Tax Reform Options for Canada

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Foreword

The Eric John Hanson Memorial Lecture Series recognizes the many contributions made by Dr. Eric Hanson to the University of Alberta and to the wider community. Eric Hanson taught at the University of Alberta from the late 1940's to the mid 1970's. He was Head of the Department of Political Economy from 1957 to 1964, and was most instrumental in building a fine department. Many of us have benefitted from his dedicated efforts and his wisdom.

Today's inaugural lecture is the first in an annual series. It was prepared by Professor John Whalley of the University of Western Ontario, where he is Director of the Centre for the Study of International Economic Relations. John Whalley is one of Canada's most distinguished and creative economists. His topic is Tax Reform Options for Canada.

Given Eric Hanson's lifelong interest in the economics of the public sector, the subject of tax reform in Canada is a most fitting one for this first Memorial Lecture. It is also the most fundamental issue in public sector economics facing us today. I am both pleased and privileged to write this foreword to Professor Whalley's masterful overview of the tax reform issue.
The Eric John Hanson Memorial Lecture Series has been financed by matched endowment contributions from Eric's friends, colleagues and students. I am particularly grateful to the Alberta Municipal Financing Corporation, of which Eric was a member of the board of directors for many years, and especially to its President, Mr. Chip Collins, for a most generous contribution to the endowment fund.

Brian L. Scarfe
Department of Economics
February 10, 1987
The title of this lecture is Tax Reform Options for Canada. Anyone reading the newspapers over the last few months will know we are in the middle of a tax reform debate. I have to confess, however, that I feel uncomfortable talking about it in any great detail at this point, because until we actually know what the proposals are it is hard to be too concrete. The topic is certainly timely and I hope you find my remarks of some interest.

A. Background to the Current Reform Debate

We have a long history of tax reform in Canada with the Carter Commission an important landmark. The Carter Commission report was a truly historic document. It is usually remembered domestically as a document that provoked strong reaction at both political levels when it first appeared. Internationally it was hailed as a major achievement. The documents that came out at that time emphasized the slogan, "a dollar is a dollar is a dollar". All dollars should be taxed no matter where they come from. However, the tax system has evolved subsequently in many ways that are opposite to the direction suggested at the time.
More recently in the U.S. we have wit-nessed another tax reform episode over the last two years. It had dramatic twists and turns over the last three months of last year, where what seemed to be total inactivity and deadlock was suddenly transformed in the congres-sional committees into some of the most sweeping tax changes ever introduced in the U.S.

Everybody would agree that this was a tax reform. Many people associate tax reform with some major new approach to tax policy. As I said in the context of the Carter Commission, the key slogan emerged and debate concentrated on the major new departure. A lot of academic literature in recent years has suggested that we should be thinking in terms of new departures in the tax code, such as a progressive consumption tax being used in place of the present income tax.

The current discussion of reform is very different. What is now underway in Canada is discussion of a group of tax changes that may or may not happen simultaneously. It is more than typically happens in a budget, probably much more. What we are looking at is a tax system that is continually in change, but where there is a coincidence in the timing of tax changes in a number of different fields.

In the corporate field the government released a discussion paper with the 1985 budget, which indicated the directions it was thinking of taking. That is one component of what is being discussed. In the sales tax area there has been ongoing discussion of reform for more than ten years. The government literature suggests there are really two-fold to the tax structure the revenue and the other level of taxation, elements of particular

We now have a deficit reduction around 25 percent of the government in deficit represents the current taxes do have to be paid to eventually represent the government in deficit that eventually the current taxes on some way to factor in the current taxes do have to be paid to the government in a budget, probably much more. What we are looking at is a tax system that is continually in change, but where there is a coincidence in the timing of tax changes in a number of different fields.

Second, if we are thinking of tax reform, philosophy for the perhaps talking of tax reform, perhaps talking of tax reform, perhaps talking of tax reform, perhaps talking of tax reform, perhaps talking of tax reform.
has indicated that it is looking at various options. Then there are various things that have been happening in the U.S., particularly with the rate reduction at a personal level, that are causing the government to start thinking about rate reduction at the personal level here in Canada. We are thus looking at a package of changes labelled as reform, but these changes are not part of a major new philosophical approach to the tax system, which one usually associates with reform.

B. Principles of Reform

There are a number of classic public finance considerations that underlie the design of any tax. These are perhaps a little remote from the practicalities of tax policy, but it is as well to keep these in mind as we proceed.

