, (March-April 1986).

6. Edgar K. Browning, "The Marginal Costs of Public Funds," The Journal of Political Economy, volume 84 (1976).

7. John B. Shoven, "Applied General Equilibrium Tax Modeling," IMF Staff Papers, volume 30 (1983).

8. Edgar K. Browning and William R. Johnson, "The Trade-Off Between Equality and Efficiency," The Journal of Political Economy, Vol. 92, No. 2 (April 1984).

9. Malcolm Gillis, "Federal Sales Taxation: A Survey of Six Decades of Experience, Critiques, and Reform Proposals," Canadian Tax Journal, volume 33 (1985).

10. An example of the "tax wedge" is the difference between what it costs a business to employ a worker (direct employment expense) and the after-tax income received by this worker. The greater this difference, the greater the negative impact on employment and work incentives.

11. For extensive discussions on the effects of income and expenditure taxation see: United Kingdom, The Structure and Reform of Direct Taxation; Report of a Committee chaired by James E. Meade (London: Allen and Unwin, 1978); and United States, Department of the Treasury, Blueprints for Basic Tax Reform (Washington: Government Printing Office, 1977).

12. For a discussion of research relating to the incidence of corporate taxation see: Robin W. Boadway and Harry M. Kitchen, Canadian Tax Policy, 2nd edition. (Toronto: The Canadian Tax Foundation, 1984), pp. 162-8.

13. The "marginal" tax rate should be distinguished from the "average" tax rate. The marginal rate is that which applies to additional increments of income as income rises in a progressive tax rate structure. The average tax rate (or rate of tax paid) is the effective rate of tax paid on all income during a taxation year; i.e. total tax paid divided by taxable or total income, as the case may be.

14. Under a progressive tax system without effective averaging, an individual who receives substantial income in one tax year and little in the following year will generally incur a heavier tax burden than one who receives the same total income but in two equal parts.

15. Tax expenditures may be defined as "any form of incentive or relief granted through the tax system rather than by government expenditures". Boadway and Kitchen, op. cit., p. 108.

16. Standing Committee on Finance and Economic Affairs, report on the Department of Finance document entitled Account of the Cost of Selected Tax Measures, Fourth Report, pp. 10-11.

17. See Henry H. Aaron and Harvey Galper, Assessing Tax Reform (Washington: Brookings Institution, 1985), chapter 1 for an overview of developments in the United States.

18. A more complete discussion of this fundamental issue can be found in Appendix 1. Classical arguments for the income base can be found in: Robert M. Haig, ed., The Federal Income Tax (New York: Columbia University Press, 1921); Henry C. Simon, Personal Income Taxation (Chicago: University of Chicago Press, 1938); Canada, Report of the Royal Commission on Taxation, 6 volumes (Ottawa: Queen's Printer, 1966); and Joseph Pechman, ed., Comprehensive Income Taxation (Washington: Brookings Institution, 1977). Classical arguments for a consumption or expenditure tax base include Nicholas Kaldor, An Expenditure Tax (London: Allen and Unwin, 1955); United States, Department of the Treasury, Blueprints for Basic Tax Reform; and United Kingdom, The Structure and Reform of Direct Taxation; Report of a Committee Chaired by James Meade.

19. The Macdonald Commission recommended that the personal tax system be converted to an "expenditure" base. An econometric estimate in the United States, quoted in the Commission's report, suggests that a switch from an income-based to an expenditure-based tax system could in itself increase GNP by more than 10%. Royal Commission on the Economic Union and Development Prospects for Canada, Report, Volume II, (Ottawa: Supply and Services, 1985), p. 207.

20. Shifts in the burden of taxation between income and expenditure have different implications for different generational groups because of the nature of lifetime consumption and saving patterns. For example, the young and the old tend to be net consumers, while those in the mid-generation tend to be net savers. A shift to an expenditure-based tax would, therefore, tend to have the hardest impact on the young and the old. It would also create the need for mechanisms to combat the incentive for retirees to move to countries without heavy consumption taxes after the retirees had previously earned and saved tax-free income in Canada.

21. The May 23, 1985 federal budget set out proposals to change RPP/RRSP contribution limits. For individuals who save through RRSPs only, the limit would be 18% of earnings up to a maximum of $7,500 in 1986, rising to $15,500 in 1990. For members of money-purchase RPPs, the combined employer/employee contribution would be limited to these same amounts. For members of defined benefit plans, employee contributions would be limited to a maximum of $7,500 in 1986, rising to $15,000 in 1990; plus, subject to the 18% earnings test, an additional amount of up to $2,000 could be contributed to an RRSP. In all cases, unused RRSP contribution entitlements could be carried forward to up to seven years; and, starting

in 1991, the maximum contribution and pension benefit limits would be indexed to the average industrial wage.

22. The term "tax shelters" is used here to refer to tax vehicles which exist primarily to allow tax avoidance. Investment in such vehicles is not undertaken because of the inherent economic merits, but rather because of the special tax advantages which they confer. Such vehicles thus direct financial resources away from their most productive economic uses. See Aaron and Galper, op. cit., p. 54.

