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## Policy Forum: Piecemeal Tax Reform Ideas for Canada—Lessons from Principles and Practice

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### PRÉCIS

La structure de base du régime fiscal des particuliers et des sociétés au Canada s'inspire de principes qui étaient répandus au moment du rapport Carter. Ces principes incluent l'imposition fondée sur la capacité de payer, qui repose sur l'imposition du revenu global comme base idéale, accompagnée d'un impôt des sociétés conçu pour retenir l'impôt à la source sur le revenu des actionnaires dans le but d'empêcher sa mise à l'abri illimitée au sein des sociétés. Diverses réformes fragmentaires ont eu lieu depuis lors, dont bon nombre déplacent la base du côté de la consommation personnelle. Cependant, des vestiges de l'approche d'imposition du revenu global demeurent, comme une structure à taux uniforme et une assiette d'impôt des sociétés qui est censée refléter le revenu de l'actionnaire.

Les idées sur l'impôt optimal et les circonstances économiques ont évolué considérablement depuis le rapport Carter. Au commencement, le revenu global comme base idéale était contesté par une taxe à la consommation progressive. Cette idée a par la suite été supplantée par une approche mettant l'accent sur le bien-être individuel ou l'« assistantialisme ». Cette dernière a été contestée dernièrement par les idées d'égalité des chances, qui mettent l'accent sur les occasions dont profitent les contribuables, plutôt que sur les résultats qu'ils obtiennent. En outre, l'impôt des sociétés est de plus en plus perçu comme une façon d'imposer les superprofits des sociétés, plutôt que de retenir l'impôt à la source sur le revenu des actionnaires.

L'auteur parcourt la littérature qui a façonné ces changements et certaines des pratiques qui ont émergé dans d'autres pays. Parmi les principaux éléments de cette littérature, il y a les récentes commissions sur la réforme fiscale au Royaume-Uni, aux États-Unis et en Australie, qui sont toutes pertinentes pour le Canada. Au nombre des pratiques novatrices, notons les régimes d'imposition différenciée instaurés dans les pays nordiques et les régimes d'imposition des superprofits, tels que la déduction pour fonds propres des sociétés et l'impôt sur les bénéfices tirés des ressources. L'auteur puise dans ces idées et pratiques afin de faire des recommandations en vue d'une réforme fiscale au Canada.

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**ABSTRACT**

The basic structure of the Canadian personal and corporate tax system is informed by principles that were prevalent at the time of the Carter report. These principles include taxation based on the ability to pay, which supports comprehensive income taxation as the ideal base, accompanied by a corporate tax designed to withhold shareholders' income at source to prevent unlimited sheltering within corporations. Various piecemeal reforms have occurred since then, many of which move the base toward personal consumption. Yet, vestiges of the comprehensive income approach remain, such as a single-rate structure and a corporate tax base that is meant to reflect shareholder income.

Ideas about optimal tax design and economic circumstances have evolved considerably since the Carter report. Initially, comprehensive income as an ideal base was challenged by progressive consumption taxation. This was later supplanted by an approach that emphasized individual well-being or welfarism. This in turn has recently been challenged by equality-of-opportunity ideas, which emphasize the opportunities that taxpayers enjoy, rather than the outcomes that they achieve. Additionally, the corporate tax has increasingly come to be seen as a device for taxing corporate rents, rather than for withholding shareholders' income at source.

The author recounts the literature that has informed these changes and some of the practices that have emerged in other countries. Key elements of the literature include recent tax reform commissions in the United Kingdom, the United States, and Australia, each of which has relevance for Canada. Innovative practices include the dual income tax systems introduced in the Nordic countries and rent tax systems, such as the allowance for corporate equity and the resource rent tax. The author draws on these ideas and practices to offer some recommendations for tax reform in Canada.

**KEYWORDS:** CARTER COMMISSION ■ TAX POLICY ■ TAX REFORM ■ INDIVIDUAL INCOME TAXES ■ CORPORATE INCOME TAXES ■ PROGRESSIVE TAXES

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## INTRODUCTION

The Canadian tax system has evolved considerably since the early postwar period, but it is still anchored in the ideas of that time. These ideas were synthesized in Musgrave's famous public finance treatise and formed the basis of two influential tax policy reports: the report of the Royal Commission on Taxation of Profits and Income in the United Kingdom and the report of the Royal Commission on Taxation (Carter report) in Canada.<sup>1</sup> The recommendations in these reports flowed from the notion that comprehensive income was the ideal tax base, and all else followed from that. Two ideas were paramount: all sources of income should be fully included in the personal tax base, and the corporate income tax should serve as a withholding tax to ensure that shareholders could not use a corporation as a vehicle for avoiding personal tax.

The Carter report recommendations were never fully implemented, and the Canadian tax system never achieved the comprehensive income tax ideal. As time has gone by, gradual reforms of the system have moved it further away from the ideal. Nonetheless, comprehensive income taxation continued to inform the policy debate, and movements away from the ideal (such as sheltering returns on retirement savings from taxation) were considered to be justifiable exceptions. The idea of the corporate tax as a withholding device persisted. The base of this tax has always been shareholders' income, and it has continued to be accompanied by devices to integrate it with the personal tax to return the taxes that had been withheld from shareholders at the corporate level. The imperfections of these integration measures were highlighted by the Mintz report,<sup>2</sup> but the role of the corporate tax was not questioned.

In light of the distance that the system has strayed from the ideal, it is odd that the comprehensive income tax has continued to be the underlying principle of taxation. This is particularly evident with the introduction and prominence of the goods and services tax (GST) and the harmonized sales tax (HST), which as consumption-based taxes contradict the comprehensive tax ideal. What is more evident is that the persistence of the comprehensive income tax ideal has been overtaken by both ideas and circumstances. The purpose of this article is to recount the evolution of ideas and circumstances, and to describe how this evolution has found its way into recent important tax policy proposals in the United Kingdom, the United States, and Australia. No such fundamental rethinking of tax policy has taken place in Canada, but some of the recent themes can be readily adapted to Canadian circumstances.

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1 Richard A. Musgrave, *The Theory of Public Finance: A Study in Public Economy* (New York: McGraw-Hill, 1959); United Kingdom, *Royal Commission on the Taxation of Profits and Income: Final Report* (London: HMSO, 1955); and Canada, *Report of the Royal Commission on Taxation* (Ottawa: Queen's Printer, 1966) ("the Carter report").

2 Canada, *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, April 1998) ("the Mintz report").

## THE EVOLUTION OF TAX PRINCIPLES AND PRACTICES

There has been a parallel evolution of circumstances, tax policy ideas, and practices. Nations like Canada now face economic settings that are very different from those encountered decades ago, and this constrains tax choices. International openness and competitiveness have increased dramatically, and capital and skilled labour are highly mobile. Labour markets have transformed as skills have improved and as labour participation rates for women have risen. Employment and earnings have become more volatile, and the composition of industries has changed, with the decline of agriculture and manufacturing and the expansion of finance, services, and resource industries. At the macroeconomic level, recurring problems of public indebtedness and growing demographic changes put pressure on public finances. At the same time, the cost of public services is rising owing to their labour intensiveness. There has been a significant rise in inequality, whose determinants are not fully understood. In addition, views of tax policy should be influenced by a less well-recognized feature of modern industrialized economies: the growing importance of rents in the economic system, whether as a result of knowledge or informational advantages, industry concentration, or fixed factors such as resources.

At the same time, tax policies have changed. Most countries have adopted value-added (sales) taxation (VAT). Combined with the increasing use of capital income-sheltering schemes, especially but not exclusively in relation to retirement savings, the overall tax system has come to be based more on consumption than on income. Even those countries, such as the United Kingdom and the Nordic countries, that include most capital income in their bases do so at preferential rates. As discussed further below, the Canadian system is arguably now very close to a progressive consumption tax system. Tax systems, income and sales taxes combined, have also become less progressive, especially in the upper half of the income distribution. In Canada, the decentralization of revenue raising to the provinces has contributed to this situation. At the lower end of the income distribution, the innovation of the refundable tax credits and the continued provision of universal public services have mitigated the reduction in progressivity, although transfers to the poor at the provincial level have faded. Notably, inheritance and wealth taxes have faded, and in Canada these taxes disappeared soon after they were devolved to the provinces.

The evolution of ideas is significant and ongoing, and it will be discussed in more detail below. The longstanding paradigm of the first half of the 20th century—going back to the German economist Schanz<sup>3</sup> at the end of the 19th century—was that taxes should be based on the ability to pay, as reflected in comprehensive income, and that progressivity relied on the notion of equal sacrifice. The Carter report proposed a nuanced version of the ability-to-pay rationale by distinguishing between

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3 George von Schanz, “Der Einkommensbegriff und die Einkommensteuergesetze” (1896) 13 *FinanzArchiv* 1-87.

discretionary and non-discretionary income. Non-discretionary income represented the amount of income that was required for the necessities of life and should be taxed at a lower rate than income that was not required for these necessities. The comprehensive income paradigm was challenged by Kaldor,<sup>4</sup> who suggested that taxing persons on the basis of their consumption (what they took from society) was fairer than taxing them on the basis of their income (what they contributed). A direct consumption or expenditure tax, whose base is income less savings, could achieve this result in a progressive way. The expenditure tax conditioned the ability-to-pay approach on the basis of the manner in which taxpayers chose to use their income.

A fundamentally different perspective on tax design—and the one that is currently dominant—was introduced by the optimal tax literature in the 1970s with the seminal work of Mirrlees.<sup>5</sup> The approach is inherently mathematical and formal, but underlying it are ideas that distinguish it from the ability-to-pay approach and its extensions. The ultimate objective of the tax system is to extract tax revenues from taxpayers according to how well off they are, and how well off a person is depends conceptually on a utility function that respects individual preferences. Noteworthy consequences of this approach, referred to as welfarism or (loosely as) utilitarianism, are as follows.

