# Canadian Tax Journal: The Second Decade—1963-1972

Neil Brooks*

## THE TAX REFORM DECADE

The journal's second decade was bracketed by the appointment of the Royal Commission on Taxation in 1962 and the enactment of the Tax Reform Act of 1972. During much of this period, tax reform dominated public policy discussion in Canada. In 1967, in his report to the members of the Foundation, Douglas Sherbaniuk, the newly appointed director of the Foundation, observed:

> In recent years, the winds of change have been blowing into every corner of the Canadian tax world. During the '60's, we have witnessed more ferment, more concerted effort to appraise and understand our tax system, and have had more proposals for reform, than at any time in our history. We have been the recipients of no fewer than seven tax reports prepared on behalf of provincial governments, as well as the monumental Report of the Royal Commission on Taxation. Certainly, this is the field where the action is.[1]

The tax reform process provided an almost unlimited source of material for the journal and its authors. Consequently, in the journal's second decade, unlike its first, very few articles were speeches or reprints of articles published elsewhere; most were written by outside authors for publication in the journal. But even more significantly than providing a source of material, the tax reform exercise, particularly the work of the Royal Commission on Taxation, provided an opportunity for Canadian tax practitioners and academics to develop a knowledge of the theories and principles of tax policy analysis and to develop skills in applying the relevant techniques and tools of policy analysis. The far-reaching process of tax reform also attracted a much greater number of economists to the field of public finance than might have been drawn otherwise.

Ronald Robertson, former director of the Foundation, and senior adviser to the House of Commons Committee on Finance, Trade and Economic Affairs when it was considering the government's *Proposals for Tax Reform*, hypothesized:

* Editor, *Canadian Tax Journal*, and of Osgoode Hall Law School, York University, Toronto.

> Perhaps the greatest aftermath of the Carter Report and a major part of its legacy is the large contingent of tax lawyers, economists, and accountants in Canada who can, at the drop of a tax proposal, analyze it in terms of horizontal and vertical equity; neutrality, or its effect on economic growth; its effect on one's incentive to work, or to invest; or its contribution to the brain drain.[2]

Throughout its second decade, the journal was a major beneficiary of this important legacy of the tax reform decade.

## THE DEPARTURE OF GWYNETH McGREGOR: END OF AN ERA

Gwyneth McGregor remained firmly at the helm of the journal as editor throughout most of the second decade, and she continued to receive accolades. In his 1964 annual report to Foundation members, Ronald Robertson paid this tribute:

> Your *Journal* received many compliments over the course of the year and it continues to hold a high place in the ranks of the world's tax literature. These compliments, which have been expressed to me in the course of my travels, I pass on to the members and contributors who make this standing possible, and of course to our esteemed editor, Mrs. Gwyneth McGregor, whose tax knowledge is combined with a mastery of the language and an impish sense of humour, which "leavens the lump" as she might put it.[3]

Her pervasive influence on the journal and its quality was further acknowledged in the director's report for 1966: "[H]er painstaking editing and criticism of articles submitted for publication in the *Journal* continues to encourage many tax writers to 'stay with it' until their work reaches a level much above that of their original submission."[4]

After 18 years as editor of the journal, Gwyneth McGregor resigned in the spring of 1970 and left the full-time staff of the Foundation, although she continued to write Around the Courts. Douglas Sherbaniuk, then director of the Foundation, paid her a fitting tribute in his annual report, noting that she not only discharged all of the usual editorial duties at the Foundation but also "rendered invaluable service by patiently instructing many budding authors."[5] He concluded: "We shall miss her at the Foundation, not only for her talents but also as a person of charm and sparkle who made the office a more interesting place to be."[6] Barbara Brougham succeeded Gwyneth as editor. Among other previous editorial responsibilities, Mrs. Brougham had served as coordinating editor for the Ontario Committee on Taxation.

Prior to the departure of Gwyneth McGregor, Ronald Robertson, who had been the director of the Foundation since 1961, left the Foundation to re-enter the private practice of law in 1967. Douglas Sherbaniuk, a University of Toronto tax professor, was appointed director, a position he would hold for more than 25 years. The journal underwent a number of changes after his appointment, many of which reflected his influence.

## THE FEATURES

Around the Courts continued to be written by the inimitable Gwyneth McGregor. She wrote a staggering number of case comments: in most issues she wrote 15 to 20 comments. By my rough count, she commented on more than 1,200 cases during the first 20 years of the journal's publication. And these comments were not just summaries of cases. They were invariably analytical, insightful, and witty, and reflected a profound understanding of the details of technical tax law and the nuances of tax policy and principles. Through her Around the Courts feature, she undoubtedly had an important influence on the judicial development of tax law in Canada. In 1965, Gwyneth took a leave of absence to assist with the writing and editing of the report of the Royal Commission on Taxation. During the four-issue hiatus in her authorship of Around the Courts, Alan Short coordinated the feature and members of the Foundation contributed case comments.

The feature Fact and Opinion, which opened each issue of the journal and in which Gwyneth McGregor and other members of the Foundation staff would comment on current issues relating to tax and public finance, was discontinued after the first issue of 1968. Perhaps it was considered too informal for an increasingly scholarly journal. Since 1966, a separate section of Fact and Opinion had been headed Checklist. In introducing this section, the editor explained that

> [t]he following brief summary of tax developments in Canada is published in response to suggestions that a checklist would be of value and interest to those members who have difficulty finding the time to keep a constant check on other regular sources. An attempt will be made to include a bare outline of developments occurring between issues of the *Journal*. Recourse should be had to commercial and governmental sources for details.[7]

When Fact and Opinion was discontinued, a new feature entitled simply Checklist was added to the journal. For a couple of issues its authorship was unattributed; from then on, however, Millie Goodman was identified as its author. The feature soon evolved into an exhaustive summary of tax developments over the preceding two months, including appointments, legislative amendments, press releases, the release of administrative documents, and debates in Parliament and the provincial legislative bodies. In the second or third issue of every year, the feature contained a summary of the provincial budgets.

The popular feature Fiscal Figures continued throughout this period. Marion Bryden, the Foundation's statistical research associate and the editor of the feature at the beginning of the second decade, left the Foundation in the fall of 1966 to accept a position as research director for the NDP caucus of the Ontario legislature. Richard Collins took over her responsibilities for a few months. He was followed, in early 1968, by David Perry, who held this position and wrote Fiscal Features for the next 34 years (and counting). Before joining the Foundation, David had worked in the area of government finance in various departments of the Ontario government and York County. By the late 1960s, Fiscal Figures had developed a number of topics that were published almost every year, such as an analysis of international tax

comparisons. Generally, if you wanted to track current public finance concerns, you simply had to read the feature. For example, in the last four years of the second decade of the journal, when David Perry was writing the feature, it dealt with the cost and financing of medicare (following the report of the Royal Commission on Health Services in 1964 and the federal government's subsequent medicare proposals, the financing of health services was a major topic of discussion in the journal—indeed, the journal included an article by the father of medicare himself[8]), Canada-US income tax comparisons (in spite of repeated reports in the press in the late 1960s that Canadians paid much more tax than Americans, David's analysis for 1967 showed that income taxes were lower in Canada for low-income individuals, higher for middle-income individuals, and significantly lower for high-income individuals), royal commission costs, the growth of educational expenditures, the cost of public broadcasting, income tax credits for consumption and property taxes, personal exemptions and credits, federal expenditures on scientific activities, and the taxes paid by families in different income ranges.

The journal continued publishing the titles of new library acquisitions in the feature In the Library, and the New Books feature continued to be published from time to time. In addition, the Correspondence feature remained a popular forum for those who took issue with the conclusions of articles published in the journal.[9]

Another feature that ran for a short period during the 1960s was International Tax News, written by Alan Short. Alan, who subsequently became the general director of tax policy at the federal Department of Finance and tax policy guru extraordinaire, was a staff member at the Foundation for almost five years, from early 1963 to mid-1967. He left in 1967 to accept a senior position in the Department of Finance, with special responsibility for the negotiation of international tax conventions. While at the Foundation, in addition to a writing a large number of articles on aspects of international tax, he developed International Tax News, which ran primarily in the issues published in 1965. The feature surveyed developments in the negotiation of tax treaties and aspects of comparative taxation. When he left the Foundation, the Fact and Opinion feature noted that, in addition to being an expert on issues of international tax, Alan

> is a good "all-rounder," interested in all problems of taxation and an expert on many technical aspects of taxation. He is and will continue to be sorely missed at the Foundation, not only for his excellent work but for his personality and his qualities as a colleague; he was a pleasure to work with, and his wit and gaiety livened up the office.[10]

As a harbinger of features that would be oriented exclusively to the practice of tax law and planning, a regular feature on Estate Planning in Canada was introduced with the January-February 1971 issue. The authors were Sheldon Silver and Stanley Taube, both members of the Toronto law firm of Goodman & Goodman. Not surprisingly, the feature was very popular with practitioners, and over the next few years it was republished in booklet form from time to time. Ironically, only five months after the feature was introduced, in the most unexpected reform of the tax law that followed the debates of the 1960s, the government announced that the

Estate Tax Act and the gift tax provisions of the Income Tax Act would be repealed. Nevertheless, the feature continued, dealing with estate planning under the income tax as well as under the various provincial succession duties that existed for a short period after the federal government vacated the estate tax field.

## THE ROYAL COMMISSION ON TAXATION

On September 25, 1962, the federal government appointed a Royal Commission on Taxation, under the chairmanship of Kenneth Carter, "to inquire into and report upon the incidence and effects of taxation imposed by Parliament . . . upon the operation of the national economy, the conduct of business, the organization of industry and the positions of individuals." The journal chronicled and was greatly influenced by the work of the commission. Shortly after the appointment of the commission, the Fact and Opinion feature reported that the commission was having difficulty recruiting senior staff because tax advisers were reluctant to leave their practices for a year or two and join the commission.[11] Eventually, when a research staff was appointed, the journal carried a list of the members.[12] Douglas Hartle was appointed research director, and because so much of the philosophy and general direction of the commission's eventual report was attributable to his vision of the commission and his tireless work, some have suggested the report should have become known as the Hartle report. The staff appointed to the various research study areas were, in the main, young academics. It has been speculated that the fact that the staff were generally young and willing to consider new ideas accounts, in part, for the radical nature of the report. The list of staff reads like a who's who of Canadian economists and public policy analysts who became prominent over the following decades. Interestingly, Marc Lalonde and Pierre Trudeau were the advisers on intergovernmental relations and legal problems.

The commission began holding public hearings in March 1963. The hearings were briefly reviewed in successive journal issues in Fact and Opinion: "The visionary with a scheme for establishing Utopia in Canada; the champion of an inflexible taxation ideology; the pedant with his learned quotations; the practical professional man or businessman—all these, and many more, come to present their submissions to the Royal Commission on Taxation."[13] The commission held 99 days of hearings across the country and heard from over 700 witnesses. Over 320 briefs were submitted. As an indication of the stature of the Foundation, it presented both the opening and closing briefs to the commission. However, the only brief published in the journal was not the Foundation's but one presented by David Slater, at the time the director of a study on taxation and economic growth at Queen's University, who would go on to enjoy a distinguished career in public service in Canada.[14] The brief provided an excellent perspective on the current state of tax policy.

In addition to public hearings, the commission undertook an ambitious research agenda. Eventually, over 30 separate research studies were published. Some of these studies subsequently provided the background research for articles published in the journal.

The commission was initially scheduled to release its findings in late 1965. Finally, after a number of missed deadlines, the journal noted in Fact and Opinion, under the heading "Yes, Virginia, there is . . .":

> We should like to tell any sceptics among our readers that we have been solemnly assured that there really is a Royal Commission on Taxation. For those who have guessed and grieved with us, during the last eighteen months or so, in the frustrating game about the date of the probably public appearance of its report, we present the latest guesstimate, which is: not before the middle of August but before the end of September.[15]

After several more missed deadlines, and more postponements of the Foundation's annual conference, the report was tabled in the House of Commons on February 24, 1967 by the Honourable Mitchell Sharp, minister of finance.[16]

The report consisted of six volumes plus an index volume. It was 2,700 pages long and in the form tabled in the House of Commons was simply an offset reproduction of the typescript of the report. In fact, for whatever reason, the report was never published by the government. Twenty years later, Harvey Perry, former director of the Foundation and a member of the Royal Commission on Taxation, expressed his wish that "the government or some interested organization will publish it in a convenient form, which Prime Minister Pearson refused to do."[17] An extremely abridged version of the report was published in 1967 in volume 15, issue 2 of the journal.

As everyone even vaguely familiar with Canadian tax policy knows, the central idea of the Carter report was that the purpose of the tax system was to raise revenue equitably: "The first and most essential purpose of taxation is to share the burden of the state fairly among all individuals and families."[18] In pursuit of this objective, the commission suggested that the base upon which the income tax is levied should be as comprehensive as possible. Its report essentially constitutes an imaginative and thorough blueprint of how the concept of a comprehensive tax base can be implemented in a practical tax system. The Carter commission took seriously the advice on tax reform that public finance scholars had been offering over the previous 30 years. For that reason, even though the Canadian business community was highly skeptical of the report, leading public finance scholars heaped praise upon it. The journal published a number of articles by leading US public finance scholars who were unreserved in their acclaim of the report. In his review of the report in the journal, Harvey Brazer stated:

> It is safe to say that no nation's tax system has been subject to an analysis as exhaustive as that of the Carter Commission. The recommendations of the majority of the Commission are bold and extremely far-reaching. To the academic student of taxation they appear to embody virtually all of the reform measures advocated by Professors Henry C. Simons and Robert Murray Haig and most of their followers, buttressed by the tenets of welfare economics and neo-Keynesian fiscal policy. The Commission's *Report* is, in consequence, a truly remarkable document, one that provides the critic

> with few substantial targets for his barbs. Even these few are, more often than not, at least implicitly recognized in the *Report* and generally remain because the Commission seems to have refrained at some points from pursuing with unrestrained boldness the directions dictated by its own basic premises.[19]

Even more fulsome praise was lavished on the report by Richard Musgrave:

> The Carter *Report* stands as a landmark in taxation. Encompassing six volumes plus numerous research studies, its sheer monumentality and structural logic tower over the reviewer. The spire of vertical equity reaches into the heavens of non-discretionary income; the nave of horizontal equity is sweeping in its purity of accretion; and the transepts of constructive realization and integration complete the unity of Simonesque design. The pilgrim cannot but bow to the architect and craftsmen who created this impressive work.
>
> The *Report* is indeed as orthodox as it is novel and revolutionary in its conception. It is orthodox in that it follows the basic structure of tax reform, first laid down by Henry Simons thirty years ago and expounded since by many, if not most academic students of taxation. It is revolutionary in that these proposals, in their sweeping totality, are ingeniously applied to the Canadian setting and are made the content of a public document, presented by practical men, for summary enactment. After sharing in many an effort to inch our own (U.S.) tax structure in this direction, I can only marvel at the courage of this frontal assault and wish it Godspeed.[20]

Finally, in concluding his review of the report, G.F. Break stated:

> The Carter Commission's bold plan for tax reform in Canada presents policy-makers with a major new opportunity to improve the operation of the economic system. Five aspects of this opportunity have been discussed above, and in each case the general prognosis has been favourable. . . . No other major country in the world today has before it the exciting opportunity for choice that the Carter Commission has made available to Canada.[21]

Ronald Robertson, the director of the Foundation at the time, published an overview of the report in the journal.[22] We are reprinting his perspective on the report in this issue because it provides a contemporary look at the philosophy of the report, some of the details, and the immediate reaction to the report. Reading the article 35 years later, one is struck by how radical the recommendations of the report were.

Robertson begins his overview by noting that he was asked to give a perspective on "the *Report* that dares to be known by equity alone."[23] The report, he says, has been praised "as an intellectual achievement and a major landmark in the study and development of tax policy," but also criticized as "being impractical, too visionary, too slick, too dogmatic in tone in areas where no certainty exists and too doctrinaire—whatever that means."[24] He explains that even after all of the debate he remained "schizophrenic" about the report; that he had a "feeling of admiration on the one hand and doubt on the other"; and that "[l]istening to arguments from

all viewpoints may give you a distinct feeling of being a ping-pong ball in a fast game."[25]

The basic premise of the report, he suggests, is that the prime goals of a good tax structure should be "equity among human taxpayers and neutrality among business entities."[26] From this premise the three main themes of the report followed logically: the concepts of the comprehensive tax base, the family unit, and the integration of the corporate and the personal tax. At a more detailed level, the consistent implementation of these themes would lead to the following results, among others: an end to the problem of surplus stripping of corporations; an end to the problems of associated companies; a reduction of the personal marginal tax rate from 80 percent to 50 percent; the abolition of the taxation of gifts and inheritances between spouses; an end to tax differentials between business income derived from different legal forms; the deductibility of all business expenses; a more realistic treatment of business losses; the removal of tax differentials between families with the same total incomes; an end to the uncertainties created by the indefinable line between income and other receipts; and greater progressivity.

The major criticisms of the report that Robertson highlights include the idea that the tax system should be used deliberately as a vehicle for the redistribution of income; that receipts such as gifts and inheritances and capital gains should be taxed in the same way as other income; and that the tax system should not be used as a means of providing special incentives for particular social and economic activities.

He notes that business groups and tax lawyers and accountants were generally opposed to the recommendations of the report while economists and the general public appeared to favour it. He offers a psychological explanation for this difference of opinion: economists are interested in rules and procedures in which equity is achieved overall, or in most cases, while lawyers are concerned about even the small number of individuals who might be unfairly taxed under general rules. He asserts that lawyers would "rather see nine people get an unintended tax break than see one person unfairly taxed." He hypothesizes that, in part, this is because a lawyer "may see more actual people in a week than the economist in a year."[27]

He then contrasts the economist's comprehensive concept of income, which led the commission to recommend adopting the comprehensive tax base, with the lawyer's social, "fruit of the tree," or annual production concept of income. He goes on to say:

> It is this difference resulting from the two approaches to a tax base that produces, I feel, the main differences of opinion toward the *Report* and accounts for the great amount of disapproval from lawyers in particular, especially with respect to the proposal for the inclusion of gifts and inheritances in the personal income tax base.
>
> It may take a new generation or more before lawyers accept this idea.[28]

To determine whether a comprehensive tax base is fair, Robertson reviews the consequences of including a number of receipts in income that the commission suggested ought to be included, such as gifts and inheritances, compensation for personal injuries, life insurance mortality gains, and capital gains on homes in

excess of $25,000 in a lifetime. He also considers a series of problems with family unit taxation. He concludes his examination of a comprehensive tax base with this thought:

> [I]t is this all-embracing nature of the C.T.B. concept that I think makes those with an individualistic point of view shudder and suggest the C.T.B.—and thus the Carter *Report*—is by logic, inadvertence or design (or a bit of each) too close to Big Brotherism to suit the Canadian temperament.[29]

Turning to the commission's defence of progressive tax rates, he notes that the commission justified progressive rates on the grounds that "equity is produced by applying a flat rate tax to income in excess of a 'standard of living' exemption (i.e. non-discretionary income) which gets bigger as income rises."[30] He concedes that "[t]he Commission's non-discretionary income rationale for progression has been attacked as arbitrary and I think the Commission will admit to this," but says that "[t]he Commission's attempt at rationalizing progression is the best I have seen."[31]

In his conclusion, Robertson notes that the commission's recommendations form part of an integrated package and that if some elements are found to be unacceptable, others must also be dropped. Nevertheless,

> because of its logic and consistency, and despite the way it pinches at some points, I wouldn't count the C.T.B., family unit or integration out on the first round of legislation. Like it or not, we shall be hearing about these concepts for years to come, and so will the taxpayers of other countries.[32]

Shortly after writing this overview of the report, Ronald Robertson left the position of director of the Foundation and returned to private practice. Years later he explained that "[a] large part of my motivation for returning to practice in 1967 was that I did not see much of a future in tax reform now that the Carter Commission had reported. They had done it all. And so far as theory is concerned, I still believe this."[33]

## THE WHITE PAPER AND THE TAX REFORM LEGISLATION

When the Carter report was tabled, the government announced a schedule for considering its recommendations. The minister of finance stated that legislation would be passed in 1968, but the legislation was not passed until three years later and did not became effective until January 1, 1972. A historical and unprecedented debate on tax reform took place in Canada between the tabling of the Carter report and the passage of the tax reform legislation.

Although the federal government initially said that it would introduce legislation to implement aspects of the Carter report, once the strength of the reaction to the report became clear, the government retreated and said that it would first issue

a white paper setting out its own proposals for tax reform. The issuance of the white paper was then put off when Prime Minister Lester Pearson resigned and the Liberals held a leadership convention in April 1968. Finally, on November 7, 1969, the government issued its reform proposals as a white paper.[34] Although not as radical as the Carter report, the proposals would have fundamentally changed the Canadian income tax. Among other things, the government proposed to remove the low rate of corporate tax, eliminate certain concessions to the natural resource industries, integrate personal and income taxes in whole or in part for closely held and widely held corporations, tax capital gains, eliminate expense-account living, and tax foreign-source income more rationally. The white paper met with reactions that ranged from skepticism to outrage. Few other government documents in Canadian history have evoked such emotional reactions.

In 1970, the journal devoted issue 2 of volume 18 to the white paper. One of the most radical proposals in the white paper recommended that marketable shares of widely held Canadian corporations be taxed every five years on an accrual basis. One of the few supporters for the plan, it appears, was Carl S. Shoup, a leading public finance scholar in the United States. He wrote an article on the subject in the journal in which he stated:

> Daring and far-sighted as was the great Carter *Report*—and its influence on tax theory and tax policy will be felt over the world for decades to come—it stopped just short of the one measure that carries the greatest potential for simplifying the income tax system: the taking into account, at fairly brief periods, of accrued capital gains and accrued capital losses. This crucial step has now been taken in the proposals for tax reform submitted by Canada's Minister of Finance, E.J. Benson.[35]

To head off a complete rout of the white paper, the government referred it to the House of Common's Committee on Finance, Trade and Economic Affairs. The committee held public hearings across the country and reported near the end of 1969. Eventually, what was left of the Carter commission's recommendations was translated into legislation and tabled in the House of Commons on June 18, 1971. The legislation was passed and came into force in 1972.

Although written a year before the final tax reform legislation was tabled, an article by Richard Bird, "The Tax Kaleidoscope: Perspectives on Tax Reform in Canada," provides an overview of the process of tax reform following the Carter report and the white paper and attempts to predict the likely direction of future reforms.[36] It is the other article from the journal's second decade that we have republished in this issue.

