Special Report, Part 2: Proceedings of a Conference on Personal Income Tax Reform— The Framework for Reform

The following paper by Robin W. Boadway and Harry M. Kitchen and comments by Alan M. Schwartz and Neil Brooks constitute the second part of the Canadian Tax Foundation's publication of the proceedings of a conference on personal income tax reform, which was held in Ottawa on April 9-10, 1999.

The conference launched the Foundation's first intensive look at comprehensive personal income tax reform—an issue that has important implications for how governments finance public services as well as for individual Canadians concerned about their tax burden. Aimed at academics, public policy analysts, and federal and provincial government officials, the conference looked first at the need for reform, the process of reform, and the relationship between personal income taxes and other federal, provincial, and local taxes. Then the focus moved to the specifics of reform: the base, the rates, indexation, and interactions with the social transfer system. The appropriate treatment of retirement savings and the broader issue of the tax treatment of savings rounded out the formal papers.

The papers presented at the conference will be published over several issues of the *Canadian Tax Journal*. In this issue, the second part of the special report on the proceedings continues from the preceding issue with discussion of the framework for reform. Subsequent journals will present discussions on joint occupancy of the personal income tax field, social transfer and retirement issues, the politics of tax reform, and concluding comments.

Personal Income Tax Reform in a Broader Context

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ABSTRACT

The Canadian economy has been subject to many changes in the past decade, including increased exposure to competition from abroad, changes in the structure of industry leading to increased earnings inequality, increased mobility of labour, a large debt overhang that must eventually be dealt with, and a more decentralized federation. These changes have potential implications for the income tax system. They suggest the need to adapt it to international realities and to encourage innovation and entrepreneurship, while at the same time ensuring that the most vulnerable persons in the economy are protected. Some reforms might include enhancing the refundable credits available to low-income persons, improving the tax treatment of those engaged in risky activities, encouraging savings by Canadians, ensuring that tax rates are not punitive for those who are most mobile, protecting the federal government's share of the income tax room so that a harmonized income tax system can be retained, reinstituting general income averaging, and enhancing the indexing of tax credits and brackets. The existing income tax system, however, is a reasonably good one. More particularly, contrary to suggestions in the popular press, there is nothing seriously wrong with the existing personal tax system.

INTRODUCTION

The tax reform initiatives of 1971 and 1987 produced a variety of changes that have improved the equity and efficiency of the personal income tax system in Canada.[1] In general, the tax base has been broadened; non-refundable tax credits have replaced exemptions and a variety of deductions; refundable tax credits have been introduced for the federal goods and services tax (GST) and the child tax benefit; and the rate structure has been simplified by reducing the number of tax brackets and lowering the

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[1] For a more detailed analytical discussion of this and the other issues in this paper, see Robin W. Boadway and Harry M. Kitchen, *Canadian Tax Policy*, 3d ed. (Toronto: Canadian Tax Foundation, 1999).

top marginal rate. Family income as opposed to individual income is now the base for determining federal and provincial refundable tax credits, and transfer programs have become more closely integrated with the personal income tax system. Improvements have been made in the harmonization of the federal and provincial tax systems. The combination of these reforms has produced an after-tax distribution of income that is narrower now than it was 25 years ago, even though the before-tax distribution of income has widened.[2]

While these measures served to both rationalize and simplify the tax system, some anomalies remain. The treatment of capital income varies widely according to assets. Both income from unincorporated businesses (self-employed, for example) and income from wages and salaries are subject to personal income taxation, but the determination of net income for tax purposes is not identical. Allowable deductions and expenses for unincorporated businesses are generally the same as they are for incorporated businesses and are frequently felt to be more generous than for individuals who earn their income from wages and salaries. In the latter instance, deductions for earning income are restricted significantly, whereas in the former instance, all bona fide costs of earning income are deductible. In addition, the tax system remains only partially indexed for inflation, leading to bracket creep and the taxation of some illusory capital income. Averaging of incomes over time for tax purposes is now non-existent. And there has been much public concern about the tax treatment of families and children.

Despite this, the accomplishments of the reforms of the 1970s and 1980s have generally been applauded. But, not surprisingly, circumstances have changed, and another set of pressures exists. The liberalization of international markets—goods and services, labour, capital, and financial—has exposed the Canadian economy to unprecedented competitive pressures. These have led to changes in our industrial structure and increased the importance of innovation and productivity as sources of employment, growth, and the well-being of Canadians. There is some evidence that international competition, especially from lower-wage countries, has exacerbated income inequalities, putting a greater burden on public policies to achieve a given amount of redistribution. In addition, tax reforms in other countries, especially the United States, have led to differences in both the level of tax rates and the mix of taxes, which have potentially important effects on our ability to retain the brightest and the best in our labour force and to attract new investment and firms. Thus, the focus of potential tax reform has changed from the standard efficiency and fairness norms of earlier years; the issues of today are competitiveness, growth, productivity, innovation, and enhancing the efficiency with which redistribution is achieved through the tax-transfer system. Further complicating the design and implementation of tax reform

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[2] Roger S. Smith, "The Personal Income Tax: Average and Marginal Tax Rates in the Post-War Period" (1995), vol. 43, no. 5 *Canadian Tax Journal* 1055-76.

is the fact that the Canadian federation has gradually become much more decentralized. Drafters of tax policy thus face the additional challenge of maintaining a rational and harmonized tax system in a world in which independent (and interdependent) taxing responsibility exists at both the federal and the provincial-municipal levels of government.

In this environment, reforms in personal income taxation should be designed

- to encourage savings and investment;
- to promote innovation, risk taking, entrepreneurship, and human capital formation;
- to remove the incentives for highly skilled persons or businesses to locate outside Canada;
- to harmonize federal and provincial taxes, if necessary adjusting the federal-provincial sharing of tax room, and to avoid the inefficiencies that arise from interprovincial tax competition;
- to achieve the desired degree of progressivity, taxation of capital income, and ease of compliance and enforcement;
- to target transfers to the poor while retaining work incentives, economizing on costs, and coordinating federal and provincial welfare programs;
- to ensure that personal income taxation makes up an appropriate share of the tax burden, given its use in competing countries; and
- to deal appropriately with the taxation of illusory income arising from inflation.

Our purpose in this paper is to outline some of the considerations that should inform contemplated reforms.

At the outset, it should be stated that the personal income tax system in Canada appears to be robust and working well. In our view, there is not much that is in urgent need of reform. In the few instances where changes should be made to improve the efficiency and fairness of the system, these would be simple to implement and easy to administer. Much of the so-called tax rage evoked in the press is bluster. Moreover, it is bluster that has the potential to do harm to the integrity of the tax system. Any tax system that is based on self-reporting and voluntary compliance relies on public acceptance. To the extent that such acceptance is undermined, compliance and the fairness of the system itself are eroded. It should also be noted that the emphasis in this paper is on tax reform, not tax reduction. They are different. Reform involves changes that would improve the efficiency and fairness of the tax system. While these may ultimately lead to changes in the tax burden, this change is a byproduct as distinct from an initial objective of lower taxes, which is the thrust of many who are arguing for changes in personal income taxes in Canada.[3]

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[3] See, for example, the discussion in David Thomas, "Tax Report: Canadians Increasingly Likely To Cheat the Taxman, Poll Finds," *National Post*, April 17, 1999.

COMPETITIVENESS

The world economy has become increasingly open and interdependent. Domestic producers are facing tougher competition in markets for goods and services, as well as greater opportunities to exploit large-scale international markets. Capital and businesses are becoming more mobile. Even labour, especially highly skilled, is able to move among countries more readily. Free trade has increased the ability of the United States to attract some of the more desirable Canadian workers. All of this makes it mandatory to ensure that our tax system facilitates the ability of Canadians to compete.

Competitiveness does not imply that all firms should succeed, or that we be good at all lines of business. Instead, the economy should aim to focus on those activities in which it has a comparative advantage in the international context. That comparative advantage is best determined by the price mechanism: those firms that can succeed using market prices as the disciplining device are those that have a comparative advantage. A competitive tax system is therefore one that is neutral with respect to market decisions, except to the extent that market prices clearly do not reflect social benefits and costs. Apparent externalities that cause market prices to diverge from social values include environmental externalities and the externalities of knowledge obtained by research and development (R & D) and human capital investment. Apart from correcting for these sorts of externalities, the tax system should not systematically discriminate in favour of some activities relative to others, and should be as benign as possible, given other objectives, with regard to providing incentives for mobile factors and businesses to leave the country.

These considerations lend support to a tax system in which the main taxes are as broad-based as possible, and with uniform rates. It is well documented, for example, that the Canadian business tax system discriminates against service and tertiary industries, and in favour of manufacturing and resource industries.[4] This bias is a result of several features of the Canadian tax system, including the preferential tax rate afforded to manufacturing and processing activities, depreciation rates that are sometimes excessive, rapid writeoffs of capital expenditures in the resource industries, and selective investment tax credits.

The present system also discriminates implicitly against small growing firms and those involved in risky activities, many of which are unincorporated and thus subject to the personal tax system. This is largely because tax-loss firms are treated asymmetrically relative to those in a tax-paying position. But the preferential treatment afforded to retained earnings as a source of finance also makes it more difficult for smaller firms to compete, since larger firms have more ready access to internal financing.

[4] This discrimination is fully documented in Canada, *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, April 1998) (herein referred to as "the Mintz report"). The recommendations of the Mintz committee are largely based on making the tax system as neutral as possible for competitive reasons.

The level of taxes is also a potential source of competitive disadvantage. High business tax rates can influence the decision of businesses, small or large, to locate in Canada or abroad, and they can erode the Canadian tax base by inducing multinational firms to arrange to shift their incomes abroad by various tax-planning devices (debt financing, transfer pricing, etc.). High personal taxes, especially for those at the upper end, can also make Canada less attractive for highly skilled workers, professionals, and entrepreneurs. Not only will these individuals prefer to reside abroad, but the firms that hire them will also be induced to locate abroad. Of course, this result assumes that the high taxes are not fully offset by a high level of public services to these same mobile persons, as seems likely to be the case.

These competitive factors impose constraints on the ability of governments to implement their own domestic fiscal policies. If neighbouring countries like the United States have significantly lower taxes, that in itself may be enough to discourage firms from opening up or expanding operations in Canada. This factor too cannot be ignored by Canadian policy makers in deciding on the level of tax rates in Canada. The message for the Canadian tax system is first, to ensure that the tax system treats all productive activities on a par, and second, to ensure that tax rates are not so onerous as to induce mobile labour and firms to move abroad. As to the first objective, the discrimination against risky activities and new investments could be removed by making fuller use of the principle of loss offsetting or refundability of losses. Other forms of discrimination that could be addressed include the discriminatory treatment of business investment relative to investment in real property and the differential treatment of different forms of investment financing. The issue of tax rate levels is not so simple, for these levels include broad-based taxes of all forms, and not just personal income taxes. The level of tax rates is constrained by the need to service and pay down the existing debt as well as by the need to provide suitable levels of public services. Perhaps the main room for manoeuvre is in the rate structure; a flatter rate structure would reduce to some extent the incentive for higher income earners to migrate.

