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ABSTRACT
The Report of the Technical Committee on Business Taxation is the first comprehensive study of business taxation in Canada in many years and is arguably of a scope that compares favourably with the business tax volume of the Royal Commission on Taxation. In May 1998, at the meetings of the Canadian Public Economics Study Group, the report was discussed by a panel consisting of Michael P. Devereux, Roger Gordon, John Helliwell, and Jack Mintz.

* The panel discussion was held at the meetings of the Canadian Public Economics Study Group, University of Ottawa, May 27, 1998. Michael P. Devereux is of the Department of Economics, Warwick University; Roger Gordon is of the Department of Economics, University of Michigan; John Helliwell is of the Department of Economics, University of British Columbia; Jack Mintz is of the Rotman School of Management, University of Toronto.

** Of the School of Public Administration, Carleton University, Ottawa.
and John Helliwell. This article is an edited version of that discussion. The panelists considered a wide range of theoretical and practical issues concerning business taxation, matching the scope of the report itself, and their comments reflect both criticism of and praise for the report’s analyses and recommendations. Following the panelists’ presentations, there is a short question-and-answer section and then a concluding comment by Jack Mintz, chair of the committee.

**INTRODUCTION**

The *Report of the Technical Committee on Business Taxation*¹ is the first comprehensive study of business taxation in Canada in many years and is arguably of a scope that compares favourably with the business tax volume of the Royal Commission on Taxation.² The stated purpose of the report is to provide “a basis for significant improvement in the business tax system and therefore in Canada’s economic performance.”³ The legacy of the committee includes more than 28 specially commissioned technical studies by academics and government experts. The report was submitted to the minister of finance, the Honourable Paul Martin, in December 1997.

The Mintz report deserves to be carefully read and assessed. What follows here is an edited transcription of a panel discussion on the report that took place during the meetings of the Canadian Public Economics Study Group—Groupe d’Étude Canadien en Économie Publique (CPESG/GECEP), held at the University of Ottawa in late May 1998.⁴ The specially

¹ Canada, *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, April 1998) (herein referred to as “the Mintz report”). The members of the committee were Robert D. Brown, James S. Cowan, Bev Dahlby, Allan R. Lanthier, Wilfred Lefebvre, Jack Mintz (chair), Nancy Olewiler, Norm Promislow, and Stephen R. Richardson.


³ Mintz report, supra footnote 1, at ii.

⁴ The panel was arranged on behalf of the CPESG by Stanley Winer, with the guidance of the scientific and local organizing committees, and with the assistance of Munir Sheikh of the Department of Finance. The scientific committee for the 1998 CPESG meetings consisted of Paul Boothe, Sam Bucovetsky, Jon Kesselman, and Marianne Vigneault. Local organization was provided by Vicky Barham, Bagala Biswal, Rose Anne Devlin, Stanley Winer, and Frances Woolley. The CPESG gratefully acknowledges financial support from the Department of Finance; the dean of the Faculty of Social Sciences, University of Ottawa; the dean of the Faculty of Public Affairs and Management, Carleton University; the School of Public Administration, Carleton University; and the departments of Economics of the University of Ottawa and Carleton University. The CPESG is also grateful to the Canadian Tax Foundation for arranging to have the discussion published in this journal. A secondary purpose of the panel was to foster an exchange of views between public finance experts in the public service and those in academic life, no doubt to the benefit of both: the members of the panel met with Paul Berg-Dick and other officials at the Department of Finance following the panel discussion. It is to be hoped that other similar events can be organized in the future.
assembled panel consisted of three distinguished experts: Michael P. Devereux of Warwick University, Roger Gordon of the University of Michigan, and John Helliwell of the University of British Columbia. The presence of one representative each from Europe, the United States, and Canada is not coincidental. The panelists were asked to discuss general issues of business taxation that they consider to be of current importance, in addition to the report, with the balance between general matters and specific details of the report being left to their discretion. In the edited remarks presented below, a wide range of theoretical and practical problems concerning business taxation are raised, matching the scope of the report itself, and the reader will find both agreement and disagreement with various aspects of the committee’s analyses and recommendations.

At the risk of oversimplification, key aspects of the three discussions may be summarized as follows:

- Michael P. Devereux focuses on theoretical foundations of some of the report’s major recommendations concerning the statutory tax rate on corporate income, capital taxes on corporations, and the integration of personal and corporate income taxation. He is somewhat critical of the analyses underlying the committee’s conclusions about these matters.

- Roger Gordon analyzes the committee’s general view of, and recommendations concerning, the international shifting of business income, and its views concerning the neutrality of business taxation across sectors of the economy. He finds the report’s forecast of a clear efficiency gain from a move toward more equal tax rates across sectors to be unpersuasive. Gordon also considers proposed tax changes in the light of the stated objectives in the report of growth and job creation, and he discusses the report’s recommendations as a whole from a broader perspective that does not take the general role played by corporate taxation for granted. He concludes with a discussion of the committee’s analysis of alternatives to the corporate income tax.

- John Helliwell strongly supports the general thrust and overall policy recommendations of the report. He deals with the implications of the differences between incorporated and unincorporated forms of business enterprise, which, he suggests, could have been given greater attention. Helliwell then provides a detailed discussion of major issues dealt with in specific chapters of the report, including tax incentives for research and development (R & D), Atlantic provinces tax credits, aspects of international taxation, and business taxes as user charges, including employment insurance and environmental taxes. In general, he argues that there is both more scope for international tax differences than many think and more need for international tax harmonization and enforcement to stop tax havens from siphoning off taxable revenue.

All of the panelists agree that the report as a whole is a substantial contribution to the analysis of business taxation.

The presentations by the three panelists are followed by selected questions from the audience and answers by members of the panel. A comment by Jack Mintz completes the discussion.
MICHAEL P. DEVEREUX

I was very pleased to have the opportunity to read this report. The Canadian government clearly made an extremely good choice in asking Jack Mintz to chair the committee. Jack is one of the leading economists working in the field of business taxation, and I was interested to see what he and his committee would come up with, given a relatively clean slate at the start.

It is probably fair to say that the proposals are incremental rather than radical. For example, it is necessary to read as far as page 7 of annex A before finding discussion of anything as radical as a cash flow tax. The basic thrust of the proposal—to lower the corporate income tax rate and broaden the tax base—is clearly along the lines of virtually all the other major corporate tax reforms of the last 15 years. Certainly many European countries, beginning with the United Kingdom in 1984, have moved in that direction. That said, the proposals concerning the tax base are quite specific, dealing with particular issues rather than simply a general lowering of allowance rates.

The report itself is long, but well written. In particular, it is very good in its discussions of the kind of important policy issues that academic economists usually ignore. For example, interest allocation rules are generally not featured in the academic economics literature, but they can have an important impact on investment and tax revenue. The report seemed to me slightly weaker in its discussions of general economic principles. An example here is the extensive use of the term “neutrality” without reference to a large academic literature that attributes several different meanings to the term. (In fact, the report usually uses the term in the sense of uniformity of tax rates, but there is little discussion as to why uniformity is desirable.) A second example is the issue of whether Canada should aim for global or national neutrality. There is a very brief discussion of this issue, which is resolved in favour of global neutrality. But it seems to me that this issue is fundamental in designing the international features of the tax system, and hence I would have preferred to see a more thorough and extensive discussion.

The report points out that there are a number of taxes on corporations, only some of which are related to income. Consequently, it addresses several different forms of taxation, including environmental taxes, employer contributions to employment insurance, and federal-provincial issues. Given the short time available, I will comment only briefly on these.

Since I have been asked to offer a perspective from Europe, I should note that the link between federal and provincial taxes certainly has parallels in Europe. In that context, the provinces would be equivalent to

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individual countries and the federal government equivalent to the European level of government. From the viewpoint of a European, I can report that Canada has virtually nothing to learn from Europe in this regard. We have made very little progress with regard to coordination, certainly of capital income taxes, in Europe. There have been a small number of agreed directives, and most recently some progress on identifying a code of practice of business taxation. How this code was achieved is instructive. The European Commission put forward a report that grossly exaggerated claims of tax competition and the reduction in tax revenue from capital income. Having made those extravagant claims, it could still put forward only very modest proposals for reform, in the knowledge that member states would not agree to anything more far-reaching.

Another feature of taxes in Europe—like Canada, but unlike the United States—has been that they have exhibited various forms of integration between corporate and personal income taxes. Recently, however, some of these forms of integration are being dismantled—for example, in the United Kingdom, Italy, and Ireland. There may be various reasons why this is the case. I will suggest one possible reason in a moment.

I would like to take three of the important issues and proposals in the report and discuss them generally from an economic viewpoint. They are

1) reduction of the statutory tax rate on corporate income,
2) capital taxes on corporations, and
3) integration between personal and corporate income taxes.

One of the committee’s main proposals—in common with other reforms, including those proposed in Canada in the late 1980s—is to reduce the statutory corporate tax rate. The report suggests two important reasons for reducing the rate: a high corporate tax rate discourages firms from locating profit-making activity in Canada but encourages firms to locate deductions, such as borrowing, in Canada.