The first is the concept of economic efficiency. Most public finance economists who discuss design of tax policy typically suggest that the underlying focus should be one of trying to minimize the distortions within the economy created by taxes, while at the same time having the government meet its revenue requirement. There is a certain sum of money that you have to raise through taxes. There are a number of different ways this money can be raised. Inevitably, no matter how one raises the funds there will be distortions and effects on economic incentives. There are effects on decisions to supply labour through distortions of worker incentives, effects on savings behaviour through savings disincentives and other incentive effects. Economists generally suggest that we should move to tax systems that in some way minimize these dis-
tortions to economic activity. As a result, public finance economists usually suggest that one direction to take in reform is to look for mechanisms that broaden the tax base in order to get rates down and reduce distortions.

Second, there is the consideration of equity. Equity objectives can be multiple. One reflects the idea that we should design tax systems so that the burden of taxes, in some sense, is borne fairly. We have to make social judgments on equity when we collect taxes, and they should be fair.

There is also often discussion of the distinction between so-called vertical and horizontal equity. Horizontal equity is the idea that you should have equal tax treatment of equals. This is a little bit tautological, but it means that people with the same income should be equally treated even if they have different characteristics in other dimensions. Then there are judgments of vertical equity; how to treat the different groups of equals.

Other people argue that the equity judgement is broader than that, and distributional aspects of taxes should be evaluated along with all the other things that governments do such as transfer programs, transfers to individuals, transfers to provinces, and so on. This combined tax-transfer system should be used to achieve a target income distribution, which again must be judged in some sense as socially just.

I will return to these two objectives as I go through the talk, but I will just mention at this stage how the thinking of public finance economists has really changed over the
last ten years as to the relative importance of these two objectives. In the 1960s, many economists were convinced that the efficiency cost of distortions in taxes was relatively small. Pioneering work was done in the early 1960s by Arnold Harberger in the U.S. which suggested that if you took the U.S. tax system at that time and picked out the major distortions and tried to add up all the costs involved, the costs may be no larger than perhaps one to one and a half percent of GNP. There is a famous quote due to James Tobin that "it takes a heap of Harberger triangles to fill an Okun gap". The Okun gap is what you lose as a result of deviations from full employment from the macro disturbances in the economy, and Tobin's remark is really a suggestion that the efficiency losses that economists love to talk about are relatively small.

At the same time on the equity side, there was important work being done on tax incidence in the 1960s, particularly by Joe Pechman at Brookings. The Pechman work was taken at that time as suggesting that there was a perverse effect from the tax system as regards equity. The personal income tax, while it looked on paper to be a progressive tax, was much less redistributive in practice. In addition, the progression in the income tax was offset by regression in other taxes, such as sales taxes and to some extent property taxes. The thrust of Pechman's work was that if you looked at the overall effect of the tax system, it really didn't redistribute income to any significant degree.

And so in the 1960s the view was that the efficiency cost of taxes were small and the redistributive effects of the tax system were
also small. In turn, the argument was that one should try to redistribute more, and hopefully some of the redistributive measures would eventually stick and redistribute income. But in the meantime the efficiency costs were something not to be worried about.

In the last five to ten years the consensus view of the public finance community of economists has changed quite radically, and I would suggest it has also changed their stance on tax reforms. The thrust of the earlier perceptions was to look for ways of moving towards a more redistributive tax system, with measures such as fully taxing capital gains, and other policies to deal with erosion of the tax base. But in more recent years economists have revised their efficiency cost calculations upwards, and quite dramatically so. There have been a number of papers in the last few years that suggest that efficiency costs of taxes can be as high as 10 percent of GNP or more. And there is major stress now put on so-called marginal efficiency costs of taxes; that is, the effect of raising additional revenues through distorting taxes, given that you already have taxes in place. Some of these numbers are very high: 35 to 50 cents as the social cost per additional dollar of revenues raised in taxes. And so I think the community of economists is now swinging toward efficiency as a much more important objective in tax policy.

On the equity side the original calculations of Pechman have been questioned by a number of people, particularly Edgar Browning in the United States. The bottom line is that by making some changes in the underlying assumptions in the Pechman work, Browning has
been able to demonstrate arguments as to why the tax system is already substantially progressive. The result is that the earlier argument that the tax system did not redistribute income has been weakened.