GROWTH AND PRODUCTIVITY

One of the main overriding concerns facing policy makers is the slowdown in productivity growth in Canada in the past two decades. Governments that relied on growth in per capita incomes as a source of additional tax revenues are now faced with the more painful prospect of funding new initiatives from higher tax rates. As the population ages and fewer working persons are called on to support the demands of a larger retirement population, the imperative of encouraging growth becomes more apparent. Per capita income growth comes from various sources. Investment causes an increase in the capital-labour ratio, or capital deepening, which will cause wages to rise. But this is likely to be no more than a temporary source of productivity growth. Permanent growth requires improvements in technology, including both new cost-reducing processes and the discovery of new products. It is therefore important that the tax system be favourable to technological progress.

Productivity growth can come from a variety of activities. The modern theory of growth posits that productivity improvements accompany investment of different sorts. Investment in R & D obviously should uncover new knowledge that leads to technical progress. Investment in capital may also lead to productivity improvements. New capital embodies the latest techniques of production, and investment also provides an opportunity for management and workers to gain experience and knowhow on the job (that is, learning-by-doing). Investment in human capital also improves skills of workers and professionals.

For some of these forms of investment, the market will be its own reward. Firms that invest more will attain higher productivity and earn more profits. But some forms of investment yield productivity increases whose benefits are not appropriated by those investing. This is especially true when the productivity gain comes from new knowledge that is readily available to other firms. In these circumstances, efficiency can be enhanced by providing an incentive to investment.

It is difficult to detect when such secondary benefits are present. By their very nature, they are not priced by the market. Moreover, there are always some winners and some losers, and even the market does not know which investments will fall into each category. It is therefore difficult to target tax incentives to the right sorts of investments. Thus, it could be argued that incentives to invest should be broad-based and available to all investment; or, at least, the tax system should not discourage investment in physical capital, investment in R & D, and investment in human capital. By and large, the latter two are treated liberally by the tax system. Investment in R & D benefits from both a rapid writeoff and the scientific research and experimental development tax credit. As the Mintz committee pointed out, Canadian incentives for R & D are among the most generous in the world, so generous that the committee recommended reducing them.[5]

Human capital investment is also well treated. Although there are no explicit incentives for it in the tax system, it can be effectively written off immediately, thereby providing a strong incentive for investment, at least for firms in a tax-paying position. This incentive is over and above the fact that the education system itself highly subsidizes education and training. Whether these measures are satisfactory to compensate for the externality that might be involved in human capital investment is, of course, difficult to know for certain. But the incentives are probably as generous as they can be in the absence of such information.

On the other hand, investment in physical capital is not treated anywhere near as well. Marginal effective tax rates (METRs) on investment in some sectors are quite high, especially service and high-tech sectors,

[5] Ibid., at 5.18.

which might be especially susceptible to technological breakthroughs. As well, the fact that the tax system discriminates against risky ventures by the absence of full loss offsetting can work against productivity-improving investments, many of which are risky by nature.

These arguments in favour of encouraging investment might be indirectly taken to suggest that savings should also be encouraged. Any increase in saving will necessarily end up in higher investment. In an open economy, it is an open question as to how much of the additional savings end up being invested domestically, but the presumption is that at least some will. Given that there are sound arguments for encouraging savings through the tax system, as discussed below, the fact that these savings might find their way into domestic investment simply reinforces those arguments. Of course, much is already done to induce domestic investment of sheltered savings: the 20 percent asset rule sees to that.

THE TAX MIX

All countries use a mix of broad-based taxes—income, consumption or sales, and wage or payroll—and the tax mix can and does vary considerably across countries. There is no widely accepted theory of the optimal mix of taxes. The three main broad tax bases overlap considerably. The presumption is that a mix of taxes serves to ensure that the tax rate is not excessive on any one base, thereby minimizing the extent of avoidance and evasion, and reducing the visibility of the tax.

Although there is considerable tax base overlap, each of the three taxes differs in some respect. Income taxes are like taxes on wages plus capital income. A mix of income and payroll taxes will ensure that capital income is taxed less highly than wage income, a result that most economists would suggest is appropriate. Similarly, consumption and wage taxes overlap considerably, at least in present value terms: the present value of lifetime consumption is equal to the present value of lifetime labour earnings plus net bequests. Thus, taxing consumption using a sales tax is a way of getting at consumption financed out of inherited wealth rather than out of earnings, and perhaps also consumption out of income that might have evaded or avoided taxes.

In Canada, the reliance on income and property taxation is high and on sales and payroll taxation low relative to most OECD countries. An exception is the United States, where income taxes are also a substantial component of the tax mix. But since overall tax levels are much lower there, that translates into lower income tax rates. The implication is that progressive tax sources are relatively heavily used in Canada, with the consequence that the more mobile skilled segment of the labour force is relatively heavily taxed. From that point of view, there might be a strong case for enhancing sales and payroll taxes at the expense of income taxes. If so, any concern with redistributive consequences for the lowest-income persons might be addressed by accommodating changes in the system of refundable tax credits delivered through the income tax system, a vehicle we consider next.

INSTRUMENTS OF REDISTRIBUTION

Two alternative institutions exist for redistributing from the better-off to the less well-off—the income-tax-transfer system and the targeting of transfers to the poor through the welfare system. The former is largely under the influence of the federal government, while the latter is exclusively provincial. There is, of course, a considerable amount of redistribution achieved by means other than income-based or needs-based transfers. Many public services take the form of in-kind transfers that serve redistributive goals. Obvious examples include the education system, health care, and welfare services.

What is perhaps surprising about the system of redistribution is that, despite the widespread view among economists and other policy specialists in favour of negative income-tax-type systems, transfers delivered through the tax system have not been widely used in Canada. Indeed, until recently, transfers made by the federal government (old age security [OAS]/guaranteed income supplement [GIS] and family allowances) were delivered outside the tax system and made relatively little use of income testing. Instead, they were largely demogrants in nature, a reflection of the principle of universality that dominated the post-war welfare state. The idea of targeting transfers is now much more in vogue, in part no doubt because of the imperatives of budget discipline.

One of the most important institutional innovations in the federal tax system has been the use of refundable tax credits—the GST credit and the child tax benefit. Some provinces also use refundable tax credits. These have the potential to convert the income tax system into a proper tax-transfer system. Transfers delivered through the tax system can take advantage of the principle of self-reporting, which reduces their administrative costs considerably (though with a corresponding possibility of errors, intentional or otherwise). They can also be conditioned on criteria that can potentially be monitored through the income tax system, including family income and various demographic indicators. Against these advantages, however, is the fact that transfers delivered through the tax system have limited ability to respond to changes in a recipient's circumstances in a short period of time. As well, they cannot be based on indicators of need that are more detailed than the income tax system can pick up, such as expenditure needs of various types or housing requirements. Thus, they are best suited to assist those whose income is low over long periods of time.

These shortcomings reinforce the need to complement transfers delivered through the tax system by those delivered by social agencies that have the ability to monitor applicants ex ante to determine who is in need and how much. Thus, social workers can be used to target assistance to those most in need based on more general criteria than income or observable demographic characteristics, and to respond quickly to changes in circumstances. They can also be used to monitor job search activities of applicants.

In the end, a balance between transfers delivered through the tax system and those obtained through the welfare system must be struck. Ideally, this would involve a coordinated approach, though that might be difficult given that the two systems are creatures of two different levels of government. But some coordination is desirable to ensure that the structure of marginal tax rates provides proper work incentives and incentives to save. It has been alleged, for example, that the welfare system has excessively high clawback rates for transfers to the poor on income that is earned. A major objection to the federal government's proposed seniors benefit was that it imposed high implicit tax rates on savings for one's own retirement. It is obviously important to avoid high implicit marginal tax rates on these sorts of decisions to the extent possible. It may even be desirable that marginal income tax rates at the lower end of the income scale be negative—that is, that there be some positive inducement for increasing labour supply. The case for wage subsidies for transfer-receiving low-income persons is now well established in the literature.[6] In addition to inducing low-skilled persons to enter the labour force, they help offset the substantial implicit tax rate on labour supply of the sales and payroll tax systems, and counteract the effects of involuntary unemployment induced by firms that offer high wages as a means of inducing their workers to be productive (the so-called efficiency wage concept). But in the end, high tax-back rates are a reflection of more selective targeting of transfers to the lowest-income persons. Avoiding high tax-back rates would mean returning to universal transfers, which involve significantly higher overall tax rates in order to achieve reasonable amounts of redistribution.

The idea of delivering transfers to the poor using refundable credits was innovative not only for its use of the income tax system as a redistributive institution, but also for the criteria used for determining eligibility for those transfers. Transfers are based not on individual income as defined by the income tax system, but on both family income and the number and age of children. The welfare system itself has long used notions of need that are somewhat divorced from standard income measures, such as expenditure requirements. Where transfers are to be delivered through the income tax system, it is necessary to decide what criteria are appropriate for targeting those transfers to the poor.

The traditional view might be that the negative side of the tax system should be treated symmetrically with the tax side, so that some notion of comprehensive income is used to determine the size of each person's transfers. Recent literature on the targeting of transfers has emphasized that income itself might not be an adequate basis for determining transfers to the poor.[7] For one thing, income as conventionally measured may not be a good indicator of individual (or household) well-being. Different households have different preferences and needs, and targeting transfers

[6] For example, see the discussion in Michael Keen, "Peculiar Institutions: A British Perspective on Tax Policy in the United States" (1997), vol. 50, no. 4 *National Tax Journal* 779-802.

[7] See Dominique van de Walle and Kimberley Nead, eds., *Public Spending and the Poor: Theory and Evidence* (Baltimore: Johns Hopkins University Press, 1995).

on the basis of these factors can improve the effectiveness of transfer policies. Examples might include household size and composition, location, disability, employment status, and so on. Targeting might also be seen as improving the cost-effectiveness of transfer programs. As mentioned, the more successful the program is in targeting those in need, the lower will be the cost to the treasury of getting a given level of support to the poor. Finally, basing transfers on observable individual characteristics other than income may improve the efficiency of the redistributive mechanism for a somewhat more subtle reason, which has been emphasized in the literature on optimal redistribution.[8] The argument is that income is only a very imperfect indicator of underlying determinants of household well-being. Moreover, it is at least partly determined by households themselves. If the tax-transfer system redistributes according to income, individuals capable of earning a higher income will be tempted to masquerade as low-productivity persons by earning lower income and thus obtain transfers intended for higher-income persons. In these circumstances, using indicators other than income may make it more difficult for such mimicking behaviour and allow the system of redistribution to be more effective in getting funds to those that need them most. The precise way in which transfers should be targeted is an issue of ongoing concern.