What does standard economic theory have to say about this? Most economic theory says that location decisions depend on the effective marginal tax rate: firms invest up to the point at which the post-tax marginal revenue product is equal to the post-tax required rate of return. A different model is one in which multinationals choose between alternative locations according to which one yields the highest post-tax return. This model implies that the effective average tax rate is important. But, crucially, both models imply that the tax base is important as well as the tax rate. So it is not clear, a priori, what impact broadening the tax base and reducing the tax rate will have.

In fact, the committee was instructed to consider revenue-neutral reforms—that is, reforms that raise an unchanged revenue. Consequently, on average, tax liabilities of firms must be unchanged, certainly leaving the effective average tax rate unchanged, on average across firms. It is possible that there might be a distributional shift; for example, reducing the tax rate and broadening the tax base may shift tax liabilities away...
from mobile capital toward immobile capital in a way that will attract more mobile capital into Canada. And it is possible to construct arguments along these lines. For example, mobile capital may be more profitable on average than immobile capital. In this case, the reform could reduce the amount of tax on the economic rent earned by mobile capital relative to the tax on normal income earned by immobile capital. But the general point is that reducing the tax rate may have little impact on location decisions if the tax base is simultaneously broadened.

This argument, of course, ignores a number of real world aspects of the behaviour of multinational firms, one of which is tax shifting. It may well be the case that the statutory tax rate is more important in determining the extent to which firms shift profits from country to country than it is in determining specific location decisions. This issue is related to the use of debt. Consider a very simple example.

Suppose a foreign-based multinational is deciding whether to locate a project in Canada or in some other country. The project will generate an income net of allowances in either country ($Y$) and will be partly financed by borrowing ($B$) at a given interest rate ($r$). If the firm borrows locally, the tax charge is simply $t_i(Y - rB)$, where $t_i$ is the tax rate in the chosen location. Other things being equal (including allowances), the choice of location depends only on the statutory tax rate, $t_i$; a high Canadian tax rate will therefore discourage inward investment.

However, suppose the multinational firm chooses the location of the project and the location of the borrowing separately. In particular, suppose Canada has a higher tax rate ($t_C$) than that in the alternative country ($t_F$). If the firm locates the new project and borrows to finance it in Canada, it generates taxable income of $Y - rB$. But this gives it the opportunity to move some of its existing borrowing into Canada to take advantage of the high tax rate. That is, it can shift into Canada borrowing of $X$ where the interest payable is $rX = Y - rB$. If the firm did so to this extent, it would pay no Canadian tax since its taxable income in Canada would be zero. But it would generate higher tax in the alternative location of $t_F(Y - rB)$ since it would no longer receive as much interest relief there. This additional tax charge is exactly the same as if the multinational had chosen to locate the project and borrowed to finance it in the alternative location. In this simple example, then, the two effects cancel out: a high Canadian tax rate will have no net effect on inward investment.

This example suggests that, taking into account both location decisions and the fact that firms might shift their profits between countries, the disadvantage of a high tax rate is less clear, and may not exist. Conversely, reducing the tax rate may do little to encourage inward investment.

A related issue here is allocation of interest. The report suggests that interest allocation rules are needed because of the higher tax rate: Canadian firms borrow too much from Canada in order to benefit from interest deductibility here. It would raise Canadian tax revenue, other things being equal, if firms borrowed abroad and claimed interest deductibility abroad. But interest allocation rules have a high compliance cost. And if
the Canadian tax rate is lower, the advantage of borrowing from Canada is, in any case, reduced.

An extreme alternative, suggested by the US Treasury in 1992, is to abolish interest deductibility altogether. Combined with no integration of corporate and personal taxes on dividend income, this is the CBIT (comprehensive business income tax), which essentially gives no relief for the cost of finance, whether equity or debt. A less extreme reform would be simply to reduce the rate at which firms were allowed to deduct interest, while setting the overall statutory tax rate separately. This would not only reduce the problem of shifting debt between countries, but also make the treatment of debt more similar to the treatment of equity. I will return to the treatment of equity a little later.

The second issue that I would like to address is the existence of capital taxes on corporations. The report raises and dismisses a number of arguments for having such capital taxes; I endorse the committee’s reasoning in dismissing these arguments. But the report also suggests that there is one very practical reason for keeping capital taxes: the existing taxes raise large amounts of tax revenue. According to the report, abolishing the existing taxes would require higher corporate income tax rates—an additional 3 percent on the federal rate and 6 percent on the provincial rate—to offset the reduced tax revenue. The size of these effects suggests that existing capital taxes are likely to be important factors in firms’ decision making.

The report acknowledges that “as capital taxes increase beyond modest levels, the impact will be taken into account in determining the cost of capital employed.”6 But what is a modest level? There is a standard way of modelling such tax effects. Just as we can compute the present value of capital allowances under the corporate income tax, and use this in determining the cost of capital, so we can compute the present value of taxes on capital. A capital allowance at rate $d$ is worth $td$ when multiplied by the tax rate $t$. If capital allowances are given on a declining balance basis, for example, the present value of allowances on a unit of investment is equal (in simple circumstances) to $td/(r + d)$, where $r$ is the firm’s nominal discount rate. The present value of an annual tax on the value of capital employed can be computed in the same way. If the tax rate is $T$, and the rate at which the value of the asset declines over time in real terms is $f$, then the present value of taxes on a unit of investment is $T/(i + f)$, where $i$ is the firm’s real discount rate.

The net impact is simply the difference between these two expressions. So what are their relative values? Taking figures from the report, the average combined federal-provincial corporate income tax rate is 43 percent, and the capital cost allowance for buildings is 5 percent. At a nominal interest rate of, say, 10 percent, this implies a present value of capital

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6 Mintz report, supra footnote 1, at 4.21.
allowances per unit of new investment in buildings of approximately 0.14. The federal capital tax rate is 0.225 percent, and a typical provincial capital tax rate is around 0.3 percent. At a real interest rate of, say, 4 percent, and assuming that the real reduction in value of the building is, say, 1 percent, this yields a present value of capital taxes per unit of new investment in buildings of approximately 0.1. Of course, these figures are plucked from the air. They do not account for differences in the definition of the tax base between the corporate income tax allowances and capital taxes. And they depend crucially on the inflation rate (since capital allowances decline in value with inflation). But they do suggest that capital taxes—even at apparently very low rates of well under 1 percent—can have effects that are of the same order of magnitude as capital allowances under the corporate income tax.

I am therefore unconvinced by the argument in the report. Capital taxes, even at very low rates, can have a significant impact on the cost of capital. It might well be the case that abolishing capital taxes and increasing the corporate income tax rate would reduce, rather than increase, the cost of capital. The argument in the report hints at the implicit notion that the wider the tax base and the lower the tax rate, the better. If this notion were true, taxes should simply be imposed on the widest possible base—for example, sales. But it is not true, and it may be dangerous to put such a heavy weight on the tax rate at the expense of the overall tax base.

The third issue that I would like to address is the integration of the corporate and personal income taxes. The report comes out in favour of maintaining integration. The main proposed reform is to follow the example of several European countries in having a minimum tax on dividends at the corporate level. That is, if dividends are paid, yet the firm does not generate sufficient taxable income in Canada, then a “corporation distribution tax” will be levied on the firm. The revenue raised from this tax will offset the cost of the tax credit given to shareholders.

If I understand the proposal correctly, dividends paid by a Canadian firm out of foreign source income would not be liable to the corporation distribution tax, even if the underlying income had not been taxed in Canada at the corporation level. Effectively, the shareholder could receive a credit on the grounds that the income had borne tax elsewhere. Since the tax credit would not be repayable to tax-exempt shareholders, the system could not generate negative tax revenue income. Nevertheless, this general approach is consistent with the view that Canada should aim for global neutrality rather than national neutrality. That is, the proposal implies that the integration of corporate and personal taxes should not be restricted to Canadian taxes. I suspect that a British chancellor of the exchequer would take a different view of the world.

Beyond this issue, I would like to address briefly the question why the corporate and personal taxes should be integrated at all. A number of reasons are discussed in the report, including a comparison of the treatment of debt and equity, and the size of compliance costs. I will address the argument concerning the likely impact on investment.
The report argues that the dividend tax credit has a positive effect on investment; if the credit were abolished, investment would fall. One argument against this view stems from an international model in which the marginal shareholder is a non-resident and is therefore not entitled to the tax credit. In this case, any changes to the tax credit would not affect the cost of capital or investment. But let us suppose instead that the marginal shareholder is a resident Canadian. Even then, I believe that the effect of the tax credit on investment asserted in the report depends on a very particular model of dividend and investment. It is generally argued—as in the report, which in turn appears to base its case on a paper prepared for the committee—that under the so-called old or traditional view of dividends, there would be some impact of dividend taxation on investment. However, I am not persuaded that this is necessarily the case, even if we follow the approach of such a traditional model.

To see this, consider another very simple model. Begin with a standard capital market equilibrium condition that describes the value of the firm in terms of the total return from the firm compared to the return that could be earned on some other investment. The crucial element here is the value to shareholders of receiving a dividend. The most obvious benefit is the post-tax value of the cash flow, worth \((1 - m)D/(1 - c)\) where \(D\) is the dividend paid by the firm, \(m\) is the shareholder’s personal tax rate on dividend income, and \(c\) is the rate of tax credit. In the absence of any other benefit, it is straightforward to show that the cost of capital for investment financed by retained earnings is independent of \(m\) and \(c\) (this is the trapped equity model). This is because the cost to the shareholder of giving up, say, $1 of cash dividend is \$(1 - m)/(1 - c)\). Any return on the investment of $1—say, \$(1 + r)\)—is paid out as a dividend and is worth \$(1 + r)(1 - m)/(1 - c)\). The rate of return earned by the shareholder is simply \(r\); it does not depend on the taxation of dividends.