First, the ideal tax base depends on the form of preferences over goods and services consumed today, those consumed in future periods, and leisure. Thus, the structure of preferences determines whether differential tax rates should apply to different goods, or whether a uniform tax should apply. Preferences also determine the tax treatment of present versus future consumption—that is, the taxation or non-taxation of capital income. Ability to pay alone is not relevant; how the ability to pay is exercised by spending and savings decisions is. Second, the degree of progressivity is determined by the concavity of utility—that is, how rapidly the marginal utility of income diminishes with income. Third, the utilitarian analysis assumes that well-being is comparable interpersonally, an assumption that typically deems persons to have identical preferences. Finally, unlike equal sacrifice approaches associated with the ability to pay, welfarism is consequentialist in the sense that policies are judged by their final outcomes, regardless of where people start. Following Rawls,<sup>6</sup> this implies that the productive capacities of taxpayers are effectively regarded as common property available for redistribution to those who are less well endowed.

Welfarism has recently been called into question, as is discussed in more detail below. Some criticisms are fundamental, such as the argument that welfare cannot be meaningfully measured and compared across persons, especially when they have

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4 Nicholas Kaldor, *An Expenditure Tax* (London: Allen & Unwin, 1955).

5 James A. Mirrlees, "An Exploration in the Theory of Optimum Income Taxation" (1971) 38:2 *Review of Economic Studies* 175-208.

6 John Rawls, *A Theory of Justice* (Cambridge, MA: Belknap Press of Harvard University Press, 1971).

very different preferences and therefore make very different choices in similar circumstances. This criticism leads some scholars, such as Fleurbaey and Maniquet, and Sen, to propose that tax policy be based on measures of resource availability, perhaps akin to the ability to pay, or the equality of opportunity in the case of Roemer.<sup>7</sup> Others argue that consequentialism is unsatisfactory since it gives the state licence to engage in excessive redistribution, a criticism recently voiced by Feldstein.<sup>8</sup> There are also objections to welfarism on the basis of behavioural economics, which suggest that basing policy on revealed preferences may lead to unsound outcomes. Finally, some observers object to normative approaches per se, and argue that they should be tempered by political economy considerations. Political constraints can certainly be demanding: consider the difficulty of enacting revenue-neutral tax reforms when some persons gain and other persons lose, or the challenge of undoing preferential and distortionary tax policies that generate rent for some taxpayers. A convincing case can nevertheless be made that normative tax prescription, unfettered by political constraints, is a sensible approach.<sup>9</sup>

Despite these concerns, welfarism remains the prevailing approach to tax policy proposals. Recent influential reform proposals have been heavily, even exclusively, influenced by the utilitarian or welfarist perspective, as represented by the optimal income taxation approach. Three important tax policy reviews include the President's Advisory Panel on Tax Reform in the United States, the Mirrlees review in the United Kingdom, and the Henry report in Australia.<sup>10</sup> Of the three, the Mirrlees review is the most thorough. Though nominally devoted to UK tax reform, its key policy recommendations for the major tax types (personal, corporate, sales, inheritance, and property) are relevant for other Organisation for Economic Co-operation and Development (OECD) countries, including Canada. It consists of two substantial volumes, one a series of tax-specific research studies, each written jointly by an

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7 Marc Fleurbaey and François Maniquet, *A Theory of Fairness and Social Welfare* (Cambridge, UK: Cambridge University Press, 2011); Amartya K. Sen, *Commodities and Capabilities* (Amsterdam: North-Holland, 1985); John E. Roemer, *Equality of Opportunity* (Cambridge, MA: Harvard University Press, 1998).

8 Martin Feldstein, "The Mirrlees Review" (2012) 50:3 *Journal of Economic Literature* 781-90.

9 The case for ignoring political constraints in normative policy analysis is made in Robin Boadway, "The Role of Public Choice Considerations in Normative Public Economics," in Stanley L. Winer and Hirofumi Shibata, eds., *Political Economy and Public Finance: The Role of Political Economy in the Theory and Practice of Public Economics* (Cheltenham, UK: Edward Elgar, 2002), 47-68.

10 United States, President's Advisory Panel on Federal Tax Reform, *Simple, Fair and Pro-Growth: Proposals To Fix America's Tax System* (Washington, DC: President's Advisory Panel on Federal Tax Reform, 2005); James A. Mirrlees, Stuart Adam, Tim Besley, Richard Blundell, Stephen Bond, Robert Chote, Malcolm Gammie, Paul Johnson, Gareth Myles, and James Poterba, *Tax by Design: The Mirrlees Review* (Oxford: Oxford University Press, 2011) ("the Mirrlees review"); Australia, Department of the Treasury, *Australia's Future Tax System* (Canberra: Commonwealth of Australia, 2010) ("the Henry report").

international scholar, a UK scholar, and a UK practitioner, and the other a report written on behalf of a committee chaired by the Nobel laureate, Sir James Mirrlees. The research deployed state-of-the-art optimal tax analysis backed up by formidable empirical analysis of the effect of taxation on household decision making over the life cycle. Its proposals include fundamental reforms to personal and corporate taxation, some of which are suitable for Canada, as discussed later. There is considerable overlap between the ideas in the president's panel and those in the Henry report. Of particular interest for Canada in the Henry report is the proposal for a resource rent tax (RRT) for the mining sector. An RRT is one of several ways of levying an efficient tax that is designed to capture a share of natural resource rents for the public sector.

The question to be explored in the following sections is what these evolutions of ideas and practices suggest for tax policy in Canada. A detailed summary of this evolution precedes a discussion of the policy implications for the Canadian tax system.

## **A SELECTIVE HISTORY OF MAJOR TAX POLICY REPORTS**

The sequence of tax policy reports over the postwar period illustrates the way in which thinking about tax policy has evolved. Three are singled out as representative.

### **The Starting Point: The Carter Report**

The Carter report, following its precursor in the United Kingdom, the Royal Commission on the Taxation of Profits and Income, represents the culmination of a long tradition of advocating the comprehensive income tax ideal. Comprehensive income aggregates income from all sources, including labour, capital, and property, and can equivalently be defined by means of an individual's budget constraint as the sum of consumption and additions to wealth through saving. Comprehensive income represents a taxpayer's command over resources: it is the maximum amount that can be consumed while keeping wealth intact. It is taken to be an index of the ability to pay taxes, and it is divorced from actual decision making. Unlike the welfarist alternative, it does not profess to measure well-being; rather, it is a measure of potential consumption and as such is in principle objective.

The comprehensive income approach uses personal income taxation as the appropriate tax form. Carter therefore focused largely on income taxation as the relevant tax base, setting aside indirect sales taxation as unnecessary.

The choice of a rate structure is more problematic since it requires some judgment about how much potential consumption should be given up by different taxpayers. It is tempting to appeal to the classical notion of equal sacrifice, but this notion is traditionally rooted in utilitarianism. The Carter prescription was innovative, and its innovation was to distinguish between necessary and discretionary consumption, with only the latter being worthy of taxation. Of course, this distinction is not sufficient to characterize the full rate structure to be applied to discretionary expenditure. It is not entirely clear what underlying principles should inform the progressivity of

the comprehensive income tax—that is, how much potential consumption should be sacrificed by various income groups. This issue was not satisfactorily resolved. What was important was that a single rate structure should apply to aggregate comprehensive income, whatever its source. As Carter put it, “a buck is a buck.”

Comprehensive income taxation is an ideal. Its practical shortcomings are daunting since it requires the measurement of all forms of income, which is especially problematic for asset income. Some income takes an imputed form, such as the imputed return on housing and other consumer durables. Income from personal business assets is particularly hard to measure since it requires estimating the costs of earning income, such as depreciation. This problem is even more difficult for human capital. Other forms of income, such as capital gains, accrue without being reflected in market transactions. The best that can be done is to include capital gains as income when they are realized, rather than when they accrue. Changes in wealth can also occur if assets are given away. Unless donations are regarded as consumption, comprehensive income should be reduced by the full amount of a donation. The proper treatment of asset income also requires that only real income, and not a nominal income, be included, which gives rise to complicated methods of indexation for inflation.

The prescription of comprehensive income taxation in the Carter report involved a natural role for corporate taxation. Because capital gains cannot be taxed unless they are realized, the taxation of shareholder income can be postponed while capital gains accumulate by retaining profits in a corporation. Corporate taxation can counteract this accumulation by taxing shareholder income at the corporate level as it is earned, and providing a credit for corporate taxes paid when the funds are paid out to the shareholders. The Carter report recommended an intricate form of personal-corporate tax integration involving a dividend tax credit system based on corporate taxes that have actually been paid on the relevant shares. This system was prohibitively difficult to implement because of the difficulty of associating the flow of past corporate tax payments with the flow of future dividend payments and the complications that arise from different forms of dividends, such as intercorporate dividends; the need to distinguish domestic from foreign shareholders; and the changing tax status of corporations. In practice, integration could be approximated only by dividend tax credit and preferential capital gains provisions that use uniform rates, rather than rates that are tied to corporate taxes that have actually been paid.

Of note for the Canadian case is that the withholding rationale for corporate taxation also applies to foreign shareholders who would otherwise escape taxation on income earned in Canada. Of course, this rationale fails to address how international income should be taxed, but these considerations take us too far afield.

Many implementation issues (apart from measurement) apply to comprehensive income taxation, and many of these also apply to tax bases, which are considered below. One is the treatment of the family, both cohabitating spouses and children. Potential consumption can be defined at either the individual or the family level, but the issue then becomes what rate structure to use. In the spirit of Carter, this involves identifying the level of non-discretionary income at the family level. Another

issue is how to deal with fluctuating income, which can lead to unfair tax treatment among taxpayers with different degrees of income volatility. In principle, this matter can be addressed by a system of income averaging over time, something that is clearly feasible with today's tax-collecting technology.