Finally, there is the objective of simplicity. Simplicity is very much in the eye of the beholder. It is something that tax reformers advocate, and tax reform documents always say that they're trying to achieve, but the net outcome is usually somewhat ambiguous. In the recent U.S. reform exercise, the objective of simplicity was very important in the political process. There was a real sense that in the U.S. paying taxes had become to some extent arbitrary. There were taxes that the rich could pay if they wished, but the rich could avoid to a large degree through clumsy tax shelters. This generated a tax system that was so complex that to avoid taxes you had to hire an expensive tax lawyer. And somehow this complexity really had to be stripped away.

C. Background to Tax Reform in Canada

I will now move on to some of the background to the reform debate in Canada, commenting on where we now stand. As I've already mentioned, there is ongoing tax change discussion in a number of areas. Thus, what we are currently looking at is an attempt to group these discussions along with some other changes as a package.

On the corporate side, there is a discussion paper that the federal government issued with the 1985 budget which indicated the directions of the federal government's think-
ing in terms of changes in the corporate in-
come tax.

There is a background to this, and it is
very much an international background. If you
look at what has happened over ten years in
the corporate tax field, in both Canada and
the United States, revenues from the corporate
tax as a percent of total revenues have fallen
quite sharply. The main reason is the move-
ment to a system of investment incentives.
Both countries have introduced investment tax
credits, and there has been substantial accel-
eration in depreciation allowances. As a re-
sult there are now widely agreed to be sub-
stantial differences in the treatment of dif-
ferent industries and different assets.

In the jargon that the public finance
economists use, this has generated substantial
dispersion in what are called effective tax
rates. That is, depending upon whether you
invest in equipment, in structures, accumulate
inventory, finance through debt, or finance
through new equity issues, the tax implica-
tions are different. The view is that this
dispersion has introduced all sorts of distor-
tions into the corporate tax. This has been a
driving force behind reform in the U.K. in the
1984 budget in which the government committed
itself to reducing the corporate tax rate and
phasing out many investment incentives. The
U.S. reform has done exactly the same thing.
The government is lowering the corporate tax
rate and eliminating investment incentives.

The federal government document from the
1985 budget suggests doing the same in Canada.
The argument is that we have to get rid of
this dispersion in effective tax rates, and we
do that by lowering the statutory rate and eliminating many of the investment incentives. In fact, some people in the U.S. observing their own reforms have suggested that this approach has a kind of perverse feature to it in that one is lowering statutory rates to raise effective rates.

In the sales area there is a long history to current reform debates. Canada has had a federal sales tax since the 1920s, and to many people in Canada it seems to be one of the most invisible taxes. Many people are only vaguely aware that we have a federal sales tax, because it's administered on a tax-inclusive basis. But we collect almost as much revenue through the federal sales tax as we do through all of the provincial retail sales taxes combined. The tax is there and it's been labelled the "bad tax that won't go away". There have been commissions and committees and so on considering the tax since the early 1950s. The Carter Commission wanted to abolish the tax and that never happened. In 1977 there was a federal sales tax review committee set up that reported again in favour of making changes. The 1981 budget tried to move the tax to a wholesale level tax but the budget produced a sharp political reaction, and the government of the day dropped its proposal and nothing happened. But as a result of the 1981 episode there was another committee set up to review the sales tax, the Goodman committee. The Goodman committee argued that the government should abolish the sales tax, and should look at other options, possibly at a federal retail sales tax or a value-added tax.
When the current government came into power, it had the report from the Goodman committee, and it started looking at the value-added tax. The discussion was about a value-added tax of the credit invoice type. That, however, has its problems, and we now are in the middle of a discussion of the business transfer tax.

So, there is ongoing debate in these areas, and the current thrust seems to be to look at a package that comprises a corporate component, a sales component and some personal component. There are references which I think you see from time to time in the press to the three legs of the stool. There's a tax reform stool with three legs and we've got to look at rearranging them.

D. Influences From Abroad

In addition to the factors noted above taking us into a tax reform debate, we have the impetus coming from changes abroad, especially in the U.S. There are people who have suggested that reductions in tax rates at the personal level in the U.S. mean that we have to follow, otherwise people will leave Canada; and that the rate cuts at corporate level in U.S. again are taking us into directions where we have to follow and if we do not, there will be problems.

But changes are taking place much more broadly than just in the U.S. The U.S. is of course of central importance to Canadians, but in Japan at the end of last year a government report has been released that commits the government to major tax change, along U.S. lines. There will be a reduction in personal rates, a
reduction in corporate rates and the elimination of the investment incentives, and the elimination of the Japanese commodity tax (which is different than our manufacturers' sales tax) which they are going to replace by a credit invoice value-added tax. The New Zealanders have also made major changes in tax policy as part of their much wider set of policy reforms. They have introduced a value-added tax, and have cut rates at the personal level. The Australian government tried to move toward a major tax reform two years ago. It dropped its reform proposals because of political reaction to the changes proposed. But now Australia is also coming back with proposals for rate reductions at the personal level, and some change in the sales system. Changes are also ongoing in the U.K., although initiated somewhat earlier.