The innovation of refundable tax credits is of immense potential importance. It provides the opportunity to turn the tax system into a true negative income tax system, one that is able to deliver fairness in a highly cost-effective and efficient way. The use of refundable tax credits could well be enhanced in the future. Indeed, there is no particular reason why existing non-refundable tax credits should not be made refundable. But the enhanced use of refundable tax credits is not a sufficient instrument for redistribution. It must be complemented by provincial needs-based social assistance programs with their administrative targeting procedures, as well as the plethora of in-kind transfers and social insurance. Given that the provinces are major players in the transfer field, the need for federal-provincial coordination should be high on the policy agenda.

FEDERAL-PROVINCIAL INCOME TAX HARMONIZATION

The personal and corporate tax collection agreements (TCAs) have served Canada well as instruments of tax harmonization over most of the post-war period. But as the provinces occupy a larger and larger share of the income tax room, there are definite signs of strain. Demands for special tax credits and other measures have increased rapidly in recent years, and the federal government seems to have acceded to most of them, even though the common base has been compromised and incentives have been introduced for business activities to choose one province over another.

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[8] For further discussion of this aspect, see Robin Boadway, "Public Economics and the Theory of Public Policy" (November 1997), vol. 30, no. 4a *Canadian Journal of Economics* 753-72.

The provinces themselves have expressed discontent with their relative lack of flexibility under the TCAs. They argue that because they must abide by the federal base and rate structure, they have relatively little independent tax policy influence. They cannot, for example, implement local preferences for redistribution by choosing a province-specific rate structure or by defining the base as broadly or narrowly as they choose. Moreover, the provinces argue that the federal government is prone to making unilateral and unannounced changes to the base or rate structure, which affect provincial tax revenues in unanticipated ways. Some provinces have even contemplated leaving the TCAs precisely in order to have more say over the form of income taxes they levy.

Various proposals have been made to give the provinces more flexibility and tax policy independence without forsaking the administrative advantages of a common tax administration. Most of these involve retaining the same common tax base but allowing provinces more discretion over their rate structures. The starkest way of doing this would be to allow provinces to select their own rate structures to be applied to the common base. This approach is referred to as moving from the present "tax-on-tax" system to a "tax-on-base," or "tax-on-income," system. It would certainly allow provinces to implement their own systems of tax progressivity, but it would also create the potential for provinces to compete with one another in rate structures with the objective of attracting higher-income taxpayers. A less dramatic way of affording the provinces some say in their rate structures would be to retain the common rate structure but give the provinces the right to choose at least some of their own basic credits for personal or demographic purposes. Now that personal circumstances are taken into account using tax credits rather than deductions, provincial preferences also can be taken into account without compromising the common base. As always, there is a tradeoff, in this case between the advantages of a harmonized income tax system (administrative simplicity, equity, and efficiency of the internal economic union) and the disadvantages (increased collection and compliance costs, and greater inefficiency and inequity induced by independent provincial tax policy choices and interprovincial tax competition). One thing is clear, however: the greater the income tax room occupied by the provinces, the greater will be the pressures for disharmonization. This is a factor that must be taken into consideration in choosing how decentralized the federation should be, and how important the income tax should be in the federal government's tax mix.

The recent agreement reached by the federal and provincial ministers of finance which allows provinces to opt individually for a tax-on-income system rather than a tax-on-tax system is a reasonable innovation in the circumstances. Given that the provinces are occupying such a large share of the income tax room, the system whereby the federal government has control of both the base and the rate structure is basically unsustainable. In the absence of a major concession, the provinces would be bound to try to achieve their income tax policy objectives in other ways, either by multiplying the number of special provincial measures or by withdrawing from the agreements altogether. Then the harmonization system itself would be threatened. Whether the tax-on-income system will lead to a competing down of provincial redistributive tax systems remains to be seen.

TAX ROOM ALLOCATION

Canada's decentralized tax system is a strength. The provinces and their municipalities have exclusive legislative responsibility for delivering some of the most important public services available to citizens, including all health, education, and welfare services. At the same time, as we have seen, they have substantial taxing authority. The provinces share all the major broad-based taxes with the federal government (income, sales, and payroll taxes) and obtain substantial revenues from their own taxes on resources and property, which they alone tap.

The system of tax allocation in the Canadian federation has evolved more or less without explicit planning, and there may be little that policy makers can do to change that. Each province and the federal government has more or less unfettered access to all tax bases; consequently, any conscious effort to rebalance the tax allocation would take an unprecedented level of federal-provincial cooperation. Yet, it is worth asking from an economic perspective whether the allocation of tax powers is appropriate, if only to serve as a benchmark for future federal tax policy. It is useful to distinguish two dimensions to the tax allocation problem—the assignment of taxes to each level of government and the division of the tax room.

Tax Assignment

The criteria for determining which types of taxes ought to be available for lower levels of government are similar to those that economists use for judging economic policies more generally—efficiency, equity, and administrative simplicity.

The efficiency issues relevant for deciding which taxes to decentralize concern the efficiency with which goods, services, and factors of production are allocated across provinces—that is, the efficiency of the internal economic union. Provincial taxes distort the internal economic union if different provinces impose different taxes on products and factors that are traded or mobile across provinces. If provinces recognize the effect they have on the interprovincial allocation of resources, they can behave strategically by using the tax system to attract desirable products and factors and repel less desirable ones. They will tend to adopt beggar-thy-neighbour policies that in the end will be partly self-defeating and will result in an inefficient set of tax rates. Moreover, if tax capacities differ across provinces, decentralizing revenue-raising responsibilities will lead to different provinces' having different capacities to finance given levels of public goods and services within their borders. This disparity can lead to inefficiency because of fiscally induced migration: persons and businesses will base their locational choice partly on fiscal considerations, rather than on productivity alone, and too many will choose lower-tax jurisdictions. The upshot is that decentralization is less desirable for taxes whose bases are mobile across provinces and for tax bases that are highly unevenly distributed across provinces, unless uneven distribution is mitigated by a system of equalizing fiscal transfers.

The role of equity in the assignment of taxes is somewhat more controversial. Not only will different observers differ on the importance of equity versus efficiency as a goal of government, but they might also differ on the level of government that ought to be responsible for redistributive issues. The argument for the federal government's assuming responsibility is based on the notion that all citizens in a nation ought to receive equal treatment regardless of where they reside. By implication, reasonably common standards of vertical and horizontal equity ought to apply nationwide. Decentralizing taxing responsibilities to the provinces can conflict with nationwide equity for a few reasons. First, provinces may adopt widely differing degrees of redistribution within their respective jurisdictions, resulting in different standards of vertical equity in different provinces. Second, if provinces have redistributive taxes at their disposal, they may use them strategically and compete away redistribution. The so-called race to the bottom is the analogue to the inefficiencies resulting from beggar-thy-neighbour policies. Third, different provinces will have different abilities to redistribute in proportion to the size of their tax base: higher-income provinces can achieve a given amount of redistribution at lower tax rates than lower-income provinces. The result is fiscal inequity, a term reflecting the fact that otherwise similar individuals will end up paying different taxes in different provinces. These equity considerations suggest that tax bases that are important for redistribution should not be decentralized, and tax bases that are distributed unevenly across provinces should not be either. Taxes that are closer to benefit taxes are ideal for decentralization.

Finally, the costs of administration and compliance can be increased if some tax bases are decentralized. Different provinces will typically choose different tax structures for a given type of tax, unless formal harmonization measures are in place. These differences will increase the administrative costs of taxpayers who operate in more than one jurisdiction. And, for some taxes, the possibilities for tax avoidance, or simply the costs of administration, arising from the possibilities of cross-border transactions may be high. Taxes on bases for which the taxpayer operates in more than one jurisdiction therefore appear not to be good candidates for decentralization.

On the basis of these economic arguments, broad-based consumption taxes levied on a destination basis seem to be good candidates for use by the provinces because their base, which is roughly equivalent to the labour income of residents, is relatively immobile. Moreover, they are not an important tax instrument for redistributive purposes. But provincial sales taxes are not without problems. The destination basis of the tax may be costly to enforce if cross-border shopping is easy. More important, the efficiency of sales taxes can be improved significantly if a value-added tax

(VAT) system is used rather than a single-stage tax, but a VAT system may be difficult to administer at the provincial level. Doing so involves keeping track of cross-border transactions for crediting purposes, and that can be cumbersome if different provinces operate their own VAT system with their own rate structure. Thus, if one wants to obtain the advantages of VAT taxation, decentralization of the sales tax to the provinces is challenging.

Since provinces have significant revenue-raising responsibilities, it is highly desirable that more than one broad-based tax be available to them. One of the most obvious candidates is payroll taxation. Its base, labour income, is not very mobile across borders. If it is applied on a broad base, it is an efficient tax, much less distorting than the income tax. It is not important for redistributive equity. And it is relatively easy to administer, since a high proportion of its revenues can be collected by payroll deduction. It is surprising that general payroll taxation is not more popular with governments in general and provincial governments especially.

Personal income taxation is less suitable than payroll taxation for decentralization, even though the bases of both taxes overlap to some extent. One reason is that personal income taxation is an important component of redistributive policy: to the extent that redistribution is a national objective, it is more appropriate for personal income tax policy to be a federal responsibility. The personal income tax, assuming that it encompasses all forms of income, includes unincorporated business income in its base. Given the mobility of capital, this feature violates one of the criteria for decentralization. Collection and compliance costs can also be difficult for a provincial income tax, especially in respect of personal capital income. It is likely that a significant proportion of capital income is earned outside the province, and that may be difficult to account for. Many of these problems can be overcome by a harmonized income tax system such as that currently used by the federal and provincial governments.

Corporate taxation is a much less appropriate candidate for decentralization to the provinces. Because corporate income is highly mobile among jurisdictions, provincial governments can use corporate taxation to influence the location of corporations. Also, compliance and collection costs are likely to be high, given the fact that corporations may operate in more than one jurisdiction and can move funds freely in and out. Similar arguments against decentralizing corporate taxes apply for the decentralization of capital taxes, whose base is also mobile, at least in the long run.