Bird notes that the "obvious gap between professional opinion and public reaction has led me to reflect on three topics that have been generally neglected in the current discussion: (1) the methodology underlying the tax reform proposals, (2) the desirability of piecemeal reform, and (3) the importance of fiscal psychology."[37] He states that the main point of his article is to illustrate "certain important

characteristics of tax reform in our time, in order to put the current furore over the White Paper into proper perspective, and to suggest that what now concerns us is simply one out of many constantly changing patterns continually produced by the tax kaleidoscope."[38] He also suggests that

> tax reform is much more than an exercise in economic analysis or tax technique: it is an intensely human and social phenomenon, which, as we have seen in recent years, touches many people to the quick, at least in passing, and provokes them to outraged defence against what they perceive to be violation of their innermost values.[39]

In his introduction, he points out that "few things so clearly reveal the naked play of vested interests in any country as do attempts to change an existing fiscal structure."[40]

Although his article is full of insights, he develops these themes by making three general points. First, although he thinks that the recommendations of the Carter report and the white paper should be implemented and that their implementation would not lead to the adverse economic effects predicted by the business community and others, he argues that the reforms should be implemented in increments, not as part of a comprehensive package of reforms. Second, the reforms represent the culmination of the direction of past reforms and do not anticipate the future direction of tax reform—namely, increased reliance on indirect and benefit taxes. Third, international forces place more decisive limits on tax reform in Canada than most commentators acknowledge, and in the future they will exert even greater influence on the design of the Canadian tax system.

Bird states that the approach taken by the commission—that of postulating an ideal tax system and proposing comprehensive and interrelated reforms—is necessary in order to provide the goals of any tax reform exercise, to ensure that it is coherent, and to educate participants. However, he cautions against any attempt to implement the proposals as a package and thus attempt "to clean up the subject of tax reform once and for all."[41] He states that "change cannot realistically be expected to come about in the form of the adoption, once and for all, of some grand comprehensively tidy and rational reform package."[42] Instead, he suggests that there are several advantages of making continual, piecemeal, and incremental changes in the tax system. He notes that such a "sequential process," among other things,

> gives our limited intelligences a reasonable chance to consider the effects of particular measures; it gives us a second chance to take remedial action if something does not work out quite the way we expected it to; and it allows us to incorporate into later measures feedback from the constituency our policy is intended to serve, thus focusing policy mainly on correcting perceived wrongs rather than on the much more controversial task of establishing future norms.[43]

"The kaleidoscope," he says, "is turning continually, and the appropriate pattern of tax legislation must shift too."[44]

In making his point that "far from being the culmination of tax changes in Canada, these proposals represent only one stage in an on-going process of tax reform,"[45] he notes that throughout the 1960s the personal income tax was becoming an increasingly important source of government revenues and that "[t]his outcome was considered by the Carter Commission to be highly desirable, because, they argued, the personal income tax was the only tax that could really be 'fair'."[46] Indeed, the Carter commission concluded that sales taxes should become even less important and eventually should be levied only by the provinces. In this respect, Bird thinks that "the tax system envisaged by the Carter Commission is probably both psychologically and economically undesirable in the long run."[47] "In a longer-range perspective," he says,

> the reforms proposed in these documents are more properly considered the culmination of the old conventional wisdom than a pattern for the new tax changes that will, I believe, almost certainly be brought about in the next decade by the continuing upward pressure of public expenditures.[48]

He argues that the future direction of tax reform will not be in fixing the income tax but in shifting the tax mix toward indirect taxes, such as the sales tax, and benefit taxes. This is the case, he argues, since government expenditures on social insurance and welfare are likely to continue to increase, and to finance them it will be necessary to raise the revenue from taxes that taxpayers will find most acceptable. Within a few years, he suggests, income taxes will likely have gone about as high as they can and citizens will probably find sales and benefits taxes more palatable, in part because they are less visible. He supports his case for this anticipated shift in the tax mix by reference to the experience in the Scandinavian countries. He is careful to explain, however, that while he favours a shift from direct to indirect taxes, he also favours the continued broadening of the income tax base along the lines proposed by the white paper, no reduction in the taxes on the rich and businesses, the broadening of the base of the existing provincial sales taxes, and an improvement in Canada's social welfare system to offset the regressivity of increased consumption taxes. In arguing for increased use of benefit taxes, he states that "[t]he economic, political, and psychological case for increased benefit taxation is . . . growing stronger every day."[49] He also notes that

> [t]he traditional arguments on the undesirable redistributive effects of benefit taxes simply miss the point that the transfer process is a quite separate question from that of financing of public services and placing the allocatively proper "price" (opportunity cost) on using resources for public purposes.[50]

Bird concludes by observing that increased international flows of information, goods and services, financial capital, and people will increasingly influence the Canadian tax structure. He gives a number of examples of Carter commission recommendations that were clearly influenced by the US system:

> the corporate rate, the form of integration between the corporate income tax and the personal income tax, and the top rate of the individual income tax schedule were all in a sense to be set by the American tax system, because of the Commission's (correct) assumption that there is in essence a unified capital market in North America.[51]

## INFLUENCE OF THE TAX REFORM PROCESS ON THE JOURNAL

Over the course of its second decade, the journal underwent considerable change. Most noticeably, the articles became more substantial. This trend started with the second issue of 1963, when a new section was added to the journal for "tax essays." As explained in the annual report for 1963:

> Last year the *Journal* was used as a vehicle for the publication of studies of such length and nature that they were unsuitable as articles or *Tax Papers*. They therefore became "Tax Essays" and appeared as appendices to the *Journal*. This arrangement gives us a new scope for publishing the kind of research work that we have sometimes had to forego in the past. We hope that this procedure will encourage more tax practitioners and other writers on tax matters to examine tax problems in depth.[52]

The first essay, by Marshall A. Cohen, was a thorough examination of the situations in which a taxpayer might constructively realize income by, for example, changing the use of an asset.[53] The second essay, published in two parts, was a study of the use of depreciation allowances as deliberate instruments of fiscal policy in the United Kingdom from 1945 to 1960. It was written by Richard Bird and was based on his PhD thesis, which he had completed at Columbia University.[54] Although the Tax Essay section of the journal continued throughout the decade, by the end of the decade it became difficult to determine the basis for distinguishing between manuscripts that were published as tax essays and those that were published simply as articles.

Many articles published in the journal over this decade dealt with issues raised by the Carter report. Indeed, by providing a baseline of the best tax policy thinking on various issues, the Carter report enabled Canadian tax practitioners and academics to easily contribute to the social enterprise of tax scholarship. By engaging with the recommendations and analysis of the Carter report, they were building on the work of, criticizing, and working through problems raised by other scholars.

The journal published many doctrinal articles on issues relevant to tax practice and planning. A number dealt with issues of statutory interpretation and the apparent emergence of a business purpose test in Canadian jurisprudence. But the journal was also publishing an increasing number of tax policy articles. As Ronald Robertson said in his report to the Foundation for 1965, "An attempt is made through the *Journal* to bring to members both theoretical and technical developments in taxation; for so often what is theory today is practice tomorrow."[55] Sophisticated articles were published on such tax policy issues as the provision of incentives for small businesses, the integration of corporate and shareholder tax,

income averaging, the technical details of the taxation of capital gains, the taxation of trusts, and the taxation of financial intermediaries. All of these articles were inspired by, and drew on the analysis in, either the Carter report or the white paper.

The perennial issue of whether and how capital gains should be taxed was the subject of a number of articles. An article that received some fame, or notoriety, depending on your point of view, was written by Ronald Robertson on the pros and cons of taxing capital gains.[56] A. Emile Beauvais, one of the commissioners of the Royal Commission on Taxation, wrote a minority report dissenting from most of the commission's major recommendations. In support of his objections to the commission's recommendation that capital gains be taxed at full rates, he appended Robertson's article to his dissent.

The radicalizing effect that the Carter report had on many of those who were involved in it is most clearly seen, perhaps, in Harvey Perry's change in attitude to the taxation of capital gains. In one of his annual reports to the Foundation in the 1950s, Harvey, then director of the Foundation, felt the need to explain that he was opposed to the taxation of capital gains. After serving as a commissioner on the Carter commission, however, his opinion changed dramatically. This is what he had to say, in his well-known paper "Anatomy of a Tax System" from the 1967 Conference Report, about the taxation of capital gains:

> Surely to heavens it is time that we saw the so-called English concept of income for what it is—a scheme that ideally suited the selfish designs of the ruling classes of England a century and a half ago. It is self-evident to me that the trade or business concept of income was a neat trick for fobbing off most of the burden of the newly arrived income tax onto the commercial middle class and leaving inviolate the wealth of the ruling aristocracy. I ask now why we feel any obligation to retain this antiquated monstrosity and I find no answer. If this deplorable concept were honestly applied it would produce by far the most vicious type of capital gains tax that could be imagined, and in fact already has this result to a large extent.
>
> Under the comprehensive tax base we propose abandoning this relic of our colonial inheritance and facing up to the reality that *any* capital gains represents just as significant an increment to one's command over the world's goods as any other form of gain.[57]

An emerging area of tax policy analysis—the use of the tax system to deliver transfer payments—was the subject of a large number of articles in the journal.[58] This subject had been put on the agenda not so much by the Carter report, although it dealt with it somewhat, as by the rediscovery of poverty as reflected in work of the Economic Council of Canada and published reports of the Department of Health and Welfare.

Throughout the 1960s, the Canadian government was assuming a larger role in the economy, and public policy analysts were increasingly raising questions about what the objectives of government policy ought to be, how these objectives should be decided and by whom, and which objectives should have priority. This debate was reflected in numerous articles in the journal. The debate was given a substantial

impetus by the establishment of the Economic Council of Canada in 1963. It set out goals for the economy in its first report and in each subsequent annual report advised the government of their achievement. The publication of its report became something of an event each year in Canada, and each report was the subject of a lengthy review in the journal. The related subject of federal-provincial relations was also a frequent subject of articles in the journal.

The concept of tax expenditures emerged in the literature at about the same time as the publication of the Carter report. Championed by Stanley Surrey, who was the assistant secretary treasurer for tax policy in the United States during much of the 1960s, the tax expenditure construct hypothesizes that provisions in the tax legislation that are designed to provide an incentive to encourage taxpayers to engage in certain social or economic activities should be analyzed as spending provisions, not as tax provisions. Although the Carter commission did not use the vocabulary of tax expenditure analysis, it clearly anticipated its insights. In recommending the repeal of this or that tax concession, the commission often noted that the concession did not serve a legitimate government objective; in other cases, it suggested that a direct subsidy would likely be a better instrument than a tax preference for achieving the same result.

Following the Carter report, this type of analysis was used in a number of articles in the journal. Arthur Scace, for example, analyzed government direct spending programs on scientific research incentives. The abstract to his article notes that these incentive measures "are in line with the suggestion of the Carter Commission that when specific government encouragement for an industry or region is deemed desirable in the public interest, direct subsidies are preferable to 'hidden' subsidies of tax concessions."[59] More explicit use of tax expenditure analysis is made in one article by Gilles Paquet on taxation and science policy and in another by Leonard Waverman on fiscal instruments and pollution. Paquet argues that direct government subsidies instead of selective tax reliefs are almost always a superior instrument of science policy because they are much easier to control and monitor.[60] Waverman argues that the use of tax incentives, such as accelerated depreciation allowances, to encourage the adoption of pollution control devices are in many ways an inferior policy instrument for curbing pollution because their true costs are hidden and they inefficiently distort firms' investment decisions.[61]

The journal also published a series of empirical studies that were undoubtedly influenced by the Carter report. For example, following up on the Carter commission's finding that tax rates likely have little effect on work effort, which was based largely on US survey results obtained by George Break and Thomas Sanders in the 1950s, A. Chatterjee and J. Robinson undertook a survey of selected occupation groups in the Kitchener-Waterloo metropolitan area in order to determine the effect of personal income tax on their work effort. On the basis of their survey results, Chatterjee and Robinson concluded that "taxation influences in the aggregate supply of effort seem to be relatively negligible."[62] In another empirical study, George Murphy investigated the influence of taxation on the depreciation practices of Canadian corporations and found them to be "enormous."[63] At the end of

1970, as an anti-inflation measure, the government changed the capital cost allowance system to require taxpayers who constructed commercial buildings in a number of urban centres to defer the deduction of their allowances. Vladimir Salyzyn and Bernd Ebel conducted a survey of commercial developers in the affected areas and examined building permits issued in those areas in order to determine whether the changed tax laws influenced investment decisions. They concluded that "the deferral had no significant effect on the volume of commercial construction."[64]

A few articles made use of simulation models to analyze tax policy and related issues. Gail Cook and David Stager constructed a simulation model to test the financial implications of various contingent-repayment student assistance programs.[65] John Helliwell and John Lester examined the tax advantages to US firms provided by the recently enacted legislation for domestic international sales corporations and its likely impact on Canada. They concluded that the impact would be "small by almost any standard."[66] Finally, Irwin Gillespie, building on a methodology he had used in undertaking background studies for the Carter commission, examined the incidence of the tax changes made in Ontario over the 1960s. He found that "[t]here seem to be some grounds for concluding that the provincial tax pattern became increasingly regressive during the 1960s, and this change was consistent with an attempt to raise revenues via increases in the federal abatement."[67]

In the journal's second decade, every type of scholarship published in the journal—whether doctrinal, interpretive, technical tax policy analysis, tax expenditure analysis, or empirical—was greatly enriched because of the process of tax reform that dominated the Canadian public policy agenda throughout the 1960s.

## NOTES

1 Douglas J. Sherbaniuk, "Report of the Director," in Canadian Tax Foundation, *Twenty-Second Annual Report*, for the year ending December 31, 1967 (Toronto: Canadian Tax Foundation, 1968), 15-24, at 15.

2 Ronald Robertson, "The House of Commons Committee and the Aftermath of the Royal Commission on Taxation," in W. Neil Brooks, ed., *The Quest for Tax Reform: The Royal Commission on Taxation Twenty Years Later* (Toronto: Carswell, 1988), 43-51, at 51.

3 Ronald Robertson, "Report of the Director," in Canadian Tax Foundation, *Nineteenth Annual Report*, for the year ending December 31, 1964 (Toronto: Canadian Tax Foundation, 1965), 15-22, at 21.

4 Ronald Robertson, "Report of the Director," in Canadian Tax Foundation, *Twenty-First Annual Report*, for the year ending December 31, 1966 (Toronto: Canadian Tax Foundation, 1967), 15-19, at 18.

5 Douglas J. Sherbaniuk, "Report of the Director," in Canadian Tax Foundation, *Twenty-Fourth Annual Report*, for the year ending December 31, 1969 (Toronto: Canadian Tax Foundation, 1970), 13-24, at 23.

6 Ibid.

7 "Checklist," Fact and Opinion feature (1966) vol. 14, no. 1 *Canadian Tax Journal* 11.

8 The Honourable Emmett M. Hall, "Health Services Costs" (1964) vol. 12, no. 5 *Canadian Tax Journal* 364-72.

9 As I mentioned in my review of the first decade of the journal, Wolfe Goodman was a regular contributor to this feature. See the particularly interesting exchange between him and the author of an article on the contentious issue of a deemed realization of capital property on death that had been proposed in the government's *Proposals for Tax Reform*. See the letters from Wolfe Goodman and J.B. Katchen in the Correspondence feature (1970) vol. 18, no. 6 *Canadian Tax Journal* 514-17.

10 "Staff," Fact and Opinion feature (1967) vol. 15, no. 5 *Canadian Tax Journal* 432-33, at 433.

11 "Carter Commission," Fact and Opinion feature (1963) vol. 11, no. 1 *Canadian Tax Journal* 7-8.

12 "Carter Commission: Research Establishment," Fact and Opinion feature (1963) vol. 11, no. 4 *Canadian Tax Journal* 281-84.

13 "Carter Commission Hearings," Fact and Opinion feature (1963) vol. 11, no. 3 *Canadian Tax Journal* 174.

14 David W. Slater, "Some Problems of Taxation in Canada" (1963) vol. 11, no. 3 *Canadian Tax Journal* 208-22.

15 "Yes, Virginia, there is . . . ," Fact and Opinion feature (1966) vol. 14, no. 4 *Canadian Tax Journal* 315. For an article that reviews the events leading up to the appointment of the commission and the explanations for its delay and that speculates about its contents on the basis of the hearings and rumours, see Philip F. Vineberg, "The Royal Commission on Taxation" (1967) vol. 15, no. 1 *Canadian Tax Journal* 50-57.

16 Canada, *Report of the Royal Commission on Taxation* (Ottawa: Queen's Printer, 1967).

17 J. Harvey Perry, "Implementing the Report: Processes and Issues," in *The Quest for Tax Reform*, supra note 2, 23-42, at 42. As justification for its subsequent publication, he stated: "The Carter Report is an intellectual masterpiece that examined fully the foundation of tax policy. Canada was not ready for it in 1970, nor is it now. All serious students of tax policy should be acquainted with it."

18 *Royal Commission on Taxation*, supra note 16, vol. 1, at 4.

19 Harvey E. Brazer, "Review of the Report" (1967) vol. 15, no. 3 *Canadian Tax Journal* 273-86, at 273.

20 Richard A. Musgrave, "An Evaluation of the Report" (1967) vol. 15, no. 4 *Canadian Tax Journal* 349-70, at 349.

21 G.F. Break, "The Report of the Royal Commission on Taxation and Economic Policy in Canada" (1968) vol. 16, no. 3 *Canadian Tax Journal* 229-51, at 250-51.

22 Ronald Robertson, "A Perspective on the Report" (1967) vol. 15, no. 3 *Canadian Tax Journal* 230-48.

23 Ibid., at 230.

24 Ibid.

25 Ibid.

26 Ibid., at 231.

27 Ibid., at 234.

28 Ibid., at 238.

29 Ibid., at 245.

30 Ibid.

31 Ibid.

32 Ibid., at 248.

33 Robertson, supra note 2, at 45.

34 E.J. Benson, *Proposals for Tax Reform* (Ottawa: Queen's Printer, 1969).

35 Carl S. Shoup, "The White Paper: Accrual Accounting for Capital Gains and Losses" (1970) vol. 18, no. 2 *Canadian Tax Journal* 96-102, at 96.

36 Richard M. Bird, "The Tax Kaleidoscope: Perspectives on Tax Reform in Canada" (1970) vol. 18, no. 5 *Canadian Tax Journal* 444-73.

37 Ibid., at 452.

38 Ibid., at 444.

39 Ibid.

40 Ibid.

41 Ibid., at 457.

42 Ibid., at 445.

43 Ibid., at 455.

44 Ibid., at 456.

45 Ibid., at 445.

46 Ibid., at 450.

47 Ibid., at 451.

48 Ibid., at 473.

49 Ibid., at 469.

50 Ibid., at 468.

51 Ibid., at 471.

52 Ronald Robertson, "Report of the Director," in Canadian Tax Foundation, *Eighteenth Annual Report*, for the year ending December 31, 1963 (Toronto: Canadian Tax Foundation, 1964), 15-24, at 17.

53 Marshall A. Cohen, "Constructive Profits Under the Income Tax Act" (1963) vol. 11, no. 2 *Canadian Tax Journal* 156-72.

54 Richard Bird, "Depreciation Allowances and Countercyclical Policy in the United Kingdom 1945-1960: Parts I and II" (1963) vol. 11, no. 3 *Canadian Tax Journal* 253-73 and ". . . Parts III, IV and V" (1963) vol. 11, no. 4 *Canadian Tax Journal* 353-80.

55 Ronald Robertson, "Report of the Director," in Canadian Tax Foundation, *Twentieth Annual Report*, for the year ending December 31, 1965 (Toronto: Canadian Tax Foundation, 1966), 19-27, at 22.

56 Ronald Robertson, "Capital Gains—To Tax or Not To Tax" (1965) vol. 13, no. 5 *Canadian Tax Journal* 355-59.

57 J. Harvey Perry, "Anatomy of a Tax System," in *Report of Proceedings of the Twentieth Tax Conference*, 1967 Conference Report (Toronto: Canadian Tax Foundation, 1968), 7-21, at 15.

58 See Ronald W. Crowley and David A. Dodge, "Cost of the Guaranteed Annual Income" (1969) vol. 17, no. 6 *Canadian Tax Journal* 395-407; Antal Deutsch and Christopher Green, "Income Security for Canadians: A Review Article" (1971) vol. 19, no. 1 *Canadian Tax Journal* 8-16; Colin J. Hindle, "Negative Income Taxes and the Poverty Problem in Ontario" (1971) vol. 19, no. 2 *Canadian Tax Journal* 116-23; and James Cutt, John Tysall, and Leigh Bailey, "A Comparative Analysis of Alternative Income Support Programs in Canada" (1972) vol. 20, no. 1 *Canadian Tax Journal* 74-100.

59 A.R.A. Scace, "Scientific Research Incentives" (1968) vol. 16, no. 4 *Canadian Tax Journal* 290-97, at 290.

60 Gilles Paquet, "Taxation and Science Policy" (1971) vol. 19, no. 5 *Canadian Tax Journal* 429-37.

61 Leonard Waverman, "Fiscal Instruments and Pollution: An Evaluation of Canadian Legislation" (1970) vol. 18, no. 6 *Canadian Tax Journal* 505-13.

62 A. Chatterjee and J. Robinson, "Effects of Personal Income Tax on Work Effort: A Sample Survey" (1969) vol. 17, no. 3 *Canadian Tax Journal* 211-20, at 219.

63 George J. Murphy, "The Influence of Taxation on Canadian Corporate Depreciation Practices" (1972) vol. 20, no. 3 *Canadian Tax Journal* 233-39, at 239.

64 Vladimir Salyzyn and Bernd Ebel, "Depreciation Changes: How Effective?" (1972) vol. 20, no. 2 *Canadian Tax Journal* 168-77, at 173.

65 Gail C.A. Cook and David A.A. Stager, "Student Aid: A Proposal and Its Implications" (1971) vol. 19, no. 6 *Canadian Tax Journal* 558-64.

66 John Helliwell and John Lester, "Reviewing the Latest DISC: Simulations of Its Aggregate Impacts on Canada" (1972) vol. 20, no. 4 *Canadian Tax Journal* 291-98, at 296.

67 W. Irwin Gillespie, "An Examination of Tax Burden Changes in Ontario: 1960-1969" (1971) vol. 19, no. 4 *Canadian Tax Journal* 340-78, at 356.