A final concern involves the treatment of inheritances. The idea of comprehensive income presumably implies that inheritances represent an addition to wealth that should be included in comprehensive income. The treatment of bequests from the donor's point of view is not as clear. If a bequest is treated as an act of consumption, this consumption cancels out the loss in wealth, and therefore the donor faces no tax consequences. In this case, the bequest gives rise to consumption benefits both for the donor and for the inheritor, a form of double counting that some may find objectionable.<sup>11</sup> If a bequest is not treated as an act of consumption, the reduction in wealth should reduce the donor's comprehensive income. The taxation of inheritances combined with the deduction for bequests would make bequest taxation a wash.

The principles of the Carter report are important because they form the basis for some aspects of the Canadian tax system and continue to inform policy. All forms of taxable income are aggregated into a single base, and a common rate structure is applied. Of course, the base is not comprehensive since some forms of capital income are exempt. The corporate tax is designed to be a withholding tax in accordance with the thinking of Carter, albeit imperfectly. The base is shareholder income (for both domestic corporations and foreign corporations operating in Canada), and the corporate tax is integrated with the personal tax through the dividend tax credit and the preferential treatment of capital gains. The tax base for unincorporated business income is defined in a similar way in accordance with comprehensive income principles. Though the base strays from the comprehensive income tax ideal, reforms are judged through the prism of this ideal.

### The Progressive Consumption Tax Alternative

A seemingly simple alternative to potential consumption as a direct tax base is actual consumption, although its practical consequences would be much more profound. The idea is typically attributed to Kaldor,<sup>12</sup> who had proposed personal consumption or expenditure taxation in his minority report to the Royal Commission on the Taxation of Profits and Income.<sup>13</sup> However, it had its classical precursors in Mill,

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11 This matter is discussed in detail in Robin Boadway, Emma Chamberlain, and Carl Emmerson, "Taxation of Wealth and Wealth Transfers," in James A. Mirrlees, Stuart Adam, Tim Besley, Richard Blundell, Stephen Bond, Robert Chote, Malcolm Gammie, Paul Johnson, Gareth Myles, and James Poterba, eds., *Dimensions of Tax Design: The Mirrlees Review* (Oxford: Oxford University Press, 2010), 737-814. This is one of the background research papers prepared for the Mirrlees review.

12 *Supra* note 4.

13 *Supra* note 1.

Pigou, and Fisher.<sup>14</sup> Kaldor's argument was a straightforward extension of the command-over-resources approach of comprehensive income: taxpayers should be taxed according to what they take out of the economy (consumption) rather than what they contribute (income). Instead of taxing a person's income, the base would be income less changes in wealth (saving). Being a direct tax levied on individuals, a progressive rate structure could be applied, and in principle any degree of progressivity could be chosen, thus undercutting any equity concerns about favouring high-income persons, whose savings tend to be higher than those of low-income persons.

Detailed policy versions of Kaldor's proposal appeared in the US Treasury blueprints and the Meade report.<sup>15</sup> Similar Canadian proposals also came from the Economic Council of Canada and the Macdonald commission.<sup>16</sup> These proposals were all similar, and I focus here on the Meade report. The rationale for consumption taxation began to take on a more utilitarian form. Consumption taxation was viewed as more equitable than comprehensive income taxation, both horizontally between persons with different saving habits and different income volatility, and over the lifetime because consumption is more stable than income. Consumption taxation might also be more efficient since, by taxing capital income at substantial rates, it discourages the choice of future over current consumption, although partly at the expense of higher tax rates on labour supply. The most powerful arguments are administrative. By eliminating savings from taxation, the problems of measuring and indexing asset income are avoided. Moreover, because the need to use corporate taxation for withholding is eliminated, it can be devoted to other tasks, such as taxing rents. From a political economy point of view, greater progressivity can arguably be achieved without including capital income in the tax base, given the responsiveness of capital income to taxation at higher income levels.

It is instructive to outline the exact tax design proposals of the Meade report. They consist of three main elements: the personal tax base, the corporate tax base, and the inheritance tax. (As in the Carter report, sales taxes are unexamined.)

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14 John Stuart Mill, *Principles of Political Economy: With Some of Their Applications to Social Philosophy* (London: Parker, 1848); Arthur C. Pigou, *A Study in Public Finance* (London: Macmillan, 1928); and Irving Fisher, "The Double Taxation of Savings" (1938) 29:1 *American Economic Review* 16-33. Fisher's arguments have recently been summarized in John B. Shoven and John Whalley, "Irving Fisher's Spendings (Consumption) Tax in Retrospect" (2005) 64:1 *American Journal of Economics and Sociology* 215-35.

15 United States, Department of the Treasury, *Blueprints for Basic Tax Reform* (Washington, DC: Department of the Treasury, 1977); Institute for Fiscal Studies, *The Structure and Reform of Direct Taxation: Report of a Committee Chaired by Professor J.E. Meade* (London: Allen & Unwin, 1978) ("the Meade report").

16 Canada, *Royal Commission on the Economic Union and Development Prospects for Canada, Report* (Ottawa: Supply and Services, 1985) ("the Macdonald commission"); Economic Council of Canada, *Road Map for Tax Reform: The Taxation of Savings and Investment* (Ottawa: Supply and Services, 1987).

The personal tax base differs from comprehensive income as a result of the treatment of assets and capital income, and this treatment takes three different forms, depending on the type of asset. Some assets, such as consumer durables and selected financial assets, are treated on a tax-prepaid basis. Their acquisition (or disposal) is not deductible from income, and their asset income is tax-exempt. To use the terminology of the Mirrlees review, their treatment is “TEE”: savings are out of after-tax income (T), asset income is tax-exempt (E), and sales of assets are tax-exempt (E). Other assets, such as savings for retirement, are treated on a registered basis, or “EET”: the purchase is tax-deductible (E), asset income accumulates tax-free while the asset is held (E), and principal and accumulated asset returns are taxed on disposition (T). A final set of assets are taxed on a cash flow basis; these assets include human capital accumulation (forgone earnings are implicitly deductible along with tuition and other costs, and increased earnings are taxed) and personal businesses (input purchases are deducted, and sales are taxed on a cash accounting basis). The intent is for the present value of the tax base to be equivalent to consumption, although, as the Mirrlees review emphasized, this is not accomplished for tax-prepaid savings. The various tax treatments of assets reflect the fact that income is difficult to measure for some assets. In addition, the ability of the taxpayer to choose how financial assets are treated allows self-averaging to smooth tax liabilities over the life cycle.

The corporate tax base proposed was cash flow: sales less all purchases, both current and capital, on a cash basis. Since persons were not liable for capital income taxation, there was no need for withholding at the corporate level. Rather than simply abolishing the corporate tax, it would instead be used to tax pure profits or rents, and a cash flow corporate tax roughly accomplishes that. I say “roughly” because cash flow taxation taxes any returns to risk, while allowing a deduction for risky losses. The integrity of the cash flow tax allows full loss offsetting or, equivalently, the carrying forward of losses with interest.

Some aspects of cash flow taxation are worth noting. First, as long as corporations are risk-neutral, cash flow taxation has no effect on investment or other choices. Risk-averse corporations might even be encouraged to invest since under a cash flow tax the government effectively shares the risk. Second, the pure form of cash flow taxation includes only real transactions. However, the Meade report suggested that the tax could either be restricted to real cash flows (the R base) or it could include financial cash flows as well (the R+F base) to tax rents in the financial sector. Third, it is necessary to consider whether the integration of the corporate and the personal tax is necessary, especially given the complexity. The case for integration is that some rents are taxed at the personal level to the extent that shareholders hold their assets in registered form, under which all asset returns are taxed on withdrawal. Because not all rents are taxed at the personal level, however, to provide credit would simply undo the purpose of the corporate tax. Since it is not practically feasible to distinguish the two cases, the case for integration is diminished.

The final element of the Meade report’s consumption tax agenda is a cumulative progressive inheritance tax on inheritors. This is a contentious proposal, and no strong justification was given for it. Implicit was the idea that inheritances represent

a windfall source of income to inheritors, which finances consumption and ought to be taxed. No consideration was given to the standing of bequests to donors and its implication for their tax treatment.

### **The Mirrlees Review: The Welfarist Reincarnation of Meade**

The Mirrlees review represents the conquest of tax policy analysis by the optimal taxation approach. It is based on state-of-the art optimal income tax principles backed by detailed empirical analysis and enunciated in detailed background research by well-known international scholars. Unlike its Carter and Meade precursors, the review covers the entire tax system. It is the ultimate welfarist blueprint for a revenue- and distribution-neutral tax reform. Some of the same ideas are found in the president's panel and the Henry report, but they are not presented nearly as comprehensively.

The Mirrlees review was set up to mark the 30th anniversary of the Meade report, and (coincidentally or not) its prescriptions for direct taxation were similar. At the personal level, its authors argued for a modern variant of the Meade progressive expenditure tax scheme. Some assets, particularly bonds and consumer durables, would be treated as tax-prepaid (TEE). Saving for retirement would be registered (EET). However, for shares held in firms a new treatment called "TtE" was devised. Instead of capital income going untaxed, as in tax-prepaid assets, only a normal rate of return would be exempt; above-normal returns, including rents, would be taxed. Returns to risk would be taxed as well, although negative returns would be exempt. This approach was presumably motivated by the desire to tax the unexpectedly high returns of a buoyant stock market, but the feasibility of administering this system was not addressed.