One formulation of the traditional model would be to let dividends have some additional benefit. Suppose the marginal benefit of an extra $1 of dividend is \(B\). If \(B\) were constant between the time the investment is made and the time the return is received, then—like the tax liability—it would play no role in determining the required rate of return. But this need not be simply an assumption of such a model; it is implied by the firm’s optimal financial policy. To see this, consider a round trip of issuing $1 of new equity and increasing the dividend payment by $1. The

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The marginal cost of this round trip is clearly $1. The marginal benefit is $(1 - m)/(1 - c) + B$. We would expect the firm to follow this policy up to the point at which the marginal cost and benefit were equal—that is, $B = (m - c)/(1 - c)$. This implies that $B$ is indeed constant over time—as long as the tax system also is constant—and hence that again the taxation of dividends has no impact on the incentive to invest.

Of course, these considerations do not imply that the dividend tax credit cannot affect investment policy. But they do imply that there are quite general circumstances in which we would not expect it to—and that these encompass formulations of both the traditional and the trapped equity models. The question for policy makers is then: is the dividend tax credit a price worth paying in terms of forgone revenue, given the uncertainty as to whether it encourages investment?

I have raised three issues that I believe are important in evaluating the proposals of the Mintz report. In each case, in my view, doubt can be cast on the beneficial effects claimed for the proposed system. Nevertheless, tax policy making is not an exact science. I believe that the Mintz committee has done an excellent job in analyzing the existing systems of business taxation in Canada and in providing a solid basis for the assessment of potential reforms.

**ROGER GORDON**

The Mintz report provides a thorough discussion of many different topics dealing with corporate taxation and a very clear defence of the proposed tax reforms. I will focus on only a few of the key reforms, in part because I am not qualified to comment on many of the intricacies of Canadian tax law that are explored in the report.

The first key proposed change is to lower marginal tax rates on non-manufacturing firms from roughly 43 percent to 33 percent, a big change. In contrast, taking into account state as well as federal tax rates, the United States has a rate of about 39 percent. To maintain revenue neutrality, the report proposes perhaps a dozen different changes to raise sufficient revenue through base broadening to compensate for this reduction in rates.

Another key proposed change is to try to move toward equal effective marginal tax rates on different types of investments, different types of industries, and different types of capital. This type of change in the tax system is one that we have seen in many countries over the last decade, starting in the United Kingdom in 1984 and the United States in 1986. Canada did respond to some degree during the 1980s to the changes that occurred during that period in the United States and the United Kingdom, but perhaps not as aggressively as other countries did. It is natural to propose going further in this direction.

The stated objectives motivating these and other proposed tax changes, according to the report, are to improve efficiency, to raise the growth rate in Canada, and to enhance job creation. In order to evaluate the implications of the proposals, I will focus on whether and to what extent these
proposed changes would in fact improve efficiency, raise growth, and create jobs.

In terms of efficiency, I think that the key issue is the effect on income shifting across borders. Currently, Canada has a relatively high statutory marginal tax rate. This gives firms an incentive to try to report profits not in Canada but in some other country where there is a lower rate. There are many mechanisms that firms have available to shift taxable income across countries. One is use of debt. Firms can do all their borrowing in Canada and then use equity finance to help finance operations elsewhere. By concentrating their interest deductions in their Canadian subsidiary, they would reduce their Canadian taxable income while raising taxable income abroad. Another means of income shifting is manipulation of transfer pricing. In intrafirm transactions, the Canadian subsidiary could be paid a low price for the goods it sells and charge a high price for the goods it buys, thereby reducing taxable income in Canada while raising taxable income elsewhere. These are only a few examples of the mechanisms that firms can use to reduce their Canadian tax base.

A high statutory tax rate can also affect firm location. For example, profitable firms would have an incentive to avoid Canada, so that their profits would not be subject to the high tax rate here. In contrast, firms with tax losses would do well in Canada.

The proposed changes should reduce this shifting of profits out of Canada. To begin with, the change in the statutory rate from 43 percent to 33 percent makes it less attractive to shift income out of Canada and in fact may make it attractive to shift profits into Canada, at least from the United States. In addition, the report proposes restricting the deductibility of interest when the borrowing is done for the purpose of financing capital abroad. The intent is to prevent firms from doing all their worldwide borrowing here and to allow the deduction of interest only on funds borrowed to finance Canadian investment. That should also increase the Canadian tax base. It is hard to judge how much income shifting will in fact change. Multinationals whose operations are confined to just Canada and the United States certainly would face very different incentives as a result of the proposed reforms and would, as a result, try to shift income into rather than out of Canada. However, larger multinationals are likely to have operations as well in a tax haven, such as Ireland or the Netherlands Antilles, and would be shifting profits out of both the United States and Canada into these tax havens. Whether the amount of income shifted to a tax haven is different when the local rate is 43 percent or 33 percent is hard to judge.

The report forecasts that the proposed changes will improve the allocation of capital by moving closer to equal effective tax rates across different types of capital and different industries. The conclusion that the allocation will improve is natural if we think that there is a fixed amount of capital. With a move toward equal tax rates, capital would be reallocated to industries where there is a high marginal product away from industries where there is a low marginal product, a clear efficiency gain. If, however,
we treat capital as mobile across borders, it is less clear whether efficiency improves. Each industry is independently facing the same required rate of return on the world market. If the effective tax rate in manufacturing were raised, as is proposed in the report, capital would flow out of manufacturing into the world market, in order to re-equilibrate the after-tax return in Canadian manufacturing to that required in the world market. Since the before-tax return in Canada would still be much higher than this required rate of return, there would be a net efficiency loss from this outflow of capital caused by a rise in the tax rate on manufacturing. There would still be an efficiency gain from reducing the tax rate on services, transportation, and communications; there is too little capital in Canada relative to its price in the world market because of the tax. Since manufacturing is much more capital intensive than most of these other industries, however, the combined changes in tax rates could cause a net outflow of capital and a net efficiency loss. I therefore find the report’s forecast of a clear efficiency gain resulting from the move toward equal tax rates to be unpersuasive.

What the report does not talk about, which I think could also be important, is income shifting within Canada between the corporate tax base and the personal tax base. The corporate rate under the proposal would drop to 33 percent. The top personal tax rate, as I understand it, is 50 percent. That creates a substantial incentive for richer individuals to try to reclassify their income as corporate rather than personal, so as to pay the 33 percent rate rather than the 50 percent rate. Currently, that incentive is quite small: 50 percent versus 43 percent. There are a variety of ways individuals can reclassify their earnings to take advantage of this increased incentive. For one, they can shift to stock options rather than wage compensation. In addition, they can create their own firm and leave money within the firm. Such income shifting will not be obvious in the data, simply looking at any increase in corporate tax revenue arising from the proposed changes. The question is how the changes may affect personal tax revenues. I suspect the effect could be fairly important. The resulting efforts to avoid high personal tax rates would represent an efficiency loss. So there are conflicting pressures in trying to judge the net effects of the proposed tax changes on efficiency.

The second underlying objective of the proposed changes is growth. If there is a net efficiency gain, there should be a one-time improvement in the size of the economy owing to the improved allocation of resources. That is not a change in the growth rate; it is just a one-time jump. What would lead to an increase in the growth rate? One proposed change that I think may be effective is a reduction of the relative tax rate on high-tech sectors (such as electronics and many types of services), shifting the composition of industry within Canada toward these sectors away from others. These are the industries that are likely to be growing in the future. Greater dependence of the Canadian economy on these industries would likely lead to a faster growth rate. These industries, more than others, generate information spillovers, implying externalities that aid the economy as a whole. Bringing in more industries that are information intensive
generates more spillovers, a net efficiency gain for Canada. I think that this is one important source of increased growth that could result from the proposed changes.

The report also proposes slightly reducing subsidies to R & D. These incentives remain extremely high by international standards, and on its face such a reduction can only harm growth. My own guess, however, is that the subsidies to R & D are a mixed blessing. R & D is a rather small subset of the various activities that generate information spillovers. Many types of decisions that firms make about internal organization, incentives within the firm, location, product design, marketing techniques, or managerial compensation can raise productivity and can be observed by others, generating information spillovers. None of these examples qualify for the R & D credit. The R & D credit then distorts the search for new information toward technology and away from these other activities. Whether the gains from the R & D credit outweigh the losses is unclear.

The proposed reduction in the corporate rate relative to the personal rate may also raise the growth rate. As I have pointed out above, when the personal tax rate is high relative to the corporate rate, individuals have an incentive to reclassify their income as corporate rather than personal for tax purposes. I have suggested that such a reclassification, to save on taxes, would cause an efficiency loss. The easiest way for people to reclassify income is to set up their own corporation, where they can control how much of the company’s earnings are left within the firm and how much is paid out to themselves as individuals. Setting up a firm means coming up with an idea for a new business that has a good chance of succeeding. Inevitably, therefore, it requires investing in new information. The resulting information would be available to others, generating positive spillovers. In addition, high personal tax rates relative to corporate rates generate a net subsidy to risk taking. In particular, individuals have an incentive to start out as an unincorporated business in order to deduct any initial losses subject to a high personal tax rate. If the investment succeeds, they can then incorporate to take advantage of the lower corporate tax rate. Facing a high rate when deducting losses and a low rate when earning profits implies a net subsidy to risk taking. The maximum difference in rates is currently 7 percent for the richest individuals; the report proposes increasing it to 17 percent. This change would create a large net increase in the subsidy to risk taking. Since risky investments generate new information, which is then available to others, this subsidy should generate added growth.