The taxation of natural resources is an interesting case because the tax assignment criteria can give conflicting advice. On the one hand, resources are essentially immobile, so that provincial taxation of them cannot cause the base to move to another jurisdiction (although, of course, the capital needed to develop resources is highly mobile). On the other hand, resource endowments can be very unevenly distributed in a federation, giving rise to large differentials in revenue-raising capacities. One approach might be to decentralize resource bases that are relatively evenly distributed among provinces and to keep within federal jurisdiction those that are highly uneven. One way to decentralize resource revenues without sacrificing fiscal efficiency and equity is to accompany the tax assignment with a system of federal-provincial transfers that seeks to undo the effects of an uneven distribution of resource revenues. Whether such a system is sustainable politically when taxes are highly unevenly distributed is an issue.

Perhaps the least suitable taxes for decentralization to the provinces are personal taxes on wealth or the transfer of wealth (for example, inheritance and bequest taxes). Not only do these taxes have a mobile base, but their main purpose is to redistribute wealth among households.

The actual set of tax responsibilities decentralized to the provinces depends on the amount of revenues that have to be raised, which in turn depends on how decentralized expenditure responsibilities are. For highly decentralized federations like Canada, where the provinces need to raise almost as much own-source revenue as the federal government, there is inevitably some overlap in the tax bases assigned to the two levels of government. The sharing of tax bases is attractive because it allows the possibility of administering the taxes levied by the two jurisdictions together, thereby economizing on collection and compliance costs. And it is consistent with each level of government's retaining the right to set its own tax rates. The disadvantage of tax-base sharing in this form is that it requires all jurisdictions to abide by the same base. This loss of tax policy independence may not be acceptable to the two levels of government. If the tax-base sharing takes place without a single tax administration, no cost savings are achieved. In fact, compliance costs might be significantly greater for taxpayers having to deal with two different administrations, each of which applies a different set of rules. In this case, it might be preferable for the two levels of government not to occupy the same tax base, or if they do, to tacitly accept similar bases (as seems to be the case in many US states).

As we have mentioned, it is not clear that steps could easily be taken to change the assignment of taxes in the Canadian federation. But if they could, there are some aspects of tax assignment that are at variance with the principles outlined above. Four examples stand out of taxes for which it might have been economically better if they had not been decentralized. The first of these is the corporate tax, which is potentially a source of significant distortions among provinces. Related to this is capital taxation, a tax that all provinces use. The third is wealth transfer taxation, such as a tax on inheritances. Indeed, the demise of this tax in Canada is a textbook example of how interjurisdictional tax competition can result in the competing away of what many would regard as a suitable component of the tax mix. The final example is rather more controversial, and that is resource taxation. The major resources—oil and gas and some minerals—are highly unevenly distributed among provinces. Economic arguments might suggest that the public's share of the rents from these resources ought to accrue to the federal government, but this is obviously not an option now for constitutional, historical, and political reasons. The same arguments do, however, lend support to an effective system of equalization to account for the uneven allocation of resources among provinces.

The Division of Tax Room

While very little might be done to change the assignment of taxes or indeed the extent of decentralization of revenue-raising responsibilities to the provinces, one degree of freedom that exists is the division of the tax room for different types of taxes. What is at stake here is that the greater the share of tax room occupied by the federal government for a given tax base, the more likely it is that the federal government will be able to induce harmonization of the tax base. For example, if a formal harmonization agreement exists—as with income taxes or, with some provinces, for the GST—the greater the tax room occupied by the federal government, the greater the chance that the integrity of the tax harmonization scheme will be maintained. There is, of course, no magic share of the tax room that is adequate if the federal government's influence is sufficient to encourage harmonization. Some would even argue that harmonization might be possible without the connivance of the federal government: the provinces could agree to a scheme of harmonization among themselves. Unfortunately, there are no instances of such agreements in the past to indicate their viability.

The federal government cannot be dominant in all major tax fields. Given the extent of decentralization of the tax system as a whole, that would not be feasible. Therefore, in deciding on its own tax mix, the federal government needs to decide which, if any, of the major tax bases are ones in which it should strive to occupy a dominant share of the tax room. Let us take each of the three broad-based taxes in turn.

In the case of the income tax, harmonization is an important policy objective for reasons of efficiency, equity, and administrative simplicity. The mobility of business income and of highly skilled persons suggests that efficiency objectives would be compromised if different provinces had significantly varying tax systems. Similarly, since the income tax is the main tax instrument for pursuing national redistributive objectives, vertical and horizontal equity can be violated to the extent that different provinces pursue differing redistributive policies using their own income tax or, more to the point, compete away redistribution through their access to the income tax. Finally, given the complicated nature of any income tax, considerable administrative simplicity is achieved if a uniform income tax system applies at the federal and provincial levels of government, especially one in which taxpayers have to deal with only one tax collection authority. These considerations imply that a strong case can be made for the federal government's maintaining a dominant share of the income tax room.

In contrast, the payroll tax is an ideal one for decentralization to the provincial level. It applies only to wage income, which is significantly less mobile than capital or business income. It is very simple to collect and enforce, and compliance is not a problem for firms. It is also a relatively efficient tax, and one that is not used for redistributive purposes. Moreover, harmonization is not nearly as important as for the income tax. These considerations lead to the conclusion that there is no need for the federal government to maintain a dominant share of payroll taxation. Indeed, provinces could be encouraged to make much more use of general payroll taxation, not just by the federal government's making room available to them, but also by incentive measures like continuing to allow payroll taxes to be deductible from income tax liabilities.

General sales taxes present much more difficult choices. On the one hand, it is very tempting for the federal government to change its tax mix in the direction of greater reliance on the GST. It is, after all, a highly efficient tax, and one with great potential as a revenue raiser. As noted earlier, many OECD countries (with the important exception of the United States) make greater use than Canada does of this type of tax. However, greater federal reliance on the GST may have some undesirable consequences. The main concern would be erosion of the federal government's income tax room, leaving harmonization of that tax in greater jeopardy. Substituting a greater share of the general sales tax room for that of income tax room might increase the likelihood of harmonizing the sales tax field, which in itself is a useful objective. But achieving harmonization of sales taxes is much more uncertain, given the current views of the provinces. It is also much more difficult. The large provinces are unlikely to agree to the harmonized sales tax (HST) arrangement negotiated by the three participating Atlantic provinces, because it would essentially take general sales tax policy out of their hands.

The feasible alternative is the sort of harmonization achieved by Quebec with its Quebec sales tax (QST), which is independent of, but harmonized with, the federal GST. It remains to be seen how well the QST experiment performs. But even if it turns out to be suitable for Quebec from an administrative point of view, extending the same sort of system to several provinces simultaneously is likely to be very complicated. Moreover, given that the QST system leaves Quebec with significant discretion to deviate from the federal GST structure, it is not clear that federal dominance of the sales tax field will be necessary to induce further harmonization. Indeed, both the provincial HST and the QST rates exceed the federal GST rate, and that has not prevented harmonization from proceeding. Thus, we are left with the tentative conclusion that it is much more important for the federal government to retain a dominant share of the income tax room than to try to capture more of the sales tax room.

Of course, some might object that if sales tax harmonization is possible without the federal government's maintaining a dominant share, so might income tax harmonization be. In some respects, it remains an open question whether the provinces will be willing to abide by income tax harmonization measures, such as the TCAs, as the federal share of the tax room erodes. However, there is some evidence that they will not. As noted above, as the federal share has eroded, provinces have explicitly questioned the relevance of these arrangements and have contemplated withdrawing from them. As well, they have increasingly resorted to the use of province-specific credits and other measures within the TCAs, many of which appear to violate the spirit of the latter, and the federal government seems unable to obstruct or discourage these actions. It seems natural that provinces would be willing to harmonize their sales taxes with the federal one, while resisting harmonizing their income taxes. The latter is, after all, a more powerful weapon for attracting desirable factors of production and for engaging in tax competition.

TAX CREDITS VERSUS DEDUCTIONS

While the income tax reform of 1987 replaced all exemptions and some deductions with tax credits, a number of deductions were retained. It has been argued that tax credits rather than deductions achieve a greater degree of equity. This argument is based, however, on a particular norm that suggests that equity is more readily achieved when all taxpayers are granted the same absolute tax relief (in terms of taxes saved) regardless of their level of income—a norm that neglects the fact that changes in the rate structure ought to be able to achieve any desired degree of progressivity. As well, it alters the incentive for taxpayers to undertake certain activities by making it less attractive for them to engage in activities for which deductions are not allowed or in respect of which deductions have been replaced by tax credits. The use of tax credits in lieu of deductions might also be viewed as generating more tax dollars for the government.

The choice between tax credits and deductions should depend on the policy objectives to be achieved. Put simply, deductions are appropriate as a means of adjusting the base for horizontal equity reasons or for providing incentives for certain forms of behaviour, while credits basically address vertical equity concerns. This distinction seems to have been lost sight of in the wholesale switch from exemptions to credits. Credits are effectively a component of the progressivity of the tax structure: the existence of a credit alongside even a flat rate structure turns the tax into a progressive one—that is, one whose average rates rise with incomes. The higher the credit, the more progressive the tax structure. Indeed, the substitution of tax credits for most deductions in Canada, over the past two decades, has been partially responsible for a narrowing of the after-tax distribution of income.[9] Credits also provide a convenient way of differentiating average tax rates across identifiable groups thought to be differing in their need. Thus, the use of credits is highly appropriate for relieving difficult family circumstances or easing the financial burden of persons suffering from a disability. But, as mentioned above, given this objective, logic dictates that these credits be fully refundable. Making them so would add immensely to the fairness of the personal tax system. Non-refundable tax credits are of no assistance to individuals without taxable income and do nothing to assist in redistributing income. Replacing them with refundable tax credits would move the tax-transfer system closer to that of a comprehensive negative income tax system.

Deductions, on the other hand, should be used when the objective is to adjust or alter the tax base. For example, all expenses associated with

[9] Smith, supra footnote 2.

earning income should be treated as a deduction. So, presumably, should medical and dental expenses. Moreover, mandatory pension contributions through the Canada Pension Plan (CPP)/Quebec Pension Plan (QPP) should, like registered pension plan (RPP) and registered retirement savings plan (RRSP) contributions, be treated as deductions. Slightly murkier are those expenditures, like charitable donations or political contributions, that are given preferential treatment as an inducement for taxpayers to make them. If one supposes that the social benefit of such contributions does not depend on the circumstances of those who make them, one might argue that the same effective subsidy ought to be given all taxpayers who contribute.