Corporate and personal businesses would also face a rent-type tax, as advocated in the Meade report, but instead of a simple cash flow version, a so-called allowance for corporate equity (ACE) was proposed. This system allows a deduction for both debt and equity finance and can be designed to be equivalent to a cash flow tax in present-value terms.<sup>17</sup> The ACE system had been proposed for Europe by the Institute for Fiscal Studies and was since adopted in Belgium, Italy, Croatia, and Brazil.<sup>18</sup>

The Mirrlees review, like the Meade report, contained recommendations for a progressive inheritance tax on inheritors' lifetime receipts, although its arguments were couched in terms of equality of opportunity rather than utilitarianism. But the Mirrlees review went beyond the Meade report in many other ways. It recognized the role of a separate system of transfers to less well off persons, but proposed that the

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17 This was demonstrated by Robin Boadway and Neil Bruce, "A General Proposition on the Design of a Neutral Business Tax" (1984) 24:2 *Journal of Public Economics* 231-9; and Stephen R. Bond and Michael P. Devereux, "On the Design of a Neutral Business Tax Under Uncertainty" (1995) 58:1 *Journal of Public Economics* 57-71.

18 Institute for Fiscal Studies, Capital Tax Group, *Equity for Companies: A Corporation Tax for the 1990s: A Report of the IFS Capital Tax Group*, IFS Commentary no. 26 (London: IFS, 1991). International experience with the ACE system has been summarized in Alexander Klemm, "Allowances for Corporate Equity in Practice" (2007) 53:2 *CESifo Economic Studies* 229-62.

tax and transfer system, including refundable tax credits analogous to Canada's working income tax benefit (WITB), should be integrated to avoid precipitous increases in marginal tax rates. Following recent optimal income tax analysis, it put particular emphasis on participation tax rates—that is, on the sum of taxes incurred and transfers lost when taxpayers choose to participate in the labour market. Its own research identified situations in which participation was particularly responsive to the tax-transfer system, including secondary earners in families with small children and workers near retirement age. It also drew on optimal tax principles, particularly the Atkinson and Stiglitz theorem and its recent generalization by Laroque and Kaplow,<sup>19</sup> and its own empirical work to recommend eliminating all special exemptions in the VAT, while changing the income tax rate structure to maintain distribution neutrality. Finally, it recommended changing the property tax to a land valuation tax and adjusting excise taxes to take proper account of road congestion and carbon pricing.

Despite this ambitious set of recommendations, there were a few blind spots in the Mirrlees report. Given the self-imposed constraint of distribution neutrality, no position is taken on the optimal progressivity of the tax system. This has been an active area in optimal taxation research, and is highly relevant to policy, given the current rancour about growing income and wealth inequality. Although much emphasis is placed on harmonizing taxes and transfers, no attention is paid to the social insurance role of the tax-transfer system, particularly unemployment insurance. This would have been timely, given the volatility of earnings and employment, and the anxiety created by the recent “great recession.” Also missing is consideration of taxation of the family and the tax treatment of human capital accumulation. There is no discussion of multijurisdictional tax issues, despite the devolution of taxation powers to the Scottish Parliament and the debate over the Scottish independence referendum.

Finally, two major issues are left incomplete, and these are relevant for my later discussion. One is the taxation of capital income. The Mirrlees review opted for a system that is very similar to the system advocated in the Meade report wherein most capital income is sheltered from tax. The exception is above-normal capital income, which is taxed on share ownership (TtE), retirement savings (EET), and personal business income (ACE). All normal returns to saving are tax-free, which is oddly inconsistent with the advice contained in the background research papers. The paper by Banks and Diamond<sup>20</sup> in particular makes a cogent case for taxing capital income, albeit at a rate that is lower than the tax on earnings.

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19 Anthony B. Atkinson and Joseph E. Stiglitz, “The Design of Tax Structure: Direct Versus Indirect Taxation” (1976) 6:1 *Journal of Public Economics* 55-75; Guy Laroque, “Indirect Taxation Is Superfluous Under Separability and Taste Homogeneity: A Simple Proof” (2005) 87:1 *Economics Letters* 141-44; and Louis Kaplow, “On the Desirability of Commodity Taxation Even When Income Taxation Is Not Optimal” (2006) 90:6 *Journal of Public Economics* 1235-50.

20 James Banks and Peter Diamond, “The Base for Direct Taxation,” in *Dimensions of Tax Design*, supra note 11, 548-648.

The second issue is natural resources taxation, particularly the taxation of offshore North Sea petroleum. This form of taxation would be a significant, albeit temporary, source of tax revenue for Scotland in the event of independence, and is currently a source of UK tax revenues, but it is not discussed in the Mirrlees review.

Non-renewable resource taxation was treated in detail in the Henry report in Australia.<sup>21</sup> The report contained recommendations to impose a rent tax on the mining industry, and proposed an RRT, following the analysis of Garnaut and Clunies-Ross.<sup>22</sup> Like the ACE, the RRT is a cash flow equivalent tax. Consider a resource project that involves some initial investment in exploration and development, and then produces a revenue stream as the resource is extracted. Cash flows are initially negative and are put into an account that increases at a risk-free interest rate each year. Once the value of the account becomes positive, cash flows are fully taxable throughout the life of the project. In effect, negative cash flows are carried forward at a risk-free interest rate until they are offset by positive cash flows. As long as all negative cash flows are eventually offset, the tax is equivalent to a cash flow tax. For firms that wind up before negative cash flows have been offset by positive ones, a tax refund is required so that the tax remains neutral with respect to a firm's decisions. This refundability of losses of firms that have been wound up is important because a significant proportion of new resource firms never become profitable. (Governments apparently find it difficult to refund losses of firms that wind up, although this is the practice in Norway.)

The RRT was implemented in the mining industry by the Australian federal government despite considerable opposition from the mining industries. It applies alongside state-level mining taxes. It could equally well be used in other non-renewable resource industries, such as oil and gas.

## HAS THE WELFARIST APPROACH BEEN TAKEN TOO FAR?

The Mirrlees review was dominated by welfarist or utilitarian thinking, which is not surprising, given Mirrlees's seminal role in developing optimal income taxation. The analytical underpinnings of the Mirrlees review rely on some key results from optimal tax theory. These include the Atkinson-Stiglitz theorem supporting a uniform VAT, with its important generalization by Kaplow and Laroque; the production efficiency theorem of Diamond and Mirrlees,<sup>23</sup> which further favours the VAT form; the role of job market participation subsidies, such as the WITB, emphasized by

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21 *Australia's Future Tax System*, supra note 10.

22 Ross Garnaut and Anthony Clunies-Ross, "Uncertainty, Risk Aversion and the Taxing of Natural Resource Projects" (1975) 85:338 *Economic Journal* 272-87.

23 Peter A. Diamond and James A. Mirrlees, "Optimal Taxation and Public Production I: Production Efficiency" (1971) 61:1 *American Economic Review* 8-27.

Diamond and Saez;<sup>24</sup> the integration of taxes and benefits into a single progressive tax-transfer system with positive marginal income tax rates throughout the income distribution; and the design of efficient rent-based business taxation. There were also important insights into optimal progressivity, based on utilitarian logic that is constrained by incentive effects, and into the desirability of taxing capital income. Although these ideas formed part of the background studies of the Mirrlees review, they were not drawn on in the final report.

As mentioned, the Mirrlees review, along with the president's panel in the United States, culminated a fundamental shift from the ability-to-pay principles of the Carter report to the exercise of the ability to pay through consumption choices in the Meade report, to the utility-based social welfare approach. In other words, it represented a shift from the opportunities provided to taxpayers by command over resources to a consequentialist approach in which individual choices are relevant. The ability-to-pay approach puts little emphasis on how taxpayers choose to use the resources at their disposal: two persons with similar opportunities are treated the same way. The welfarist approach puts all the emphasis on ex post consequentialism—that is, outcomes actually achieved, rather than ex ante opportunities. Kaplow has provided a vigorous defence of welfarism as the sole criterion for public economics choices, and has offered the same advice for legal decision making in Kaplow and Shavell.<sup>25</sup> Adler is also worth considering in this regard.<sup>26</sup> The question is this: has welfarism been taken too far?

The basic argument for welfarism is that it is based on individuals' own evaluations of their well-being as reflected in their revealed preferences or inferred by other indirect means. To override this individualism seems to be improper per se and, as Kaplow argues, it can lead to Pareto-inferior policies. However, respecting individual preferences is not sufficient for public policy. Interpersonal comparisons of welfare are required as well. Formally, these comparisons are made by representing individual preferences in a utility function and aggregating utilities into a social welfare function. The optimal tax literature makes this seem elementary by assuming that individual utility functions are the same, and therefore comparable across individuals. All that is required, then, is a presumption about the rate at which marginal utility of income diminishes, or about "the aversion to inequality," as it is called technically. The conceptual meaning of this process of measuring and aggregating utility is not clear, apart from its analytical convenience. Kaplow apparently takes

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24 Peter A. Diamond, "Income Taxation with Fixed Hours of Work" (1980) 13:1 *Journal of Public Economics* 101-10; Emmanuel Saez, "Optimal Income Transfer Programs: Intensive Versus Extensive Labor Supply Responses" (2002) 117:3 *Quarterly Journal of Economics* 1039-73.

25 Louis Kaplow, *The Theory of Taxation and Public Economics* (Princeton, NJ: Princeton University Press, 2008); Louis Kaplow and Stephen Shavell, *Fairness Versus Welfare* (Cambridge, MA: Harvard University Press, 2002).

26 Matthew D. Adler, *Well-Being and Fair Distribution: Beyond Cost-Benefit Analysis* (New York: Oxford University Press, 2012).

the view common to classical utilitarians that utility can in principle be measured scientifically.<sup>27</sup> Others recognize that an important value judgment is required, although who makes it is not clear. As Arrow showed long ago,<sup>28</sup> arriving at a social consensus about social orderings is a very difficult task.