23. A cash flow base at the corporate level is often associated with an expenditure base at the personal level, since a cash flow base can be designed to be a tax on the "pure profits" of a firm plus a withholding tax in lieu of distributions of cash profits to shareholders. When distributions are made, appropriate credits for the withholding portion are given. The effect is to ensure that the entire income stream is fully taxed at some point, but that there is not double taxation. The possibility of altering the current corporate income tax system to one based on a cash flow base was recommended for consideration by the Macdonald Commission. Royal Commission on the Economic Union and Development Prospects for Canada, op. cit., p. 207.

24. A more comprehensive treatment of these issues can be found in Appendix 2.

25. Minister of Finance, A Corporate Loss Transfer System for Canada (Ottawa: Department of Finance, May 23, 1985). As a minimum the Business Council believes that the present regime, which permits reorganizations of capital and assets in a manner that does not entail current taxation at the corporate or shareholder level, should be maintained.

26. In essence, sub-chapter S in the United States allows any small firm with one class of shares and a limited number of shareholders to opt to be treated as a limited partnership for tax purposes. This allows profits or losses to flow directly to the shareholders, making it much easier to bring additional shareholders into a small firm, and thus to raise new equity capital.

27. Subject to the current lifetime capital gains exception of $500,000.

28. Aaron and Galper, op. cit., pp. 63-4.

29. Boadway and Kitchen, op. cit., pp. 19-20.

30. The May 1986 tax reform package voted out of the U.S. Senate and supported by President Reagan reflects this concern. Under these proposals, the top marginal tax rate for individuals would fall to 27%, and for corporations to 33%. (See Appendix 3.)

31. Browning, op. cit.; Shoven, op. cit.; Ingemar Hansson, "Marginal Costs of Public Funds for Different Tax Instruments and Government Expenditures," Scandinavian Journal of Economics, volume 86 (1984).

32. Lawrence B. Lindsey, Taxpayer Behavior and the Distribution of the 1982 Tax Cut (National Bureau of Economic Research, Working Paper Number 1760, November 1985).

33. Preliminary analysis of 1984 United States tax returns conducted by the U.S. Internal Revenue Service, April 1986, as reported in The Detroit News, Editorial, April 29, 1986. Consult Appendix 4 for details.

34. Data drawn from Taxation Statistics, Revenue Canada, Taxation, editions 1982 and 1984 (Ottawa: Supply and Services). Consult Appendix 4 for details.

35. This is based on the tax reform legislation pending in the United States. In making comparisons, it is noteworthy that the tax rates frequently quoted in Canada are combined federal and provincial tax rates, and in the United States most taxpayers -- individual and corporate -- are also subject to state income taxation. The effective burden of state personal income taxes, after taking into account the fact that they are deductible for federal tax purposes, may range from under 1% to perhaps 5% to 6%, while a typical corporate tax burden for state income taxes might range under 5% of income. Substantial variations in both rates and tax base are found between states. For further details, consult Appendix 3.

36. Patrick Grady, "The recent Corporate Income Tax Reform Proposals in Canada and the United States," Canadian Tax Journal, volume 34 (1986), discusses some of the problems that may arise for the Canadian manufacturing sector if the tax reforms currently under consideration in the United States are implemented.

37. The Business Council understands that it is impossible to predict the effects of reductions in tax rates over small ranges. Therefore, we cannot say what the marginal effect would be of a reduction in the top

rate of taxation from 40% to 35%, or from 35% to 30%. The ultimate effect of such reductions depends on many factors, including the rate from which the reduction is initially made, the public's perception of the effectiveness with which government is using its tax dollars, and various economic variables. However, based on the available evidence, and having regard to the tax reform package likely to be put into place in the United States, we are persuaded that the top marginal tax rate (combined federal plus provincial taxes) in the personal and corporate income tax systems should not exceed 35%.

38. Aaron and Galper, op. cit., p. 31; see also Boadway and Kitchen, op. cit., pp. 31-36.

39. This is partially offset by "gains" on the debt owed by business as their real value is reduced by inflation, less the "loss" on other net monetary assets.

40. Aaron and Galper, op. cit., p. 33.

41. This assumes that under any tax regime individuals act so as to minimize their lifetime tax liabilities.

42. Business Council on National Issues, Directions for Social Policy Reform, forthcoming in November, 1986.

43 Gillis, op. cit., pp. 71-2.

44. Ibid., p. 71.

45. Boadway and Kitchen, op. cit., p. 263.

46. Preliminary analysis of 1984 United States tax returns conducted by the U.S. Internal Revenue Service, April 1986, as reported in The Detroit News, Editorial, April 29, 1986.

47. Adjusted gross income is total income reported by the taxpayer before any deductions, exemptions, etc. Taxable income is equal to adjusted gross income minus all deductions, exemptions, etc.