# A Perspective on the Report

*[From Vol. XV, No. 3 (1967), 230-48]*

Ronald Robertson

*This article is based on a background paper delivered at the opening of the Queen's University Tax Management Seminar on the Report of the Royal Commission on Taxation in May. Whereas much comment about the Report has been devoted to specific matters, this article seeks to discern the bases of some of the main lines of criticism, both pro and con, which has been directed at the Report and its underlying concepts.*

The topic assigned to me is "Perspective" on what we might call "the *Report* that dares to be known by equity alone". Needless to say, this has to be a personal perspective although I shall try to convey a range of viewpoints I have encountered. In other words, if you don't agree with some of the opinions I express, please don't blame them on the Foundation, and if you do agree, it would be incorrect to assume that the same opinion is held by all or even a majority of the Foundation's individual and corporate members.

It is necessary for me to make the same excuse about the scope of my remarks as you have heard *ad nauseum* —that I cannot hope to cover or comment upon all the points of interest or dispute raised in the *Report*.

When he addressed the Foundation's Conference on the *Report* in Toronto recently Professor Frank Sander said it reminded him of the little girl who, when asked to review a book about elephants, wrote: "It tells me a lot more about elephants than I care to know." This sentiment about the *Report* seems to be held by many people, whether they have accepted it unreservedly or have grave doubts about its practicability.

But almost without exception, the *Report* has been praised as an intellectual achievement and a major landmark in the study and development of tax policy. I share this opinion. On the other hand, it has been criticized as being impractical, too visionary, too slick, too dogmatic in tone in areas where no certainty exists and too doctrinaire—whatever that means. I happen to share some of these opinions too. As a result I believe I qualify for the description applied by Foundation Chairman, Phillip Vineberg, Q.C., to himself and many others he had spoken with about the *Report*. At this date I remain schizophrenic about it.

The enthusiast for or against the *Report* will no doubt have other descriptions for this—fence sitting and so on—but I can assure you that this feeling of admiration on the one hand and doubt on the other is firmly and sincerely held, for a great many reasons, by a great many people who have studied the *Report* and have thought a lot about Canadian tax policy. Listening to arguments from all viewpoints may give you a distinct feeling of being a ping-pong ball in a fast game.

**Plus Signs**

The features of the *Report* that give rise to the great acclaim it has deservedly received I would describe as follows:

1. Its basic premise that equity among human taxpayers and neutrality among business entities should be prime goals of a good tax structure.

2. Its declaration that departures from equity and neutrality should be countenanced only where there is clear, perhaps overwhelming, evidence that such departures, or incentives, are in the public interest.

3. Its logical development of these themes from beginning to end.

4. The theories and ingenious mechanisms devised, to permit the logical development and implementation of these themes. The main ones are: the concept of the comprehensive tax base which is responsible for the proposals to tax capital gains and gifts and inheritances at full rates; the family unit; and the integration of the corporate and personal taxation, or more broadly the concept of all non-human entities, trusts, corporations etc. being regarded as intermediaries where tax is withheld pending adjustment to personal rates.

It is fair to say, I believe, that these basic concepts have so far emerged largely unscathed from criticism directed at the *Report*—or at least its supporters do not regard the points made against its main core as substantial.

In comparison with the broad sweep of the *Report*, criticisms often have had an appearance of "nit picking". But I believe we must keep in mind the fact that criticisms of most grand designs are likely to appear in this light. What has still to be determined is how many of the "nits" are symptomatic of undesirable principles, whether these can be ironed out within the grand design, or whether their number and importance are sufficient to ruin the grand design. It takes only a few tiny holes below the waterline to send a battleship to the bottom.

More specifically, the *Report* offers the following.

1. An end to the problem of surplus stripping of corporations — the Commission's proposal would strip all companies as far as residents are concerned. That is, there would be no more double taxation of corporate profits (most people had long since given up on this one!).
2. An end to the technical problems of associated companies—since all corporate profits would initially attract the same tax rate — 50%. The visible price tax is about $10,100 per company, offset however by item one, and capital cost incentives for small businesses.
3. Reduction of marginal income tax rates from a maximum of 80% to 50%; and application of the 50% rate at $100,000 instead of about $25,000. The Commission estimates that 46% of taxpayers would pay less tax.
4. Abolition of the taxation of gifts and inheritances between spouses, long a major point of irritation; and of gift and estate taxes—although a better description would be that they have been defined away only to arise again in much more virulent form in other circumstances.
5. Abolition of the 12% federal manufacturer's sales tax, and with it the long-standing difficulties about appeals from department rulings, price pyramiding, discount rates, private brand and import v. domestic production tax base problems and so on. It would reappear again, however, as an additional retail levy of some 7%.
6. Disappearance of the special excise rates on so-called "luxury goods"

—long considered unfair by the producers and consumers of these goods.

7. An end to the annoying tax differentials between business income derived from partnerships and from corporations, the long-standing tax differentials between co-operatives and ordinary corporate businesses, and possibly the tax differences between bond and equity financing.

8. Deductibility of *all* bona fide expenses in computing business profits; there should be no more "nothings" for which both deduction or capital cost allowance is at present denied, as long as the expenditures were reasonable and were not of a personal nature.

9. A more realistic treatment of business losses, including capital losses now denied deduction, with loss carry-over extended forward indefinitely.

10. The granting of an allowance to employees for the costs of earning their incomes; the present absence of any such deduction has long been a grievance of employees and the cause of acid comments even by judges.

11. Removal of the tax differentials between families with the same total incomes but with a different number of income recipients.

12. Income averaging for all taxpayers rather than for just farmers and fishermen.

13. An answer to the taxpayer's plea (and particularly his lawyer's and the court's) for an end to the uncertainty created by that indefinable line between income and other receipts which do not now attract tax and which are usually, if inaccurately, heaped under the title of "capital gains". The cost here is substantial, namely taxation of such gains at full rates.

14. A major incentive for Canadians to buy shares in Canadian companies which are now owned by foreigners —this feature alone will endear the *Report* to many and perhaps offers an answer which will satisfy the politicians in all parties who have been trying to outdo each other in economic patriotism.

15. Following a transitional period, the production of more revenue than the present system.

16. More progression. This would benefit the lower income groups at the expense of the middle and upper income groups, but in terms of rates would alleviate the burden on middle and upper incomes.

17. Removal of much of the tax differential between middle income earners here and in the U.S. and thus of taxes as one of the possible causes of the "brain drain".

18. Improvement in the allocation of resources in Canada over time.

19. Removal of any suggestion of political interference in the tax collection process, and the upgrading of confidence in the appeal procedure by abolishing the Department of National Revenue and The Tax Appeal Board, and establishing in their stead a Board of Revenue Commissioners and a Tax Court; and provision of advance rulings and a limit to ministerial discretion.

**Criticisms**

I shall now try to pick out the main trends of criticism.

1. A main one, perhaps, is a largely unspoken but fundamental disagreement with the idea that the tax system should be used deliberately as a vehicle for redistribution of income, or that redistribution is (as the Commission emphatically concludes) *per se* fair.

2. Clearly related to the first item is a fundamental disagreement about what should constitute the tax base of individuals for regular taxation. Disagreement with the Commission's 'buck-is-a-buck' approach is strongest in connection with gifts and inheritances passing in line to adult children, and with full-rate taxation of capital gains.

3. A third area of criticism is disagreement with the Commission's view that the use of the tax system as a means of providing special incentives for particular pursuits or activities should be severely restricted. A major point in this area is whether in its pursuit of neutrality the Commission has gone too far, relative to the world context of taxation, or has not gone far enough in that it excludes tariffs from its neutrality analysis because of its terms of reference.

4. A fourth area of criticism is that however theoretically desirable the proposals may be, some of them, despite the Comission's confidence that they will work and will not unduly disrupt the economy, constitute too big a change from the present system and the systems of other countries to be worth the risk to the economy. Closely related is a real concern that such major changes would place an intolerable compliance load on the administrative machinery and on taxpayers and their advisors.

**Viewpoints**

Businessmen have, understandably, tended to reflect views consistent with the impact of the *Report* on their particular industry. The general public, as reflected by press comment, has generally approved. This is not surprising in view of the Commission's determined effort to make the tax system more equitable, which, loosely translated, may mean that most people think they will pay less tax and the "rich" people will get their comeuppance. The average taxpayer may be in for some surprises if he gets into some of the details.

More often than not economists have voiced general approval of the proposals while many accountants and lawyers have been voicing criticisms in the areas I have mentioned. The majority of a distinguished group of Canadian and American economists which discussed the *Report* at the University of Western Ontario recently indicated they would favour its implementation.

I have been asking myself why this latter division exists. It is both too simple, and I believe inaccurate, to say that the economists are right and the lawyers and accountants wrong, or vice versa, or that the economists have a greater sense of fair play in taxation or a greater interest in the common good than the rest of us. As one who, for a number of years, in the course of directing the affairs of the Foundation, has tried to interpret to one another the outlook on taxation held by these professions, I will attempt an answer. It goes something like this.

Most economists look at humanity from above, from the same vantage point as governments, and, if my observations are correct, are largely satisfied if equity is achieved in nine out of ten cases. (And this would be a pretty good batting average.) This is understandable when you consider that their training is largely concerned with reducing things to common denominators, wiping out distinctions, and treating as real—for the most part at least—only things that can be measured or expressed in equations: subsidies rather than tax incentives; dollar limits rather than exclusions or deductions from the tax base. Distinctions, particularly fine ones, so dear to the hearts of lawyers, seem to cause them real pain. They seek always new or improved allocations of resources, incomes and goods and services, new equilibriums, new equalities. It is this tendency, it seems to me, that makes them such steadfast supporters of progression in taxation—besides, of course, their humanitarian instincts which are

shared by others. For progression means continual redistribution and (if we skip over the sticky possibility of the shifting of personal taxes, which economists have yet to explore in any depth or with any enthusiasm and which, if proved to be substantial and rapid would upset most prevailing yardsticks of tax equity) a trend, in theory at least, toward more evenness in the distribution of income.

Perhaps at the other end of the scale is my own profession—law—where the making of distinctions is an everyday occurrence and where distinctions have real significance in terms of individuals and are often of a subjective nature.

A lawyer sees the world through the eyes of individuals and very often the individual he is helping is that one man in ten who doesn't fit into the economist's average, median or typical situation. If the tax law is unfair to that one man the lawyer, as well as the individual concerned, will be inclined to conclude it's a bad law. The fact that the provision may produce equity in the other nine cases doesn't change things. The lawyer, in taxation as well as with criminal law would usually, I think, rather see nine people get an unintended tax break than see one person unfairly taxed.

As I have indicated, I believe economists see the public interest from the other side—and so do most taxpayers—that is, until they find themselves in the position of being the odd man out—and then watch the tears roll.

For very basic reasons related to differing concepts of income, which I shall try to describe briefly, and only partly because of the intentions of the Commission, I feel that the Carter *Report* would produce a 9-out-of-10 tax system, whereas it is now — but inadvertently and far from completely—a 1-out-of-10 system.

This differing point of view underlies, I feel, much of the uneasiness about the *Report* among lawyers and businessmen, who often find themselves the odd man out. And it also may account for the appearance that opponents of parts of the *Report* are "nit pickers" and special pleaders.

In between, most of us, including lawyers, accountants and economists, are torn between subjective and objective considerations of equity, qualitative and quantitative considerations, if you like. In the real world it is sometimes difficult to discern, particularly in taxation, which view represents progress toward equity. Governments deserve our sympathy since, while the 9-out-of-10 approach to equity would make life a lot simpler for them, the public has a habit of suddenly becoming very sympathetic with the one person in ten who may appear to be unfairly treated if they think that some day they may possibly be in his shoes.

We might also ask: whose view of human motivation and reaction to taxation is closest to the truth? The economist's opinions are based on his own intuition of what society should be like, tempered by studies involving interviews and the assessment of statistical data of many sorts, which may cover thousands of people. The lawyer has his intuitions too, but he may see more actual people in a week than the economist in a year, and when he does it is to draw their wills, deal with their inheritances, help them buy or sell their houses, investments, businesses and so on, with tax implications always near at hand. Perhaps the surprising thing is that the viewpoints are often as close as they are.

The main differences of opinion arise from the "comprehensive tax base" which, together with the inevitable concept of progression, is the heart of the *Report* and produces most of the situations which seem so radically different from the result produced by the "fruit of the tree" concept of income, which we now use as the basis of our income tax law.

Those in favour of the *Report* can point—as can its critics—to what seem like ridiculous omissions from an "ability to pay" tax base in the present law: windfall gains such as sweepstake winnings, capital gains, damage awards for loss of income, strike pay, unemployment benefits and so on. Why should these not be taxed when hard earned wages get the full treatment?

How can we talk about incentives to work when this situation prevails? This is hard, if not impossible to answer, unless one takes the view that the hot pursuit of capital gains on the stock market (the main villain of the piece) and by other routes, is the product of the heavy taxation of earned and ordinary investment income (often resulting from saved earned income) when the amount of such income is at all substantial.

I am quite sure that many who suffer heavy rates on larger earned incomes—earned often by extraordinary hours of work and years of study or low-paid experience — feel simply that the rates they pay are outrageously unfair. (The Commission's proposals offer lower rates in exchange for a broader tax base.) These people often feel, however, that they haven't a snowball's chance of winning any sympathy from those with lower incomes, politicians, or even perhaps those who "have it made" in terms of asset accumulation and for whom, perhaps, they—the climbers up the asset and income scale—pose a threat. So discontent may be expressed in other language, in which the word "incentive" is a key one. While the thought process is seldom articulated, my observations suggest that these people with relatively high incomes but little or no wealth feel that their only hope lies in being able to convince the general public that it is to the community's economic advantage to foster the pursuit of such non-taxed receipts as capital gains. Unfortunately the risk-incentive arguments don't stand up too well on analysis or when the experience of the U.S. is examined. It should be noted, however, that the U.S. has other vents for this feeling—tax free municipal bonds interest, for example, and there the capital gains rate and method of taxation is, it seems in some cases, an escape valve for lower taxation of some receipts which, in Canada. might already attract full taxation.

However, if you discount this approach — as do most economists, who embrace some form of a comprehensive tax base and steep progression as articles of faith as well as reason, and in so doing reflect the vague but vociferous opinion of the majority—we are back to the criticism of the concept of tax base income now in our law, which by default, rather than by design, permits the exclusion of items which by any test most people would feel should be included.

**Concepts of Income**

The comprehensive tax base concept used in the Carter *Report* is for many of us, particularly lawyers, a radical departure from what we now know as income for tax purposes. It is firmly based, however, in economic literature and is what nearly every economist who has studied in the last 25-40 years, or more in some countries, now accepts in some form, virtually without question, as a more appropriate base for individual taxation than we now have.

While there are many variations of the "economic concept" of income, the one most often referred to in North America today is the Haig-Simons definition of income which is expressed as the *"algebraic sum of a person's consumption during the tax period plus the net increase in the individual's personal wealth during the period; each measured in dollar terms"*.

On the other hand, the lawyer's concept, which an economist might describe as the "social" income concept, is primarily a measure of the production of an

individual or the community during a period. The lawyer's concept is basically in the British tradition, going back centuries, and centres around the idea of income's being an annual product. Haig, writing in 1921, finds the accountant's concept of income almost identical with the economist's. This may surprise some accountants today who have examined the Carter *Report*, but may also account for the fact that Mr. Carter, F.C.A., has no qualms about the tax base proposed.

(Incidentally, the "social" concept is roughly what is used in the National Accounts of a country. Theoretically a comprehensive personal income tax base which included capital gains and inheritances and gifts could be larger than the total national income for a period.)

While developed independently, the Carter *Report* comprehensive tax base, designed to measure changes in a tax unit's "economic power", is clearly in the Haig-Simons tradition, but refined —extended in some cases and curtailed in others in the interests of administrative feasibility. (Chief exclusions for this last reason are "imputed income" arising from the use of owner-occupied dwellings and other assets which do not produce a monetary return, and capital gain accruals not realized or deemed to have been realized.) It is in fact this development from theory to what the Commission is convinced is a practical plan for a tax system, which delights the economists.

The Haig-Simons definition obviously includes the social concept—or, if you like, the annual new production or "fruit of the tree" concept—but just as obviously goes much further and embraces all gains: capital, gifts, windfalls, transfers and so on.

To the present-day economist, therefore, all such items not brought into the tax base by the present income tax laws are loopholes, whereas to those of us taught and raised on the "annual production" concept there is simply no reason why these items should be in an income tax base. If governments want to take these "extraneous", "non-income" items, they should have to justify taking another bite at previously taxed "income" on other grounds. For example, taxing gifts and inheritances on the need for revenues, or on social grounds of preventing too large accumulations of wealth which would stultify the economy or threaten the sovereign power of government.

So sold are economists on the comprehensive concept that they rarely take time to explain it to those who toil in the involved sections of income tax laws. Sometimes, unfortunately, a result is a tendency by economists who have seen the light to regard the protestations of those who have not worked their way through the economic reasoning as somewhat unsavoury servants of vested interests or odd men out, and so on. I'm afraid this tone creeps into the *Report* and detracts from it in the eyes of many who had not hitherto been exposed to the light.

It is interesting—to me at least—to note that these great truths were not always with us or with the economists either. Kaldor in his book *An Expenditure Tax,* in an appendix entitled "The Concept of Income in Economic Theory", notes that even the great economist Marshall in *Principles* had, according to Keynes, broadly speaking, while pointing to inconsistencies, accepted the income definitions of the Income Tax Commissioners. Haig, in his famous exposition, on the other hand, quotes Marshall as pointing the way to the broad economic concept of income.

Kaldor also notes that German public finance critics were debating the concept of income from around 1832. It was not until 1896 that an economist called Schanz won the day in Germany for a comprehensive definition. In other countries the debate came later and it was not in fact until 1938 when Simons, in *Personal Income Taxation*, put the cop-

ing stone on the argument in the United States by agreeing with the approach Haig propounded in *Federal Tax Reform*, published in 1921.

The so-called economic or Haig-Simons concept of income is, therefore, in terms of the development of law and legislation in both Canada and the United States, of comparatively recent origin. In fact one of the few articles by other than an economist on the comprehensive tax base concept is to be found in the March 1967 issue of the *Harvard Law Review* by Professor Bittker of Yale Law School.[1]

The headnote to the article indicates Bittker's conclusions which he reaches after examining the U.S. tax code in considerable detail.

It states:

> Taking issue with those who contend that the income on which taxes are paid should be the same as what an economist would consider "net income", Professor Bittker urges that a neutral, scientific measure of taxable income is a mirage. In many of the vexed areas of income definition, the concept of economic income yields no help; in others, it implies results from which even its proponents would recoil. There is no touchstone for tax reform: proposals must be considered provision by provision and policy by policy, on their particular merits.

One outstanding American tax lawyer, Stanley Surrey, formerly of Harvard Law School and now Assistant Secretary of the U.S. Treasury, in an article written in collaboration with William C. Warren in 1953, had this to say in discussing the definition of income for use in tax laws.

> The economists' definitions, apart from the fact that there is no unanimity among economists, are here not desirable. While they are helpful in understanding possible overall objectives of an income tax, they are neither appropriate for statutory use nor intended to be.[2]

Referring to the Henry Simons definition, he observed:

> From the standpoint of tax administration this definition clearly covers too much ground—for example, all forms of imputed income would be included—and hence puts too great a strain on the exclusion section . . .
>
> . . .
>
> Essentially the concept of income is a flexible one, with the result in a particular case being determined by the interplay of common usage, accounting concepts, administrative goals, and finally judicial reaction to these forces. Each force and judicial reaction in turn reflects an underlying judgment as to what types of receipts should be subject to a tax imposed on "income".
>
> It is believed that this combination of wide inclusiveness and elasticity should be retained, and that simple reference to "all gains, profits and income" is sufficient.

That was in 1953, by a tax lawyer who was and is well versed in economics. It may be that today, in the light of the endeavours of the Carter Commission to put the economic concept further than ever before toward administrative feasibility in the computer age, Mr. Surrey might be prepared to accept more of the economic concept of income for tax purposes. The same applies to Professor Bittker, whose article was written before the Carter *Report* was published.

I have previously noted that the social or—as the economists sometimes call it, the "legal" concept of income—remains a main core of the Haig-Simons concept. The main differences are obvious from the Carter *Report* — namely the allowance of all losses, including capital under the Haig-Simons definition, and

[1] "A 'Comprehensive Tax Base' as a Goal of Income Tax Reform", Boris I. Bittker, 80 *Harvard Law Review*.

[2] "The Income Tax Project of the American Law Institute: Gross Income, Deductions, Accounting Gains and Losses, Cancellation of Indebtedness", by Stanley S. Surrey and William C. Warren, 66 *Harvard Law Review*.

the inclusion of gifts, inheritances and so on.

It should be noted as well, of course, that the Carter *Report* does not push the full way to this economic concept. As I have mentioned, it stops short, for the time being at least, of including imputed income such as the rental value of owner occupied houses, and for capital gains does not require their inclusion in income on an accrual basis (although this is permissive) because of the obvious problem of annual valuation which would be involved.

What I have been trying all too briefly to outline may be regarded as academic twaddle. But it seems to me that the switch in the concept of income from our present system to the tax base proposed in the Carter *Report* is vital and the effects of it show up throughout the *Report,* not just in the obvious specific recommendations but in the whole tone of the proposed approach to equity, and for that matter neutrality among industries, as compared with the present approach.

## The Conflict

The rather subtle, but fundamental difference, it seems to me, is that "fruit of the tree" concept of income directs our attention to the nature of the receipt or gain or the activity which produced it. And, as a result, with receipts falling outside its orbit, we are forced to apply intuitive or qualitative concepts of equity. A receipt, benefit or transaction is to be taxed or not taxed, or taxed at a particular rate, according to its quality or source. Government is expected to justify the weight of taxation with arguments and reasoning in equity related to the qualitative aspect as well as with regard to size or amount.

Starting from this point there is nothing odd or inconsistent about attaching a different quality to capital and savings and to life insurance, welfare payments or to tax inheritances at weights which differ depending upon the degree of consanguinity between testator and beneficiary.

The economic, Haig-Simons or Carter concepts, on the other hand, are, by comparison, all embracing and look to the human individual (or family tax unit in the Carter *Report*) and measure equity by the quantity of receipts, gains or benefits. They find equity in numbers of dollars and disregard almost entirely any qualitative notions of equity relating to the source of the receipts, benefits or gains to individuals. When the equitable pinch of a "buck is a buck" plus progression approach is too obvious, lifetime exemption limits, averaging or adjustment accounts are wheeled in. But never is it conceded that some gains or benefits should be treated differently per se, regardless of the amount involved.

This theme carries through to the approach to tax concessions for resource industries. Much stress seems to be laid in the *Report* on the fact that the greatest part of the benefits accrue to large companies. Under the currently used concepts there is nothing odd or sinister about this; there is equity if gains from the same activity or sources are treated the same, regardless of the amount involved or the income size of company receiving them.