Savings and Capital Income

The tax treatment of savings and capital income varies widely across different types of savings in Canada. For example, contributions to RRSPs and RPPs (up to a specified limit) are deducted from income for tax purposes. A tax credit is provided for compulsory contributions to the CPP/QPP. Annual accrued interest earned on funds contributed to registered education savings plans (RESPs) and on a portion of premiums paid for some whole life insurance policies is excluded from annual taxation. One-quarter of net capital gains (gains minus losses) is excluded from taxation. Farmers and small business owners are eligible for a $500,000 lifetime capital gains exemption. Tax incentives are provided for tax shelters such as flowthrough shares, film shelters, and labour-sponsored venture capital corporations (LSVCCs); the effective tax rate on these may even be negative. The net imputed rent on owner-occupied housing, and all other consumer durables for that matter, is excluded from taxation. Dividend income from Canadian sources is taxed at a lower rate than interest income because of the dividend tax credit, except for sheltered savings on which the dividend tax credit does not apply. Income from unincorporated business is treated differently depending on the type of asset and industry, and depending on the history of profits and losses of the business. And, of course, the absence of indexation for inflation affects some assets much more than others. When all these features are taken into account, one is left with a tax system that leaves a significant proportion—perhaps the lion's share—of capital income untaxed, and that which is taxed is treated very differently. This differential treatment not only leads to economic inefficiencies, but also increases collection and compliance costs and encourages wasteful tax planning.

While special treatment of different forms of savings has been challenged, especially by those who adhere strictly to the Haig-Simons comprehensive income base vigorously proposed by the Carter report,[10] it has been defended for a variety of reasons. From the point of view of the basic principles of taxation, the case for preferential treatment of capital income is a consequence of the view that the proper base for personal

[10] Canada, *Report of the Royal Commission on Taxation*, vols. 1-6 (Ottawa: Queen's Printer, 1966).

taxation should be consumption and not income. After all, consumption—not income—is what generates consumer well-being and is thus said to be a more equitable base. The important point in the debate over income versus consumption relates to the base rather than the rate structure: equivalent degrees of progressivity can be achieved under either income or personal consumption tax systems by an appropriate choice of rate structure. The exemption of capital income might also be efficiency-enhancing, since capital income taxation effectively discriminates against future consumption. Perhaps most important, personal consumption taxes are actually much easier to administer than comprehensive income taxes; indeed, the latter are virtually impossible to achieve. It is not surprising that many economists and policy analysts alike have opted for consumption taxation.

Detractors will point out that the case for consumption taxation is not a perfect one. It essentially ignores the fact that leisure is untaxable under either system, and this consideration can in principle add strength to the case for taxing capital income. But even this argument, to the extent that it is valid, is unlikely to call for rates of taxation on capital income that are anywhere near those on labour income or consumption, as the vast optimal tax literature has made clear. The theoretical case for at least substantial sheltering of capital income is a compelling one.

From a more practical point of view, a significant rationale for deducting RRSP and RPP contributions is to encourage individuals to save for retirement and hence reduce the need for government transfers to the elderly. The main benefit of RPPs and RRSPs is the value of the tax deferred on both the principal and annual earnings. The tax credit for compulsory contributions to the CPP/QPP has the same rationale as the deductions for RRSPs and RPPs. Exclusion of the net rent on owner-occupied dwellings exists for a variety of reasons, not the least of which is the public outcry that would result if the government taxed this source of income. Excluding interest earned on RESPs is intended to increase savings and subsequently investment in post-secondary education. Excluding one-quarter of capital gains is partly designed to increase savings and investment, although apparently also partly to act as an ad hoc measure of integration of personal and corporate taxation, as well as a means of offsetting the taxation of inflationary capital gains. Lower taxation of dividend income is also intended to offset the double taxation of corporate source income that would otherwise exist and to place small corporations on an even tax footing with unincorporated businesses. Special tax incentives for tax shelters are intended to increase investment in specific types of business ventures.

Given this variety of tax incentives and deductions, a couple of issues arise, not the least of which is whether or not capital income or savings should be taxed and, if so, to what extent. On the one hand, capital income apparently accrues disproportionately to higher-income persons, so that failure to tax it seems to be inequitable. To the extent that capital income is in part obtained from inherited wealth, the case is strengthened. On the other hand, if the bulk of inherited wealth is passed on to the next generation, taxing the capital income of those persons may result in double taxation. Moreover, capital income earned from ordinary savings simply reflects a person's level of earnings. If earnings are taxed progressively, it is not clear that capital income has to be taxed as well. Scandinavia has adopted a dual income tax system whereby capital income is taxed at a lower flat rate than other income. If the tax system needs to be more progressive, it might be better to make the rate structure applying to earnings more progressive and, if necessary, to tax wealth transfers separately.

As suggested above, a tax base that excludes capital income has a number of advantages in its own right. For one thing, it does not discourage saving, including saving for retirement, and there may be good reasons to increase the level of savings in the economy. More saving provides more finance for investment, which in itself may be beneficial for employment and growth of the economy, as stressed in the new growth theories. As well, the more that persons save for their own retirement, the less dependent they will be on the public purse later in life. Equity arguments might also favour exempting capital income or sheltering savings from taxation. Tax systems that exempt capital income, or that allow taxpayers to shelter savings from income taxation through registered savings plans, are equivalent (in present value terms) to taxes based on consumption. Indeed, the argument that consumption is a more equitable basis for taxation than is income is summarized in the notion that consumption is what determines a person's level of well-being, not income; that is, it is better to tax persons on the basis of what they take out of the social pot (their consumption) rather than what they add to it (their income).[11] Adopting consumption as a tax base need not detract from vertical equity because a progressive rate structure can be applied to a personal consumption base.

Administratively, there are advantages to sheltering capital income from taxation. These stem from the fact that it is virtually impossible to include capital income properly in the tax base. Some forms of capital income are very difficult to measure, including imputed rent on consumer durables such as housing, the return on human capital investment, accrued capital gains, and capital income from unincorporated businesses. These difficulties of taxing capital income are made even more pronounced in an open economy where assets can be shifted across borders at will. In fact, when one adds sheltered retirement savings (contributions to RPPs and RRSPs) to this picture, it is evident that a substantial proportion of capital income is currently excluded from the tax base, so that the tax system is closer to an expenditure tax than to a comprehensive income tax. Table 1 illustrates the current pattern of personal savings in Canada. The evidence suggests that the majority of savings is tax-deductible, supporting the contention that the current income tax treatment of savings has moved closer to a consumption base over the past few years. This move could be completed

[11] Nicholas Kaldor, *An Expenditure Tax* (London: Allen and Unwin, 1955).

Table 1 Personal Savings and Components as a Percentage of Personal Disposable Income, Selected Years, 1971-1995 (Excluding the Value of Owner-Occupied Dwellings)

	1971	1980	1984	1988	1993	1995
Canada Pension Plan/Quebec Pension Plan	0.9	0.9	0.9	1.0	1.2	1.3
Registered retirement savings plans	0.5	1.8	1.9	2.7	3.6	4.1
Registered pension plans	1.3	1.5	1.4	1.3	1.4	1.4
Registered home ownership savings plans	na	0.3	0.2	na	na	na
Other savings	4.1	8.8	10.4	4.9	3.2	1.4
Total	6.8	13.3	14.8	9.9	9.4	8.2

Source: Calculated from data in *Tax Statistics on Individuals* (Ottawa: Revenue Canada), selected years; and *Economic Reference Tables, August 1995* (Ottawa: Department of Finance), reference table 13.

and the remaining distortion eliminated with relatively little impact on government revenues if all forms of savings were exempt from tax.

There are also "second-best" arguments for relieving capital income of some taxation at the personal level. Elsewhere in the tax system, there are taxes that indirectly impinge on capital or its income. Property taxes levied at the provincial/municipal level are effectively taxes on some forms of capital. The corporate income tax also is in part a tax on capital in the corporation, at least to the extent that corporate tax payments are not fully integrated with personal taxes.

While the fact that some types of savings receive preferential tax treatment and others do not is seldom criticized, some criticism has been directed at the type of differential treatment—tax credits for CPP/QPP contributions and deductions for RRSP and RPP contributions. It is difficult to understand why these are treated differently. Deductions, when compared with tax credits, for RRSPs and RPPs apparently benefit higher-income taxpayers, who are in higher marginal tax brackets and are better able to take advantage of retirement savings plans than are lower-income taxpayers.

One way of reducing or eliminating this differential is to switch to a tax credit system for RRSPs and RPPs. This could, however, increase the inequities and distortions because it could discourage savings in RRSPs and RPPs when tax rates are expected to change over time. For example, if the tax rate at the time of contribution was lower than at the time of withdrawal, the taxpayer may have an incentive to hold taxable assets outside RRSPs and RPPs.[12] Take an individual who is close to retirement,

[12] Jack M. Mintz and Thomas A. Wilson, "Private Provision of Retirement Income: Tax Policy Issues," in Keith G. Banting and Robin Boadway, eds., *Reform of Retirement Income Policy: International and Canadian Perspectives* (Kingston: School of Policy Studies, Queen's University, 1997), 209-39, at 232.

wishes to make a $2,000 contribution earning a return of 10 percent, and is in a 25 percent tax bracket. This contribution generates a tax credit of 25 percent. When these funds are withdrawn, however, the individual's marginal tax rate is expected to be 45 percent. In other words, the individual incurs a tax saving of 25 percent before retirement only to face a tax rate of 45 percent after retirement. This is equivalent to a wealth tax of 20 percent and well in excess of the annual 10 percent return on the asset.

Another suggestion for altering the tax treatment of RRSPs and RPPs is to tax income earned by these plans. This solution may not, however, improve allocative efficiency or equity because a number of other forms of savings are either tax-free or taxed at a negative rate. It has also been suggested that for RRSPs, a penalty should be imposed on early withdrawals and/or the contribution limits should be lowered. Each of these is inferior to the current system. A penalty reduces the flexibility to use RRSPs to average one's income or to finance unexpected expenditures before retirement. As well, it may discourage individuals from using this instrument to save for retirement because they may view their contributions as being essentially locked in.

While limiting RRSP contributions has been the favoured option of governments, primarily because it improves vertical equity (although, as mentioned above, vertical equity is more appropriately addressed by the rate structure), increases government revenues, and may not reduce savings,[13] it has its deficiencies. It discriminates against those who do not have the opportunity to use RPPs because it reduces RRSP tax-deductible contributions, and it reduces the flexibility to average one's income, especially if confronted with job layoffs or unexpected expenditures.[14]

The treatment of savings for retirement purposes has improved noticeably over the past two decades. A suggestion for further reform includes raising the limit for RRSP contributions to 30 percent, as was recommended by the Economic Council of Canada a number of years ago, and then to index further changes to match the average annual change in the industrial wage. The federal budget of 1996, however, indicated that the limit of $13,500 will be maintained until 2002 and that indexation of this limit will not take place until 2004.