One qualification to this scenario is the lack of full loss offsets under the corporate tax. The lack of full loss offsets can discourage risk taking, since profits are always taxable but losses are not deductible. I was amazed to learn how large the accumulated losses are in Canada. Provisions denying loss offsets have been, and under the proposal will remain, an important aspect of Canadian tax legislation.

The final stated objective of the Mintz committee’s proposals is job creation. In my view, economists have not directed as much effort to this
issue as is warranted, given its importance in the political debate. The number of jobs can change for various reasons. If demand for labour goes up because of efficiency gains, the increased wage rate may pull more people into the labour market, people who might otherwise have chosen not to work. There may also be people who would like to work but cannot find a job. This could be due, for example, to the minimum wage or to unions negotiating wage scales above market clearing levels. Changes that raise the marginal product of some workers above the minimum wage can therefore induce firms to hire more people.

What would the proposed changes in the tax system do to the number of jobs? If there is an increased demand for capital because of the tax changes, new firms using extra capital will need extra workers. The demand for workers will thus increase, resulting in an increased wage rate, which will pull people into the labour force. In addition, the proposed changes in relative tax rates will shift the composition of production toward the service sector and away from manufacturing. I would guess that the service sector is much more labour intensive. As activity in the economy shifts toward more labour-intensive industries, the demand for labour will increase.

What about the demand for the lower skilled, who may have a hard time finding jobs because their marginal product is below the minimum wage? Here I think the result of the proposals is less clear. One major proposal is to introduce experience rating into the employment insurance system. In itself, this should be an efficiency improvement, by improving the incentives that firms face when they consider laying off workers. But it also increases the cost of hiring the types of workers who would likely end up being laid off. The workers who are likely to be laid off would consist primarily of the young and the low skilled. By raising the cost of employing these young low-skilled workers, the proposal would reduce their marginal product relative to the fixed minimum wage and so could cause a loss of jobs. The expansion of the service sector may create jobs, but I picture the service sector as mainly employing the high skilled, while manufacturing jobs are much more likely to be low skilled. Lowering the relative tax rate on the service sector will therefore cause a drop in demand for lower skilled workers, potentially leading to a decrease in low skilled jobs. This type of reallocation of resources is one of the explanations for the increased wage dispersion in the United States in the 1980s. In particular, there was a shift in demand away from manufacturing toward the service sector, resulting in a drop in the relative wage of the unskilled. The proposed shift in relative tax rates could well cause a loss of jobs.

One possible complication is the role of unions in Canada. I picture the service sector as being less unionized than the manufacturing sector. Shifting demand toward a less unionized sector may lead to a lower unemployment rate, by shortening the queue of people willing to be unemployed in the hope that they may eventually find a manufacturing job.

I would now like to put the report, and the recommended tax changes, into a broader perspective. The report focused on possible changes in the
corporate tax alone. How does the corporate tax fit into the tax system as a whole? What alternative reforms might have been considered, other than changing the corporate tax rate or the corporate tax base? It is hard to judge what types of reforms the committee would recommend for the tax system as a whole, based on the report alone. I imagine, given the discussion in the report, that the committee generally agreed with the views expressed by the Carter commission some decades ago. The discussion in the report is very much consistent with the notion of a comprehensive income tax that taxes income from labour and income from capital equally. Consistent with the Carter report, the Mintz report proposes moving toward economic depreciation and maintaining integration between the corporate tax and the personal tax. Under a comprehensive income tax, the role of the corporate tax is to impose a tax on those forms of income that cannot easily be taxed at accrual under the personal income tax. Dividends can easily be taxed at accrual, justifying dividend imputation schemes. Accruing but unrealized capital gains cannot easily be taxed under the personal income tax, and the corporate tax acts as a substitute. This is a traditional justification for the corporate tax.

In an open economy, under a comprehensive income tax, individuals should face a tax on income accruing abroad at the same rate as applies to domestic income. As a result, if individuals have invested abroad, they should be taxed on any dividends and capital gains that they accrue abroad, dividends directly under the personal income tax and capital gains through a corporate tax on foreign source income.

The actual tax in Canada is very different from this comprehensive income tax, and one might therefore ask whether this is the right context in which to discuss corporate tax reform. My understanding is that individuals in Canada have available many different ways to invest tax-free, much more so than in the United States. While there are some taxes on dividends and capital gains, a large fraction of savings is explicitly free from personal income tax. In addition, the existing corporate tax in Canada is not the residence-based tax that would be suggested under a comprehensive income tax, taxing foreign source income equally with domestic source income under the Canadian law. Instead, it is almost entirely source based, exempting income earned abroad from domestic corporate taxes.

Under a source-based tax, after-tax rates of return would be equated in Canada and abroad. The tax would not reduce the rate of return available to Canadian savers, since they can always go abroad to invest; Canada is too small to affect prices available in the world capital market. For firms to locate in Canada in spite of the high corporate tax rate, something else must be sufficiently cheaper to compensate. The other main cost of production is labour. The Canadian wage rate would therefore need to fall to the point where firms would choose to locate here in spite of the high corporate tax rate. The burden of the corporate tax should therefore fall primarily on workers. In the process, the tax would introduce a variety of distortions. Capital-intensive firms would find this combination of low wage rates and a high tax on capital income relatively unattractive compared
with labour-intensive firms. Firms that had high pure profits would also find the drop in wage rates insufficient to offset the high tax on their pure profits. A source-based tax therefore would discourage highly profitable and capital-intensive firms from locating in Canada. It may be no accident that the capital-intensive manufacturing industry has faced a lower statutory tax rate, helping to offset this distortion to industrial composition.

There are clear gains to be achieved in moving away from a source-based corporate tax. To begin with, there are gains from cutting the rates on domestic investors in Canadian firms. On efficiency grounds, it is attractive to have investment in Canada as long as the rate of return here earned by both the investor and the government together is larger than the opportunity cost of funds in the world capital market. But Canadians would choose to invest in Canada until the after-tax marginal product here was equal to this cost of funds abroad. Cutting the effective marginal corporate tax rate on investment in Canada therefore generates an efficiency gain, by pulling more investment into Canada. Cutting the statutory rate generates a further gain, by encouraging the shift of income into Canada away from other countries and thus generating extra tax revenue here at the expense of foreign tax revenue.

What can we say about the tax on foreign investors? As in most countries, the Canadian corporate tax taxes the income earned on foreign-owned shares equally with the income accruing to Canadian residents. How should a comprehensive income tax treat domestic income accruing to foreigners? From the perspective of Canada acting alone, it should try to get from foreigners what it can. When a country has market power, it should take advantage of it. A small country such as Canada, however, has limited market power, implying a very low tax rate on foreign investors in Canada.

The rationale that the report focuses on for taxing foreign investors is the tax-crediting arrangements in countries such as the United States, Germany, the United Kingdom, and Japan. These regimes give investors a credit against their domestic taxes for whatever taxes they paid in Canada, up to the amount of taxes they owe at home, when profits are repatriated. The argument is that if these investors save a dollar in home-country taxes for every extra dollar they pay in taxes here, the Canadian tax on net does not cost them anything. It generates tax revenue without distorting allocation decisions.

Is this a plausible rationale for the current tax treatment of foreign investors in Canada? It relies on the presumption that these investors would have paid a dollar extra to their home government if their taxes had been reduced by a dollar in Canada. At least on the basis of the US evidence, this is highly improbable; almost no corporate taxes are paid on net to the US Treasury on profits earned by foreign subsidiaries. Why? For one thing, the tax is due only when profits are repatriated. Not only does this postpone the offsetting reduction in home-country taxes, lowering their present value, but firms can also choose to repatriate only when little or no tax would be due. In addition, under US law, firms can combine their repatriations from high-tax and low-tax countries. They commonly
design their pattern of repatriations so that on net they have paid sufficient taxes abroad on the combined profits they choose to repatriate as to fully offset any of the US taxes due on the repatriated profits. It is easy for firms to acquire a combination of investments in high-tax and low-tax countries so that this coordination is readily feasible. If it is easy for firms to avoid US taxes on repatriated profits, the Canadian tax is in fact a cost.

I think the argument should instead focus on the elasticity of investment by foreign multinationals in Canada. The availability of an offsetting tax credit at home is only one reason why investment may be relatively unresponsive to Canadian taxes. There may be many distinctive attributes of the Canadian economy that attract firms, and these may not easily be replicated elsewhere. How inelastic in fact is foreign investment in Canada? Can existing taxes be rationalized on the basis of this inelasticity? My sense is that a level of inelasticity of demand sufficient to justify current tax rates is implausible, though the empirical evidence is insufficient to support firm statements. I would have preferred that the report at least attempt to justify the recommended level of tax on the basis of evidence of the inelastic rate of foreign direct investment.