All these changes have been part of a revenue neutral package. The idea is that you take the whole tax system, realign this bit, increase a tax here, cut a tax there. These packages are quite separate from any debates on the use of taxes for macro stabilization purposes, and particularly deficit reduction. Much of the debate in the U.S. took place in isolation from the large U.S. deficit, with which Congress is now trying to deal. We in Canada seem to be in the same kind of debate.

At the corporate level, there is pressure for a rate reduction, as is acknowledged in the 1985 discussion paper. There is an argument that a lower statutory rate in the U.S. inevitably causes Canada a major problem. And it is a problem that is so severe that we cannot escape from it unless we also lower our rate. As we know, a large fraction of indus-
Try (particularly manufacturing industry) in Canada is foreign owned. For integrated multinational companies it makes little difference to them where they issue debt. They can issue debt in Canada, or they can issue debt in the U.S. Companies in that situation will always issue debt in the high tax jurisdiction. If tax rates are higher in one country than in another and you are an integrated company, you issue debt in the higher rate country since you get a larger tax reduction. The concern in Canada is if we do not follow those lower U.S. rates, the large integrated multinational companies will start issuing a lot more debt in Canada. What is the effect of that? Well, all interest costs are deductible in calculating corporate tax liabilities. So corporate revenues would fall sharply. In effect this large switch into debt issuance in Canada which could be induced by such a change would be transferring revenues to a foreign treasury; and our tax base would shrink. The argument is that we have to follow rate reductions in the U.S., otherwise we will lose out substantially.

There is a further argument that we also face a problem with the erosion of the U.S. foreign tax credit as a result of the U.S. rate reductions. The U.S. foreign tax credit has always been a very important piece of U.S. tax law from a Canadian point of view. What it says is that if you have a U.S. company that invests in Canada, and if it earns income in Canada and pays corporate taxes in Canada, these taxes are fully creditable against U.S. tax liabilities. This means that for many large U.S. companies if our tax rates are appropriately aligned then the taxes that they pay in Canada do not affect their investment
decisions, because for investments made in Canada when Canadian taxes are paid, you get a full credit for those taxes in the U.S. If U.S. rates fall and our rates remain unchanged, some of our taxes will then come into play and start affecting investment decisions in Canada.

This issue is in practice more complex. The U.S. does not have a country by country limitation in their foreign tax credit. That is, they do not simply take taxes paid in Canada and allow them as a credit against income earned in Canada. The rules in the U.S. allow companies to take their income from many countries, aggregate them, take the taxes paid in many countries, aggregate those, and apply them all against U.S. tax liabilities on combined overseas income. The U.S. has made some changes in their rules on U.S. foreign tax credit in the 1986 reform bill, which again makes life in Canada a little more difficult. But the general thrust of the argument is to say that unless we in Canada do something about our rates, we face a problem of the erosion of the value of U.S. foreign credit, and that our taxes will now start acting as a disincentive to investment in Canada.

Finally there is the argument I referred to earlier about the dispersion in effective tax rates. There has been quite a bit of the academic literature over the last five years on effective tax rates. If you look at the way the corporate tax has evolved over the last ten or fifteen years as we have introduced investment incentives, the net effect has been that the taxes paid are now very sensitive to the type of investment you make; the type of asset, the industry you invest in, and
also the method of financing. So the argument is that what we need to do is reduce our rates and use that as a way of eliminating these investment incentives to get a more neutral treatment in the tax system across all these different transactions.

On the investment incentive side, the major incentives are the investment tax credit and acceleration of depreciation. There are arguments for and against changing these. Some say that if you remove the dispersion in effective tax rates, you will remove inter-asset and intersectoral distortions within the tax system, which is good. Others argue that if the net effect of the change in the U.S. (and this would also be the net effect of the change in Canada) is to lower tax rates and eliminate investment incentives, the result is lower taxes on old capital. All the investments in the economy made before the date of the tax change will suddenly receive lower tax treatment. That will confer windfall gains on existing owners of assets. The change will have smaller incentive effects on new investments being made in the economy. From an efficiency point of view, such an outcome is undesirable.