INTEGRATION OF PERSONAL AND CORPORATE INCOME TAXES

Various measures are in place to integrate personal and corporate income taxes so that corporate source income is not taxed twice, once at the corporate level and again at the shareholder level on distribution. The

[13] Christopher Ragan, "Progressive Income Taxes and the Substitution Effect of RRSPs" (February 1994), vol. 27, no. 1 *Canadian Journal of Economics* 43-57.

[14] For a more detailed discussion of these deficiencies, see Mintz and Wilson, supra footnote 12, at 232-33.

main elements of this integration are the dividend tax credit, the partial exemption of capital gains, and the exemption of intercorporate dividends.[15]

The dividend tax credit is available for dividends received from Canadian corporations. The combined gross-up and credit rate of 25 percent implies that dividends from corporations subject to the small business tax rate are roughly fully integrated, while those from corporations subject to higher tax rates are less than fully integrated. The dividend tax credit can be claimed only against income taxes owing; it is not refundable and cannot be carried forward. But it applies regardless of the amount of taxes that have been paid by the corporation. In particular, even dividends paid by corporations in a loss position for tax purposes are eligible for the credit. On the other hand, dividends earned on tax-exempt assets, such as pension funds, are not eligible for the dividend tax credit.

Capital gains are taxed at the personal level on realization, but only three-quarters are included in the tax base. There is no further integration as such, the one-quarter exclusion apparently serving as a pseudo-integration device. This is equivalent to the effect of the dividend tax credit for taxpayers in the 50 percent income tax bracket. However, the effective credit is available only when capital gains are realized, which may be long after the corporate tax has been withheld. Moreover, while the one-quarter exclusion makes the capital gains treatment similar to the dividend tax credit for high-income persons, the value of the exclusion is much less for those in lower tax brackets, implying that as an integration device the three-quarters taxation of capital gains is inequitable.

Dividends received by a resident corporation from another resident corporation are tax-deductible. This tax-free flow of dividends precludes the multiple taxation of the same corporate income, although it does not guarantee that the dividends will be subject to tax at the initial point of distribution. Note that the same tax-free flow of funds is not ensured for capital gains, implying that there can be multiple taxation. In addition, special measures exist for ensuring that the investment income of Canadian-controlled private corporations is fully integrated with the personal tax of the shareholder.

In evaluating this system of integration, it is worth considering the arguments for and against it, including whether there should be integration at all. (The US tax system, for example, has no dividend tax credit.) The tax treatment of capital and business income under the existing income taxes is a hybrid. Some forms of capital income are taxed more than others, and some escape taxation altogether. This may be partly a matter of policy choice and partly an inadvertent consequence of other policy decisions. Moreover, the implications of the openness of capital markets

[15] This discussion draws on Robin W. Boadway, "The Economic Rationale for Integration," in *Business Tax Reform*, 1998 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1998), 21:1-26.

are potentially profound. To the extent that Canadian firms are price takers in capital markets, business taxes on capital income cannot be borne by asset holders.

Integration or its absence can serve to undo some of the effects of capital income taxation, either at the personal level or at the level of the firm. For example, the absence of integration can partially undo the intended sheltering of retirement savings. It can also result in the double taxation of savings. In addition, the absence of refundability in the integration system can compromise the fairness of the personal tax system. The presence of integration, if restricted to situations in which corporate taxes have actually been paid, can partially undo preferential tax treatment accorded to certain industries. To the extent that these tax preferences have been instituted as a matter of policy, integration of the corporate tax contradicts corporate tax policy.

To make matters more difficult, things get turned on their head to the extent that Canadians are price takers in capital markets. Corporate tax distortions are not affected by integration implemented at the personal level. Instead, they simply serve to undo capital taxation at the personal level, presumably contradicting the intent of personal tax policy. More generally, the open economy assumption calls into question the standard rationale for the corporate tax as a withholding device. Given the segmentation of the savings from the investment side of the market, the corporate tax serves little purpose as a withholding device against domestic capital income. At best, it serves only to withhold against corporate income accruing to non-resident corporations whose governments offer a foreign tax credit. Implementing a highly complex and distortionary corporate tax for this purpose may not be worthwhile.

Finally, there are those who argue that capital income tax policy is itself misguided. Taxes on capital income at the personal level are probably much too high from the point of view of economic efficiency, growth, and even equity. The fact that different assets are treated in different ways adds its own sources of inefficiency. This state of affairs might be attributed to the irrationality of government, or it might be attributed to the short time horizons of government. In any case, measures that undo the taxation of capital income, or that prevent governments from imposing a high tax on capital income, might be welcomed by some. Similarly, at the corporate tax level, it might be argued that government policies aiming to achieve industrial policy objectives through the tax system are misguided for one of two reasons: one might argue that there should be no such industrial policies; or one might argue, as the Mintz committee does, that to the extent that such policies may be desirable or necessary, they should not be implemented through the tax system.[16]

The upshot is that evaluating reform options for the system of integration involves some judgment. The Mintz committee largely endorsed the

[16] Mintz report, supra footnote 4, at 4.4.

existing structure of integration. Its main recommendation in this area addresses what the committee regards as a serious concern about the existing system—namely, that the dividend tax credit is available whether or not corporate tax has been paid on the income from which the dividends have been paid.[17] To address this issue, the committee recommends that a corporation distribution tax (CDT) be introduced. As noted above, the committee takes the view that industrial policies should not be implemented through the tax system. The CDT has the effect of overriding such preferences. An argument can be made that the tax system is precisely the proper vehicle for delivering tax preferences. It is formula-driven, with a minimum of administrative cost and discretion, and is subject to the normal standards of tax accountability and compliance. The Mintz committee takes the rather strong position that any policy decision to implement industrial policy should be overridden by the integration proposals. It justifies this position by suggesting that tax preferences should be given only for the purpose of encouraging growth through retained earnings finance. To the extent that corporations pay out dividends, this objective is being frustrated. That seems an odd position, for it suggests that policy should discriminate in favour of retained earnings finance as opposed to outside finance. It could be argued that the tax system and capital markets more generally already discriminate in favour of retained earnings finance; to penalize payouts might compound this problem. The CDT would also penalize firms in a tax-loss position that are paying out dividends—dividends that the firms may feel obliged to pay out as a prerequisite for obtaining financing on reasonable terms. Tax-loss firms presumably include risky firms and young growing firms, precisely the sort that might be important for generating growth and dynamism in the economy. Allowing shareholders to obtain a dividend tax credit undoes at least some of the discriminatory treatment faced by these firms. The CDT would have the opposite effect.

There are a number of anomalous aspects of the existing system of integration that are worth considering. The first is the treatment of tax-exempt assets (such as RRSPs and RPPs) that are not eligible for the dividend tax credit. A standard view of a competitive capital market would suggest that the benefits of the tax sheltering of, say, pension funds go to savers. This would be so in either an open or a closed economy. If one views the corporate tax as primarily a withholding device, denying the benefits of integration to tax-sheltered assets amounts to undoing the purpose of the tax sheltering in the first place. From an economic point of view, that makes little sense. Even if it did, consistency would demand that the same principles apply to debt financing by tax-exempt funds. These funds should be denied tax deductibility at the corporate level so that debt and equity would be treated comparably.

A second issue concerns the non-refundability of the dividend tax credit. Similar arguments can be made with regard to the question whether the

[17] Ibid., at 7.9-7.11.

dividend tax credit should be refundable at the personal level. If the corporate tax is a withholding device, logic demands that if tax has been paid on behalf of taxpayers at the corporate level, full credit should be given at the personal level. It is inherently inequitable for the dividend tax credit to be non-refundable, for it is low-income taxpayers who will be affected. Even if it is to remain non-refundable, at least it should be subject to carryforward and carryback.

A third issue concerns the treatment of capital gains. Such integration of capital gains as exists is accomplished by partial exemption rather than partial crediting. There is no apparent reason for this dichotomy. As mentioned above, it implies that integration of capital gains is of more benefit to high-income than low-income taxpayers, a result that is inequitable. There may be some perceived administrative difficulties with operating a credit system for capital gains. In addition to the anomalous treatment at the personal level, intercorporate flows of capital gains are also treated differently than intercorporate dividends. It is not clear why this should be the case.

Perhaps most important is the issue of what purpose integration serves in a highly open economy such as Canada's. A good case can be made that it serves very little purpose. That being the case, enhancing integration by measures such as the CDT could be viewed as moving in precisely the wrong direction.

AVERAGING

The lack of an averaging scheme leads to inequities and discriminates against activities that are likely to result in fluctuating incomes. Taxpayers usually do not and cannot arrange their business and personal affairs to conform with the calendar year. Annual income fluctuations are frequently beyond the control of the taxpayer, yet he or she is taxed as if 12 months were a suitable horizon for decision making.[18] Authors, artists, composers, professional athletes, and people whose extended training significantly shortens their working lives are all penalized by the single tax year system. These individuals may have spent several years on a low or zero income writing a book, perfecting a piece of art, composing a musical score, developing an athletic skill, or training for a specialized occupation, the income from which is taxable in the year in which it is received.

Income tax averaging was once permitted in Canada.[19] However, the 1981 federal budget and the tax reform of 1987 explicitly removed income tax averaging from the tax system. RRSPs permit limited income tax averaging for individuals whose income fluctuates over their lifetime.

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[18] Joseph A. Pechman, *Federal Tax Policy*, 3d ed. (Washington: The Brookings Institution, 1977), at 116.

[19] For a discussion of earlier income tax averaging schemes, see Robin W. Boadway and Harry M. Kitchen, *Canadian Tax Policy*, 2d ed. (Toronto: Canadian Tax Foundation, 1984), 111-14.

During years of relatively high income, taxpayers are able to reduce their taxable income by contributing to an RRSP. In years of relatively low income (as in retirement or when searching for work, for example), a taxpayer may withdraw funds from his or her RRSP without penalty, although he or she must pay income taxes on the amount withdrawn. While RRSPs are useful as an averaging vehicle, they do not provide perfect averaging because of their contribution limits.

A case exists for an income tax averaging scheme based on the personal income tax system. A relatively simple scheme could be implemented, and it should apply to all taxpayers regardless of occupation or level of income. The existing technology of tax recording and collection could fairly easily accommodate an averaging system that taxpayers could readily understand. Indeed, the averaging system could even be based on a five-year moving average if tax authorities did not want to extend it over all tax years.