If an inelastic rate of foreign investment in Canada explains the existing Canadian taxes on this investment, there should be an efficiency gain from having countries jointly reduce these taxes on foreign investment. This point is exactly equivalent to the argument that countries gain by jointly reducing their tariff rates. In fact, Canada has been actively doing this through bilateral tax treaties with other countries, reducing witholding tax rates on dividends paid to foreign investors. The same argument could be made for reducing corporate taxes paid on the income received by foreign investors, as is done in the United Kingdom, by making foreign as well as domestic shareholders eligible for a rebate of corporate taxes paid on income later distributed as dividends.

Finally, I will shift to the appendix of the report, where there is an explicit discussion of a broader range of alternatives to the corporate income tax. One alternative that is discussed is a cash flow tax. This alternative is a natural one to examine, since it would eliminate many of the misallocations that the report focuses on. In particular, the report claims that the existing tax system distorts the allocation of investment both across types of firms and in total. With a cash flow tax, new investment can be expensed while depreciation and interest deductions can be eliminated. With the costs of investments being immediately deductible and the returns immediately taxable, the government simply becomes an implicit coinvestor with the firm. On net, there would be no distortions to the allocation of marginal investments across industries or across types of capital. The report also raises concerns about income shifting and the incentive to concentrate borrowing in Canada. With a real cash flow tax, interest would be non-deductible. This reform would provide a much more dramatic increase in the Canadian tax base, at the expense of the tax bases of other countries, than would occur under the committee’s proposals,
which would simply restrict interest deductions to funds borrowed to finance investment in Canada. Firms would then have an incentive to locate debt abroad where there is an income tax and interest is deductible, rather than in Canada where interest would be non-deductible.

Under an origin-based cash flow tax, there would still be problems with transfer pricing. An origin-based tax differs from an income tax by replacing depreciation and interest deductions with expensing of new investment, but it still imposes taxes on domestic production rather than domestic consumption. Transfer pricing can still be used to reduce the apparent cash flow from domestic production, raising the cash flow from foreign production. With a further change in law, exempting exports and taxing imports, as occurs under the European value-added tax (VAT) and (as I understand it) under Canada’s goods and services tax (GST), there would no longer be a gain to Canadian firms in shifting profits out of Canada. The aggregate tax base becomes the sales revenue received from domestic consumers, which is unaffected by accounting tricks that change the amount of profits reported here and elsewhere. In fact, with a VAT, demand by firms to locate a subsidiary in Canada would go up. Firms in the United States and elsewhere, which still face an income tax at home, would be delighted to have operations in Canada to which they could transfer their US profits without generating Canadian taxes as a result. Canada would in effect become a tax haven under the income tax, regardless of its VAT rate.

The report does argue that having a tax system in Canada that was very different from the US system would be a problem. I agree, but it would be a problem for the United States, not for Canada. The United States would face a large tax haven on its borders, undermining its existing corporate income tax. Holding fixed the level of income (and therefore of consumption) of Canadian residents, the consequent relocation of firms would have no direct effect on Canadian tax revenues. In the process, Canada would gain a competitive advantage in developing its capital-intensive and most profitable industries. Firms in these industries earn a higher pre-tax rate of return, to compensate for the taxes they normally owe elsewhere. Shifting the composition of production toward more profitable sectors is an efficiency gain from Canada’s perspective, although the United States would lose the firms that would have faced the highest relative tax rates.

A shift toward relying on a VAT rather than an income tax has its costs. There would be much more of a problem with cross-border shopping. In Europe, where populations tend to be much closer to the borders, this issue has received a lot of attention. However, estimates of the amount of cross-border shopping suggest that it is of second-order importance. Enforcement problems for the income tax, such as arise from transfer pricing, have been much more difficult and important.

Another drawback of a VAT, which is discussed in the report, is that it would not be creditable against US tax. As I argued above, I do not think this is the right focus. I think that firms can easily avoid the US tax on repatriated profits, regardless. I would therefore encourage further discussion of a cash flow tax or a VAT, even though it would be costly to the
United States. Of course, the United States may well change its tax system in the same direction, given the focus on cash flow taxes in the recent debate in that country.

JOHN HELLIWELL

This is a great report. Its breadth and tone take me back to the early days of Canadian tax reform, as embodied in the Carter report. I will come out swinging in favour of the Mintz report’s principles, which are also the principles of the Carter report. My objectivity may perhaps be impugned because of my work for the Carter commission. However, I was not implicated directly in the Carter commission’s reforms, since I was a very junior researcher working independently, writing one of their footnoted background studies. My study, number 3, was a series of case studies of the impact of taxation on investment decision making in large corporations.10

I first read the Carter report while sitting on a beach in Bermuda, en route from Oxford to the University of British Columbia, preparing myself to explain the Carter report to tax accountants and lawyers in a series of cross-Canada workshops sponsored by the Canadian Institute of Chartered Accountants, in which I was partnered with a tax accountant. By the time the workshops were over, I knew the Carter report pretty well, as well as the reactions of tax specialists across the country. I later had a tour of duty, along with Bob Brown, a member of the Mintz committee, as an adviser to the House of Commons Finance Committee when it was holding hearings on the 1969 Benson white paper proposals,11 which reflected specific—though partial—implementation of the Carter principles.

The Mintz committee has learned a lot from earlier attempts to achieve tax reform, and it has had the advantage of working on partially cleared ground. Many reforms that were urgently needed at the time of the Carter commission have since been put in place. Facing a partially reformed tax system, the Mintz committee proposes to nudge the business taxation regime closer to the principle of neutrality that lay at the centre of the Carter report.

In addition, since the Carter report, other countries have recognized the importance of tax reform and have moved in similar directions, so that international tax gaps, which always pose problems for domestic reforms, are less of a concern now than they were 30 years ago. As the Mintz committee points out, international comparisons are perhaps even more important now than they were 30 years ago because there is now much more awareness of how other people do things and how easy it is to shift tax base from one jurisdiction to another, especially for firms that already have operations in other jurisdictions. However, I would warn

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against assuming too readily that capital moves freely from one country to another, especially equity capital of the sort we are talking about here. There are many studies that have convinced me that national capital markets are very distinct from one another. Recognition of this separation affects a lot of tradeoffs that must be borne in mind in making tax policy. In many cases, domestic neutrality may require taxes to be higher on some activity, while international comparisons, at least with some jurisdictions, may suggest that rates should be lower. If international capital markets are more segmented than was previously thought, there is more scope for getting a good policy balance domestically as opposed to worrying about the international margins. In addition, the cost of getting the internal balance correct relative to the international one is lower than would be the case if capital were perfectly mobile.

The name of the Mintz committee and the title of its report refer to “business taxation,” yet much of the discussion surrounding business taxation reform, and most of the content of the report, is restricted to corporate business taxation. This focus overlooks the increasingly important tax differences between corporate and unincorporated business forms. The report could have been strengthened by a thorough study of the margin between the corporate form and the unincorporated form. It is quite apparent from the data that the committee has so ably collected and presented that one of the big stories of the last 30 years has been the rising importance of the small business corporation. Chart 3c of the report shows the incorporated self-employed rising from about 2 percent of employment in 1976 to about 6 percent in 1995, while the proportion of unincorporated self-employed has remained roughly constant. Thus, the big increase we have seen in self-employment over the last 20 years is almost entirely in the corporate form. I would be surprised if tax considerations have not played a very large role in that.

The report makes the point, in the integration section, that the integration proposed represents partial underintegration for large corporations but full integration for profits of small corporations. However, this calculation is for distributed profits of small corporations, and there is no requirement to distribute. Thus, the tax gap between an unincorporated and an incorporated proprietorship, a form in which the distribution decision is in the hands of the proprietor, is now equal to the gap between the typical marginal personal rate and the low rate of corporate income tax on the first $200,000 of annual profits. That difference provides a very large tax preference for incorporation, and a striking example of the sort of non-neutrality that the Carter commission was anxious to eliminate. It is in sharp conflict with the fundamental principles of both the Mintz and the Carter reports, since both aimed to be neutral among forms of business organization as well as across industries and among similarly placed individuals.

Because the Mintz report emphasizes corporate taxation rather than business taxation more broadly defined, it does not address the large tax gap between small corporations and unincorporated businesses. The
proposed lowering of the corporate rate applies chiefly to large corpora-
tions, with much less change for small corporations and even some increase 
for those that do not create employment. Thus, the tax gap favouring the 
corporate form for small business is still there, though not worsened by 
the committee’s proposals. The committee recognizes in the report that 
Canada’s tax system is unusually generous in its treatment of incorpo-
rated small business. It appears that the committee could have taken this 
opportunity to make the Canadian system more neutral and more in line 
with other tax systems by reducing the tax preferences for small corpora-
tions. If you take integration seriously, and you want simplicity, you 
certainly do not want to have large tax incentives for the incorporated 
over the unincorporated form; but that was quite clearly the situation 
before the committee’s deliberations, and it remains afterward—a big 
issue that still needs to be addressed.

I would now like to go through some specifics in individual chapters 
of the report. Chapter 5 discusses several special cases under the business 
taxation system that represent big dollar items to the Canadian govern-
ment. I have already commented on the first of these, which is the small 
business incentive. Now I will turn to the second special case, which is R & D.