Public economists are increasingly recognizing that there are significant difficulties with the welfarist approach, and that there are alternatives worth considering that typically go back to command-over-resources ideas. Concerns with welfarism are discussed in the following sections.

### **Preference Heterogeneity**

If individual preferences differ, interpersonal welfare comparisons are difficult. Two persons with the same opportunities may make different choices. Some of these choices, such as the choice of clothing colour, are inconsequential. Others are more fundamental, especially if all we can observe are final outcomes; these choices include labour-leisure, occupation, saving, and risk taking.

One way to address this issue is the equality-of-opportunity approach of Roemer, and Fleurbaey and Maniquet.<sup>29</sup> These authors suppose that individuals differ in two types of characteristics: those they have no control over, such as native ability, and those they do have control over, such as preferences. The authors propose the principle of compensation, whereby individuals ought to be compensated for characteristics that they do not control, and the principle of responsibility, whereby individuals should not be rewarded or penalized for characteristics that they do control. This seemingly attractive approach encounters difficulties, however. It is not clear how to identify characteristics that individuals control. While preferences are the standard example, Roemer himself recognizes that preferences can be conditioned by socio-economic circumstances. More fundamentally, it turns out that the principles of compensation and responsibility conflict: they cannot both be satisfied at the same time.

Nonetheless, there is something appealing about neither rewarding nor penalizing persons' choices as a way of addressing preference heterogeneity. This is essentially what the ability-to-pay approach did.

### **Equality of Opportunity**

The notion of equality of opportunity is often used in a distinct sense in policy discourse. It refers to the ideal of giving everyone an equal starting point in life so that success is determined by merit rather than by luck. Equality of opportunity in this sense is referred to in section 36(1) of the Canadian constitution, which commits

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27 Kaplow, *supra* note 25, at 376-77.

28 Kenneth J. Arrow, *Social Choice and Individual Values* (New York: Wiley, 1951).

29 Roemer, and Fleurbaey and Maniquet, *supra* note 7.

the government of Canada and the provincial governments to “promoting equal opportunities for the well-being of Canadians.” The precise meaning of these words is unclear. They could mean simply that persons should be able to make the best of their abilities through access to education, training, and labour market opportunities, unfettered by socio-economic and other constraints. They might also be more pro-active and call for society to invest resources in equalizing abilities through education and training. Whatever perspective is adopted, the idea of equality of opportunity informs the tax policy that applies to education.

### Behavioural Issues

Welfarism relies on revealed preferences for gauging individual well-being, but, as the recent literature on behavioural economics makes clear, this approach may be unreliable. Individuals make decisions that even they know are not in their long-term interest and live to regret it. The sources of these inappropriate decisions have been widely studied,<sup>30</sup> and they are particularly important in some areas of relevance to tax policy. One is the tendency to save too little for one’s retirement. Another concerns consumption choices, including diet and addictive substances, combined with lifestyle choices that lead to health problems. Finally, present-biased preferences can lead to scant effort in the field of education and work, which has long-term consequences. Government intervention in the face of these behavioural problems is controversial. The apparent paternalism can be softened by adopting nudge policies that induce consumers to make appropriate decisions.<sup>31</sup>

### Which Preferences Count?

Strictly speaking, utilitarian-based social welfare should count all sources of individual utility, but this is clearly problematic. The well-being of one person may be affected by the income or consumption of another. This might cause an excess labour supply as everyone tries in vain to be above average. Should the government respond with policies to dampen labour supply, as a pure welfarist would presumably argue? Along the same lines, one may simply dislike the colour of one’s neighbour’s house. Should interdependent utility of this type be counted in social welfare (despite the obvious difficulties in measuring such avarice)?

A particularly relevant example concerns voluntary transfers, such as bequests or donations to charity. From a strict welfarist point of view, voluntary transfers give rise to two benefits: one to the recipient and, by revealed preference, one to the donor. This leads some observers to argue that bequests should be subsidized, as

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30 See, for example, the summary in William J. Congdon, Jeffrey R. Kling, and Sendhil Mullainathan, *Policy and Choice: Public Finance Through the Lens of Behavioral Economics* (Washington, DC: Brookings Institution, 2011).

31 Richard H. Thaler and Cass R. Sunstein, *Nudge: Improving Decisions About Health, Wealth, and Happiness* (New Haven, CT: Yale University Press, 2008).

well as taxed in the hands of recipients.<sup>32</sup> Others, including Mirrlees, argue that this double counting of benefits is unreasonable.<sup>33</sup> Other purely altruistic benefits are not counted, so why should the altruistic benefits of bequests be counted just because a transfer has occurred? Moreover, if altruistic benefits from bequests are included, what about other intrafamily transfers, such as child care, which could give rise to multiple altruistic benefits in large families? Some argue, perhaps fancifully, that if bequests give double benefits, so does saving because it constitutes a voluntary transfer from one's "current self" to one's "future self." Finally, if government transfers to the poor satisfy the altruism of well off taxpayers, one should count the benefits both to the transfer recipients and to the well off taxpayers. Since that is unlikely to be agreed on, voluntary transfers should not be double counted either. This has potentially important policy implications: because bequests make the donor worse off, a tax credit should be given. Interestingly, the authors of the Mirrlees review struggled with this idea, and in the end eschewed welfarism in the case of bequests, opting instead for equality of opportunity as the guiding criterion for inheritance taxation.

### Consequentialism

As mentioned earlier, some of the consequentialist implications of the welfarist approach have been criticized by Feldstein in his commentary on the Mirrlees review.<sup>34</sup> Under strict welfarism, individuals' initial situations are irrelevant in judging social outcomes, implying that society can effectively exercise property rights over all productive skills, subject of course to incentive constraints. Rawls<sup>35</sup> famously justifies this position on ethical grounds, arguing that if everyone imagined being in an "original position" before skills have been assigned, they would agree to a consequentialist social contract. Feldstein, following Nozick,<sup>36</sup> takes issue with this and argues that individuals should have a prior ownership right in their own human capital. The implications of assigning property rights to one's own skills for tax-transfer policy are not clear, except that redistribution would presumably be heavily muted. How much depends on formulating the circumstances in which individual

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32 Louis Kaplow, "A Framework for Assessing Estate and Gift Taxation," in William G. Gale, James R. Hines, and Joel Slemrod, eds., *Rethinking Estate and Gift Taxation* (Washington, DC: Brookings Institution, 2001), 164-204; Ivan Werning and Emmanuel Farhi, "Progressive Estate Taxation" (2010) 125:2 *Quarterly Journal of Economics* 635-73.

33 Peter J. Hammond, "Altruism," in John Eatwell, Murray Milgate, and Peter Newman, eds., *The New Palgrave: A Dictionary of Economics*, 1st ed. (London: Palgrave Macmillan, 1987), 85-87; Peter Diamond, "Optimal Tax Treatment of Private Contributions for Public Goods with and Without Warm Glow Preferences" (2006) 90:4 *Journal of Public Economics* 897-919; and James A. Mirrlees, "Taxation of Gifts and Bequests," unpublished slides for a talk at the Centenary of James Meade Conference, 2007.

34 Feldstein, *supra* note 8.

35 Rawls, *supra* note 6.

36 Robert Nozick, *Anarchy, State, and Utopia* (New York: Basic Books, 1974).

property rights should be violated. In a democracy, these things are presumably resolved by coming to a social consensus, which varies from nation to nation.

## FROM THEORY TO PRACTICE: REFORMING THE CANADIAN TAX-TRANSFER SYSTEM

As the above discussion shows, welfarism provides a powerful basis for tax design but has some shortcomings. It has difficulty dealing with preference heterogeneity and, if taken literally, leads to unpalatable policy prescriptions. Given the important value judgments involved, this is not surprising. It is wise to adopt an eclectic approach, complementing welfarism with other principles when appropriate, such as equality of opportunity or neutrality with respect to preference differences.

Before turning to concrete policy recommendations, it is worth summarizing where piecemeal reform has taken us in the past several decades and also reviewing some key initiatives from abroad.

### Important Tax Policy Innovations in Canada

In this section, I focus on significant structural policy changes, rather than the small targeted tax reforms of the past few years. Several key reforms have moved the tax system closer to a consumption-based one, to one that is more progressive at the bottom and less progressive at the top, to a more decentralized and more harmonized system, and to one with lower corporate tax rates applied to roughly the same tax base. The following list summarizes these changes.

- *Refundable tax credits and the flattening of the rate structure.* The replacement of personal deductions with credits and the introduction of refundability, initially with the GST credits and child tax credits and subsequently with the WITB and educational tax credits, essentially turned the system into a limited negative income tax system. Such a system allows the federal government to contribute to redistribution at the bottom end of the income distribution, especially since refundable tax credits themselves are income-tested. Unfortunately, provincial transfers to the poor have fallen in real terms since the early 1990s. At the same time, the income tax rate structure has flattened out considerably at both the federal and the provincial levels, leading to less redistribution at the top. This phenomenon has occurred over the same period as pre-tax income inequality has been rising.
- *Vehicles for sheltering saving.* A number of tax-sheltering vehicles have been introduced over the years, including registered retirement savings plans (RRSPs), registered pension plans (RPPs), the Canada Pension Plan, the Quebec Pension Plan, and most recently tax-free savings accounts (TFSA). Along with the tax-free status of imputed rent on owner-occupied housing and the implicit sheltering of the returns to human capital, most asset income can now be tax-sheltered. The Department of Finance has estimated that with the introduction of TFSA, up to 90 percent of taxpayers will be able to shelter all

of their capital income by 2030.<sup>37</sup> This estimate was corroborated by Milligan, who finds that when the TFSA system matures, only 2 percent of families will have taxable assets if TFSA opportunities are fully exploited.<sup>38</sup> This brings the personal tax system remarkably close to a progressive consumption tax system, except in the case of the highest income taxpayers and those taxpayers (such as the elderly) who have not exploited their TFSA and RRSP opportunities. This has implications for both the progressivity of the income tax and the design of the corporate tax, as suggested below.