INDEXATION

Apart from concerns about the personal tax base and the level of tax rates, there remain concerns about the way in which income is taxed in times of inflation. At the personal level, three main problems can be identified.

First, nominal capital income received may overstate the real return on capital. In the case of interest, the underlying asset on which interest is paid will decline in real value because of inflation. Part of the nominal interest payment will simply offset the decline in real value of the asset and thus add nothing to the purchasing power of households. Since the tax system does not account for this implicit decline in wealth, the tax base overstates true interest income. On the other hand, since share values presumably rise with inflation, no such problem arises with dividends, which are the return paid on shares. But nominal capital gains on shares will themselves overstate their value. Since capital gains are not indexed for inflation, this problem also is not addressed. It is true that only three-quarters of capital gains are subject to taxation; but as mentioned earlier, this measure might be viewed more as a form of integration for corporate taxes withheld than as compensation for inflation. At least, that is how the three-quarters inclusion is viewed by the Mintz committee.[20]

The second problem at the personal level concerns the rate structure, which includes both the set of credits and the tax brackets. In the absence of indexation, increases in nominal income would cause the taxes of individuals to rise more than proportionately to their nominal income, since a larger proportion of their income would be in a higher tax bracket and the value of their credits would be reduced. The Canadian tax system takes partial account of this problem by adjusting both the level of credits and the boundaries of the tax brackets by the amount by which the change

[20] Mintz report, supra footnote 4, at 7.7-7.8.

in the consumer price index (CPI) exceeds 3 percent. The effect of this method of adjustment is bracket creep, which surreptitiously increases the average tax rate and generates more revenue for the government, even though taxpayers may be no better off. This argument also presumes that the CPI accurately measures changes in the price of goods and services due to inflation. However, there is some evidence that the CPI overstates the true rate of inflation. Indeed, it was for this reason that indexing was limited to CPI increases in excess of 3 percent in the first place.

In a similar vein, the third issue is that the system of transfers offered by the federal government through the tax system—the refundable tax credits—is itself only partially indexed, causing the value of these credits to be eroded through time. An attempt in 1986 by the federal government to extend partial indexing to OAS/GIS payments was met with considerable political resistance and was subsequently abandoned in favour of maintaining full indexation. Critics have argued that partial indexation of refundable tax credits amounts to "social policy by stealth"[21] and is highly regressive.

The absence of indexation also plagues the business income tax system, affecting both corporations and unincorporated businesses. Capital income received by businesses is not indexed; both interest income and capital gains are taxed on a nominal basis. Perhaps more important, interest income is deductible on a nominal basis, and as a result the true cost of interest financing is overstated. Such a policy provides a tax incentive for debt financing in a time of inflation, as well as being of more general benefit to firms. Against this is the fact that other deductions for capital costs are not indexed, including capital cost allowance on depreciable capital and writeoffs for use of inventory. The former is based on historic cost, which understates the replacement cost of capital as it depreciates and must be replaced. The latter is based on first in, first out accounting, which again understates the replacement cost. The consequences of these two offsetting effects of inflation depend on the circumstances of each corporation—its reliance on debt financing, the amount of inventory it uses, and the age structure of its capital. Studies of the effects of inflation on aggregate METRs of corporations suggest that, on average, inflation has relatively little effect on most forms of capital other than inventory. But that does not mean that individual firms are not affected significantly.

The relatively low rates of inflation in recent years have blunted the effects of the absence of full indexation in the tax system. Moreover, the revenue gains from bracket creep have been welcomed during the period in which governments have been primarily concerned with fighting budget deficits. But as that era passes, concern about the hidden effects of inflation on the tax system will likely resurface. A recent study[22] noted that

[21] The term was coined by Grattan Gray, "Social Policy by Stealth" (1990), vol. 11, no. 2 *Policy Options* 17-29. "Grattan Gray" is a pseudonym for Ken Battle, who now presides over the Caledon Institute for Social Policy.

[22] Finn Poschmann, *Inflated Taxes, Deflated Paycheques*, C.D. Howe Institute Commentary 118 (Toronto: C.D. Howe Institute, December 1998).

over the past decade, the value of deductions increased by less than 8 percent while consumer prices increased by 34 percent. As a result, about $10.4 billion more in federal government (and more than $3 billion in provincial government) revenue was generated than would have been the case if full indexation had remained in place from 1985 to 1998. Most of the additional revenue came from increased taxes as taxpayers moved into higher tax brackets. The federal government also saved money by paying less (in real terms) to lower-income Canadians in OAS payments, disability benefits, the GST credit, and the child tax benefit because thresholds for these benefits have been frozen since 1992.

Whether one views the reinstatement of full indexation of the personal income tax system as a pressing issue depends, in part, on one's attitude toward debt financing. Some might argue that bracket creep is justified because the additional revenue it has generated has enabled governments to address the deficits of the past and pay off some of the debt overhang. Bracket creep is, after all, not an unfair way to raise tax revenues to pay for postponed tax liabilities. On the other hand, others might argue that obtaining additional tax revenues in this way has partly absolved the government from the need to reduce expenditures and to get the overall tax burden down to levels comparable with those in the United States.

PROGRESSIVITY

The degree of progressivity of the tax system reflects a judgment about the tradeoff between vertical equity and the disincentive effects of progressive taxation. Over the past several years, there have been various proposals for broadening the base and making the rate structure both lower and less progressive. The most extreme suggestion is to move to a "flat rate" income tax, which would replace the existing base and rate structures.[23] Most proposals for flat rate taxation recommend both base-broadening and flattening of the rate structure. These two proposed changes reflect the two major considerations that have motivated proponents to advance flat rate taxation as an alternative to the present income tax system.

First, it is argued that the existing tax system includes too many deductions, exemptions, and types of preferential treatment (so-called tax expenditures)—more than would be called for on standard horizontal equity

[23] A summary of flat rate tax proposals in Canada may be found in Michael A. Walker, *On Flat-Rate Tax Proposals*, Focus no. 4 (Vancouver: The Fraser Institute, 1983). For an explicit proposal, see Dennis Mills, *The Single Tax* (Toronto: Hemlock Press, 1990). A discussion of the issues may be found there and in Joseph J. Minarik, "A Flat Rate Income Tax for Canada?" in *Report of Proceedings of the Thirty-Fourth Tax Conference*, 1982 Conference Report (Toronto: Canadian Tax Foundation, 1983), 37-52. The seminal proposal for a flat tax is presented in Robert E. Hall and Alvin Rabushka, *The Flat Tax*, 2d ed. (Stanford, Cal.: Hoover Institution Press, 1995). This proposal includes not only a move to a flat tax but also a change from income to consumption as the base—that is, base-narrowing rather than base-broadening. For an analysis, see Joel Slemrod and Jon Bakija, *Taxing Ourselves: A Citizen's Guide to the Great Debate over Tax Reform* (Cambridge, Mass.: MIT Press, 1996).

grounds. In addition to detracting from the equity of the tax system, the presence of these different ways of treating different sources of taxable income considerably increases the administrative and compliance costs of the tax system. Taxpayers are induced to devote resources, including the services of lawyers and accountants, to obtaining as much of their income as possible in sheltered forms. With the base-broadening recommended in most proposals for flat rate taxation, only basic personal exemptions and exemptions for dependants are allowed. This broadening of the base has the additional value that it allows for a general lowering of tax rates.

There is, of course, a possible cost to base-broadening. Many of the deductions currently in the tax system may be there for particular reasons of horizontal equity—to reflect the cost of earning income, for example, or the extraordinary expenditures involved in raising a child. The gains in simplicity from eliminating these deductions would have to be weighed against the loss in horizontal equity. On the other hand, many deductions or credits currently in effect fulfil no real horizontal equity function, and some actually make the tax system less equitable. Examples are credits for charitable donations or political contributions, deductions for medical and dental expenses, educational deductions, and perhaps even deductions for RRSP and RPP contributions (depending where one stands in the income-versus-consumption-base debate).

The second consideration behind the flat rate proposals concerns the rate structure. Most proposals call for a single marginal tax rate and a given level of exemptions. Economists have referred to this model as a linear progressive income tax system, since it has a fixed marginal tax rate but increasing average tax rates.[24] The higher the level of exemptions, the higher will be the marginal tax rate necessary to raise a given amount of revenue and the more progressive will be the tax. Marginal tax rates in the neighbourhood of 20 to 25 percent have generally been proposed for flat tax systems.

The concept described above is, of course, significantly different from the present system in terms of breadth of base, rate of progressivity, and marginal tax rates. The lowering of the marginal tax rate on taxable income for most taxpayers is really the sine qua non of flat rate tax proposals. In addition to the administrative simplicity of having a single marginal rate, it is argued that a lowering of marginal tax rates will have substantial incentive effects, encouraging taxpayers to work more, save more, invest more, and take more risks. As well, it is argued that a lowering of the marginal rate will reduce the incentive that now exists to underreport

[24] The average tax rate is the ratio of taxes paid to taxable income. The marginal tax rate is the additional tax paid on an incremental dollar of income received. A linear progressive tax system can be expressed in the equation $T = t(Y - E)$, where T is total taxes, t is the marginal tax rate, Y is income, and E is an exemption level. Both E and t are the same for all individuals. The average tax rate is T/Y. It can be seen that even though the marginal tax rate—the tax paid on each additional dollar of income earned—is constant, the average tax rate rises with income.

taxable income. Against this incentive effect must be set the likelihood that a flat rate tax will make the tax system less progressive, as estimates for both Canada and the United States have found.[25]

The arguments for replacing the existing rate structure with a flat rate tax depend on two sorts of judgments. First, there is the empirical judgment as to how strong the incentive effects really are. Unfortunately, we have no good empirical evidence on these so-called supply-side effects of the tax system. Second, there is the value judgment already referred to concerning the tradeoff between equity and efficiency. Different persons can rationally disagree as to how progressive the tax system should be. Recognizing that high marginal tax rates create harmful disincentives and reduce economic output,[26] the federal government has reduced the number of tax brackets and narrowed the marginal rates over the past 50 years. At the same time, the tax base has been broadened, all exemptions and a number of deductions have been replaced with non-refundable tax credits, and the refundable child tax benefit and the GST credit have been introduced. As we noted at the beginning of this paper, the combination of these changes has produced an after-tax distribution of income that is narrower now than it was 25 years ago. The question whether or not the current marginal tax rate structure is the correct one cannot be answered, because there is no unequivocal benchmark against which it can be compared.

THE TAX-PAYING UNIT

The current tax system in Canada is based on the individual rather than the family as the tax-paying unit, but it includes several provisions that depart from this basis. The tax credit for a spouse; the use of interspousal tax credits for age, pension, disability, tuition, and education; the opportunity for an individual to contribute to a spouse's RRSP; and the fact that refundable tax credits (the GST credit and the child tax benefit) are based on a definition of net family income—all suggest a partial recognition of the family as the tax-paying unit. Some provincial refundable tax credits are also based on family income.