The tax subsidy available for R & D, like the small business incentive, 
places Canada at the expensive end of the international tax comparison 
spectrum. The question that is obvious from the material presented in the 
report, but is not addressed at length, is why Canada, an open industrial 
economy with very high education levels and a number of respected re-
search institutions, should have by a factor of 2 the richest treatment of 
R & D in the world but also the smallest R & D share of all the industrial 
countries. That is a genuine research question. The very least one must 
conclude is that Canada is not getting a lot of R & D back from the R & D 
incentives. Either there is not a strong incentive effect from R & D subsidies, 
or else there are some special features of the Canadian situation, linked 
perhaps to a high degree of foreign ownership in manufacturing, that 
cause research to be done outside Canada. A deeper study of the causes of 
the current anomaly of high subsidies and low research should precede 
any wholesale revamping of the current system. However, some scaling 
back of the current levels of subsidy, of the sort suggested by the Mintz 
report, could be viewed as a cautious first step in the direction of reform.

It may reflect special pleading for a professor, even one close to retire-
ment, to suggest that in fact the spillovers from R & D are higher for 
fundamental grant-funded research than for research targeted to more spe-
cific applications. Recent studies show that R & D spillovers at the 
aggregate level appear to be even larger than those at the industrial level. 
Thus, there is indeed a case to be made, on the basis of beneficial spillo-
vers, for special treatment for R & D. The key questions relate to the 
form and scale of the taxpayer support. To concentrate the incentives so 
exclusively through the income tax system, as is currently done in Canada, 
is probably a mistake. A more balanced portfolio of research support 
would almost surely provide a better result. Canada may be the global
leader in tax subsidies for R & D, but it lags well behind international standards for government support of peer-reviewed basic research. Support of this sort goes primarily to the support of graduate students who are combining the production of current research results with the development of their own research skills, thus providing the critical supply of researchers needed for industrial research with a Canadian base. Financial support of the federally financed fundamental research councils falls below that of either the United States or the United Kingdom by a growing margin, while the tax treatment for R & D is much richer. I suggest that reform in this area should be directed to establishing a more diversified portfolio of support for R & D in Canada.

I turn now to the resource industries, the third of the special cases discussed in chapter 5 of the report. It was also a large and difficult item for the Carter commission. It is not as big an issue as it was 30 years ago, because the taxation of resource industries has been partially reformed already, and because the increasing share of employment in the service industries has lessened the resource industries’ share of gross domestic product. The issues, however, are the same, the politics the same, and the remedies roughly the same as they were 30 years ago.

It is well worth returning to this area, since in general tax reforms require patience and repeated efforts. However, if current efforts are to succeed better than those of the Carter commission, they must concentrate on one item that Carter neglected. The biggest error in the whole Carter strategy was to pay inadequate attention to transition. When people ask me now what are the three most important aspects of implementing tax reform, I say, “Transition, transition, and transition.” That includes a detailed mapping of how you get from here to there, of when you get from here to there, and of how the bits tie together, both in the end and along the adjustment path. Without effective transition provisions, you scare the people who lose and you lose the people who win. The people who are supposed to gain correctly believe that they are never going to get their tax reductions unless the base broadening takes place. They need to be convinced that the broadening will in fact take place if the reforms are passed. If they are convinced of this, they are more likely to form a political consortium that is willing and able to use its weight to support the base broadening and to treat every attack on base broadening as an attack on their potential for getting lower rates. Without such a coalition of widely dispersed beneficiaries from smallish reductions in tax rates, tax reform is dead. This is because base broadening takes specific groups of taxpayers and raises their rates significantly. That is the whole point of base broadening. A coalition of affected groups, even if they represent a small fraction of the voting public, can be decisively effective. In order to offset that, it is essential to have significant and easily understood transition provisions to reduce the immediate pain, to minimize the costs of adjustment, and to avoid excessive losses to those who have invested much on the basis of the current tax provisions. Only thus is it possible to avoid major capital losses to current shareholders and workers in the sectors and activities most affected. It is also important to link the promised
tax reductions very explicitly to the broadening of the tax base, as is done in the Mintz report.

Turning to the Atlantic provinces tax credit, the committee argues, using reasoning similar to that used for the analysis of special resource incentives, that the tax credit is expensively non-neutral. I agree. Although politically it would be very difficult to eliminate the credit, it is still important to put forward the argument for reform, as the committee has done. In Canada, which, as compared with other countries, has by far the biggest and most effectively targeted system of regional equalization payments, there is a strong case for avoiding regional targeting in other programs. The big advantage of having a large and efficient equalization payments system, combined with harmonized personal transfer payments based on individual needs, is that it is possible to exclude regional politics from the rest of the tax and expenditure system. If Canada did not have those basic systems roughly right, it would be politically and economically much harder to make a case for having a neutral system with respect to the regions and the basic tax instruments.

For the tax reformer, there are three baskets for the flow of work. There is the In basket for the jobs about to be dealt with; there is the Out basket for the things already successfully wrapped up; and there is the Too Hard basket for the items that are too hot or too messy to handle. For the Mintz committee, tax reform for the financial sector was lodged in the Too Hard basket. The logic behind this treatment was that the financial sector was already under review by other committees. The Mintz report argues against immediate tax reductions for the financial sector, in part to leave scope for potential tax reduction as leverage to achieve other unknown objectives. The committee thus recommends that general tax reductions on profits should be offset by a capital tax to recoup the revenue losses until the whole sector is brought into line with the rest of the system. The committee does not address what would be required for such harmonization, leaving the issues for consideration by those with special responsibility for the financial sector. While this hands-off approach may have been necessary to permit the Mintz report to be completed while the committee on financial sector reform was still deliberating, it does increase the risk of designing a system that is distinctly non-neutral across industries.

I am going to skip over the committee’s proposals about general tax rates except for making one comment not raised by earlier panelists. It relates to the committee’s dismissal of the cash flow tax and its treatment of capital cost allowances as though economic depreciation were an efficiency criterion for a corporate income tax. That assumption does not easily mesh with fiscal theory. We know that with respect to factor inputs, the neutral system is the one in which the investor receives the tax deductions (or refundable credits) at the time the money is spent and pays tax when income is accrued. Thus, the cash flow tax is correct with respect to the treatment of investments of different sorts. The committee accepts capital cost allowances lined up with the economic lives of capital assets, without addressing the more fundamental question of why there should be
that particular delayed response of tax credits behind the timing of expenditures. That said, I think the committee’s treatment is fair enough. But I would be even more modest than the report is about the strength of the logic behind that conclusion.

I turn now to international issues, which are perhaps the most important ones addressed in the report. The report says the right things roughly at the right time on these big issues, but I do not think it pushes them quite far enough. The broad point to make, I think, is that if you want simplicity (as the committee does), and if you want equity and efficiency, then you certainly want international harmonization. Every time you depart from neutrality, you get complexity, and many of the proposed departures are to accommodate the lack of international harmonization. Many of the perceived pressures on the domestic tax system are due to differences in tax status or rates in other jurisdictions. The most effective way of dealing with international discrepancies is harmonization. An alternative view, which the committee rejects for two reasons, is to treat other countries’ tax systems as fixed and to exploit any differences between domestic and foreign systems. The first reason why this is a bad idea is that foreign tax systems are not likely to remain exploitably fixed, since tax authorities in other countries are likely to play the same game, to mutual disadvantage. The second reason is that mutual competition for mobile taxable capacity will make the global tax system inefficient and inequitable. The purpose and aim of harmonization should be to attain a globally efficient tax system. A globally efficient tax system will involve more harmonization efforts on factors that are mobile because in the absence of such harmonization, there will be an international race for the bottom. This competition is likely to be more marked for capital than for labour, given the greater international mobility of capital than of labour. I would go much further in this direction than the Mintz report does. There are tentative international attempts to harmonize withholding and other taxes, but so far very little effort has been made to establish minimum taxes or otherwise to limit the scope for tax havens to distort the global efficiency and equity of tax systems. What is required is harmonization of structure as well as rates, agreed procedures for international allocation of capital income tax base, and international cooperation against tax evasion.

Some of the issues that are now recognized in Group of Seven, OECD, and IMF discussions about the need for harmonized regulation of banking and securities regulation need to be matched for taxation. To establish a robust international financial system, the most important element is a reliable judicial system (including efforts such as the recent OECD anti-corruption agreements to make bribes illegal to pay as well as to receive). The second element is a greater degree of tax harmonization, and the third is the harmonization of financial regulations. Partially in response to recent banking crises in Asia, there is now more focus on getting international comparability of financial sector oversight and regulation. There should be the same level of attention to the tax side. As the Mintz report notes, the biggest leakages in the Canadian tax system are not due
to exploitable margins between the Canadian and US or other well-regulated tax systems. The biggest difficulties relate to Barbadian trust arrangements and many other tax-planning devices intended to remove capital income from taxation in any country. Without international cooperation, such devices will continue to exist. They can be very expensive in lost tax revenues, very easy to exploit, and very difficult to obstruct. The most straightforward way of dealing with this class of problem is not by each country acting on its own to protect its tax base, but by the establishment of internationally agreed rules. There are fiscal landmines, and we need a fiscal landmine treaty that says there are certain things we simply do not do because they blow up tax systems for no obvious general gain. In the meantime, I think the committee’s approach to this issue—which is to attempt to remedy Canada’s own tax leakages as best it can—is probably quite right.