It is this difference resulting from the two approaches to a tax base that produces, I feel, the main differences of opinion toward the *Report* and accounts for the great amount of disapproval from lawyers in particular, especially with respect to the proposal for the inclusion of gifts and inheritances in the personal income tax base.

It may take a new generation or more before lawyers accept this idea. A bit of the same applies to some capital gains, but not nearly to the same extent, since many lawyers for a variety of reasons would not object to capital gains bearing some tax. These two items are simply not "income" in the minds of

many of them and to make them so by redefining income doesn't change their character in the slightest.

I hope this bit of background may be useful. However, it does little to advance our consideration of the main point—regardless of its origin, regardless of definitions and past practices, is the comprehensive tax base proposed by the Commission an appropriate one for Canadian taxation? This has to be dealt with on its merits and I think the yardsticks that should be used are those used by the Commission itself: equity, administrative feasibility and economic effects The Commission, of course, believes its proposals, taken together and separately, pass each of these tests.

## Equity

Time permits me to discuss only one of these tests, so I will take the one the Commission chooses as the most fundamental—equity.

Implicit, if not explicit, in the comprehensive tax base concept is the simple equation that income measured by the comprehensive tax base (to the extent this is possible administratively and not clearly productive of bad economic effects) equals ability to pay, and that taxation at progressive rates on an ability to pay base so measured is automatically equitable and fair. Or, as an economist might express it: CTB = ATP = E.

It is my personal opinion that this equation stands up in most cases, but not in all. This, of course, must be largely a personal assessment if you agree that equity and fairness have a large subjective element. But since the Commission has used a dollar yardstick as its measure of equity, this begs the questions somewhat. This yardstick produces consistency within its own definition, but by my standards it does not always produce fairness. The final test, of course, is the standard of fairness of the community. (I rather regret the Commission did not at least try to take even a rough measure of community opinion instead of relying entirely on its own judgment of what equity is. While the effort might well have proved fruitless, there may have been some surprises. Since equity and fairness are taken as the foundation of the entire structure of the *Report*, I feel some objective testing of the underlying ground would have been appropriate, whatever the result.)

I might point out that in logic the C.T.B. is not a fully comprehensive measure of ability to pay. A total ability-to-pay tax base at any point in time would, it seems to me, have to include wealth and not just the income, imputed or real, or other gains relating to it. But the inequities and economic effects of including wealth are all too obvious, except, perhaps, when unsavoury millionaires are used as scapegoats in examples.

If A and B each earn $10,000 in year One, and A spends all he has left after tax and B saves $3,000; and in Year Two each again earns $10,000, A then has $10,000 at his disposal and B $13,000. It seems obvious to me that at that point in time B has more ability to pay than A. But just as obviously it would be grossly unfair to again tax B's $3,000, at progressive rates. And under such a system one can really imagine the disastrous effects on the propensity to save and invest, even though one can argue that this is roughly what happens now, with real property, sales and death taxes.

The Commission rejects the inclusion of wealth in the ability-to-pay equation, as does the economic concept of income, and I doubt if anyone would disagree with this exclusion. But it is one illustration that obvious ability to pay does not always equal equity or fairness.

## Are These Things Fair?

The real test comes when we look at receipts the Commission does include in its ability-to-pay C.T.B. base. Although ability to pay clearly exists in C.T.B. terms, let us consider the following.

### *Gifts and Inheritances*

1. Is it fair to tax at ordinary graduated income rates gifts and bequests from parents to adult children right down to small estates? People have fought vigorously from feudal times to the present against claims by the state to redistribute their property on their deaths. I don't think the logic of the C.T.B. will change this attitude, particularly where near kin are the beneficiaries and even in exchange for removing such taxes between spouses. This attitude may be even stronger among people with modest estates than those with very large estates, where what is left after tax is still a lot of money by most standards.

As has been noted often since the *Report* was released, while estate taxes would be eliminated, total tax, where amounts over $100,000 were involved after averaging, could run as high as 75% compared with the top 54% under the present federal death tax laws. This would occur where a deemed realization of capital gains at death attracted tax at 50%. When this portion of the estate was received by someone outside the donor's family unit and the recipient's tax rate was 50% (on amounts over $100,000) only 25% of the original amount would be left after tax.

From a "buck is a buck" view of equity there can be no doubt that the recipient of such receipts obtains an economic gain which can be put to the same use as ordinary income receipts. But if we take a multi-generation view of the family unit, these receipts take on a different character—they are the savings of one generation and not additions to the country's "fruit of the tree" income. They presumably have been taxed at some previous stage as "fruit of the tree" income. From a multi-generation view of family, the taxation of gifts and inheritances as income can therefore be viewed as double taxation as surely as the current method of taxing corporate source income. (The Commission rejects any suggestion that double taxation is involved. But the illustration it uses is an arm's length situation not involving family connection.) Savings passed along as gifts and inheritances provide the following generation with a head start, and many people (and this seems to be evidenced by the present tax treatment) are convinced that the state has at best a limited right to tax such savings, and only to the extent that the revenues are essential for state purposes and that full freedom from tax on inter-generation transfers would, after generations, result in intolerable disparities of wealth and such power as wealth is presumed to bring.

Also involved is the sentiment that preservation of savings and capital is in the national interest and accumulations should not be discouraged, impeded or reduced by taxation. "It is immoral to finance current consumption out of capital" is perhaps the way this would have been put in Victorian times. The taxation of savings or capital to enable others, as a result, to be less heavily taxed and therefore to consume more, would be considered from this viewpoint to be damaging to the nation's future productive capability (and perhaps even its morals) particularly if the taxation required the breakup of going business concerns. This approach sees accumulation of savings and capital as continuing to retain special qualities as they pass from hand to hand. A bit of this sentiment seems to be involved in arguments that capital gains should not be taxed or should be taxed at special rates. The C.T.B.'s approach clearly rejects this type of view.

In some families the multi-generation concept is particularly strong and each generation regards its inheritance as

something received in trust for succeeding generations and feel that their only moral entitlement is to the "income" from it during a lifetime. This concept, of course, played a major role in the past in the development of our and other western economies. For at one time the family was perhaps the only institution with sufficient stability to provide the continuity required to build industrial and other business complexes. The advent of the corporation and stable government institutions capable of surviving the disruptive effects of the death of individuals has lessened considerably the social need for the multi-generation family concept. To many people, in fact, the social need either no longer exists or is even nowadays a socially undesirable concept. The Commission's proposals arising from the C.T.B. concept reflect this latter view to a considerably greater extent than the present tax structure.

The Commission has not, of course, ignored entirely this feeling about there being something special about gifts and inheritances. Its Income Adjustment Accounts, averaging provisions and lifetime gift allowances (up to $5,000) are all alleviations from the full impact of progression.

### *Compensation*

2. Is it fair to tax damage awards, insurance or workmen's compensation for permanent disability? It can be argued that such amounts, even if computed in terms of lost income, are really payment for a capital loss and that no gain is being realized. The Commission would permit such lump sum receipts to be used to purchase government annuities. The annuity payments would be taxed as received, but tax would apply to the "capital element". Were a computer to be destroyed, insurance received to the extent of its depreciated capital value would not constitute a gain. But compensation for destruction of a human brain apparently does.[3] The situation arises from the impracticality of assigning a capital value to human beings for tax purposes.

### *Mortality Gains*

3. Would it be fair, as the Commission suggests be considered in the future, to tax the "morality gain", roughly the "profit" of life insurance, as ordinary income to the recipient, say a widow without at least some allowance for a "capital loss" related to the deceased's normal life expectancy? Removal of death duties between husband and wife could be a harsh illusion if this occurred. A husband's only estate might be just the insurance. Such receipts now bear no tax if the total estate is within exemption limits of $50,000, or more, depending on the number of dependent children or if the policy is not owned by the deceased. The "capital loss" argument can be applied here as well. The emotional view might be that as between the government and the surviving spouse it would be unfair to tax the income source replacing the deceased as income. The "buck is a buck" approach is to regard the receipt as future income and to point out that the next-door neighbour would be taxed more on his ordinary income if such a receipt "escaped".

### *Capital Gains on Homes*

4. Would it always be fair to tax capital gains on the sale of residences and farms in excess of $25,000 in a lifetime? A person moving often because of his job, once past that limit, and because of inflation in the value of houses, could find himself taxed at his top marginal rate on his inflation gain even though his new home was identical with and cost the same as his old one. The problem here arises from the impossibility, for practical reasons, of taxing gains as they accrue. The person who does not have to move, gets his capital gains tax deferred until death. These

[3] Some support for the "capital loss" approach suggested here is to be found in *The Queen (In the Right of Ontario) v. Jennings* (1966) 57 DLR (2d)(644)—see "Around the Courts", this issue [vol. XV, no. 3 (1967)], p. 249.

gains, incidentally, if large enough, are now taxed under estate and succession duties, if the property is retained until death.

The Commission provides "roll-overs" where gains occur from forced dispositions from Acts of God or expropriation. In this narrow situation I have described, for the person concerned selling his home could well be equivalent to a forced disposition. Once started, however, general roll-overs create sizeable administrative and other equitable problems and the result would probably be that no capital gains tax would ever be paid until death, or possibly never in the case of corporations.

### *Work and Bucks*

A more general, and certainly more difficult, point about equity is raised by the Commission's judgment that effort, hardship or working time involved in obtaining a given level of income is irrelevant or impossible to take into account in determining equity for tax purposes. I don't agree that such a differentiation is irrelevant in equity, but I must agree with the impossibility of taking such factors into account in a C.T.B., "buck is a buck" concept or, for that matter, our present concept of income.

One can approach this from several levels. It can be argued that it is just not fair to tax identically the same amount of dollar income derived from extra long hours of work as from a short work day or year, or, to take the other extreme, the same dollar income derived from investment income for which no personal labour has been expended. In the latter case the capital from which the investment income is derived might of course be the product of savings from long hours of work, or may have been inherited. The British tax system has long distinguished between earned and unearned income. The only residue of this approach in Canada, if we exclude the question of "double taxation" of corporate profits, is the surtax on investment income from foreign sources over a certain amount.

### *Imputed Income*

Another approach is to think in terms of leisure having an "income value" either of itself or as permitting the person having it to have a greater opportunity than the person working long hours for the same amount of money to obtain "imputed" income from "do it yourself" projects.

For example, the university professor or other person with a long vacation may use it to build a cottage for himself or to study and add to his capital stock of learning. Both such theoretical additions to his economic power would be untaxed and he would pay the same tax on his salary earned in eight or ten months as would the person who earned the same amount by working twelve months — perhaps at two jobs, or 12-hour days — and had no time left to gain tax-free or imputed income or a "capital gain" from do-it-yourself employment or study.

While the Commission at times seems to make a virtue of its inevitable omission of this type of imputed or "do-it-yourself" income, it is more a case of making a virtue of necessity, a practice to which most of us are addicted at one time or another. The failure to distinguish dollars on the basis of the effort involved in obtaining them cuts both ways and graduated rates accentuate discrepancies.

### The Family Unit and C.T.B.

A number of the equity questions arise out of a combination of the C.T.B. and the family unit concept. C.T.B. income of husbands and wives is to be lumped, as is the C.T.B. income of children. This means higher marginal rates than would be the case if the incomes were separately taxed. Some of the results which may be regarded as inequitable arise out of including dependent children in the family unit for tax purposes.

1. Is it fair to lump the earnings of children in excess of $500 a year with that of their parents, in effect taxing it at the top rate of the parents? As a hard case one thinks of the age-old tradition of immigrant families where the whole family works after school and on weekends to establish a stake.

2. Is it fair, when the child leaves the family unit, to tax again at his income rate what he takes with him, particularly if this consists of his own earnings already taxed at the unit's rate? This would happen if the amount exceeded the exemption and unless it had been placed in a low-interest Income Adjustment Account. The same treatment would apply, of course, to gifts and inheritances, subject to the lifetime and small annual gift exemptions. The reasons this is recommended flow from the fact that within the family unit gifts and transfers would bear no tax. Without a second tax, inheritances between generations, or earnings which might have come from father's business, might escape tax or escape the progressive rates. The Commission labours mightily throughout to protect the graduated rate structure. Perhaps this is another example of hitting the odd man out.

3. Is it fair not to permit the inclusion of, say, an aged parent in the family unit where he is in fact dependent and part of the family unit, or not to permit any size of support payment to a "predecessor" unit to be deducted from the donor unit's C.T.B. income providing the recipient unit takes it into his or its income?

4. It is fair not to permit, say, two widowed sisters living together to form a family unit for tax purposes (to take the hardest cast)? Here the loophole that would worry the Commission would be the passage of gifts or inheritances without tax between them. Compared with the present situation under the *Estate Tax Act* the results of such transfers appear harsh. For example, one sister dies and leaves her $20,000 home, or other assets to that value, to her sister who earns, say, $8,000 a year. Under Carter, the surviving sister would take at least $15,000 into her income. Assuming her employment income remained level the tax on the gift, after being spread out over a number of years to reduce the tax impact, would amount to some $3,900, or some 18% of the gift. There would be no federal estate tax on an inheritance of this size in these circumstances today.

I've heard some of the horrid and sometimes amusing possibilities lawyers have been able to conjure up in connection with children and the family unit.

(a) Father gives son an asset worth $1,000. Twenty years later when son is leaving the family unit it is worth $10,000. There would be a deemed disposition and the $9,000 gain would be taxed at the unit's marginal rate. The son then has to take the $10,000 into his income and pay tax at his marginal rate (subject always to the possibility of averaging and the $5,000 lifetime gift allowance of the son). The government would do very well: $19,000 worth of tax base is created from an original gift of $1,000 and no real disposition or sale has occurred. This would be manufacturing income with a vengeance. The old saying that the law may define income but cannot create it seems a bit archaic in this case.

(b) The suitor proposes marriage in the park: "Darling will you marry me?"; "Yes, darling"; "But before I give you this valuable engagement ring since you are still a member of your father's family unit please execute this declaration of trust that you are holding the ring for me. Otherwise your father will have to pay tax on its value at his top rate and you will have to pay tax on that amount again at your marginal rate when you leave the family unit to marry me."

The family unit concept, which bolsters progression and permits in a limited way inter-family transfers without tax

consequences, is an ingenious one and fits at many points what I think are the economic facts of family life. But these examples indicate that it produces some difficult situations which I doubt would be regarded as fair by many people if they faced the situations themselves.

I find it difficult to believe the government will be able to adopt it, at least in its present form. Unfortunately a lot of good features would fall by the wayside if all of it were rejected. The chief loss might be the elimination of death taxes between spouses. But to tighten the law too much in some of these areas, where enforcement is difficult or impossible, would probably turn a number of minor tax avoidances into tax evasions; and this, it seems to me, could have just as bad an effect on respect for tax law as the Commission seeks to remedy by removal of some avoidance routes.

### *Children's Tax Credits*

Another area of interest in connection with equity is the Commission's proposal for flat tax credits for children instead of deductions. The reasoning is that deductions provide more benefit for those with higher incomes since with a deduction the tax saving can be related to the family's top marginal rate. Where the deduction is, say, $300 the tax saving for a family paying 35% would be $105; for a family at a 20% rate it would be $60.

The tax credit proposal seems to me to be unfair by the Commission's own standards. The Commission's rationale for progressive rates is that tax should be paid at a flat or proportionate rate on "discretionary" income, i.e. income in excess of "non-discretionary" income required to maintain one's standard of living. The key plank in the Commission's platform for progression is the proposition that one's non-discretionary expenses rise with income but not, of course, as fast as income.

If this proposition of the Commission is correct it seems to me to be only logical that the non-discretionary cost of raising children also rises as a family's income rises. To achieve mathematical equity among families with different numbers of children would require a different rate schedule for families with different numbers of children; but short of such a cumbersome approach, the continued use of deductions for children with the effect I have mentioned would, it seems to me, be closer to fairness as described in the Commission's own reasoning elsewhere.

### What Alternatives?

I do think all these points illustrate again that ability to pay, which is present in all these cases, does not necessarily add up to fairness between the individuals involved and government — although it can be argued, as does the Commission, that more equity is achieved between individuals.

And to each of these points supporters of the *Report* can quite fairly ask of those who criticize it, "Very well, what alternatives can you suggest to the concepts in the *Report*?"

Unfortunately, to cure some of these equitable anomalies might require major revisions in the grand design, although in some cases much larger exemptions could be used to relieve the small taxpayers. Gifts might be made deductible for the donor, but this would breach the "personal consumption" definition of gifts adopted by the Commission. I doubt if larger exemptions would remove the inherent inequity that I feel exists in some of these situations, no matter what amount was involved.

The difference between some of what may be considered unfair anomalies between the present system and that proposed is that the former are sins of omission and the latter of commission (no pun intended!). As I have noted before, the C.T.B. grabs all ten taxpayers, including the one innocent one. The present system, more by inadvertence than by design, may sometimes let as

many as nine go free of tax rather than catch the one. There are probably cases under the present system, however, where the law catches the one and still lets the nine go free.

But it is this all-embracing nature of the C.T.B. concept that I think makes those with an individualistic point of view shudder and suggest the C.T.B.—and thus the Carter *Report*—is by logic, inadvertence or design (or a bit of each) too close to Big Brotherism to suit the Canadian temperament.

## Progressive Rates

I might digress for a moment on the question of progressive rates. As I have noted the Commission argues that equity is produced by applying a flat rate tax to income in excess of a "standard of living" exemption (i.e. non-discretionary income) which gets bigger as income rises. If equity were the only criterion, according to the Commission the flat rate for income in excess of the "exemption" (i.e. discretionary income) would be whatever was necessary to produce the revenue required from the discretionary income available in the country. The Commission, however, pegged the rate at 50% to coincide with the corporate rate which, in turn, was set with an eye on U.S. and other corporate rates. It is also convinced that rates above 50% have an adverse effect on work and savings incentives.

The Commission's attempt at rationalizing progression is the best I have seen. It is interesting to note that it seems to point out that the only difference between, on the one hand, those who, like the late Kenneth Eaton, have favoured a flat rate tax on top of exemptions, and, on the other hand, the ideological progessionists, is whether the exemption should be the same for every taxpayer or whether it should get larger as incomes get larger. Both approaches can be expressed in graduated rates for one's total income.

The interesting point is that, having determined the proportionate rate by the Commission's method, one can then re-examine the "package of national exemptions" represented by the total amount of "non-discretionary income", notionally set aside from the tax base by the Commission's theory. If this amount were re-allocated among all taxpayers as a flat exemption it would obviously result in slightly larger exemptions or lower tax for taxpayers with lower incomes. The bite would be felt by those with incomes above the exemption line since the progression would be much "steeper". It may be comforting to those who see considerable merit in the flat-rate-flat exemption technique, in terms of the simplicity it produces, to know that, given agreement on the proportionate rate to be used under either approach, a flat exemption could be more beneficial to the lowest income earners than what the Commission proposes.

The Commission's non-discretionary income rationale for progression has been attacked as arbitrary and I think the Commissioners will admit to this.

One might go further with the Commission's rationale for progression and apply it to sales taxes. Applying the non-discretionary — discretionary approach it might be argued that the equity fault in sales taxes could be described in its not being possible with exemptions to measure with the same arbitrary precision the portion of "non-discretionary" income attributable to a particular family unit. Were this possible, even by way of tax credits or rebates, the fact of a sales tax being a flat rate would not seem to conflict with the Commission's rationale for equity and progression.

One prominent critic, Harvey Brazer[4] of the University of Michigan, agrees in principle with what Ken Eaton used to

[4] See article on p. 273 of this issue [vol. XV, no. 3 (1967)].

say, that rate structures reflect only an arbitrary feeling of how high they should be. But Professor Brazer objects to the rate ceiling proposed by the Commission because he would prefer a higher top income tax rate so that sales taxes could be reduced or removed entirely. He points, as have others, to British and U.S. research into the disincentive effects of high tax rates and disputes the Commission's conclusions that high rates impair incentives to work and invest. (In fact the Commission's "supporting" staff study reaches a conclusion opposite on this point to that reached in the *Report*.)

It is, incidentally, possible to find some support for the Commission's measure of "non-discretionary" income for incomes up to $10,000. Urban family consumption data from the D.B.S. publication, *Urban Family Expenditures, 1959,* are not inconsistent with the Commission's assumptions about non-discretionary income. But the evidence available does not permit any stronger factual support.

## More Criticisms

Most of the items I have questioned are in the category of criticism that the Commission has gone too far in its redistributive, loophole-closing and equity pursuits.

There are some attacks from the other direction and we may be hearing more of them as time goes on.

One is that the Commission should have pushed further with imputed income and should have recommended at least that the imputed rental value of owner-occupied homes be included in the comprehensive tax base so as to produce more equity as between tenants and home owners. One can imagine how this would strike retired people already struggling to pay property taxes on their homes! Of course those who propose this step would undoubtedly want it combined with reduction or removal of real property taxes.

And more significant, perhaps, could be the attacks which may develop in connection with the integration of the personal and corporate taxes. People with a variety of viewpoints about tax equity—lawyers, accountants and economists in the U.S. and Canada—are questioning this, and the political people may follow.

They have a lot of ammunition. It comes in two related packages — one marked "separate entity" and the other marked "shifting".

The separate entity package contains the body of theory, research and observation which has defeated in the past the arguments about double taxation of corporate profits, justified in the U.S. the removal of dividend tax credits; and supported the British move to a separate corporate tax. It contends that corporations, at least those widely held, do have a separate and real taxpaying ability distinct from that of the shareholders. Shareholders, on the other hand, invest for dividends and view their return in terms of payouts rather than pre-tax corporate earnings.

The shifting package is newer. Economists are far from agreed on the validity of its contents, which indicate that corporate taxes are passed on in higher prices for its products and services, lower wages to employees, etc. and are not in fact borne, or at least not entirely, by the shareholders.

The Carter *Report* doesn't pay much heed to either set of arguments. In its view the corporation may be administratively separate from its shareholders but for tax purposes it is really just an intermediary since only human beings have taxable capacity. On shifting, the Commission concludes—as it must from the first point— that the corporate tax ends up in prices either by being shifted forward or, over a long run, as a result of being borne by the shareholder, in a reduction in investment and ultimately in the supply of a company's goods and services.

You can take your pick of the theories and write several books about them, as has already been done. But the focal point in the attack could be the fact that integration will benefit shareholders relative to their present situation, at least until the economic effects of the changes work themselves out in changes in share prices. A simplified view of the change will curl the hair of those who now regard our 20% dividend tax credit as a giveaway to the "rich" in that an individual with no other income can now receive some $11,566 in dividends and not be liable for any tax other than the Old Age Security levy. Integration, if viewed from the same angle, produces more spectacular results since any amount of dividends can be received without giving rise to additional tax liability.