Precisely how the tax system should reflect family size and circumstances is one of the more vexing questions of tax policy. It raises not only standard equity and efficiency issues, but also issues of social policy and the responsibility of individuals versus society for the well-being of family members. There are a variety of family circumstances that must be distinguished: single-adult versus two-adult families, two-adult families with one versus two earners, and each of the preceding families with and without children. It may be useful to classify the main issues into four

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[25] See Walker, supra footnote 23; Joel Slemrod and Shlomo Yitzhaki, "On Choosing a Flat-Rate Income Tax System" (1983), vol. 36, no. 1 *National Tax Journal* 31-44; and Roger S. Smith, "Base Broadening and Rate Changes: A Look at the Canadian Federal Income Tax" (1984), vol. 32, no. 2 *Canadian Tax Journal* 277-93.

[26] Smith, supra footnote 2, at 1062-63.

categories, each of which has potential implications for tax policy design. Some of their implications are conflicting, so that in the end, a judgment must be made as to which are the more relevant.

Family Versus Individual Income

Even if one accepts the view that taxpayers are ultimately individuals, and that an individual's tax liability depends on how well off he or she is, one is nonetheless obliged to consider how family circumstances affect the individual's well-being. The most obvious way might simply be that he or she shares a common family budget. Assuming that the family arrangement is an amicable or cooperative one,[27] this circumstance suggests that family income should be pooled and each person taxed on a per capita share of family income. Indeed, a recent study[28] suggests that income splitting in Canada would lead to improvements in horizontal equity afforded couples versus singles and one-earner versus two-earner families. As well, it would integrate tax policy and social policy, although economic, administrative, and social objections to taxing on the basis of the family unit, as noted below, would likely be significant. A system where there is full income splitting within the family would be similar to that in the United States.

The Canadian tax system does not permit full income splitting, but the opportunity to use tax credits for one's spouse effectively reduces tax liabilities for two-adult families when only one is working. The fact that full income splitting is not permitted may well be related to the next category of issues.

It should be noted that this argument, like the ones below, presumes that the tax system is progressive, so that average tax rates rise with real income because of the combination of credits and exemptions and a graduated rate structure. In a purely proportional tax system, there would be no need to account for family differences on equity grounds. For taxes such as the GST, family characteristics come into play only insofar as the tax system attempts to render the tax progressive. Thus, the GST credit specifically takes family size into account, as does the child tax benefit.

Household Production

An important issue from an economic perspective concerns the taxation of imputed income from household production. Most individuals presumably engage in household chores like preparing meals, gardening, laundry, house maintenance, and so on, which, in principle, are services that could

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[27] Not all economists view the family in these terms. Some treat the family arrangement as simply a matter of convenience that participants enter into to achieve gains from exchange. According to this view, sharing is not equal and cooperative but a result of bargaining in which those with more economic strength gain the most.

[28] Kenneth J. Boessenkool and James B. Davies, *Giving Mom and Dad a Break: Returning Fairness to Families in Canada's Tax and Transfer System*, C.D. Howe Institute Commentary 117 (Toronto: C.D. Howe Institute, November 1998).

be acquired on the market. If they were, the persons performing them would be subject to taxation. If all individuals devoted comparable amounts of time to household chores, issues of taxation would not be relevant. But some persons systematically devote more time to household chores than others, and as a result, issues of horizontal equity arise. These issues are particularly relevant in two-adult families, especially where only one partner is in the work force. The stay-at-home partner presumably is engaging in significant amounts of (unpaid) household production. Horizontal equity suggests that this should be accounted for in the income tax system. In practice, it is very difficult to measure the value of unpaid household production; and even if measurement were possible, monitoring to verify it would not be easy since there is no market transaction involved. Thus, the best that can be done is to adopt somewhat ad hoc presumptive measures to account for situations in which household production is likely to be relevant.

At the level of generality, if one accepts the argument that household production should be taxed, the standard prescription is to impose a higher tax liability on single-earner two-adult families than two-earner families with the same total income. At the same time, one might want single-earner two-adult families that earn a given amount of income to pay less than half the taxes of two-earner families earning twice as much, given that one wants the tax system to be progressive at the individual level. When taxes are levied on individuals, as in the Canadian case, these objectives are partly accomplished by not allowing income splitting in single-earner families and by the use of spousal credits. Whether the amounts are precisely sufficient is a matter of judgment, of course. Unfortunately, the elimination of the working supplement for the child tax benefit program means that those in the work force no longer receive assistance to offset their reduced time for household production.

The non-taxability of household production has similar implications for the taxation of two-adult versus one-adult families with a single earner. For a given level of income, taxpayers with a non-working spouse should pay less tax than those who are single, given that two adults must be supported, but more than half of the tax paid by single taxpayers, given the presumption of significant household production. If the single-earner couple have twice the income of the single person, presumably one would want them to pay more than twice the tax. Again, these general prescriptions are satisfied with a tax system that is progressive at the individual level but has credits for non-working spouses.

While the treatment of non-working spouses in the current system accords with the spirit of the first two categories of arguments, the issue of income splitting is still relevant for two-earner families. There seems to be no good economic reason why income splitting should not be allowed between two working spouses. There may be social reasons. Income splitting treats families as arrangements whereby the members pool their incomes and draw on them mutually. It might be objected that this notion implicitly subordinates the independence of the two partners in a marriage.

Designing the tax system so that taxpayers are treated differentially depending on whether they have a working or a non-working partner gives rise to new problems. For one thing, it begs the question of what kind of partnerships are deemed to be treated as families for tax purposes. If an expansive definition is used, there is then the administrative issue of monitoring living arrangements to verify whether the household contains a non-working partner.

Economies of Living Together

Another potential argument that might be relevant for the tax treatment of the family is that there are various economies of living together. Family members share consumer durables, and they can specialize in household chores. To the extent that this argument were accepted, it might suggest that two income earners living together should be taxed more heavily than the same two persons living apart—a distinction that the current tax system makes no effort to apply. Apart from the fact that applying such a principle would be difficult administratively, it is not clear that living arrangements per se should be a factor in tax policy. They are entered into voluntarily and presumably reflect the personal tastes of the individuals concerned.

Cost of Raising Children

An extremely difficult issue to resolve on economic grounds concerns the tax treatment of raising children. The above argument about sharing family income applies. A household with children earning a given amount of income should pay less tax than an identical household without children, simply because there are more family members. This equivalence could be achieved through a basic tax credit or deduction. Unfortunately, neither exists in Canada. While this lack of assistance may reflect the fact that children provide some household production and jointly consume household services with other members of the family, the tax system does not compensate for the costs of raising children, such as providing them with food and clothing, shelter, and so on. Exceptions are medical and dental care, and educational expenses, but these have less to do with the fact that the consumers are children than with the fact that these expenses are creditable for all persons in the family.

The most important exception concerns the costs associated with child care in the case where there is no stay-at-home parent. A horizontal equity justification for this exception is that it constitutes a cost of earning income. In order to enter the labour force, it is necessary to make some arrangements for child care. Moreover, since the providers of child care are themselves typically taxable, the deduction does not entail that the provision of child care is tax-free. It has recently been advocated, especially by the Reform Party, that stay-at-home parents should be able to take advantage of the tax benefits of the child-care expense deduction. One argument is that, in the absence of such a benefit, the tax system discriminates against families with a stay-at-home parent. This argument is readily dismissed on the grounds that child care by a stay-at-home parent involves untaxed household production, which is favoured already. If a child-care expense deduction is allowed, at least the imputed income on which the deduction is based should be taxable in the hands of the stay-at-home parent.

A more serious and controversial set of arguments for extending the child-care expense deduction to stay-at-home parents is that which reflects social objectives. The argument is that parents should be rewarded for staying at home to take care of their children (presumably over and above the reward associated with the non-taxability of their household income). There are variants to this argument, all of which stand or fall on social judgments rather than economic ones. One is simply that the traditional family should be supported as an important institution in society. A second is that children, especially those from disadvantaged backgrounds, have higher chances of success and impose less of a social and economic burden on society in the future when raised by a stay-at-home parent. The third is even more controversial. It is that society itself shares the burden of ensuring that all children, regardless of their means, have equal opportunities. This argument raises the substantial issue of who is ultimately responsible for children—society or their parents.

A major problem with the current system is that it fails to recognize the non-discretionary expenses of raising children. To overcome this inequity, it has been suggested that a universal deduction should be allowed for children and that further improvements in equity could be made without increasing anyone's tax burden if this were accompanied by a similar size reduction in the deduction for child-care expenses.[29] Whether these non-discretionary expenditures should be treated as a deduction or as a tax credit should depend on the desired policy objectives. Credits should be used when the objective is to increase progressivity, and deductions should be used when the objective is to adjust the tax base.

CONCLUSIONS

Income tax systems can always be improved in light of given circumstances, and the Canadian income tax system is no exception. Even though major income tax reforms were undertaken in the late 1980s, circumstances have changed sufficiently that revisiting the issue is useful. The Canadian economy has been subject to many changes in the past decade, including increased exposure to competition from abroad, changes in the structure of industry leading to increased earnings inequality, increased mobility of labour, a large debt overhang that must eventually be dealt with, and a more decentralized federation. These are major changes that have potential implications for the income tax system. In particular, the need exists to adapt the income tax system to international realities and to encourage innovation and entrepreneurship, while at the same time ensuring that the most vulnerable persons in the economy are protected.

[29] Ibid.

We have suggested various ways of reforming the tax system to address this need. These suggestions include

- enhancing the use of refundable credits targeted to low-income persons;
- improving the tax treatment of those engaged in risky activities by improving loss-offsetting provisions;
- encouraging savings by Canadian households;
- ensuring that tax rates are not punitive for those who are most mobile; and
- protecting the federal government's share of the income tax room so that the benefits of a harmonized income tax system can be retained.

Other measures that might be considered include reinstituting general income averaging and enhancing the indexing of tax credits and brackets.

Some questions have been raised in public debate about the tax treatment of the family and of children in particular. We have argued that the existing system is a reasonably good one. We have also considered the issues involved in improving the system of integration of the personal and corporate tax systems, arguing that if integration is to be maintained, it should be extended to tax-sheltered capital income and the dividend tax credit should be refundable. It is, however, worth repeating a point made in the introduction to this paper. Contrary to what one might infer from the popular press, there is nothing seriously wrong with the existing personal income tax system, and the need for major reform is not pressing.