With respect to the relation between the personal and corporate income taxes, the dividend distribution tax has been well reviewed by my fellow panelists, and I think the committee’s proposal is probably appropriate. Such a tax may well be the cheapest and easiest way of limiting the extent to which tax credits are received for taxes that were never paid. It would not raise much money, but it is not expected to do so; the purpose is to keep taxpayers doing what they have always been intended to do—paying their basic taxes in a timely way.

The committee displays angst about the loss of corporate income tax base through the establishment of trusts and other mechanisms. I say relax, stand back, and ask if the proposed changes are in accord with the objectives and philosophy of the overall tax system. The Canadian system, by combining the income tax system with an integrated tax credit for the GST and with several means of deferring income tax until after retirement, provides a good blend of income and expenditure tax elements. What pension plans, and other untaxed entities of that sort, are doing is achieving integration. They are placing funds where they will bear no tax on entry but will bear the full personal tax when they are paid out. I do not think that should be regarded as a bad thing. If it becomes too much of a good thing, with too much current income receiving deferred tax treatment, some overall limits may be in order. However, it is necessary to remember that all these tax deferrals are eventually going to produce tax revenues, and with generally low rates of inflation and interest rates, the fiscal cost of the deferral may not be excessive. Once the system is mature, it is not so much of a problem in any event. So I am not as disturbed as the committee by these innovations.

If income on investments of conventional charities is a concern, that issue should be assessed in terms of how much tax subsidy is desired for charities. It is probably true that the system is now on the threatened side with respect to tax status of charitable organizations. There are probably people now operating charitable organizations for purposes that do not merit as much tax support as they are getting, but that is an issue that needs to be addressed by some other committee.
When considering taxes as user charges, the report considers both employment insurance and environmental charges. In Canada, the current lack of experience rating for employment insurance acts chiefly as a subsidy for seasonal industries, a result that is neither efficient nor equitable. That is the committee’s view, and I agree with it. Much attention is also paid to environmental taxes as user charges, a welcome addition to the usual range of topics considered by tax committees. I have some qualms, however, about the committee’s specific suggestions. The argument is made that if global warming is what you are after and carbon is the villain, motive fuel taxes should be reduced and other carbon-based product taxes increased. I suggest caution here because there is much more to the motive fuel tax than a carbon tax, and we almost surely do not want lower motive fuel taxes. We probably do want some carbon taxes. We may even want to keep the gap between the two. Why? First of all, on environmental grounds, it is necessary to make a much clearer distinction than is made between global warming, where carbon content is all that counts, and local air quality, where on-site generation of particulates and emissions is what matters. Motive fuels are particularly bad for the environment in the sense that they are the primary contributors to low air quality in urban areas. For local air quality, motive fuel taxes have a special role to play. Second, the motive fuel tax, if finely tuned, can act as an anti-congestion tax. Congestion is another factor with spillover effects. In British Columbia, there is a special local motive fuel tax, for the lower mainland only, and the revenues are put into public transit. At one time, there was also a motive fuel tax in British Columbia that went directly into the insurance system, quite appropriately. This provided a variable component in car insurance along with the fixed one, thus matching insurance premiums more closely with risks.

In the light of these arguments, I do not think I would adopt the report’s specific suggestions about the rebalancing of environmental taxes. Overall, energy fuels, and especially motive fuels, should almost surely bear higher total taxes than do other contributors to global warming. The committee has suggested that it might improve the efficiency of environmental taxes, while maintaining revenue neutrality, to lower these taxes on motive fuels and raise them on the other contributors to global warming. I worry about that strategy because it is probably going to result in too low a motive fuel tax and almost certainly too high a tax on coal.

I will conclude with a brief comment on compliance and enforcement. I have already implied, in my advocacy of greater harmonization, that there should be higher levels of enforcement of both domestic tax and international tax law. The report says the right things about tax compliance and enforcement. If anything, these conclusions need to be announced even more widely and implemented more aggressively. As a first step, it will be necessary to develop some case law by testing Bahamian and Barbadian trusts in the court system. Once the limits of the law are clear and well known to taxpayers and their advisers, the next step will be to put more resources into national and international policing of tax systems.
SELECTED QUESTIONS AND ANSWERS

Question
We have heard a lot of interesting things about the interaction between income shifting and distortions in real investment decisions by firms. I am surprised that Roger Gordon included cross-border income shifting among the distortionary effects of the tax system. I expect that these income-shifting incentives would have no impact on the marginal excess burden of capital taxation, since people at the marginal rate are able to avoid taxes on Canadian source income. Roger, I wonder if you could clarify that issue.

Response: Roger Gordon
When the corporate tax rate falls, as proposed, firms can respond both by increasing their investment in Canada and by shifting taxable income back to Canada from abroad. Both responses will result in an increase in taxes paid in Canada. Firms themselves should be left essentially unaffected by the change in behaviour. Therefore, from a Canadian perspective, the change in behaviour represents an efficiency gain whether it relates to real investment or to income shifting. Of course, income shifting to Canada may result in a fall in tax liabilities abroad, so that worldwide efficiency may or may not go up. Similarly, real investment in Canada may increase at the expense of real investment abroad. My statements focused solely on efficiency from a Canadian perspective.

Question
Repeatedly, I have heard people whose opinions I trust implicitly say that tax-exempt investors really do pay tax, so we should not worry about them so much. I am not sure that I understand this view. I am referring particularly to John Helliwell’s comments on corporate tax erosion. It seems to me worth stressing that, for tax-exempt pensions, income is tax-free for a very long time, and therefore the tax consequences of this kind of erosion can be very severe. Could you explain why you do not seem as worried as I am about tax erosion?

Response: John Helliwell
The present value effect of the tax deferral is indeed big. I was just saying that, to a substantial degree, diversion of tax from present to future is an inherent part of the logic of the current Canadian income tax system. You are suggesting, quite rightly, that there could be a big loss of corporate tax. However, full tax must eventually be paid at the personal level, since an essential condition of the retirement savings schemes is that money cannot be withdrawn without payment of the personal income tax. There may also be payment of consumption taxes like the GST, but my appeal to the analogy of a consumption tax was to emphasize that deferring payment of the income tax from the time of earning until retirement or after is like shifting from an income tax to a consumption tax, even if the vehicle for collection remains the personal income tax.
Question

The panelists talked at some length about economic efficiency in the corporate tax world, but they made no mention of political efficiency. The corporate tax is a price, and one of the critiques of the corporate tax system is that consumers who buy a company’s goods do not really know the exact price they are paying for those goods. Are the panelists concerned, or are they happy with the present state of corporate tax as a signal to consumers of the true price of goods?

Response: John Helliwell

The answer is that in an integrated system, there is nothing special about the corporate income tax as a signal of anything. The corporation is merely acting as an advance collector for tax eventually due and payable at the individual level.

Question

At various places in the report, the committee recommends against the use of the corporate income tax to create incentives; instead, it recommends that, where possible, incentives generated by government for economic activity should be implemented through the expenditure system or through regulation. I wonder what the basis for that recommendation is. In general, all methods of influencing the economy have costs and benefits. I do not know of any evidence that would suggest that the corporate tax system is less efficient than the expenditure or regulatory systems. Indeed, it may well be the most efficient way of, for example, subsidizing small business or certain types of employment creation. So the question is: what lies behind the general recommendation that the corporate income tax not be used to create incentives?

Response: Roger Gordon

While the report recommends that desired reallocations be attempted through direct subsidies rather than through the tax system, you argue that incentives provided through the tax system are often equivalent and may be easier to implement. In theory, this may be true. But this use of the tax system has several problems. For one, not all firms have taxable income, so that firms with losses cannot make use of the desired tax incentives. In addition, the nature of the tax incentive that has been implemented can often be obscure to outsiders. The tax law is very complicated, even ignoring explicit attempts to redirect the allocation of resources, and taxpayers already face many difficulties in measuring accruing income. As a result, taxpayers often perceive explicit incentives as just another complication in measuring corporate income accurately. An easy example is more rapid acceleration of depreciation, say, for pollution abatement equipment. Is this a subsidy for pollution abatement, or simply a reflection of the unusually short working life of such equipment? While I agree with the committee that explicit subsidies should generate much more informed and focused political discussion, I also disagree with the suggestion that such a change in policy is easily feasible.
The pressure to aid particular constituents in a way that will not be noticed by those who pay for it is always present.

A COMMENT BY JACK MINTZ

I wish first to thank Michael P. Devereux, Roger Gordon, and John Helliwell for their considered and careful analysis of the Report of the Technical Committee on Business Taxation. I enjoyed sitting back and hearing comments on the report after spending several months explaining it to business groups and tax practitioners. I gained a number of insights from the panelists’ discussion of the report, and I am sure many others will also benefit from reading their comments.

Rather than trying to pick special points of agreement and disagreement, I thought it would be useful and more interesting to explain the process by which three economists, four lawyers, and two accountants could agree unanimously on a set of recommendations to improve the business tax structure in Canada. We had a number of very detailed discussions—even passionate debates—that were a compliment to all those involved. I believe that the quality of the report reflects very much what each independent-minded committee member brought to the table.