We can expect to hear more examples than have already been heard of the effects of integration. For example, A earns $10,000 salary and after tax has $8,045 left; B gets $10,000 in dividends and after tax ends up with not just $10,000 but $14,985.

Combine B's relative situation with the argument that the corporate tax wasn't borne by him in the first place but was passed on to the consumer, and on top of that add the fact that integration is for residents only and therefore unfair to non-resident shareholders, and you have the makings of some real academic, equity and political arguments.

The Commission looks through the corporation and says the proper comparison is $10,000 wages for A and $10,000 worth of corporate income including goodwill gains payable to B as a shareholder. The $10,000 of corporate earnings are taxed initially at 50%. B gets $5,000 in dividends or allocations and the tax paid by the company is credited to him. He gets back the difference between 50% and what he would pay on $10,000.

I should add for good measure that some academics (and some people in politics may take up this point also) who argue against integration from either separate entity or shifting grounds do not necessarily hold with the Commission's view that it would be "disastrous" to tax capital gains or share gains at full rates without integration. This view, prevalent in the U.S., sees nothing inconsistent or economically damaging in taxing corporate profits, including corporate capital gains, separately, although perhaps at about 40% instead of about 50%, and taxing personal capital gains at full rates and with personal rates going somewhat higher than 50%.

For these reasons I regard the integration proposal as the keystone in the debate about the acceptance of the *Report.* If the government is not able to bring itself to accept full integration a special rate for capital gains would be likely to follow, as would personal rates in excess of 50%, or at a point lower than $100,000.

If capital gains don't get the full treatment I doubt if the government could go for the full treatment of gifts and bequests, although I also doubt if this part of the *Report* could be accepted at once in any event—it's just too big a step from the present system, apart from the points of equity I have mentioned.

With just these modifications of the "inner package" we would have something which would look much more like Mr. Beauvais' minority report than that of the majority. And right here it would be necessary to work out new revenue calculations and rate schedules, since such changes would upset the Commission's estimates considerably.

And if capital gains and gifts get special treatment there is even less likelihood of welfare payments, unemployment insurance, veterans' pensions and the like being made taxable. The value of subsidies for low rental housing should, by the economic definition of income, be

brought into the tax base if these other items are included. But if they stay out, the non-cash housing subsidies undoubtedly would too.

If integration for corporations tumbles it may be impossible to use the full intermediary concept for trusts, and co-operatives.

What we would witness if this chain of events unfolds would not be the implementation of the Carter *Report* but a number of separate reforms. In the process the tax treatment of the more emotionally sensitive types of receipt or benefit which the C.T.B. concept would bring in without hesitation, would be picked over one by one, or as one strong supporter of the *Report* phrased it: "Put up for grabs". I don't agree with the way he put it, but in the end it may look to the C.T.B. devotee as if that is what has happened—every departure or special rate will to him be a loophole or an inconsistency. To many others it will be a process of examining each type of receipt and deciding on the equitable and any other merits of whether or not to include it for income tax purposes.

But because of its logic and consistency, and despite the way it pinches at some points, I wouldn't count the C.T.B., family unit or integration out on the first round of legislation. Like it or not, we shall be hearing about these concepts for years to come, and so will the taxpayers of other countries.

# The Tax Kaleidoscope: Perspectives on Tax Reform in Canada

*[From Vol. XVIII, No. 5 (1970), 444-73]*

Richard M. Bird*

## Introduction

I do not intend in this paper to discuss the economic substance of the changes in the Canadian tax system proposed by the 1969 White Paper and by the Carter Commission. Others have already treated this matter competently and at length.[1] Taking a different and broader viewpoint, I aim instead to consider these proposals as illustrating certain important characteristics of tax reform in our time, in order to put the current furore over the White Paper into proper perspective, and to suggest that what now concerns us is simply one out of the many constantly changing patterns continually produced by the tax kaleidoscope. Despite the obvious danger of empty generalization in so broad an approach, this long-range look at tax reform serves to reduce the current tax reform proposals to what I regard as their proper dimensions: a needed and useful, but far from earth-shaking, adjustment in one part of the Canadian tax structure.

In addition to considering long-run trends in tax structure, I have also ventured into what an economist must consider the treacherous morass of fiscal psychology and philosophy, in order to emphasize a point that seems to have been lost sight of in many recent discussions. This point is that tax reform is much more than an exercise in economic analysis or tax technique: it is an intensely human and social phenomenon, which, as we have seen in recent years, touches many people to the quick, at least in passing, and provokes them to outraged defence against what they perceive to be violation of their innermost values. Joseph Schumpeter may have phrased it rather strongly when he wrote "... nothing shows so clearly the character of a society and of a civilization as does the fiscal policy its political sector adopts ...".[2] But it is surely true that few things so clearly reveal the naked play of vested interests in any country as do attempts to change an existing fiscal structure. Tax reforms, like tax systems, thus in a sense reflect "national character" — one of those almost meaningless but nevertheless useful catch-all concepts which even social scientists sometimes must use to capture the myriad

* Professor of Economics and Research Associate, Institute for the Quantitative Analysis of Social and Economic Policy, University of Toronto. The preparation of this paper was made possible by an Izaak Walton Killam award from the Canada Council. A preliminary version of some of this material was presented at the Fourth Annual Meeting of the Canadian Economics Association, Winnipeg, Manitoba, 4 June 1970. I should like to thank John Bossons, John Head, and John Helliwell, my fellow participants on the C.E.A. panel on tax reform, as well as R. D. Brown and D. J. Sherbaniuk, for helpful discussions of some of these questions, without in any way suggesting that any of them would agree with my personal views of the controversial and vague issues discussed in this paper.

1 See, in particular, Canadian Tax Foundation, *Report of Proceedings of Twenty-Second Tax Conference* (Toronto, 1970), on the White Paper (*Proposals for Tax Reform* (Ottawa, 1969), hereinafter cited as White Paper) and *Reports of Proceedings of Nineteenth and Twentieth Tax Conferences* (Toronto, 1967 and 1968) on the Carter Report (*Report of the Royal Commission on Taxation* (Ottawa, 1966), hereinafter cited as *Report*). Two other noteworthy symposia on the Carter Report appeared in the *Canadian Journal of Economics*, Supplement No. 1 (February 1968) and the *National Tax Journal*, XXII (March 1969).

2 Joseph A. Schumpeter, *History of Economic Analysis* (New York: Oxford University Press, 1954), 769.

influences shaping policy and politics that cannot be neatly separated out and dissected by conventional analytical tools.[3]

Whatever the validity of this sweeping generalization, Schumpeter was surely correct when he pointed out that depicting a change in tax policy as the logical implication of such definitional verities as "horizontal equity" or "neutrality" is unlikely to convert anyone who dislikes the *results* of the proposed change in tax policy.[4] The controversy in Canada since the publication of the *Report of the Royal Commission on Taxation* in 1967 has amply proved this point. Tax policy does not simply reflect the resultant of pressures from opposing interest groups, but neither does it simply reflect the logical application of economic reasoning. Hence tax reform cannot be understood in economic terms alone. Further, change cannot realistically be expected to come about in the form of the adoption, once and for all, of some grand comprehensively tidy and rational reform package.

The remainder of this essay sketches briefly the arguments underlying my conclusions: (1) that the White Paper tax reforms are, in long-term perspective, useful but less significant for good or, especially, ill than the more full-throated participants in the current controversy would appear to believe; (2) that, far from being the culmination of tax changes in Canada, these proposals represent only one stage in an on-going process of tax reform; and (3) that future tax changes may well take directions not clearly foreseen in the Carter Report, in particular towards heavier reliance on indirect taxes and more use of benefit taxes. The case for these conclusions cannot be proved here in any rigorous fashion. This paper is therefore not a "scientific" analysis but a speculative essay. Its objective is rather to provoke a wider-ranging and deeper discussion of tax reform than has yet taken place in this country than to provide definitive answers to the many big questions raised in the course of the discussion. My purpose is not to criticize the White Paper reforms (for, as will become clear, I am in general agreement with their objectives) but to attempt to descry, albeit necessarily "through a glass, darkly", the outline of the probable next major reform—to preview some of the rather surprising recommendations that may appear in the next royal commission report on the fiscal system—the one that, I suggest, may be demanded within the next decade.

### The Changing Composition of Canada's Tax Structure

The proportion of national income channelled through government in Canada has doubled in the last forty years—and quintupled over the last century. Since World War II, however, the changes have been considerably less dramatic than this. Not until 1966, for example, did total government taxes as a percentage of GNP exceed the 27% level achieved in the War. . . . Federal taxes, indeed, are still lower relative to GNP than they were even in the 1950s, let alone the 1940s. Although the increase in the total tax ratio has been especially marked since 1965, much of this recent increase has been in provincial and municipal taxes rather than in federal taxes. In 1968, for example, federal taxes constituted only 52% of total taxes, compared to 58% in 1965 (and 69% in 1950).[5]

• • •

[3] See, for an example, Harley H. Hinrichs, *A General Theory of Tax Structure Change during Economic Development* (Cambridge, Mass.: The Law School of Harvard University, 1966), ch. 4 on "Tax Structures and Cultural Style".

[4] This statement paraphrases Schumpeter's views on Irving Fisher's well-known proposition that savings should not be subjected to income taxation. (See Joseph A. Schumpeter, *Ten Great Economists: From Marx to Keynes* (New York: Oxford University Press, 1965), 229, n. 9.)

[5] Unless otherwise specified, all calculations in this section are based on the accompanying tables and the sources there cited.

In short, Canada has not in the last twenty years seen a sharp increase in the relative importance of federal taxes. Rather, it has been provincial taxes, and especially provincial consumption taxes, that have increased most strikingly in this period, largely to pay for increased social expenditures.[12] Within the declining federal share of tax revenues, however, there has been a marked rise in the importance of the personal income tax in recent years—especially over the period from when the Carter Commission began its deliberations in 1963 until the White Paper was issued at the end of 1969. (Personal income taxes are also, of course, of increasing relative importance in provincial revenues.)

The focus of the current tax reform discussion on the federal income tax thus perhaps reflects less present tax reality than people's perception of taxes and the emphasis on income taxes in the major recent official studies of our tax system, although it is true that the high income-elasticity of the income tax ensures it an increasingly important role in the Canadian fiscal system. The adoption of the recommendations in the White Paper (or the Carter Report) would simply reinforce the trend for government revenues in general, and federal revenues in particular, to become increasingly dependent upon the income tax.

**Carter, the White Paper, and the Process of Tax Reform**

This outcome was considered by the Carter Commission to be highly desirable, because, they argued, the personal income tax was the only tax that could really be "fair". Consistent with their view that the main object of tax reform was to produce a fairer tax system, the Commission suggested that taxes on consumption and wealth should ". . . either be abandoned or integrated with personal income taxes".[13] Although they drew back from advocating complete and immediate abandonment because of their acceptance, more by assumption than by reasoned argument, of the "financial responsibility" doctrine (which led them to allocate consumption taxes to the provinces and wealth taxes to municipalities in their ideal tax structure), the Commission were strongly sympathetic to the idea that the federal government should itself gradually ease out of the sales tax field. The tax system envisaged by the Carter Commission in the long run, then, was one in which the relative importance of taxes on consumption and wealth in the tax mix would decline over time and in which these "second-best" taxes would more or less disappear completely from the federal tax mix.[14]

Fulfilment of this ideal is probably politically impossible in the present state of federal-provincial relations. Why should the provinces accept the proposal that their own revenue systems should be based on the sales tax when the Commission tells them it is an inherently bad tax? "When, furthermore, they are told sales tax revenues are less responsive to increases in income than are income taxes? And when they would bear the political onus for imposing the highest explicit general retail sales tax rates ever levied in the world?"[15] There thus seems to be no prospect that the

12 The elasticity with respect to GNE of provincial consumption taxes in 1953-65, for example, was 2.0, and of total provincial own revenues 2.1, compared to an elasticity for total government revenues of only 1.2. . . . For 1952-65, Robinson and Courchene calculated that the full-employment growth rate of provincial expenditures was almost twice that of the federal government, with transfers and subsidies the fastest-growing category of expenditures (T. R. Robinson and T. J. Courchene, "Fiscal Federalism and Economic Stability: An Examination of Multi-Level Public Finances in Canada, 1952-1965", *Canadian Journal of Economics*, II (May 1969), 184).

13 *Report*, III, 35.

14 See, for example, *Report*, V, 210-11. A somewhat similar view was expressed by Mr. R. B. Bryce, Deputy Minister of Finance, in testimony on the White Paper: see House of Commons, Standing Committee on Finance, Trade and Economic Affairs, *Minutes of Proceedings and Evidence*, No. 30 (7 April 1970), 60-1: also Senate of Canada, *Proceedings of the Standing Senate Committee on Banking, Trade and Commerce*, No. 5 (28 January 1970), 16.

15 R. M. Bird, *Sales Taxes and the Carter Report* (Don Mills, Ont.: CCH Canadian Ltd., 1967), 28.

Royal Commission proposal that the federal government replace its sales tax by taking over the provincial income taxes will come to pass in the near future. Quite apart from this political problem, I suggest that the tax system envisaged by the Carter Commission is probably both psychologically and economically undesirable in the long run. In the perspective of long-term trends in taxation, the Carter Report looks rather like the war plans of some generals earlier in this century—superbly detailed and well thought out, but for the wrong war.

Having said this, I must at once note that in my view the Carter Report and—to a lesser extent, because it is a lesser document—the White Paper are fundamentally correct in most of what they say. Some very important battles are still to be fought in the old war for a more equitable and efficient income tax, and the current tax reform proposals are generally well conceived in this respect. Nevertheless, I believe that much of the current controversy about tax reform in Canada, by both proponents and opponents of the proposed changes, can fairly be characterized as looking backward—the opponents with nostalgia to the low-tax, small-government world that will never come again, and the proponents to the incredible perversions and distortions of rationality and fairness that constitute much of the present tax system. I am, of course, on the side of the angels of equity and efficiency in this controversy. But I would still suggest that, important and desirable as adoption of most of the White Paper and Carter reforms is, these proposals constitute more the essential culmination of the present phase of tax development in Canada, than the first wave of the future.

Furthermore, the impact of these tax changes would almost certainly be less striking than most current discussion would lead one to believe. Indeed, one might state as a general rule that predicted irreversible social catastrophes as a result of tax changes somehow seldom occur. This fact has not, however, prevented the usual outcries concerning the possible disastrous consequences to Canada of adopting the "radical", "untested" and "dangerous" White Paper reforms or, even worse, the Carter reforms. Such statements from representatives of some of the largest and best-known enterprises in the country have far outweighed in the media and the public eye more reasoned appraisals. The assurances of economists that ". . . the various prophecies of unmitigated disaster are simple nonsense,"[16] while in my view entirely correct in stressing the resilience of the Canadian economy and its ability to absorb much greater shocks than those entailed by the adoption of the White Paper (or even the Carter[17]) proposals, seem to have done little to soothe the savage breast of the taxpayer. Nor have large segments of the vocal public received much solace from the arguments of eminent public finance scholars that "the proposals of the White Paper should be given a high rating on grounds of equity and fairness,"[18] while the Carter Report constitutes "a landmark in the annals of taxation"[19] and a "daring and far-sighted" document.[20]

This obvious gap between professional opinion and public reaction has led me to reflect on three topics that have been gener-

[16] A. R. Dobell and T. A. Wilson, "The Effects of the White Paper on Saving, Investment, and Economic Growth", *Report of Proceedings of Twenty-Second Tax Conference*, 233.

[17] See A. R. Dobell and T. A. Wilson, "Overall Effects of the Proposed Tax Reforms: Savings, Investment and the Balance of Payments" (with Addendum), Working Paper Series No. 6806, Institute for the Quantitative Analysis of Social and Economic Policy, University of Toronto (multilith; 1968).

[18] R. A. Musgrave, "White Paper Proposals for the Tax Treatment of Corporate Source Income", *Report of Proceedings of Twenty-Second Tax Conference*, 136.

[19] Arnold C. Harberger, "A Landmark in the Annals of Taxation", *Canadian Journal of Economics*, Supplement No. 1, (February 1968), 183-94.

[20] Carl S. Shoup, "The White Paper: Accrual Accounting for Capital Gains and Losses", *Canadian Tax Journal*, XVIII, 2 (March-April 1970), 96.

ally neglected in the current discussion: (1) the methodology underlying the tax reform proposals, (2) the desirability of piecemeal reform, and (3) the importance of fiscal psychology.

**The Methodology of the Tax Reform Proposals**

The first point is simply that the proposed tax reforms are, in essence, based on a particular set of ethical precepts. However much positive analysis may be employed to depict the desirable economic effects of tax changes designed to accord with such textbook characteristics as "horizontal equity" and "neutrality", to illustrate the divergences between the present tax system and the "desirable" one, and to quantify the "trade-offs" between the assumed objectives, the fact is that the postulated objectives of the reforms derive from a particular vision of the "good life".[21] The Carter Commission was clearly aware of the ethical basis of its recommended reforms, as shown by its repeated emphasis on "the consensus of informed Canadians" which it hoped would support its recommendations.[22] My personal vision of the good life in Canada is apparently similar to that of the authors of the Royal Commission Report (and the White Paper). But this does not mean I can simply *assume* the underlying ethical postulates to be of such power and cogency that the desirability, even the necessity, of the recommended policy changes cannot be questioned by men of good will.

While it may be frustrating to the expert when advice formulated after careful and (he believes) objective study goes unheeded by policy-makers, it is not necessarily wrong. The nature of politics is to reconcile conflicting interests in order to bring about acceptable and workable solutions. If the proposed reforms are not in the first instance designed to be acceptable, we may therefore be sure that they will be made acceptable before being implemented—or very shortly thereafter! A recent example is the government's decision to reform the estate tax rather than to make bequests and gifts taxable as income, as the Carter Report urged. The reason for this decision was clearly a different reading of the social welfare function: ". . . the government believes the commission carried some of its arguments to extremes which the Canadian public would not support. One of the government's decisions in this regard has already been implemented by Parliament in connection with the estate taxes."[23]

Since most economic analysis is, in a sense, based on the assumption that individual preferences differ, there should be nothing surprising to economists about this obvious proposition that "tastes" for tax reform differ also. The Commission itself noted that the concept of equity is "peculiarly specific to time and place".[24] I would go further and argue that the concept of equity (horizontal and, especially, vertical) is also specific to individuals. Instead of some kind of "consensus" on the desired degree of redistribution, for example, there is inevitably a conflict of values and interests on this question which can be resolved only through the political system. It is naive to believe otherwise. It is thus most unlikely that there would be any readily discernible widespread agreement (or "consensus") on the desirability of a particular set of reforms. It is the function of politics to conciliate our differing interests and to enable us to live with one another in a tolerable, if

21 This line of argument is elaborated in my "Optimal Tax Policy for a Developing Country: The Case of Colombia", *Finanzarchiv* (N.F.), Band 29, Heft 1 (February 1970), 33-5, following John G. Head, "Welfare Methodology and the Multi-Branch Budget", *Public Finance*, No. 4 (1968), 405-24.

22 See, for example, *Report*, II, 10, 17; III, 5. In John Bossons's elaboration of "The Objectives of Taxation and the Carter Commission Proposals", *Canadian Public Administration*, XII (Summer 1969), 142n., the task of the Commission is similarly implied to be "to determine what social welfare function expresses the popular consensus".

23 White Paper, para. 1.8.

24 *Report*, II, 17.

not perfect, fashion. The political system thus fulfils with respect to the "buying" of tax reform the role of the market system with respect to the buying of apples.

This approach suggests that the surprising thing is not the extent of the differences in substance between the Carter Report and the White Paper, and the opposition to both, but rather the extent of the similarities and the weakness of the opposition. Assuming I am correct in my argument that the Royal Commission inevitably based its recommendations on a quite arbitrary social welfare function, this similarity may be explained in several ways. It is possible, for example, that the Royal Commission was correct in its determination of "the consensus of informed Canadians", or at least that it was correct in perceiving the views of the key policy-makers. More probably, however, what has happened is that over the last three or four years the level of misinformation surrounding tax issues in Canada has been substantially reduced as a result of the Herculean efforts of the Commission and its staff, so that more Canadians have become "informed" and have been persuaded, as the government clearly has, of the cogency of many of the Commission's main recommendations.

Further, in such matters familiarity tends to lead eventually to acceptance. The idea of taxing capital gains, for instance, has now been around long enough to overcome people's deep-seated reluctance to accept rapid changes in matters which, they think, concern them intimately and individually. It seems less likely that the integration of personal and corporate taxes has yet achieved the requisite degree of familiarity and acceptance.

A close reading of the proceedings of the Commons and Senate Committees now considering the White Paper makes it impossible to be very optimistic about how general such acceptance now is or how deep it goes. Nevertheless, it seems clear that, while the ethical approach of the Carter Commission to tax reform may have initially alienated many Canadians who (unlike most economists) did not share this particular value framework, the power and clarity of their argument has, within a few short years, made this approach much more acceptable to both government and people than I would have predicted. The White Paper and the probability that its main proposals will be enacted are proof of this acceptability. To one who believes that rationality is better than irrationality, as all academics presumably must (even these days), if they are in good conscience, to stay in the university environment, this is a most optimistic finding: whatever happens in the way of actual tax change, at least we have seen that careful policy analysis can change the character and to some extent the outcome of the policy process. This has not always been evident in the past.

This praise, however, is not intended to suggest that the Royal Commission's apparent long-run conception of the evolution of the Canadian tax system deserves equal acceptance and success. Nor does it mean that either the Commission's methodology, or, indeed, the idea of an overall look at the whole system through the device of periodic commissions is a particularly good one. It is open to question whether the search for paradigms that characterized much of the Carter Report[25] is more of a hindrance or a help to understanding the real world. Simplified models are often an essential starting point to begin understanding complex reality, but it can be very misleading to draw conclusions from them. Similarly, many of the recurrent difficulties with tax policy stem from the fact that the tax system has not been subjected to the continuous review and evaluation required to keep it in tune with the changing world. A comprehensive review every ten, twenty or fifty years is unlikely to prove an adequate

[25] This approach is much more explicit in Bossons, "The Objectives of Taxation", *op. cit* (in fn. 22) than in the Carter Report itself, but it seems fair to say that much of the Commission's work can be similarly characterized.

substitute for the needed piecemeal and gradual adjustments in any fiscal structure.