- *Corporate tax initiatives.* Corporate tax rates have fallen dramatically in Canada, as in many other OECD countries. There has been some broadening of the corporate tax base, following the recommendations of the Mintz report, but the basic structure remains a tax on shareholder income. Integration provisions through the dividend tax credit and preferential capital gains taxation remain in place, reflecting the view of the corporate tax as a withholding tax. Integration is imperfect, however: shareholder income in sheltered assets obtains no relief, while tax relief is given whether or not corporate tax has actually been paid.
- *Tax decentralization and harmonization.* Canada's income tax system has gradually become as decentralized as any system in any federation in the world. The bases of both the personal and corporate taxes remain highly harmonized, but provinces have been given leeway to choose their own rate structures and credits within limits. Gradually, many provincial rate structures have become less progressive, no doubt as a result of the pressures of tax competition, with Alberta adopting a linear progressive tax (flat tax) system.<sup>39</sup> Considerable progress has been made in harmonizing sales taxes through the HST, with participating provinces having discretion over their own rates. This further consolidates the move to consumption-based taxation. An extremely important innovation that has facilitated harmonization and tax administration more generally has been the institution of the Canada Revenue Agency (CRA). Arguably, the HST would not have been administratively feasible without a single tax-administering authority.

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37 Canada, Department of Finance, "Tax-Free Savings Accounts: A Profile of Account Holders," in *Tax Expenditures and Evaluations 2012* (Ottawa: Department of Finance, 2013), 31-45.

38 Kevin Milligan, "Policy Forum: The Tax-Free Savings Account—Introduction and Simulations of Potential Revenue Costs" (2012) 60:2 *Canadian Tax Journal* 355-60.

39 Milligan and Smart have recently studied the taxation of high incomes in the Canadian provinces. They find that the responsiveness of top income earners to increases in provincial top tax rates is quite high. Despite this fact, five provinces have recently raised their top tax rates. See Kevin Milligan and Michael Smart, "Provincial Taxation of High Incomes: What Are the Impacts on Equity and Tax Revenue?" paper presented at the IRPP-CLSRN conference "Inequality in Canada: Driving Forces, Outcomes and Policy," held in Ottawa, February 24-25, 2014 (<http://faculty.arts.ubc.ca/kmilligan/research/taxation-federation.htm>).

- *Human capital incentives for post-secondary education.* A variety of tax measures have been introduced to shelter savings for post-secondary education (registered education savings plans and Canada learning bonds), to provide credit for education costs (education and textbook tax credits), and to assist persons from low-income families in financing post-secondary education through loans and grants (Canada education savings grants, Canada student grants) and loans (Canada student loans). Some of these programs have their provincial equivalents.
- *Elimination of inheritance taxation.* One of the casualties of the post-war realignment of tax responsibilities between the federal government and the provinces was the inheritance tax. Not long after it was devolved to the provinces, it was eliminated—a classic example of tax competition in action. There is nothing in principle to prevent the federal government from reinstating inheritance taxation.

Other reforms have been significant, but they are beyond the scope of this discussion. These reforms might include the institution of market value property taxation and the limited introduction of provincial carbon taxes. There have also been some instances of provincial non-renewable resource taxes adopting a rent tax form. Overall, the Canadian tax system approximates progressive consumption taxation, but with vestiges of comprehensive income and equality-of-opportunity elements, and with progressivity compromised.

### **Some Relevant Tax Policy Innovations Abroad**

Recent tax reform initiatives in several countries have included some interesting approaches that Canada could learn from. Many of these initiatives draw on the current taxation literature and on tax commission reports. Perhaps the most wide-ranging is the Nordic dual income tax that was originally applied in Denmark, Finland, Norway, and Sweden; variants are used in Germany, Switzerland, and the United Kingdom. Simply put, labour earnings and transfers are taxed according to a progressive rate structure, while capital income bears a uniform rate, typically that of the lowest earnings tax bracket. The uniform rate facilitates withholding by financial institutions and integration with the corporate tax, whose rate is the same as the capital income tax rate. By separating earnings and capital income taxation, the dual income tax both enables the taxation of capital income in an administratively feasible way and gives full freedom to tailor the progressivity of the earnings tax without being constrained by the more elastic capital income tax base. Notably, the dual income tax is often accompanied by inheritance or wealth tax systems to address the issue of wealth inequality.

A number of countries have chosen to move to a rent-based corporate tax system instead of using shareholder income as the base. Most of these countries have adopted an ACE form of tax since it represents the simplest transition from the traditional system. Countries that have used the ACE system include Belgium, Brazil, Croatia, and Italy, and others are contemplating its use. There is growing recognition

that considerable rents accrue to the corporate sector, something that has been documented in studies of the revenue cost of shifting to an ACE system.<sup>40</sup>

Some countries have adopted rent tax regimes for non-renewable natural resources. These include the Australian mining tax, which takes the RRT form, and Norwegian offshore petroleum taxation, a form of cash flow tax. Other cash flow equivalent taxation applies selectively: in the oil sands in Alberta and mining operations in British Columbia, for example. In addition, the auctioning of natural resource rights, as in the Alberta oil and gas industry, provides a complementary way for governments to obtain a share of resource rents. Three things distinguish the Norwegian case from most others, all of which require political self-discipline. First, full refundability is offered to resource firms that incur losses, including those that are never profitable and eventually go out of business. Second, the rate of rent tax is well over 90 percent, no doubt partly resulting from the fact that a Norwegian public firm dominates the offshore industry. Third, the resource revenues are put into a sovereign wealth fund, the proceeds are invested in foreign assets, and only the capital income is spent. This goes a long way toward mitigating the Dutch disease in Norway.

Other more specific measures also have promise. Various countries harmonize their systems of taxation and stand-alone transfers, including the United Kingdom. Others, including federations such as Spain, Germany, and Australia, harmonize elements of their transfer systems, such as unemployment insurance and welfare. Many countries maintain inheritance tax systems, although their role as revenue raisers has diminished. Their existence, however, provides a base on which to build. Carbon-pricing schemes are deployed in various places, either cap-and-trade systems, as in the European Union, or carbon tax systems, as in British Columbia and until recently in Australia. Efforts, especially by the OECD, continue to address international tax avoidance through international agreements and protocols, and there are ongoing attempts to restrain corruption through natural resource reporting protocols.

## TAX REFORM PROSPECTS FOR CANADA

There is currently little enthusiasm for comprehensive tax reform in Canada or for the establishment of a tax reform commission. This is regrettable because Canada's tax system is founded on outdated principles. Nonetheless, piecemeal reforms based on widely accepted principles are possible, and these would improve efficiency, equity, and administrative ease without sacrificing revenues. These reforms would build on the successful piecemeal reforms of the past and on innovative thinking about the objectives of the tax system. They would also reinstate some fairness in the tax-transfer system, which has been left to languish in recent years. The following discussion draws on previous work concerning various aspects of tax-transfer

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40 Ruud A. de Mooij, *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions*, IMF Staff Discussion Note SDN/11/11 (Washington, DC: IMF, May 3, 2011).

reform in Canada.<sup>41</sup> These views are purposely presented without taking into account supposed political constraints.

Some key objectives inform these proposals. The fairness of the tax-transfer system would be prioritized by focusing on those at the lower end of the income distribution and worrying less about middle- and upper-income persons. The social insurance function could also be improved, and egregious increases in wealth inequality could be addressed. These fairness concerns reflect a desire to mitigate the consequences of luck, both good and bad, as determinants of economic outcomes. This approach would be complemented by using more efficient tax instruments, especially for the business tax system, which can be designed as an efficient system whose main purpose is to capture a share of the rents generated by the private sector. The personal tax-transfer system could also be reformed to minimize the amount of revenue needed to achieve the desired degree of fairness. Finally, federal-provincial tax-transfer harmonization should be reinforced to protect the overall equity of the fiscal system.

These principles can be translated into the following proposed tax reform priorities.

### **Tax Reform Priorities I: Individual Income Tax**

The personal income tax is a hybrid system that taxes income in name only. A significant proportion of asset income is sheltered through RPPs, RRSPs, TFSA, and the exclusion of imputed income on housing and other consumer durables. The asset income that is taxed also benefits from the dividend tax credit and the partial capital gains exemption, as well as special treatment applying to personal businesses. Otherwise, the common individual rate structure applies, and progressivity is also influenced by various credits and deductions, some of which are refundable.

Some measures that would improve the fairness of the tax system, especially for those at the bottom end of it, include the following:

- *Refundability of tax credits.* Make all tax credits refundable and let them vanish with income. Income-tested refundable tax credits would enhance targeting in a revenue-neutral manner. This would convert the income tax system into

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41 Robin Boadway, "Rethinking Tax-Transfer Policy for 21st Century Canada," in Fred Gorbet and Andrew Sharpe eds., *New Directions for Intelligent Government in Canada: Papers in Honour of Ian Stewart* (Ottawa: Centre for the Study of Living Standards, 2011), 163-203; Robin Boadway and Jean-Denis Garon, "The Design of Employment Insurance in a Federation," in Keith G. Banting and Jon Medow, eds., *Making EI Work: Research from the Mowat Centre Employment Insurance Task Force* (Kingston, ON and Montreal: Queen's University, School of Policy Studies, and McGill-Queen's University Press, 2012), 119-55; Robin Boadway and Katherine Cuff, "The Recent Evolution of Tax-Transfer Policies," in Keith G. Banting and John Myles, eds., *Inequality and the Fading of Redistributive Politics* (Vancouver: UBC Press, 2013), 335-58; and Robin Boadway and Jean-François Tremblay, *Corporate Tax Reform: Issues and Prospects for Canada* (Toronto: Mowat Centre, April 2014).

a proper negative income tax, and go some way toward establishing a basic income for all Canadians. As it stands, persons who are not taxpayers rely largely on provincial social assistance, which puts them well below the poverty line.