At the very beginning of the process, we started with a clean slate, although every member realized that one may not take a tax system and completely redesign it from top to bottom. A tax system reflects a political and an economic equilibrium that has been achieved. Changes to the system will create controversy, especially for those who may pay more tax—even a little more. Tax reform is therefore better understood as a process for change that pushes the system toward the laudable objectives that we often promote—efficiency, fairness, and simplicity.

Despite these constraints, which we all recognized, we started our investigation by considering alternative taxes to the existing business taxes. Some of this discussion is reflected in the annex to the report, which considers financial transaction taxes, wealth taxes, and cash flow taxes. We also looked at some other proposals such as the dual income tax of the Nordic countries, the comprehensive business tax on income gross of interest expense, and some excise taxes, including luxury taxes. We rejected all these alternative taxes, but the most intriguing discussions revolved around cash flow taxes.

As we indicated in the report, we considered introducing a cash flow tax as a full or partial replacement for the corporate tax. The benefits of the cash flow tax include the following:

1) the cash flow tax is an efficient tax compared to the corporate income tax in that it does not distort investment decisions; and

2) with the elimination of interest deductibility, the cash flow tax would reduce pressure resulting from tax base erosion arising from businesses shifting indebtedness to Canada, which has relatively high corporate income tax rates by world standards.
In the end, we rejected the cash flow tax as a full or partial replacement for the corporate income tax for three reasons:

• First, even though the cash flow tax could be operated as part of the corporate income tax, it would require the incorporation of a number of complex rules similar to the GST legislation. Although the cash flow tax could operate as a high-revenue-yielding consumption tax if wages were not deductible from the cash flow base, the committee was concerned about the overall complexity in the tax system introduced by a new tax. Canada already has three value-added taxes—the GST, the Quebec sales tax (QST), and the harmonized sales tax (HST)—as well as provincial retail sales taxes and federal and provincial excise taxes. The committee was not convinced that the introduction of a fifth form of consumption tax was better than simply raising the current GST/HST rate, which would mean a shift from business to personal taxes.

• Second, the revenue yielded under a cash flow tax with wage deductibility would not be sufficiently high to warrant substituting it, in full or in part, for the corporate income tax. We calculated that the base would be somewhat narrower under the cash flow tax, so that the cash flow tax rate would be higher than the general corporate income tax rate of 43 percent. However, the cash flow tax as a partial replacement for the corporate income tax would fail to provide significant efficiency gains that would otherwise arise from its adoption as a full replacement for the corporate income tax.

• Third, the cash flow tax raises a number of international issues that would be difficult to deal with, including the fact that the United States has already demonstrated that it will not provide a foreign tax credit for cash flow taxes paid abroad by US multinational companies. We were also concerned that multinational companies would have a significant advantage compared to smaller businesses with limited access to international markets, since the expensing of capital in Canada could be accompanied by the taking of interest deductions elsewhere so long as other countries maintained their corporate income tax regimes.

One alternative tax that the committee did not reject was an environmental tax. The topic of environmental taxes became especially important when we started to consider the economic and environmental effects of the current fuel excise tax on gasoline products. The committee was aware of the tax disadvantages faced by the transportation industry because of the much higher fuel excise tax in Canada compared to the United States. We also were aware of the debate that was developing with respect to global warming and the arguments made by some to introduce a carbon tax or to increase the gasoline tax. The committee, however, recognized that global warming was not the only issue to be considered in the context of environmental taxes. There were other important environmental problems, including urban pollution and toxins. The committee therefore considered the partial substitution of environmental taxes for the federal fuel excise tax on a revenue-neutral basis. The tax on gasoline would be reduced in favour of imposing taxes on other energy sources and toxins.

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according to their environmental effects. Thus, the committee’s proposal was to move from a carbon tax, narrowly applied to gasoline, to other forms of broad-based environmental taxes. This recommendation was not part of the revenue calculations since we believed that it would take some time for governments to study the implications of our proposal.

Having rejected alternative taxes of various sorts, the committee then examined the existing taxes, especially the corporate income tax. We began with a very tough proposal, discussed at the beginning of chapter 4 of the report. We considered a neutral corporate income tax with an average combined federal and provincial rate of 30 percent on both large and small firms. Under this proposal, we would eliminate the Atlantic investment tax credit and the R & D tax credit, scale down capital cost deductions to reflect economic depreciation, and provide for the deductibility of resource royalties instead of the current resource allowance. However, when we looked at the impact of these changes, we were concerned that there would be considerable economic transition costs associated with a shift to a broad-based low-rate corporate income tax. We were also concerned about radical shifts in taxes paid across regions, and we avoided trying to increase taxes paid by small businesses in favour of reductions in taxes for large corporations.

The committee therefore examined carefully those elements of the corporate tax base that create inefficiency and unfairness. From our studies, we found that it was critical for the business tax structure to be made more neutral, with rates—particularly corporate income tax rates—more consistent with international norms. We recommended a reduction in the general combined federal and provincial corporate income tax rate from 43 percent to 33 percent. We also recommended a number of base-broadening proposals that would raise sufficient revenues to compensate for a major reduction in corporate income tax rates. We also suggested that provinces, with additional revenues resulting from a broadening of the tax base, could afford to reduce both corporate income and capital taxes. Our analysis suggested that implementation of our proposals would reduce one-third of the variance of effective tax rates on capital for business activities without increasing the overall cost of capital for investment.

We agreed that, if adopted, our proposals should provide for transitional relief. We tried to avoid radical shifts in taxes paid by business sectors and regions. We also kept our proposals revenue-neutral for the small business sector. Most important, we suggested keeping some incentives, such as the R & D tax credit, since they were appropriate for economic reasons (although we did suggest that the R & D credit is too generous by international standards).

In other words, the committee looked for a balanced package of corporate income tax changes. It seems that this balance was largely achieved. After the release of the report, it became apparent to me that most business groups were split in their reaction to the recommendations, since some members were to gain from the proposals and others were to lose.
Most, however, supported the principle that the tax system should be more neutral, with internationally competitive tax rates.

The committee looked not only at the corporate income tax and environmental taxes, but also at the employment insurance system. The work by Statistics Canada showed considerable variation among firms in terms of the difference in firms’ contributions paid to the fund and costs imposed in dismissing workers. The committee thought it was appropriate to consider how the employment insurance employer premiums could be restructured. One view was to proceed on the basis that employers’ contributions are simply revenues received by the government that may fund any operation, not just employment insurance. With this view, the employer contribution should be assessed as a flat tax on payroll without an earnings limit. The other view, and the one adopted by the committee, was to improve the underlying principles of employment insurance. The committee assessed the move to a partial experience-rating system, whereby a firm would have to pay higher contributions if it tended to lay off workers more often than other firms—a system that in the United States is almost 75 years old. The employment insurance system would still share risks with employers facing economic instability, but the partial experience-rating system would reduce the moral hazard associated with increased turnover of workers. The one issue of concern to the committee was the administrative and compliance costs of an experience-rating system, compared to the existing system. However, given the recent changes to employment insurance in restructuring individual benefits that would facilitate administration, and estimates of substantial economic gains resulting from an experience-rating system, we concluded that the net benefit of moving to an experience-rating system was considerable.

One of the central issues that the committee had to deal with at the final development of the report was the international competitiveness of the business tax system in Canada. As our proposals had to be revenue-neutral, we were able to reduce the effective tax rate on marginal costs of production for service industries that have increasingly been subject to international competitiveness. However, this reduction was achieved at the expense of increasing the effective tax rate on marginal costs of production for internationally competitive manufacturing industries, even though the effective tax rate is currently consistent with that of other countries, especially the United States.

The implications of our proposals raised a central issue of debate for the committee—namely, what is the best tax structure for international competitiveness? One view, which is largely consistent with the traditional free trade theory of international trade, is that the best tax structure is one that is neutral across business activities. Under this theory, an equal tax burden on production costs would not affect the relative terms of trade for a country and therefore would achieve the highest degree of productive efficiency. The tax on production costs would be reflected in a lower exchange rate for the economy, but resources would be allocated to
their best use, which is to produce goods and services that are the comparative advantage of a country.

A second view is that tax burdens should vary across business activities depending on the degree of competition faced by international competitors. This view would be more consistent with a theory that considers multinational firm production in different markets throughout the world. In contrast to the traditional international trade model, which assumes that each country has its own independent production sector, under this theory businesses operate with worldwide production processes that link factors of production across countries. Thus, differences in tax rates on business activities across countries affect directly the location and efficiency of multinational business activities, and it may not be advantageous for a country to tax some sectors more highly than international competitors. A country should accordingly try to harmonize its tax policies with those of other countries, even if other countries have non-neutral tax systems.

The committee came to the view that it is nearly impossible to match what other countries do, since tax rates vary across countries and industries and may be assessed at a rate of zero in at least one country in the world. Instead, one should only be very selective, taking an approach that generally supports tax neutrality across business activities within Canada but keeps in mind significant constraints when tax rates may be out of line with those applied to major competing industries. Thus, the committee suggested that the federal government review the overall amount of business taxes that are collected if its proposals result in problems of international competitiveness, particularly for the manufacturing sector.

Overall, international competitiveness of tax systems is an issue that needs far more understanding than is currently provided by the economics literature. We need to go beyond the typical trade models with country-specific production to models with internationally linked production processes. I recommend to my economic colleagues that they develop further theoretical and empirical work on this topic.