**The Desirability of Piecemeal Reforms**

From the present point of view, one of the most significant differences between the Carter Report and the White Paper is not the different form of integration or the proposed taxation of some unrealized capital gains in the latter—interesting though it is to discuss such points[26]—but rather that the White Paper is concerned with reforms only in one part, albeit a major part, of the federal income tax system. It is true that the scope of the Carter Report was also considerably limited by the exclusion of both provincial and municipal taxes and public expenditures. Nevertheless, the Royal Commission was much more ambitious than the White Paper in proposing a comprehensive reform of all federal taxes (except customs duties and excise duties).

No one would have expected so ambitious a reform package to be quickly and completely accepted, and it was not. First, the government introduced a substantial revision in the estate taxes (contrary to Carter[27]). Then it revised considerably the taxation of banks and insurance companies (more or less as proposed by Carter). The White Paper may be considered the third step in this process. That it is not the final step is suggested by the references in the White Paper itself to further studies and perhaps proposals concerning the family unit[28] (an important Carter proposal), capital cost allowances,[29] consumption taxes,[30] and (presumably) tax administration.[31]

One reason that has been offered in defence of this piecemeal approach to tax reform is that limited staff resources have precluded doing more.[32] To anyone aware of the tremendous burden placed on a very few people in the tax policy division of the Department of Finance, this point is clearly valid. I would go further, however, and argue that not only is this piecemeal approach necessary for practical reasons, but it is also desirable in principle. That is, a piecemeal tax reform such as that which we are now undergoing is, despite its conceptual untidiness, to be welcomed rather than attacked, as it has been by fiscal purists, over-enthusiastic reform-mongers, and perhaps some who have not thought the issue through.

This proposition is based on both a theoretical argument and a political assessment. The latter is simply that a political system can absorb only so much policy change at any one time without serious fracture, particularly with respect to tax reform which in the nature of things engenders few supporters and many opponents. (Those whose tax burdens are lightened by the reform will take it as merely a delayed and inadequate recognition of their special circumstances, while those whose burdens are increased can never be persuaded that the increase is justified.) Major changes in tax systems therefore usually take place only in times of acute fiscal crisis, such

[26] See, for example, Shoup, "The White Paper", *op. cit* (in fn. 20); and John Bossons, "The Impact of Tax Rates on the Effect of Tax Reform", *Report of Proceedings of Twenty-Second Tax Conference*, 26-59.

[27] The Royal Commission had urged that gifts and bequests be taxed like any other income under the income tax (*Report*, III, ch. 17). In freeing spouses from tax on most transfers from the other spouse, however, the government's amendments appear to reflect at least in part the Commission's reasoning on the family unit.

[28] White Paper, para. 2.5.

[29] *Ibid.*, para. 5.14.

[30] *Ibid.*, para. 1.19.

[31] Passage of the White Paper proposals will clearly call for some changes in the administrative structure. In addition, the Minister of Justice has already introduced in the House of Commons legislation intended to replace the Tax Appeal Board by a new, less formal agency, to be called the Tax Review Board (Toronto *Globe and Mail*, 23 May 1970 and 13 August 1970).

[32] The Minister of Finance, Mr. Benson, in House of Commons, Standing Committee on Finance, *Minutes and Proceedings*, No. 12 (5 January 1970), 57.

as wars or depressions.[33] Ordinarily, even in times of constant upward pressure on expenditures (such as now), tax changes normally take place only incrementally—the introduction of a new low-rate tax here, a base change there, and rate changes everywhere. The evolution of the provincial finances in the last decade well illustrates this proposition.[34] A glance at the personal income tax return with its "Temporary Surtax" and its "Old Age Security and Social Development Tax" suggests that a similar process is not unknown at the federal level. The practical reasons for this mode of proceeding seem as relevant for the future as they have been in the past, so there is no reason to expect an abrupt switch to a holistic approach to tax reform.[35]

There are also good theoretical reasons, apart from the limitations of our collective political digestion, to support a continued piecemeal approach to tax reform. One such reason is the effort involved in obtaining information and reaching a decision. Given our finite intelligence, there is, I think, good reason to expect that introducing an element of "disjointedness" into the tax reform process by considering only a part of the system at a time will enable us in general to reach more satisfactory decisions, by placing the dimensions of the problem more within the limitations of our communicating and information-absorbing abilities.[36] Rationality is in fact generally aided by the subdivision of problems into manageable parts, so long as the relevant ramifications of the change throughout our complex economic and social system are adequately taken into account (for example, through models such as those developed for the Royal Commission, and similar aids to thought). In practice, policy-making is almost invariably a never-ending process of nibbles rather than a once-for-all resolution of some important question. This sequential process has several important advantages: it gives our limited intelligences a reasonable chance to consider the effects of particular measures; it gives us a second chance to take remedial action if something does not work out quite the way we expected it to; and it allows us to incorporate into later measures feedback from the constituency our policy is intended to serve, thus focusing policy mainly on correcting perceived wrongs rather than on the much more controversial task of establishing future norms.

This sequential approach to policy, far from being inherently deficient compared to the

33 For example, a federal sales tax was first introduced in Canada in 1920 to cope with the large postwar deficits and the strong resistance to increases in the relatively new income tax. It was kept on because of the revenue needs arising from the depression. A similar path was followed in the provinces, with Alberta, Saskatchewan, and Quebec all imposing sales taxes to cope with financial crises before World War II (though the Alberta tax was soon removed). After the war, rising expenditure needs forced province after province to introduce a sales tax. See John F. Due, *Sales Taxation* (Urbana: University of Illinois Press, 1957), ch. 8 and 13, and also his *Provincial Sales Taxes* (rev. ed.; Toronto: Canadian Tax Foundation, 1964). The conversion of the personal income tax to a mass tax during World War II provides another instance of crisis-induced change in the Canadian tax structure.

34 This subject has not yet received the careful study it deserves, although much relevant information may be found in Canadian Tax Foundation, *Provincial Finances 1969* (Toronto, 1969), and earlier issues of this biennial publication. New Brunswick's retail sales tax, for example, rose from 3% in 1962 to 6% in 1967 to 8% in 1969; Ontario's gasoline tax from 13¢ per gallon in 1962 to 18¢ in 1969; Quebec introduced new taxes on hotel rooms and telecommunications; and so on and on.

35 Whether a holistic or a piecemeal approach is more advisable as a tactical matter depends on the prevailing circumstances. Sometimes a more radical approach (for example, the White Paper proposal to tax some accrued gains every five years) may make a less drastic, but still radical approach (taxation of deemed gains at death) more acceptable than it otherwise would be. But as a rule it would appear that dramatic breaks with the existing system are more likely to generate tension than to produce acceptable solutions immediately.

36 See Charles E. Lindblom, *The Policy-Making Process* (Englewood Cliffs, N.J.: Prentice-Hall, 1969). See also Herbert Simon, *Administrative Behavior* (2nd ed.; New York: The Free Press, 1957) for similar ideas in a different context. A general philosophical argument against holistic planning of reforms may be found in K. R. Popper, *The Poverty of Historicism* (London: Routledge & Kegan Paul, 1957).

holistic, comprehensive approach favoured by most would-be reformers, thus actually improves our chances of making good policy decisions in the face of the constantly-changing interdependent complexity of modern social and economic realities. As Charles Lindblom put it: ". . . analytical methods cannot be restricted to tidy scholarly procedures. The piecemealing, remedial incrementalist or satisficer may not look like an heroic figure. He is nevertheless a shrewd, resourceful problem-solver who is wrestling bravely with a universe he is wise enough to know is too big for him."[37] Unless, therefore, one has much more faith than I do in the wisdom and foresight of any conceivable person or group, the piecemeal approach is not only the necessary tactical approach to implementing even large changes, but it is also, although messy, usually the best way we have to be even partly sure the changes we implement will be the "right" ones.[38]

This line of reasoning argues for changing only a few at a time of the many policy instruments constituting the tax system. It should not be interpreted as a plea for partial-equilibrium as opposed to general-equilibrium analysis, for, so far as possible, the total effects of each partial measure should clearly be taken into account. In this sense, then, the White Paper approach to tax reform is to be preferred to the Carter approach, taking the former to be incremental (although admittedly involving a rather large increment!), and the latter to mean everything should be changed at once—though it seems clear that the authors of the *Report* did not really intend it to be taken this way.

Not only is tax reform inevitably a piecemeal process from the nature of the problems and the political and human resources available to deal with them, but it is also a continual process. Even if some grand once-for-all reform scheme were adopted, it would probably soon have to be altered. Circumstances change, and policies must change with them. No tax system can long remain *the* optimal system for any country in a changing world. The Carter Report, if one accepts its value judgments, may well have depicted the optimal tax system for Canada in 1965. It is still, in my opinion, largely valid in 1970. But it is unlikely to handle adequately the problems of 1980 and almost certain, I would argue, to be wrong for 1990. The kaleidoscope is turning continually, and the appropriate pattern of tax legislation must shift too.

In Canada in the circumstances of the 1960s, then, the Royal Commission on Taxation served an essential function in standing back and taking a much-needed look at the federal tax system as a whole. The results of this look remain invaluable to would-be tax reformers today, but they do not constitute a ready-made comprehensive reform. At most, the Carter Report provides a set of objectives towards which piecemeal reforms may, if policy-makers desire, be directed. This is what, in broad terms, the government may perhaps be said to be doing with the series of proposals of which the White Paper is as yet the most important.

Being a royal commission, moreover, the Carter Commission could at most take into account tax reality only at a particular point in time. It also suffered in a sense from its own virtue of not being an overtly political body, since, as already argued, tax reform is an eminently political process. The White Paper from this point of view thus has the important advantage of being not only piecemeal but also political. In particular, it is political in an open and innovative fashion previously unfamiliar in Canada, where tax legislation has heretofore generally been conceived and brought to fruition out of public view. This is a most commendable change in terms of both my personal values and theoretical argument.

37 Lindblom, *op. cit.* (in fn. 36), 27.

38 This argument is, of course, quite different from the usual arguments heard from affected taxpayers about the need for business certainty. Why, in this world of upsets, taxes alone must remain unchanged in order to permit businesses to plan ahead has never been clear to me.

Unless the preferences of all Canadians for tax reform are identical, those in the minority on any issue are subject to what may be called a "political externality" when their preferences are overridden by the majority. The more heterogeneous the population in this respect, the larger the proportion of it that has to be involved in the decision-making process in order to reduce by a given amount the "cost" of decisions, in terms of the political externalities created. Of course, the more people involved the greater the cost of reaching a decision is likely to be, in terms of time and effort involved.[39] This consideration again points to the advisability of limiting the issues to be debated at any one time. The White Paper approach of prolonged and open public discussion is in this sense clearly superior to the old approach in which tax changes in virtually their final form were presented to a startled public. It is true that nothing new is likely to be added to knowledge by the present lengthy discussions, but there is nevertheless a clear political gain (if not necessarily in party terms[40]) in this mode of proceeding. Furthermore, as already noted, the feedback produced by open and prolonged discussion will probably, despite all the obvious problems of representativeness, delay, uncertainty, and so on, help produce a better change in the end—unless, that is, one is so firmly convinced that one has the "right" answer in the first place that one considers all this loud and messy procedure quite unnecessary.[41]

The propensity of the expert to view his particular subject as a whole, while ignoring most of the complex and changing reality facing political decision-makers, thus provides a reason additional to differences in value systems, explaining why governments seldom do what experts think they should do, and why the public sometimes seems unable to see obvious truth even when writ large and in plain English. I have suggested in this section that frustrating the understandable wish of tax experts, Ministers of Finance,[42] and provincial governments[43] to clean up the subject of tax reform once and for all is probably not only a necessary but a desirable course of action.

### Taxes, Expenditures, and the Future

Taxes have increased in recent years because expenditures have increased. While forecasting is a treacherous art, I think there is a strong probability that government spending as a proportion of national income will continue to rise over the next decade in Canada, although there is no reason why the rate of expansion should be particularly smooth from year to year, for the future, like the past, will presumably be made up of a series of discrete events. Expenditures will continue to rise because of the continuing increase in the population and its concentration in ever-larger urban agglomerates, the continuing substitution of public for private expenditures on health services, and the probable adoption in the near future of more comprehensive social welfare measures than now exist. The new expenditures arising from these developments, added to the constant incremental upward pressure on all existing

[39] See James M. Buchanan and Gordon Tulloch, *The Calculus of Consent* (Ann Arbor: University of Michigan Press, 1962), ch. 6, for an interesting discussion of this analysis.

[40] There would appear to be no apparent political gain in terms of electoral support to the governing party from permitting more open discussion of its proposed policies, unless the electorate is really exceptionally enlightened.

[41] The first try at any new mode of procedure is unlikely to be too successful. Neither the relationship of the government to the parliamentary committees nor that of the committees to their staffs has yet been worked out very well within the Canadian parliamentary framework (see the discussion in House of Commons, Standing Committee on Finance, *Minutes and Proceedings*, No. 12 (15 January 1970), 67-70) It is thus to be hoped future hearings of this sort may be more productive of useful information and opinion than some of those on the White Paper have been.

[42] Mr. Benson, *ibid.*, 54.

[43] See *Ontario Proposals for Tax Reform in Canada* (Toronto: Department of Treasury and Economics, 1970), 7.

spending programs due to the normal workings of the bureaucracy and the political system should suffice to bring about the predicted result of an increase in the relative size of government.[44]

Furthermore, for government as a whole—though not necessarily for each sub-national government individually—the bulk of the evidence is that the revenue cloth can and will be stretched to fit the pattern of the expenditure coat for some years to come, at least in an organized state like Canada with an adaptable administrative machine. Unlike poor countries, in which it appears that the level of government expenditures depends chiefly upon the availability of suitable tax bases, in developed countries it appears that the direction of causation is, as a rule, reversed and that the demand for government services is an important determinant of the level of taxation.[45] There are, of course, occasions on which what may be called "revenue-induced spending" occurs,[46] but the general rule is that expenditures lead revenues, and not the converse.

There may well be some critical "limit" to this expansion of government, after which the character of the economy will either change beyond recognition or else the revenue constraint will, through the economic and psychological effects of increased taxation, operate to check the expansion of the public sector.[47] But in my opinion Canada is not near any such breaking-point now, nor does it seem likely to reach one in the immediate future—at least not if the tax system is changed as I suggest below it probably will be.

**The Importance of Fiscal Psychology**

The probable continued pressure of expenditures on revenues reinforces a point that has impressed on me the importance of fiscal psychology. In brief, it can be argued that the increasing weight of taxation resulting from rising expenditures and inflation, when combined with the publicity attendant on the recent proposals for tax reform, has greatly increased people's sensitivity to tax questions. The "beneficiaries" of this increased tax sensitivity have not necessarily been those taxes that have in fact grown most: instead, resentment tends to be focused on those taxes that people are most aware of—for example, the personal income tax and the property tax. When people feel pressure from generally increasing taxation they tend to react most adversely to those taxes of which they are most aware, whether or not these are in fact the taxes that have increased.

An example of such a "fiscal illusion" was the extent of the furore caused by the recent revisions in the federal estate tax. Less than 5% of Canadian taxpayers are affected by death taxes, and even for many of this select group, the beneficial effects of the revisions (notably the full exemption of transfers to spouses) would seem at least as great as, if not greater than, their harmful effects. The particular problems of family businesses and farms, which received so much publicity at the time, were in fact only marginally affected by the changes, despite the rate increases, since most of the difficulties alluded to in the discussion already existed in the unreformed tax. Certainly in terms of their economic effects on the national well-being, the estate

[44] This paragraph summarizes some conclusions from the much lengthier discussion in my *Growth of Government Spending*, especially ch. 6 and 10, to which readers are referred if they find the argument hard to swallow. See also Economic Council of Canada, *Sixth Annual Review: Perspective 1975* (Ottawa: Queen's Printer, 1969), ch. 3.

[45] See Hinrichs, *op. cit* (in fn. 3); and Jorgen Lotz and Elliott R. Morss, "Measuring 'Tax Effort' in Developing Countries", *I.M.F. Staff Papers*, XIV (November 1967), 478-97, for some evidence bearing on this point.

[46] This term is taken from *Ontario Proposals for Tax Reform, op. cit.* (in fn. 43), 13.

[47] The traditional "tax limits" literature is summarized in Bird, *Growth of Government Spending*, ch. 6. For two particularly interesting recent discussions, see Carl S. Shoup, *Public Finance* (Chicago: Aldine, 1969), 497-8, and Amotz Morag, *On Taxes and Inflation* (New York: Random House, 1965), ch. 1.

tax changes were unimportant.[48] Much of the upset at the time was thus probably due more to the shock of recognition that we must all some time die—and pay taxes—than to any particular aspect of the actual changes made. In any event, the entire episode serves to illustrate the importance of fiscal psychology as well as economic fact in the design, presentation, and implementation of tax reforms.

That the government itself is not unaware of the importance of fiscal illusion in selling tax changes is suggested by the increase in personal exemptions proposed in the White Paper. In the rather laboured official paper defending the costly use of increased exemptions instead of the tax credit approach recommended by the Carter Report, the only argument not mentioned is what may well have been the decisive one—that exemptions *look* a lot bigger.[49] Similarly, some of the likely retreats on the form of capital gains tax proposed in the White Paper may fairly be said to reflect awareness of the costs of taxpayer irritation rather than technical or economic problems.[50]

Considerations such as these raise a whole range of issues on how people perceive the tax system and how their perception affects (or should affect) the tax reforms put forward. For instance, the Carter Report rejected the strong case for cumulative lifetime averaging,[51] and the White Paper rejected even the less drastic recommendations for extended averaging put forward by the Commission.[52] Various reasons were given for these positions, one of which was that taxpayers would find it hard to understand complicated averaging systems. To this comment, one can only ask: do taxpayers understand most of the things now appearing on tax returns? and does it matter whether they understand?

Space precludes further exploration of the important questions raised here about the significance in designing tax reforms of taking into account such intangibles as tax tension, tax sensitivity, tax consciousness, tax awareness, tax visibility, tax illusion, and tax anesthesia—to use a string of words found in the scanty literature on the subject[53]—but it is important to be clear what the issues are. Are people aware of the cost of government? Will they be less willing to "buy" more public services when the tax price to them is, if not raised, then made more obvious? Is there some threshold of tax sensibility? Are hidden taxes, such as the present federal sales tax, undemocratic? Are they necessary anyway? In short, is greater taxpayer awareness a positive good, as the Carter Commission argued,[54] or irrelevant or even harmful, as others would have it?[55] These are basic poli-

[48] In part, what the discussion may have reflected is that many Canadians have a dynastic conception of the family. They do not agree with the traditional wealth-redistributing objective of a separate death tax—which has long been the tax thought to have less economically adverse effects than any other feasible tax. A similar lack of interest in the alleged egalitarian objectives of this fiscal instrument is reflected in the many current suggestions that bequests out of capital gains should not be subject to death tax.

[49] See Department of Finance *News Release*, No. 70-28. For effective critiques of the official position, see Bossons, "The Impact of Tax Rates," *op. cit.* (in fn. 26), 31-3, and T. R. Robinson, "The Treatment of Dependants under the Personal Income Tax", *Canadian Tax Journal,* XVIII, 1 (January-February 1970), 44-7.

[50] Examples may be the treatment of capital gains at death and on owner-occupied houses.

[51] *Report,* III, ch. 13.

[52] White Paper, para. 2.55.

[53] An interesting brief discussion of some of these issues may be found in Shoup, *Public Finance,* 37. See also James M. Buchanan, *Public Finance in Democratic Process* (Chapel Hill, N.C.: University of North Carolina Press, 1967), ch. 10; Carl S. Shoup, "Tax Tension and the British Fiscal System", *National Tax Journal,* XIV (March 1961), 1-40: Robin Barlow, Harvey E. Brazer and James N. Morgan, *Economic Behavior of the Affluent* (Washington, D.C.: The Brookings Institution), ch. 11.

[54] *Report,* V, 36.

[55] A. Kenneth Eaton, in *Essays in Taxation* (Toronto: Canadian Tax Foundation, 1966), 88, argues that the open or hidden nature of taxes is irrelevant, while Morag, in *On Taxes and Inflation,* 116-17, suggests that hidden taxes are better on both psychological and economic grounds.

tical issues, which can presumably be resolved only through the political process.[56]

The point I want to make here is simply that these intangibles matter in designing, appraising, and implementing tax reforms, and that they are likely to matter still more in the future because the weight of taxes in the national income is almost certain to continue to increase. As Amotz Morag put it, "an important factor in the realities of the limits of taxation are the psychic costs of paying tax, costs which politicians will carefully heed because they are clearly relevant to the prospects of re-election. Economists should heed them too."[57]—especially, I would suggest, when it comes to designing a tax reform.

These intangible constraints to increasing income tax rates might be expected to become more important as the rates applicable to the bulk of the taxpaying population rise, as they must to cope with the increased expenditures that I have argued lie in our future. There may soon come a point at which the side effects on taxpayer attitudes of increased tax rates may come to outweigh in political importance the need for increased revenues, at least so long as major reliance is still placed on an income tax of our present type.[57a] By alleviating some of the grosser inequities of the present income tax, the White Paper reforms should relieve some of the current tax tension and hence postpone any such day of reckoning, but the rising needs of public-sector finances suggest that the postponement may not be for too long.

### Scandinavian Parallels

One way to take a look at the future is to consider a situation in which what may well be our future is already past. The usual Canadian practice in this regard is to look southward. I have instead chosen to look eastward (though not too far!) to Scandinavia, for, as many distinguished American commentators have correctly assured us in recent years, our tax reform discussion (if not yet practice) is already far ahead of that in the United States. I am well aware of the hazards of international tax comparisons, that favourite refuge of knaves and fools in tax reforms discussions. Recent trends in Scandinavia, however, are so interesting, and, to my mind, so illuminating, as to encourage me to venture these few remarks regardless of the company in which I may inadvertently find myself as a result.

• • •

There are thus at least four interesting characteristics of the Norwegian tax system as compared to the Canadian: (1) the higher level of taxes relative to GNP; (2) the higher level of income taxes relative to GNP;[59] (3) the much greater importance of benefit taxes;

[56] A related argument which I cannot discuss at length here is Bossons's contention in "The Impact of Tax Rates", *op. cit.* (in fn. 26), 49, that an advantage of a *comprehensive* inflation adjustment mechanism in the tax structure would be to improve the rationality of political decisions by making the trade-off between costs and benefits more explicit.

It seems unlikely that differences in people's knowledge of taxes will have much effect on the rationality of government expenditures. In any event, as will become clear from the subsequent discussion, much the same objective can perhaps be achieved less painfully by separating the basic proportional (income and consumption) tax rates from the steeply progressive (income and net wealth) tax rates. The latter, I agree, should ideally be "inflation-proofed", for example, as suggested by Bossons, in *ibid.*, 48-9, or by John Helliwell, in "Inflation and Tax Reform", *Canadian Tax Journal*, XVIII, 2 (March-April 1970), 129-30.