- *Tax treatment of capital income.* The breadth of asset income sheltering has reached the point at which most taxpayers (up to 90 percent by 2030, according to the Department of Finance, or even more, according to Milligan)<sup>42</sup> can shelter all of their savings, if they choose to do so, leaving the capital income tax as largely a tax on upper-income taxpayers. This approach is reasonable, but further reforms could enhance the fairness of the overall system. First, drawing on experience in the United Kingdom and several European countries, the treatment of taxable capital income could be based on a rate schedule that is separate from that of earnings. Canada could adopt the so-called Nordic system, wherein a uniform tax rate applies to unsheltered capital income. This would reduce the incentive for tax planning. More important, removing capital income from the standard income base would allow the government to choose the progressivity of the earnings tax structure, unfettered by concerns arising from the responsiveness of reported capital income at high income levels. (Of course, taxpayers would have to be discouraged from converting earnings into capital income artificially). Second, the dividend tax credit and the preferential treatment of capital gains could be eliminated, as proposed in Boadway and Tremblay.<sup>43</sup> These measures are in place mainly as integration devices, as was observed in the Mintz report. However, as such they are faulty. Evidence suggests that the corporate tax is largely shifted to labour, so giving credit to shareholders for it is largely a windfall. In addition, there is no relationship between the dividend tax credit and the payment of corporate taxes. Moreover, the dividend tax credit does not apply to sheltered share income. This change will complement the proposal below to change the corporate tax to a rent-based tax, and it will both partly recoup the revenue loss from that reform and enhance the fairness of the tax system.
- *Equality of opportunity agenda I.* The personal tax system largely addresses fairness based on ex post outcomes, as in the welfarist tradition. But it also includes elements that contribute to fairness in ex ante prospects, particularly the tax treatment of post-secondary education costs. (Of course, most of the equality-of-opportunity agenda is on the expenditure side of public policy, especially the provision of universal education and health care and some social services.) This includes registered education savings plans and education tax credits, as well as non-tax programs, such as income-tested student grants and loans. These

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42 Department of Finance, *supra* note 37; and Milligan, *supra* note 38. An issue remains concerning how to deal with persons who neglect to shelter their savings to the extent permissible. To the extent that these persons earn relatively low income, some unfairness remains.

43 Boadway and Tremblay, *supra* note 41.

programs are useful as far as they go, but their benefits are spread thinly and go disproportionately to students from wealthier families. Accessibility problems resulting from financial constraints are much more a concern of low-income families, which have less wealth to begin with and more difficulty borrowing to finance post-secondary education. Moreover, existing programs are not well designed to address the social insurance dimension of post-secondary education, given the uninsurable riskiness of success in education, as well as in subsequent employment. These fairness and insurance issues can be mitigated by better targeting grant and tax credit programs, and by converting programs like the Canada student loan program and its provincial counterparts into an income-contingent loan system delivered alongside the income tax.

- *Equality of opportunity agenda II.* A more ambitious reform of personal taxation involves the treatment of bequests. In Canada, bequests trigger a realization of capital gains on an estate, but there is no tax on bequests or inheritances per se (the conceptual issues faced by welfarism in dealing with bequests have been discussed earlier). A reasonable alternative, adopted by the Mirrlees review, invokes equality of opportunity. Donors would neither be penalized nor rewarded for making bequests, but inheritances would be treated as windfall gains to inheritors. The Mirrlees review, following the earlier Meade report, advocated a progressive cumulative lifetime inheritance tax, separate from the income tax and focusing on large estates. Such a tax would be an important complement to the favourable treatment of capital income in a dual income tax system, and it would also mitigate concerns recently expressed by Piketty that wealth inequality tends to grow in normal times.<sup>44</sup> This would be a major reform for Canada, but one that deserves to be on the agenda.
- *Smaller personal tax reforms.* There are endless possibilities for personal tax reform, but a few that fit with normative principles could be mentioned. One reform would be to reinstate general income averaging so that taxpayers with fluctuating incomes are treated fairly. This is particularly important for persons who move in and out of employment: for taxpayers whose employment income fluctuates, the need for averaging is perhaps less pressing since there are now only four income tax brackets with tax rates that differ relatively little. The details of precisely how to apply general averaging would have to be worked out, but technically it is feasible and in principle desirable.

Second, as the Mirrlees review emphasized, personal taxation should not discourage participation in the workforce by those groups whose participation is highly responsive to participation tax rates. The Mirrlees review singled out second earners in families with small children and taxpayers near normal retirement age. More generally, the participation of secondary earners in any family is more elastic than that of primary earners, which suggests that family

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44 Thomas Piketty, *Capital in the Twenty-First Century* (Cambridge, MA: Belknap Press of Harvard University Press, 2014).

income splitting would unduly discourage participation, apart from the fairness concerns that it would entail.<sup>45</sup> In the case of retirement age taxpayers, participation concerns involve coordinating the tax and transfer systems. The same can be said for encouraging the participation of the unemployed, to which I briefly return below.

Finally, the progressivity of the personal tax rate structure deserves a second look. As income tax devolves more and more to the provinces and they have more discretion over the progressivity of their share, not surprisingly there are competitive pressures for provinces to flatten their rate structures. The federal government then assumes greater responsibility for preserving tax equity. Despite concerns about the elasticity of taxable income at the top of the income distribution<sup>46</sup> and the limited potential for revenue raising at the very top, there is scope for increasing the progressivity of the rate structure. This is especially true under a dual income tax system, in which progressivity applies selectively to earnings.

### **Tax Reform Priorities II: Corporate Income Tax**

The existing corporate tax is designed to be a tax on shareholder income, reflecting its prevailing rationale as a withholding device for the personal income tax. This tax is complemented by the dividend tax credit and preferential treatment of capital gains as mechanisms for crediting Canadian shareholders for corporate taxes withheld on their behalf. This approach to corporate taxation has outlived its relevance. In today's global economy, with interdependent capital markets, evidence suggests that corporate taxes levied at source are largely shifted to labour rather than being borne by shareholders. Providing relief is unnecessary. Moreover, since a high proportion of shareholder income is now sheltered from personal tax, the rationale for withholding disappears. There is one exception: the corporate tax applied to foreign corporations operating in Canada can still be a mechanism for transferring tax revenues from foreign to Canadian treasuries, assuming that foreign governments allow tax crediting, although the number that do so is dwindling. One other disadvantage of the current tax is that as long as full integration does not apply, the interest deductibility provision of corporate taxation encourages excessive leverage and favours firms that are able to finance with debt.

These concerns have stimulated arguments for abandoning the withholding rationale and substituting the collection of rents or above-normal profits. This is not as dramatic a change in the corporate tax as it may seem to be, since shareholder income already includes rents as well as normal shareholder profits (adjusted for risk). A rent-based corporate tax is highly compatible with a personal tax system that

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45 See the analysis in Henrik Jacobsen Kleven, Claus Thustrup Kreiner, and Emmanuel Saez, "The Optimal Income Taxation of Couples" (2009) 77:2 *Econometrica* 537-60.

46 For example, see Canada, Department of Finance, "The Response of Individuals to Changes in Marginal Income Tax Rates," in *Tax Expenditures and Evaluations 2010* (Ottawa: Department of Finance, 2010), 45-65; and Milligan and Smart, *supra* note 39.

shelters most shareholder income. Moreover, there is no compelling need to integrate a rent-based corporate tax with personal income, which would be very difficult to do in any case.

The idea of the corporate tax as a tax on rents has been in the literature at least since Brown.<sup>47</sup> Brown was the first to recognize that a cash flow tax was virtually equivalent to a tax on rents, which would otherwise be virtually directly immeasurable. (Rents are the difference between revenues and all imputed current and capital user costs measured on an accrual basis and indexed for inflation. Cash flow is simply receipts less expenditures for both capital and current inputs measured on a cash basis. The present value of cash flows equals the present value of rents.) As mentioned above, the authors of the Meade report advocated changing the corporate tax to a cash flow tax to accompany the reform of the personal income tax into a personal direct consumption tax by effectively sheltering all saving.

A cash flow tax is neutral with respect to a corporation's choices only if refundability of all losses is allowed.<sup>48</sup> With rare exceptions, governments seem unwilling to allow refundability, but the equivalent effect can be achieved if losses can be carried forward at the risk-free interest rate, and if all losses are eventually recouped, even if a firm winds up. (The risk-free interest rate is appropriate as long as there is no risk that the government will renege on the promise to make good on the tax losses.) There are various systems that are equivalent to a cash flow tax. In one variant proposed by Boadway and Bruce,<sup>49</sup> firms in a loss position postpone their deductions for costs and carry them forward with risk-free interest. The ACE system puts this into operation in a simple way. Another variant, epitomized by the RRT used in Australia, allows negative cash flows to be carried forward with risk-free interest.

The ACE system could readily be adopted in Canada with minimal reform of the existing system. The main change would involve allowing corporations to deduct the normal cost associated with their equity financing as well as interest on debt.<sup>50</sup> When taxable income is negative, these deductions would be carried forward at the risk-free interest rate. This system has the advantage of removing the various distortions of the existing corporate tax system, including the disincentive to invest; excessive leverage; and discrimination against small, growing, and risky firms. The same ACE treatment would apply not only to corporations but also to unincorporated businesses. It would apply to both domestic and foreign corporations, and to all sectors. The hope is that foreign tax-crediting arrangements would still apply (mainly in the United States), given that the reform makes tax crediting less onerous for foreign governments.

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47 E. Cary Brown, "Business-Income Taxation and Investment Incentives," in *Income, Employment and Public Policy: Essay in Honor of Alvin H. Hansen* (New York: Norton, 1948).

48 Strictly speaking, a cash flow tax is neutral with respect to investment only if firms are risk-neutral. Cash flow taxation allows the government to share firms' risks, and this can actually increase risk taking.

49 Boadway and Bruce, *supra* note 17.

50 For more details, see Boadway and Tremblay, *supra* note 41.

The move to a rent-based corporate tax presumes that there are sufficient rents in the system to warrant the tax. There can be little doubt about that. In some concentrated industries, such as the financial sector, rents are likely. Sectors with fixed factors, such as all resource industries, can have significant rents. But, more generally, rents are a fact of modern economies. Even in competitive industries, there are liable to be inframarginal investments yielding rents because of locational, informational, or other advantages. Rents also accrue to protected intellectual property, and presumably one would not want to tax them fully for fear of undoing the incentive to invest. It is arguable that preferential treatment should be given to intellectual property rents, at least those that are exploited domestically.<sup>51</sup>

Some issues remain in the event of such a reform. A rent-based corporate tax would do little to address the issue of profit shifting, which induces corporate tax competition. This would require a more coordinated international approach. However, a rent tax would be less susceptible to ordinary corporate tax competition because a normal rate of return to investment would not be taxed. A rent tax would, however, lead to a loss of revenue in the absence of increases in the tax rate. Boadway and Tremblay argue that this revenue loss could be offset by two accompanying reforms.<sup>52</sup> First, the dividend tax credit and preferential treatment of capital gains could be eliminated. Second, the deductibility of provincial resource taxes could be eliminated. This serves mainly to reduce federal resource tax revenue, while at the same time introducing a source of inefficiency into the taxation of resource industries.

### **Tax Reform Priorities III: The Tax-Transfer Nexus**

Some transfers to low-income persons are delivered through the income tax, mainly through refundable tax credits. However, the majority are delivered through stand-alone programs. Several things distinguish these transfer programs from the refundable tax credits.

First, unlike the income tax system, which operates by means of taxpayer self-reporting, most stand-alone transfers are administered by means of ex ante application and screening for eligibility criteria, such as disability, financial need, or involuntary job loss.

Second, some transfer programs for individuals who are not employed are conditional on the recipients actively searching for work and accepting suitable job offers. Program administration is thus an important element of these transfers. The integrity and generosity of disability assistance and employment insurance (EI) depend on sound administration and compliance.

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51 The case for offering preferential corporate tax rates on income generated by intellectual property is made in Nick Pantaleo, Finn Poschmann, and Scott Wilkie, *Improving the Tax Treatment of Intellectual Property Income in Canada*, C.D. Howe Institute Commentary no. 379 (Toronto: C.D. Howe Institute, April 2013).

52 Boadway and Tremblay, supra note 41.

Third, there are many different types of transfer programs, each catering to a particular type of disadvantage. Some are social-insurance-type programs that protect workers from unexpected shocks, such as job loss or injury. Others are programs for individuals whose need is more permanent. The heterogeneity of need associated with stand-alone transfer programs makes it difficult to apply standard welfaristic arguments.

Finally, some programs (such as EI and transfers to the elderly) are legislated and administered by the federal government, while others (such as social assistance, disability assistance, and workers' compensation) are provincial. Although the effective delivery of these programs may require decentralization, interprovincial fiscal competition can compromise fairness for the poorest persons in the economy, and can complicate the harmonization of programs delivered by the two levels of government. Indeed, casual observation indicates that citizens whose transfers are primarily federal (the elderly, children, and the temporarily unemployed) have been much more successful in avoiding poverty than those who rely on provincial governments (welfare and disability assistance recipients).

The multiplicity of transfer systems results in considerable movement of persons from one category to another—for example, from working to unemployed, from EI recipient to welfare recipient, and so on. This movement can be very disruptive because of the time and information involved in applying for each program and the change in transfers that this can entail. Moving between federal and provincial programs can be particularly problematic because these programs are managed by separate agencies. There is no agency such as the CRA that oversees transfers.

This state of affairs and the experience of other federations, such as Australia, Germany, and Spain, suggest several directions for reform, none of which will be easy as a result of the divided jurisdictions. Here the focus is mainly on EI and welfare. Disability assistance is also in dire need, but fixing it is no mystery. Payments are woefully inadequate owing to both need and deservedness, but the political will does not exist at the provincial level. The federal government could make a much more meaningful contribution to the income of the disabled by using a refundable tax credit whose eligibility is coordinated with provincial disability assistance schemes. EI and welfare require more fundamental rethinking.

EI is not an insurance program in the usual sense. Contributions are mandatory and bear no relation to expected benefits, and EI benefits are only vaguely related to contributions. The program is better seen as a social insurance program that fills a vacuum created by the absence of private unemployment insurance, and it is particularly valuable to the workers who are least able to self-insure. Its role in providing insurance to low-income vulnerable workers could be better recognized in its design. Another problem with EI is that its main focus is on workers who are temporarily unemployed. Such a focus favours industries that have a relatively high incidence of temporary layoffs, such as seasonal industries. It does not serve the needs of workers who face structural unemployment, including displaced workers who face both a long period of unemployment and a permanent loss of earnings. For these workers, the transition from EI to welfare can be both painful and cumbersome.

Several significant revisions to EI and welfare could help address some of these problems. First, EI financing could be changed from contributory to general revenue financing to improve fairness. Second, EI benefits could move to a two-tier system. The first tier would continue to be based on replacement income, reflecting the insurance aspects of the program, while a second tier would apply to workers who have exhausted their first-tier eligibility and would be needs-based. First-tier eligibility could be relaxed to reflect the difficulty that new workers now face in accumulating the minimum hours of work. The two-tier system would smooth the transition from temporary to long-term unemployment status. Provincial welfare assistance would then constitute the third tier, and would include both those who have exhausted their first two tiers of benefits and those who have never succeeded in becoming eligible. Ideally, there would be cooperative administration of second-tier EI and welfare to ease the transition. Both EI and social assistance would continue to be administered by ex ante screening and continued monitoring for compliance with job search activities.

In addition, some reforms to welfare could enhance job market participation and self-insurance incentives. Rules restricting earnings and asset holdings could be relaxed considerably to encourage part-time work and some self-insurance capability. Eligibility rules for WITB could be loosened so that more part-time low-income workers are eligible. Ideally, welfare rates could be considerably improved, and rigid monitoring could be enforced to mitigate incentive problems. It may be difficult for the provinces to improve their welfare rates independently, but, as mentioned, the federal government could contribute to the basic income of welfare recipients by expanding refundable tax credits.

## CONCLUDING COMMENTS

Ideas about tax reform have evolved considerably since the days of the Carter report. Many countries have begun to experiment with major tax reforms, and others have initiated important studies on taxation. Canada's tax system is built on foundations that were outlined five decades ago in the Carter report, whose main building blocks consist of the comprehensive income tax ideal backed up by a corporate tax on shareholders' income that is designed to serve a withholding purpose. I have recounted the evolution of ideas about reform of the tax-transfer system and what they imply for policy design. I have then speculated about lessons for Canada and proposed some broad reforms for the tax-transfer system. These reforms are feasible and mirror some of the best practices elsewhere in the world.

My discussion of Canadian reforms has necessarily been selective. Space limitations prevent me from considering some important areas of the tax-transfer system that are candidates for reform. A major concern for Canada is the federal-provincial dimension, and particularly the manner in which the decentralization of the Canadian revenue system, while motivated by the intention to contribute to accountability, has led to some major concerns. Many of these concerns stem from the large horizontal imbalances created by provincial natural resource revenues and the inability

to cope with these by means of equalization. In addition, the few provincial governments that obtain the bulk of the resource revenues seem intent on using them now to build their provincial economies, rather than saving them for future generations. This both exacerbates the Dutch disease in provinces that rely on manufacturing and other tradable production and intensifies interprovincial fiscal and redistribution competition. As discussed elsewhere, this is an issue of profound policy importance in Canada, and one that has implications for tax policy.<sup>53</sup>

Another issue of growing concern is the role of carbon taxation. National carbon taxation could yield a double dividend. It would encourage economizing on carbon use by reducing demand for carbon-using products and inducing abatement technologies. At the same time, it would provide substantial tax revenue for the federal government that could be used to reduce personal and corporate tax rates. Of course, a key problem with carbon taxation is that the major beneficiaries of reduced carbon use are future generations and persons in other countries. It takes considerable national will not to act as an international free rider.

Finally, the issue of family taxation remains vexing, and the welfarist approach can be of only limited value in resolving it. Family taxation raises difficult issues of how to compare the well-being and/or opportunities of persons according to their family circumstances and relatively standard incentive effects. It also involves social policy issues about the importance of the family and the implications of family policy for fertility. Simple solutions, such as income splitting, are unlikely to provide a satisfactory solution.

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53 Robin Boadway, Serge Coulombe, and Jean-François Tremblay, "The Dutch Disease and the Canadian Economy: Challenges for Policy-Makers," in Keith G. Banting, Richard P. Chaykowski, and Stephen Lehrer, eds., *Thinking Outside the Box: Essays in Honour of Thomas J. Courchene* (Kingston, ON: Queen's University, School of Policy Studies, forthcoming); and Robin Boadway, Serge Coulombe, and Jean-François Tremblay, "Canadian Policy Prescriptions for Dutch Disease" (2013) 3 *IRPP Insight* 1-27.