A simple shift to an inflation adjustment in the mass income tax as proposed by these authors might well precipitate the shift to consumption taxes predicted below by removing the element of illusion which has heretofore made increased income tax yields politically feasible. It is thus an open question whether the Canadian electorate is sophisticated enough to stand open taxation at the effective rates we are now paying, let alone those which will be levied in a few years.

[57] Morag. *op. cit.* (in fn. 47), 21.

[57a] For some justification of the view that the public sector is as likely to be "too little" as "too big" relative to the true (and unknowable) desire of citizens, see text at note 95 below.

[59] It should be noted that the "income" tax in Norway includes a progressive net wealth tax at rates of up to nearly 2%. Municipalities are financed mainly through substantial proportional income and net wealth taxes. Sweden's direct tax system has similar characteristics.

and (4) the shift to indirect taxes. I suggest that these features are closely related and that the Canadian tax structure may well tend to alter to a similar pattern as the level of total taxes relative to GNP continues to rise.

• • •

It may be noted parenthetically that two recent authors interpreted the Carter Report itself as having recognized the essentially transitory perfection of its reform program.

> Twentieth century Swedish tax developments may, indeed, show more similarity to the Carter pattern than difference. The progressive income tax is the tax to be preferred (Sweden since the early years of the century). When income tax rates cannot be increased further to meet rising needs for revenue, so that a general sales tax must also be used, the retail sales tax is to be preferred as the best form of sales tax — so long as rates remain moderate (Sweden, 1960 to 1968). At high rates, the value-added tax may be a better form of sales tax.[62]

Although this quotation in part appears to misinterpret the Carter Report (where the declining importance of the sales tax in the tax mix is clearly seen as desirable), it accords with my own views on the probable future pattern of events.

At present, while the personal income tax has become increasingly important in Canada in recent years, is still has some distance to go to reach the level and importance of its Scandinavian counterparts. The White Paper would move it closer to their level, and, indeed, well beyond in such key respects as the degree of integration and the taxation of capital gains.[63] These reforms are thus, on the whole, not only commendable as improving horizontal equity and neutrality, but also necessary to bring the present Canadian tax system, which as we have seen still relies heavily on largely regressive consumption and wealth taxes,[64] up to a reputable standard—at least according to my values, which are more or less the same as the Carter Commission's.

Suggestions that Canada should consider adopting a heavy national value-added tax *right now* thus seem to me to be quite misconceived: what we need *now* is the better income tax proposed in the White Paper.[65] Nevertheless, in a slightly longer run I believe the shape of the Canadian tax system may well come more to resemble that of Sweden today than the vision of the ideal overriding all-encompassing personal tax on income that shines through the pages of the Carter Report —if not so clearly in the more pragmatic White Paper. I shall now offer a few reasons for this conclusion.

### The Coming Shift to Indirect Taxes

The pressures for rising government expenditure mean that the pressure on the tax system will increase too. In this connection the Scandinavian experience is particularly

[62] [Martin Norr and Niles G. Hornhammar, "The Value-Added Tax in Sweden", *Columbia Law Review*, LXX (March 1970), 391.]

[63] It should be remembered, however, that Sweden and Norway have substantial net wealth taxes which somewhat offset their considerably more lenient treatment of capital gains (especially in Norway).

Incidentally, the White Paper is seriously deficient in not proposing to tax *all* accrued gains at death: in addition to the obvious inequity of this treatment, it has long been known that precisely this failing is the major reason for the marked "lock-in" effect of the U.S. tax (see, for example, Charles C. Holt and John P. Shelton, "The Lock-in Effect of the Capital Gains Tax", *National Tax Journal*, XV (December 1962), 337-52). Carry-over of basis is a completely unsatisfactory alternative whose economic effects are adverse in every relevant way: see Martin David, *Alternative Approaches to Capital Gains Taxation* (Washington: The Brookings Institution, 1968), ch. 7.

[64] The regressivity of these taxes is depicted in W. Irwin Gillespie, *The Incidence of Taxes and Public Expenditures in The Canadian Economy*, Studies of the Royal Commission on Taxation, Number 2 (Ottawa: Queen's Printer, 1966).

[65] The balance-of-payments reasons often alleged to urge the substitution of a value-added tax for the income tax are particularly specious. A brief summary of the case for and against this tax substitution may be found in an editorial in the *Globe and Mail* of 30 December 1969, and my letter in response (*ibid.*, 2 January 1970).

suggestive, for it reflects the reaction of what are generally considered to be progressive social democratic states (although Norway in the last few years has been governed by a non-socialist coalition) to similar pressures. The marginal and average tax rates in Sweden and Norway, for example, are among the highest in the world on earned incomes at most levels,[66] except for the very highest incomes, on which the United Kingdom takes the lead in terms of effective rates and Canada and (until its recent reform) the United States are higher in terms of nominal marginal rates. But Swedes and Norwegians with incomes of $5,000 to $20,000 probably pay about the highest marginal and effective income tax rates in the world. As money incomes have increased fourfold in the last twenty years, the highly progressive rate structure (which includes an average 20% proportional local income tax) came to bear more and more heavily on more and more Swedes. The result of this increased tax pressure is that *no* participant in the current tax reform discussion in Sweden, whether on the left or the right of the political spectrum, proposed any alternative to heavier reliance on indirect taxes: there was unanimity that income taxes had gone as high as they could.[67] The reasoning behind the recent Norwegian reform appears to have been very similar.[68]

I suggest that a situation much like the current one in Scandinavia may well emerge in Canada after, say, the mid-1970s, once a tax system more or less along White Paper lines has been introduced and has been in operation for a few years. Because the tax base proposed in the White Paper is (quite correctly) more comprehensive than that in Scandinavia, the marginal rates of income tax should remain somewhat lower here and hence be more bearable. Nevertheless, the resistance to increasing tax rates on this broader base can be expected to be fierce.[69]

Most taxes in all economically developed countries are in fact paid by ordinary salaried employees and wage-earners. In Canada, for example, 74% of income tax in 1966 was paid by the 3.4 million taxpayers with reported incomes of between $4,000 and $25,000; only 5% came from those with reported incomes of $50,000 or more.[70] A very rough estimate is that the same income groups are also the source of about three-fourths of *all* tax revenues.[71] No conceivable changes in income distribution or tax policy seem likely to alter this central fact in the next few decades.

The long-run tax policy problem from the administrative point of view is thus how best to extract the needed sum from this mass of income recipients without unduly adverse effects. I am simply suggesting that, after some point, sales taxes probably become a more acceptable technique of extraction than further increases in income taxes and that, if the White Paper proposals are adopted—as

[66] See Richard Musgrave, *Fiscal Systems* (New Haven and London: Yale University Press, 1969), 180-8; Lee Soltow, "Norwegian and United States Tax Rates and the Distribution of Income", *National Tax Journal*, XVI (June 1963), 200-5. It is, of course, true that the lack of effective taxation of long-term capital gains enables many wealthy people to escape these high rates to a large extent.

[67] See Norr and Hornhammar, *op. cit.* (in fn. [62]), 382-7.

[68] ". . . The Ministry considers it highly desirable to reduce the amount of direct income taxation. This tax form seems now to be excessively utilized, considering its inevitable drawbacks. Important advantages would be attained by a reduction of the marginal rate of taxation over a broad range of the income scale" (Ministry of Finance, "The Norwegian Government's Proposal for a Reform of the Tax System as from 1st January 1970" (mimeo., 1969), 16).

[69] A sympathetic interpretation of the Carter Report's concern with the desirability for incentive reasons of a maximum 50% tax rate, in the face of all the evidence suggesting that even higher rates have no noticeably adverse effect on incentives (see, for example, Barlow *et al.*, *op. cit.* (in fn. 53), might be that it is one thing to have a marginal tax rate of, say, 80% with loopholes, and quite another to have the same rate without the loopholes. In terms of tax pressure, 50% on a comprehensive base may be equivalent to 80% on the present porous base.

[70] Department of National Revenue, *Taxation Statistics 1968 Edition* (Ottawa, 1968), 10.

[71] Based on data in *ibid.*, and in Gillespie, *op. cit.* (in fn. [64]).

they should be, in general, on their merits—Canada may reach that point fairly soon.[71a]

I hasten to add several important qualifications in order to reduce the inevitable misinterpretation and, I hope, to discourage those who might construe these remarks as an attack on the White Paper. First, I am not saying we should increase indirect taxes *instead of* adopting the White Paper, but just that we will probably have to do so at some not-too-distant date after the White Paper (or something close to it) is adopted. The reason for this conclusion is twofold: I expect government expenditures to continue to rise as a proportion of GNP; and I expect political resistance, reflecting real taxpayer irritation, to preclude further expansion in revenues from income taxes beyond those already embodied (as many others have pointed out) in the original White Paper proposals.[72]

In the second place, I am definitely not suggesting that we should reduce taxes on the rich, or even necessarily on business. Indeed, I sincerely hope that the wealthy as a group will pay more under the White Paper tax system than they now do. The Swedes, for example, kept the high income tax rates in the upper brackets and intend to lower them only in the lower and middle brackets. Although their taxation of capital gains leaves much to be desired, they also have a progressive net wealth tax—a device I would like to see considered more seriously in Canada, perhaps as a partial replacement for the onerous and inequitable real property tax.[73] But this is simply not where the money is.

Third, I am also assuming that techniques of sales taxation will continue to improve so that a broad-based consumption tax at the retail level (preferably including some services) will be administratively feasible, as, indeed, experience in most of Canada suggests it now is.[74] Whether this tax is collected by the value-added technique or not is a minor point. (The level of government that would levy the higher sales tax is not a minor point, but it is not one that can be discussed here.)

---

[71a] To some extent an important question is being begged here in that I am *assuming* government spending will, and probably should, rise anyway: see the comments elsewhere in the paper on this question and on the virtues and vices of "tax consciousness" in the modern context.

[72] Apart from the White Paper itself, the most interesting documents on the revenue controversy are perhaps Dobell and Wilson, "The Effects of the White Paper", *op. cit.* (in fn. 16), and Ontario Studies in Tax Reform, I, *Analysis of the Federal Tax Reform Proposals* (Department of Treasury and Economics, Toronto, 1970). See also fn. 56 above.

[73] The Swedes kept the high income tax rates in the upper income brackets—indeed even higher ones have been proposed for social, not revenue, reasons—but propose to lower them in the lower and middle brackets. (Norr and Hornhammar, *op. cit.* (in fn. [62]), 387, n. 40). The Norwegians, however, lowered the corporate tax as part of their tax reforms by removing the tax on corporate capital and allowing corporations to deduct dividends paid from corporate income before subjecting it to tax (an alternative method of integrating personal and corporate taxes to that proposed in the White Paper). The distributive effects of these measures are supposed to be offset by taxing the value of shares held by individuals under the net wealth tax (Norges Bank, *Economic Bulletin*, XXXX (1969), 59). In view of the apparent confusion on this point in the minds of many, it perhaps deserves reiteration that *nowhere* in Europe or elsewhere have these increased sales taxes, value-added or not, replaced corporate income taxes.

Incidentally, in my opinion the tax most needing reform in Canada is the municipal real property tax, which might, for instance, be reduced to a tax on land values, with a lower benefit-based tax on improvements, while the total tax burden on capital is maintained by the introduction of a progressive net wealth tax. Further elaboration of these ideas, however, would take us too far astray from our main theme.

[74] Nine provinces now have retail sales taxes. While it is premature to discuss the form of a revised national sales tax at this time, I must confess that my previous conviction, which I shared with the Royal Commission (see *Report*, V, and my *Sales Taxes and the Carter Report*), that the best form of sales tax is a retail tax, has been shaken by the recent careful discussions of the Swedish and Danish reasons for changing to value-added taxes in Norr and Hornhammar, *op. cit.* (in fn. [62]), 388-97, and [Carl S. Shoup, "Experience with the Value-Added Tax in Denmark, and Prospects in Sweden", *Finanzarchiv* (N.F.) Band 28, Heft 2 (March 1969), 236-52)]. It now appears that with a tax at rates of close to 20%, which is what we will likely contemplate in the mid-1970s, there is much to be said for the value-added form of collecting sales tax (as, indeed, the Carter Report, V, 50, noted). Long before then, however, the many anomalies in the federal manufacturer's sales tax should be cleaned up along the lines proposed by the Royal Commission, in vol. V.

Finally—and most important—I am assuming that we shall by the mid-1970s have introduced a decently comprehensive social welfare system—whether it be called a "negative income tax" or something else — so that the undoubtedly regressive effects of increased consumption taxes can be readily offset by altering transfer payments, either by way of credits against positive tax, as suggested by the Carter Commission[75] and the Ontario Government,[76] or directly, as was done in Sweden and Norway.[77]

I would particularly stress this last condition as essential in Canada as compared to the Scandinavian countries, because of our even less equal income distribution and the less homogeneous nature of our society.[78] Without a more effective social policy to reduce poverty and improve the welfare system, although the pressure of rising expenditure may still force us to rely much more heavily on indirect taxes in the future than we do now (and more than many now seem to believe we will), I could not personally contemplate such a shift with equanimity.[79]

The significance of any shift to indirect taxes, if I turn out to be a good prophet, should not be overstressed, however. As already pointed out, what is involved is more a shift in the technique of collecting taxes from most taxpayers than a change in the substance of the tax system.[80] Furthermore, the net effect of increases in indirect taxes can be made more "direct" (that is, personal and progressive) by being coupled with a more effective transfer system and supplemented by a more comprehensive income tax (or a net wealth tax), and this should certainly be done. On the other hand, direct taxes have, over time, become more and more "indirect" (that is, relatively unseen and unfelt by the taxpayer) in Canada, as in all countries with a mass income tax, owing to the increased importance of tax withholding at source, which now accounts for over three-quarters

75 *Report*, II, 29.

76 "The Reform of Taxation and Government Structure in Ontario", Budget Paper B, 1969, reprinted in *Ontario's Proposals for Fiscal Policy Co-ordination in Canada* (Department of Treasury and Economics, Toronto, 1970), 59.

77 Several schemes which could readily serve as a basis for such offsetting transfers are discussed in Colin J. Hindle, "Negative Income Taxes and Poverty in Ontario", paper presented to the Fourth Annual Meeting of the Canadian Economics Association, Winnipeg, 4 June 1970.

78 See, for example, the data on income distribution in Sweden, Norway, and Denmark, in Simon Kuznets, *Modern Economic Growth* (New Haven and London: Yale University Press, 1966), 209-11: also Soltow, *op. cit.* (in fn. 66); and Jenny R. Poduluk, *Incomes of Canadians* (Ottawa: D.B.S., 1968), especially ch. 11.

The lack of homogeneity in Canada has been illustrated recently by the strong attacks on some tax proposals by geographically distinct producers' groups—for example, the wheat farmers against the estate tax in 1968 and the mining interests against the White Paper in 1970. As Anthony Downs pointed out, "men are more likely to exert political influence in their roles as income-receivers than in their roles as income spenders, whether acting as private citizens or as members of a corporate entity." (*An Economic Theory of Democracy* (New York: Harper & Row, 1957), 255.) As Douglas Hartle and I have argued elsewhere, geographical distinctiveness fosters the formation of such attitudes: "Criteria for the Design of Governmental Decision-Making Units", Working Paper 6905, Institute for the Quantitative Analysis of Social and Economic Policy, University of Toronto (multilith; 1969).

79 This is not to deny that there is a reputable theoretical case for taxing consumption as well as income (see, for example, the paper by Hirofumi Shibata, in Canadian Tax Foundation, *Report of Proceedings of the Twentieth Tax Conference* (Toronto, 1968), 325-31). But it is difficult to personalize consumption taxes adequately to satisfy our sense of justice, so heavier reliance on them can, I believe, be supported only in the context of a tax system with a heavy (White Paper?) personal income tax and a well-functioning (guaranteed annual income?) universal transfer system. See, however, the case for more benefit taxation in the next section.

80 In a broad sense, of course, the tax base of all general taxes, properly defined, can be readily shown to be equivalent (at least in a closed economy): see, for example, Shoup, *Public Finance*, ch. 9. But I am going further than this and saying that since most of the income above subsistence ("taxable capacity", the "economic surplus", or whatever one wishes to call it) is in fact in the hands of a certain large group (say, those with from $4,000 to $25,000 in money income), any tax with a large yield will necessarily be paid mainly by this group. Those below this level should not, in common decency, be expected to pay much, and those above it, while they should certainly pay, do not in aggregate account for sufficient income to pay much in total.

of all income tax collected.[81] The psychological pain of paying income taxes could be further reduced, and hence higher income tax rates presumably made more politically feasible, by the adoption of some variant of the British technique of cumulative withholding, which would probably have to be accompanied by a system of administrative assessment of tax liability.[82] As a result of these devices, the British taxpayer usually does not know at exactly what rate he is paying tax, but very few taxpayers have any additional tax payment to make at the end of the fiscal year.

I would suggest that further improvement in such administrative devices as withholding deserves close study in Canada. They would reduce the pain of paying tax, which is a real cost not to be neglected simply because it cannot be measured. These administrative changes would also remove a principal barrier to the introduction of conceptually desirable—and "fair"!—schemes such as cumulative lifetime averaging, whose essentially superficial complexities have long stood in the way of the dramatic tax simplification that could result from removing the troublesome time-period problems in the income tax.[83]

Which is more desirable, a system that people can understand even if it is in fact unfair, or a system that is fair even if people cannot understand it? The fundamental political question is, of course, whether it is better to be more fully aware of the costs than of the benefits of government activity, which I have suggested is coming to be our present situation, or whether it is better also to reduce our awareness of the costs. Which path will better achieve social goals and satisfy individual preferences? There can be no certain answer to this question.

**The Case for Benefit Taxation**

A second distinctive feature of the Scandinavian tax systems is their heavy reliance on benefit taxes in the form of various social security contributions. Even ten years ago, all the major European countries relied more heavily on such special taxes than Canada.[84] This difference has grown over the years, as suggested by the Norwegian figures cited earlier. . . . Whatever the international facts, however, I suggest that we are probably soon going to see a revival of benefit taxation in Canada, if only as one way of alleviating the increasing political pressure likely to result if my prognosis of higher future revenue needs is correct.

The principal current instance of benefit-tax financing of government in Canada appears to be the substantial provincial fuel and motor vehicle taxes, which are generally related to provincial expenditures on highways. This system of benefit taxation could be substantially improved to charge more of road costs to users by taking better account

[81] Department of National Revenue, *Twenty-One Million Dollars a Day* (Ottawa: Queen's Printer, 1966), 11.

[82] See Alan P. Murray, "A Proposal for Cumulative Withholding", *National Tax Journal*, XV (June 1962), 184-93. A somewhat similar suggestion is made in the 1969 Ontario staff papers cited in fn. 76 above.

[83] The *locus classicus* for cumulative averaging is William Vickrey, *Agenda for Progressive Taxation* (New York: Ronald Press, 1947), ch. 6.

A move away from self-assessment and towards more accurate withholding and more adequate averaging would increase the apparent cost of tax administration and probably also the compliance burden for intermediaries with respect to personal taxes. Whether the *total* cost of complying with tax law would be increased is a moot question. These costs would have to be weighed against the potential resolution of the problem of tax postponement and the reduction in taxpayer irritation. (Incidentally, the White Paper averaging scheme is so minor as to be useless, especially since it adjusts only for increases in income, when it is in fact for decreases that the strongest rationale for adjustment can be made.)

[84] See Musgrave, *op. cit.* (in fn. 66), 170. The same source also defends the practice I have adopted of taking social security taxes into account in international comparisons. See also Vito Tanzi, "Tax Systems and Balance of Payments: An Alternative Analysis", *National Tax Journal*, XX (March 1967), 39-44: and Claude E. Forget, *International Tax Comparisons*, Studies of the Royal Commission on Taxation, Number 14 (Ottawa: Queen's Printer, 1967), ch. 4.

of knowledge gained recently on the connection between road expenditures and individual benefits received by motor vehicle users (for example, by changing the emphasis of the system from reliance on fuel taxes to greater reliance on motor vehicle taxes and by making more use of toll expressways as well as land-value improvement taxes[85]), but it is fundamentally correct in economic logic and well accepted by the public.

Another important example of benefit taxation is that portion of the property tax that goes to finance those services of local government that can be related in a direct and fairly measurable way to individual buildings or their inhabitants. The principal examples of such services are fire and police protection, street cleaning, garbage removal, and the like. The great bulk of the property tax in most areas goes to finance elementary and secondary education, however, and this allocation generally cannot be justified on benefit grounds.[86] The increasingly costly financing of post-secondary education, where the private gain reaped by the recipients of the education is substantial and measurable, provides, however, a field in which application of the benefit principle is worth further investigation.[87] Much the same might be said of certain of the rapidly growing expenditures in the health field, and more generally of urban investment expenditures (for example, in transport systems) that increase land values and should, according to economic reasoning, be financed much more heavily than they now are by those whose wealth is directly increased as a result of the investment.[88] Other instances where more use of benefit-financing might be suitable can be found even at the federal level (for example, airport user charges), but the most profitable field for further exploration of the technique of relating taxes to the expenditures they finance is clearly at the provincial and municipal level —which is also where taxes have been increasing most rapidly in recent years.

In short, the increasing demands on the revenue structure due to recent and prospective expenditure growth suggest that it is time to examine carefully the feasibility of financing expenditures, to the extent possible, through benefit-related taxation.[89] Not only does there appear to be much more scope in practice for benefit financing than the Carter Report recognized,[90] but, equally important, the case for the benefit principle in public

85 See A. A. Walters, “The Economics of Road User Charges” (Report No. EC-158, Economics Department, International Bank for Reconstruction and Development, January 1968), for an elaboration of this argument; also M. Q. Dalvi, “Highway Costs and Expenditures in Canada”, *Canadian Journal of Economics*, II (November 1969), 509-25.

86 The reasons why the property tax is an unsuitable means of financing education, except perhaps in homogeneous “dormitory” suburbs, are explained in Bird, “Taxes and Tax Reform in Canada”, Policy Paper Number 5, Institute for the Quantitative Analysis of Social and Economic Policy, University of Toronto (multilith, 1969), 15-18: see also Douglas G. Hartle, “Financing Education: The Major Alternatives”, Policy Paper Number 4, Institute for the Quantitative Analysis of Social and Economic Policy, University of Toronto (multilith; 1968).

87 See, for example, Karl Shell *et al.*, “The Educational Opportunity Bank: An Economic Analysis of Contingent Repayment Loan Program for Higher Education”, *National Tax Journal*, XXI (March 1968), 2-45; and Gall C. A. Cook and David A. A. Stager, *Student Financial Assistance Programs* (Toronto: Institute for the Quantitative Analysis of Social and Economic Policy, 1969).

88 See W. G. Rhoads and R. M. Bird, “Financing Urbanization in Developing Countries by Benefit Taxation”, *Land Economics*, XLII (November 1967), 403-12.

89 A similar argument may be found in Bossons, “The Objectives of Taxation”, *op. cit.* (in fn. 22), 145-6. The present earmarking of portions of the income and sales taxes for social security programs cannot be classed as benefit taxes in the sense discussed here, as is suggested by the fact that the White Paper proposes to include both the old age and social development taxes in the regular income tax structure.

90 “A careful examination of the goods and services provided by government or government enterprises does not suggest that greater emphasis should be placed on the benefit approach in Canadian taxation.” (*Report,* III, 3.)

finance theory is much stronger than the Commission were prepared to admit.[91] In fact, the benefit principle, it is fair to say, stands up much better under close analysis than the ability-to-pay principle with its assumption that the volume of public goods supplied is completely independent of the tax structure. The "benefit principle" in a sense thus stands at the core of modern fiscal economics as the essential link between taxation and expenditures.[92] The traditional arguments on the undesirable redistributive effects of benefit taxes simply miss the point that the transfer process is a quite separate question from that of the financing of public services and placing the allocatively proper "price" (opportunity cost) on using resources for public purposes.

The reason for the common acceptance by theorists of the primacy of some version of the ability-to-pay principle is either pragmatic—as in Lindahl's proposal of a proportional income tax as a practical approach to benefit taxation[93] (to be coupled with a severely progressive tax for redistributive purposes[94])—or cynical, as in the traditional view that the more progressive the tax system, the greater public expenditure would be in a democratic country with an unequal income distribution. The assumption here, of course, is that the majority poor are voters but not taxpayers. These days, however, when most voters pay taxes and are well aware of the fact, the opposite case may be made, that taxpayer resistance has "starved" the public sector relative to private affluence. As the previous argument suggests, I am in some sympathy with the relevance of the latter view for the future, if not so much for the past. Galbraith in *The Affluent Society* was thus right, but twenty years too early for Canada—and perhaps even more for the United States with its even less well developed welfare system.[95]

The relatively strong theoretical case for a new look at the merits of benefit taxes does not, I repeat, mean that the present income distribution is inviolable. Nor does it mean that more effective redistributive measures, such as that entailed in the taxation of capital gains, are not desirable. They are. Nevertheless, the time will soon be here when those interested in fiscal affairs—which in this day of mass taxpaying means all of us—will be forced to rethink some of the oldest arguments in fiscal economics. I hazard the guess

---

[91] Some commentators on the report recognized this weakness: see R. A. Musgrave, "The Carter Commission Report", *Canadian Journal of Economics*, Supplement No. 1 (February 1968), 161; and, especially, Albert Breton, "Some Problems of Major Tax Reforms", *National Tax Journal*, XXII (March 1969), 154-63, though I do not agree with Breton's unhelpful conclusion (p. 158) that expenditures and taxes cannot usefully be treated separately—they can, and must be for many purposes. His central criticism is correct, however: neither equity nor neutrality in budget operations can be achieved by altering the tax side alone.

[92] See R. A. Musgrave, *The Theory of Public Finance* (New York: McGraw-Hill, 1959), Part I.

[93] On the ground that incomes rather than tastes are likely to be the major determinant of the money value of the marginal utility of public goods (J. G. Head, "Lindahl's Theory of the Budget", *Finanzarchiv* (N.F.) Band 23, Heft 3 (October 1964), 436-7, 451-3). A system of taxes imposed on moderate "ability" principles may thus be the best feasible approximation to the benefit tax ideal for externality-intensive goods. Breton, *op. cit.* (in fn. 91), 161, extends a similar point to say that if tastes are identical and if the income-elasticity of public goods is greater than unity, a progressive income tax might approximate to benefit neutrality.

Interestingly, the existence of both a significant proportional local income tax and a severely progressive national tax in Norway and Sweden—home of the greatest benefit theorists (Wicksell and Lindahl)—might perhaps be taken to provide a practical example of this part of the Lindahl system.

[94] The redistribution that concerned Lindahl was aimed at a more equal income distribution, whereas I would argue that most redistributive policies in Canada have been intended rather to put a floor under the income distribution—that is, to make the poor richer rather than the rich poorer (see my "Equity and Taxes in the Carter Report", *Report of Proceedings of the Twentieth Tax Conference* (Toronto: Canadian Tax Foundation, 1968), 257-8). The aim of Canadian redistributive policy is thus mainly humanitarian rather than egalitarian. If so, the case for steep progression (and heavy taxes on gratuitous transfers) is weaker here.

[95] J. K. Galbraith, *The Affluent Society* (London: Hamish Hamilton, 1958), ch. 18, is probably the best known exponent of the argument that more use should be made of sales taxes to finance public-sector expansion. See also Head, "Lindahl's Theory of the Budget", *op. cit.* (in fn. 93), 453.

that the outcome of such deliberations will be a much better opinion of the merits of benefit taxation both in the large (Lindahl's proportional income tax) and in the small (Wicksell's flexible burden-sharing arrangements) than we now hold. The economic, political, and psychological case for increased benefit taxation is thus, in my opinion, growing stronger every day.[96] It deserves a better press and much more careful exploration than it has received to date.[97]

## International Influences on National Tax Structures

One final theme needs to be touched on in this already long catalogue of the many questions on tax reform which neither the White Paper nor the Carter Report asks or answers. Earlier I have made considerable play of some recent developments in Scandinavian tax structure and have suggested that we may perhaps there discern the future path of Canadian tax structure, essentially because much the same pressures are at work in both societies and the White Paper will, quite correctly, accentuate rather than alleviate these particular pressures. This use of parallels from abroad suggests three reasons for the convergence of tax structures which I think one can discern today in the western world: (1) increased international flows of information, (2) increased flows of factors and products, and (3) the reaping in all developed countries of the full effects of the great ideological shift in the perceived social role of the State that has taken place during the twentieth century. The third of these reasons has already been commented on adequately for present purposes.[98]

The present paper itself perhaps affords an example of the influence of improved information flows. More concretely, it seems clear that one reason underlying recent tax changes has been not so much economic necessity as increased knowledge of how things are done elsewhere, and of the advantages and disadvantages of particular tax technologies. The rapid world-wide spread of the value-added tax, for example, is hard to understand except in part as an imitation of what has been observed elsewhere and (usually incorrectly) associated with some kind of "success".[99] More reputably, it seems clear that the structure of both sales taxes and income taxes in many countries has been becoming more similar, partly because of the improved international transmission of technical knowledge. Apparently successful innovations are soon imitated elsewhere, which is presumably one reason why American fiscal experts have been so enthusiastic about the prospect of Canada's adopting many of the more daring proposals in the Carter Report and the White Paper. Thus, for example, in the income tax field schedular income taxes have been replaced by global income taxes, and capital gains are now taxed almost everywhere.

---

96 Parenthetically, it should be noted that increased use of benefit taxes will heighten taxpayer awareness, thus offsetting to some extent the reduction in awareness that might well result from some of the earlier suggestions.

97 For an interesting example of recent political-economic analysis of the benefit principle, see Per Eklund, "Taxation and Earmarking in Developing Countries", International Bank for Reconstruction and Development, Economics Department Working Paper No. 43 (mimeo.: 1969).

98 It should be noted that I do *not* have a rigid "stage theory" idea of the development of public expenditures and revenues: for a critique of such theories, see my *Growth of Government Spending*, ch. 4. Further reflections on the role and possible influence of ideological change may be found in *ibid.*, ch. 5 and 7.

99 The replacement of defective sales tax structures, as in the European (and most Latin American) countries that have adopted the value-added tax, should be distinguished sharply from the specious reasoning often advanced with respect to replacing business income taxes (see fn. 65 above). It will have been noted, however, that I am sympathetic to an integrated personal and corporate income tax together with a proportional general sales tax *provided* there is (1) a good welfare system and (2) a progressive net wealth tax or some other effective wealth redistributor in the fiscal system. The narrower European reasoning on the merits of different sales tax forms is, of course, partially applicable to Canada in view of our important and archaic manufacturer's sales tax (see fn. 74 above).

The increasing contacts between tax administrators, scholars, and taxpayers' organizations have certainly contributed to the tendency toward more uniform tax structures, as have the similar pressures—to finance expanding expenditures and manage the internal and external balance of the economy, for instance —to which most advanced nations are now subject.[100] One would expect these information flows and similar pressures to be especially marked in countries in close geographical and economic proximity such as the EEC countries, Norway and Sweden, and Britain and Ireland.[101] The frequent reference to American precedent and experience in the current debate on tax reform suggests that the same holds true for the United States and Canada.[102]

A major problem in analyzing the extent to which these linkages are due simply to access to information is that those who make such comparisons tend to have an economic rationale for saying that whatever is done in country A *must* be done in country B, to avoid distorting (naturally in an unfavourable direction) trade and factor flows. Conversely, those who dislike such innovations as taxation of accrued capital gains frequently claim they are untenable because they are not used elsewhere and hence are unfamiliar to the international financial community.[103] It appears that the gnomes of Zurich, when not busy manipulating the international currency exchanges, spend their time viewing with disfavour proposals to tax capital more heavily.

There is now an extensive body of analysis on problems of policy harmonization between nations connected by trade or factor flows. It may be summed up, albeit inadequately, for present purposes as telling us that while tax and expenditure patterns (not levels) affect both trade flows and labour migration in various ways, mostly minor, the only serious problem arises with respect to capital flows.[104]

In view of the openness of the Canadian economy to international capital flows it may be argued, therefore, that we have lost some policy autonomy over the way in which we finance our government. For example, the Carter Commission proposed that the top rate of the personal income tax should be no higher than the corporate tax rate, in order to remove any incentive to retain earnings in the corporation just to avoid tax, and in order to facilitate the form of integration they proposed—which was itself apparently chosen in large part to avoid giving too much benefit to American investors.[105] Furthermore, the corporate rate itself was largely to be set by

[100] Similarity in the structure of particular taxes does not necessarily imply similarity in tax systems, of course, though I am inclined to think that systems too will tend to converge over time. See Carl S. Shoup, "Comparative Approaches to Tax Policy within the Major Countries", *Proceedings of the 50th Annual Conference of the National Tax Association* (Harrisburg, Pa., 1966), 409-16, on the convergence in tax structure. (The importance of contacts between state administrators in the United States in shaping policy has recently been stressed by Ira Sharkansky, in "Regionalism, Economic Status and the Public Policies of American States", *Social Science Quarterly*, XLIX (June 1968), 9-28.)

[101] An apparent linkage between the United Kingdom and Ireland with respect to public policies was noted by M. O'Donaghue and A. A. Tait, "The Growth of Public Revenue and Expenditure in Ireland", in *Economic Policy in Ireland* (Dublin: Institute of Public Administration, 1968), 281.

[102] White Paper, para. 2.41. For some preliminary discussion of U.S.-Canadian links on the expenditure side, see my *Growth of Government Spending*, ch. 3 and, especially, ch. 8 on defence spending.

[103] Frequent references to this "problem" may be found in the hearings of the Senate and House committees considering the White Paper—for example, Senate, *Proceedings of the Standing Senate Committee on Banking, Trade and Commerce*, Number 13, pp. 13-14 (Anglo American) and p. 75 (British Columbia Forest Industries).

[104] Such a capsule statement obviously cannot be very accurate. For a sampling of the large relevant literature, see the basic study edited by C. S. Shoup, *Fiscal Harmonization in Common Markets* (2 vol.; New York: Columbia University Press, 1967); and two recent studies issued by the Private Planning Association of Canada: H. G. Johnson *et al.*, *Harmonization of National Economic Policies under Free Trade* (Toronto: University of Toronto Press, 1968) and H. Shibata, *Fiscal Harmonization under Freer Trade: Principles and their Applications to a Canada-U.S. Free Trade Area* (Toronto: University of Toronto Press, 1969).

[105] *Report*, IV, 44.

that prevailing in the United States.[106] In short, the corporate rate, the form of integration between the corporate income tax and the personal income tax, and the top rate of the individual income tax schedule were all in a sense to be set by the American tax system, because of the Commission's (correct) assumption that there is in essence a unified capital market in North America. The reasoning underlying the White Paper seems very similar.[107] Others have analyzed such arguments with care and found them to have some validity.[108] I am in no position to dispute this conclusion, nor am I inclined to do so. But I would like to point out that to the extent that money, with or without individuals attached, moves fairly easily across international borders, the inter-country competition for capital and wealthy individuals will limit the ability of governments to enforce independent income distribution policies.[109]

The increasing economic interdependence of today's world thus limits the role of redistributive fiscal policy by forcing, or at least encouraging, the establishment of a "least common denominator" tax system. The least common denominator will prevail since it is capital and the higher-income individuals that are most readily able to flow away under increased tax pressure. As economic interdependence increases, whatever the realities of the need for international tax competitiveness,[110] the avenues of escape for the well-to-do will thus increase relatively more than for the characteristically less mobile poor. The growing importance of multi-national corporations, for example, makes it increasingly difficult for satellite countries such as Canada to finance public expenditures through independently taxing their profits. No single country can act as a "tax policeman" over the intricately complicated manipulations of transfer prices and investment decisions that are open to such corporations. Moreover, apart from these real administrative and economic problems, the well-to-do may be able to use the increased pressure arising from increased interdependence to support reductions in the progressivity of the tax system which they would, in their own interest, urge in any case. The innovator in tax policy thus faces peculiar difficulties in a world of internationally mobile capital, for some multi-national enterprises may retaliate against it, even at direct cost to themselves, in order to deter would-be imitators.[111]

There is thus a real danger that unless care is exercised, a more regressive budget system will gradually come into existence. If these dire forecasts have any validity at all, the results will presumably be more serious in Canada, a less homogeneous society with less adequate welfare policies, than it would be in the more egalitarian Scandinavian countries where evidence of similar favouritism shown to wealth is not hard to find. Even the Carter Report with its strong orientation toward the personal income tax reveals an acceptance of certain limitations on this account.[112]

Examples of similar reactions to such pressures may be found within the Canadian federation itself. The point referred to here, of course, is the possibility of a "tax war" between competing provincial jurisdictions,

106 *Ibid*, 5-6.

107 White Paper, para. 2.41, 4.35, 4.49-50.

108 See, for example, the two studies by Dobell and Wilson cited in fn. 16 and 17 above.

109 Cf. Shibata, *Fiscal Harmonization under Freer Trade*, 6, 22, 26, although he does not seem to notice that capital flows alone can reduce the degree of freedom each country enjoys in its redistributive fiscal policy.

110 And they are probably not great, as Forget (*op. cit.* in fn. 84) convincingly argues. Most arguments about international tax competitiveness appear, under analysis, to reflect either inappropriate exchange rates or inefficient industries, or both.

111 In some of the comments on the White Paper, in which the alleged U.S. unwillingness to revise the existing tax treaty is used as an argument for suppressing the tax on accrued gains or extending the benefits of integration to foreigners, one can perhaps descry a new version of the old ill of economic imperialism, in which the flag follows trade (or at least investment).

112 See also the comment in fn. 94 above, where it is argued that the thrust of Canadian fiscal policy has never been particularly egalitarian anyway.

in which each feels constrained in its ability to raise its taxes on its inhabitants or on the purchases of its inhabitants or, especially, on the business enterprises within its jurisdiction, for fear that some other province will attract away its industry, its customers, or, in the most drastic case, its inhabitants. Numerous studies have shown that this fear of losing industry and economic strength is greatly exaggerated.[113] But numerous studies have also shown that this fear is a very real influence in shaping tax policy at the provincial and local levels of government, with, for example, every local jurisdiction, often illegally, making special deals to attract industry into its own area.[114] The principal result of this competition has been a tendency to impose on mobile businesses a lowest common denominator tax system of precisely the sort discussed above in connection with increasing international interdependence.

If it were not for the existence of the overriding federal system, and the resultant financing of a good many provincial expenditures through the national income tax, it seems unlikely that some provinces would have any redistributive elements in their fiscal systems at all. The recent frantic scramblings of some western provinces to follow the uninspiring example of the State of Nevada in abolishing death taxes for all residents[115] and the recent suggestions of the Ontario Provincial Treasurer with respect to Ontario's losing industry if it is forced to raise its personal income taxes[116] indicate something of the strength of this fear. If there *is* a real possibility of industry leaping about the country in response to relatively minor tax differentials (and the evidence is against this belief), then it is better that the differentials be brought about by the raising of rates in the rich areas than by the lowering of tax rates in the poor areas. Under our present system, it is precisely the poorer provinces that are less well placed to compete for industry, partly because they have less to give away and partly because they can less afford to give anything away.

Although the subject requires further careful study, it is thus not at all clear that increased tax differentials of the right kind between provinces would necessarily be a bad thing.[117] The real problem is that without great care the development of more independent provincial revenue systems is likely to lead to even less acceptable distributions of the tax burden and distortions of industrial location than now prevail. The only way to avoid this outcome is through continued federal influence, as well as such new devices as intergovernmental tax commissions[118] and explicit agreements between governments on what devices are and are not legitimate in the competition for industry.[119]

A principal fiscal argument for a strong overriding national tax system is thus the presumed desirability of some redistribution,[120] although, as pointed out above, the national degree of freedom in this direction itself seems

[113] See John F. Due, "Studies of State-Local Influences on Location of Industry", *National Tax Journal*, XIV (June 1961), 163-73 for a review of U.S. literature, and Charles McLure, "Taxation, Substitution, and Industrial Location", *Journal of Political Economy*, 1969, for a careful theoretical exploration in the neoclassical framework of the locational impact of tax policy.

[114] See the study of New England towns reported in Federal Reserve Bank of Boston, *New England Business Review,* February 1968, 2-10. Although similar evidence has apparently not been documented in Canada, there is reason to believe the practices cited in this study are not unknown here. One interesting piece of evidence may be found in Royal Commission on Finance and Municipal Taxation (New Brunswick), *Report* (Fredericton, N.B., 1963), Appendix N.

[115] Toronto *Globe and Mail,* 15 May 1969, reported that each of Alberta, Saskatchewan, and Manitoba has either introduced or was considering at that time rebates to residents of the province's 75% of the federal estate tax.

[116] Province of Ontario, *1969 Budget* (Toronto, 1969).

[117] For apparently opposing views on this question see the papers given by Louis Bernard (Quebec) and Ian MacDonald (Ontario) at the Twenty-Second Tax Foundation Conference: *Proceedings,* 396-7, 401.

[118] As suggested by Quebec (see Bernard, *loc. cit.*, 396).

[119] An example of the resolution of very similar problems is afforded by some of the current discussion on pollution (see R. M. Bird and L. Waverman, "Some Fiscal Aspects of Controlling Industrial Water Pollution", to be published in a forthcoming book on pollution edited by D. A. L. Auld).

[120] A similar conclusion emerges from the very different analysis of the appropriate geographical dimensions of different public-sector activities in my *Growth of Government Spending*, ch. 9.

also to be increasingly limited by international considerations, whether legitimately or not. This limitation may well be more apparent than real, however, for, judging from our past actions, Canadians as a people have never really been much interested in reducing inequality just for the sake of reducing it. The purpose of our redistributive policy is not to make the rich poor or the poor rich but rather to prevent the grosser forms of poverty, and this can, indeed must, be done not by taxing the rich but by taxing the not-so-poor, which is how we really do it anyway.

## Conclusion

The lengthy and wide-ranging argument of this paper may now be summed up briefly. By my standards the Carter Report and more immediately the White Paper, viewed as a step toward Carter, should be implemented. No substantial adverse economic effects are to be expected as a result of such implementation, which I would expect to take place, quite properly, on the instalment plan over the next few years, with further changes in the family unit, the structure of the present federal sales tax, and tax administration. In a longer-range perspective, however, the reforms proposed in these documents are more properly considered the culmination of the old conventional wisdom than a pattern for the new tax changes that will, I believe, almost certainly be brought about in the next decade by the continuing upward pressure of public expenditures. I have suggested two possible directions for such future tax changes—toward more reliance on indirect taxes and more use of benefit taxes—and have tried to show that these shifts need not necessarily hamper the attainment of such traditional objectives of public policy as some redistribution. Finally, I have pointed out some apparent problems for redistributive fiscal policy as a result of economic interdependence and have suggested that what our reaction to these problems perhaps suggests is that we have never been much interested in being egalitarian anyway.

## A Postscript

Fiscal psychology may not be as intangible a subject as the preceding discussion would suggest. Vito Tanzi, in an interesting paper encountered after this essay was completed, has suggested that an "index of tax awareness" can be constructed by adding together the percentage of GNP taken by personal income taxes, property taxes, and excise duties.[121] It is hard to see why excise duties are included in this list.[122] On the other hand, as mentioned above, the "awareness quotient" of estate taxes seems to be high. If estate taxes are substituted for excise duties in Tanzi's index, then, using his data, Canada ranks sixth out of 16 countries, with an index of 11.6 compared to 18.3 for Sweden (the highest) and 2.2 for Greece (the lowest).

The six highest countries in terms of this index, ranked in order, are Sweden, Denmark, the United Kingdom, the United States, Norway, and Canada. This group makes an interesting contrast with a similar list of the six countries with the highest aggregate ratios of taxes to national income: Sweden, France, Norway, Austria, Germany, and Luxembourg (data, based on OECD statistics, from same source). The first list, rather than the second, contains those countries that appear to be considered by their inhabitants to be "high tax" countries, with a consequently high degree of internal discussion about taxes and open resentment of the tax "burden".

It may thus be possible to quantify, at least to some extent, the subjective burden of taxes. More refined efforts at quantification might take into account, for example, methods of tax collection (how much income tax is withheld at source? to what extent are sales taxes quoted separately to consumers?) and perhaps also the nature of expenditures (how much for defence? to what extent are taxes considered "benefit" payments for services?). Further work along these lines may prove rewarding.

121 Vito Tanzi, "International Tax Burdens: A Study of Tax Ratios in the OECD Countries", in: *Taxation: A Radical Approach* (London: Institute of Economic Affairs, 1970), 1-49.

122 Tanzi, in *ibid.*, 35, gives several reasons for this procedure, all of which seem to me to be wrong (and to be contradicted by, for example, Shoup, "Tax Tension and the British Fiscal System", *op. cit.* (in fn. 53). Interestingly, the main result of Tanzi's original formula would appear to be to increase the "awareness index" for the United Kingdom, a very heavy user of the traditional excises on tobacco and alcoholic beverages.