E. Existing Problems with the Federal Manufacturers' Sales Tax

On the sales tax side there are also some special features. What is driving the debate on sales tax reform is a widely shared perception that we have major problems with the existing system. There is a long list of these problems beginning with the restricted base of the tax. Because it is a tax on manufacturers, all services, agriculture, food,
and housing are excluded. The tax base is only about 30 percent of consumption.

So the argument is that we have a federal sales tax with high rates on a small component of consumption. And from the point of view of efficiency, removing these distortions in the tax system would be best accomplished by using a broader base and getting the rates down.

The second problem is that we have multiple rates. We have a basic rate of 12 percent but we have a 14 percent rate which applies to certain categories and an 8 percent rate applying to others. On top of this we have a problem of cascading. That is, certain components of the federal sales tax do not show up simply as taxes on final sales, but act as taxes on business inputs. Fuel is subject to the federal sales tax, which then shows up as an added cost to producers who use it. This is the case not only for goods that are delivered in Canada, but also for exports. To the extent that cascading occurs, distortions arise that impede exports.

One of the interesting things is that when the Europeans were debating the merits of the value-added tax in the late 1960s, European countries were largely convinced of the virtues of the value-added tax because it would remove the cascading in their existing taxes (referred to as turnover taxes). The perception is that we also have a problem of cascading in our federal sales tax and that is not good.

On top of that we have some complex administrative problems that stem from the fact that it is a manufacturers sales tax.
With a tax administered on manufacturers, it is very difficult to define what you mean by manufacturing. Should you include the transportation cost from the factory to the warehouse? Should you include warranty costs? Should you include advertising costs?

What has happened over the years with our sales tax is that various firms within industries have found that they are treated differently under the tax than other firms in the same industry. This is because of the way that business is organized or because of the way in which these firms are located spatially. Firms have thus come to Revenue Canada and made a case that they are treated unfairly under the tax. Revenue Canada over the years has accumulated a large inventory of cases, settled by the use of administered values. That is, a firm will claim it is being differentially treated relative to another firm. In administering the tax, Revenue Canada may agree and make special allowances to tax only on a certain percentage of the value of sales. These administrative arrangements go back to the 1920s when the tax was first introduced. The number of administrative arrangements has grown over the years and there are now thousands of them. This system itself is beginning to creak since there have been a number of recent cases involving litigation, where companies argue that their product was misclassified. Some of this activity seems to stem from the attempts to change in 1981.

On top of all of this, there is a well known bias in favour of imports in the existing federal sales tax. What we do with the tax is this. We say that we tax manufactures, either produced in Canada or imported into
Canada, and so we apply the tax at the border. Because we apply the tax at the border, all of the added costs of warranty and promotion and distribution and so on which apply after the border do not get included in the tax base. Calculations that have been made suggest that there is significant bias in favour of imports. In the last budget, for instance, the government changed the rules as to the valuation of imported cars for tax purposes to deal with the problem in that area.

So these are all seen then as problems with the existing federal sales tax. If you look at the reform options, they span piece-meal change to wholesale change. One approach is to try and patch up the existing system. Maybe there is some way we can fix up these administered values. Perhaps we can change the valuation process for imports. The restricted base has perhaps to be left, but we can try and bring things into the tax base. This has been the approach over the last 20 or 30 years. The advocates of change would probably say that this approach has failed. It is difficult to do; the attempt to expand the base by putting additional things in at the margin is divisive. You need wholesale change.

Moving up the scale, the next thing is to try and change the point of operation of the tax in the production/distribution chain. We have tried to tax at the manufacturing level, now let's try and move it a little bit, and use a wholesale level tax. Wholesale level taxes were quite common in a number of European countries before the switch into more broadly based taxes under the value-added tax. In the U.K., there was effectively a wholesale
level tax labelled the purchase tax. Many developing countries still use wholesale level taxes at the manufacturing level and administer them quite successfully. The government tried to do that in 1981 in the budget, but the reaction was hostile. That led to the creation of the Goodman committee. So the widely held view is that that option has been tried and failed.

So what are the other options? The central option is to try and move to some broadly based tax involving more radical change. In this way, you expand the base and cover all consumption, and do that in a way that gets rates down. There are three alternatives for this strategy that have been discussed at various times.

One is to try to move to a retail sales tax at the federal level. The Carter Commission suggested that if the provinces use retail sales taxes, it really makes sense for there to be only one single retail sales tax system in the country. In fact the Carter Commission suggested that the retail sales tax system should be exclusively run by the provinces. The federal government should collect no retail sales taxes and the reduction in the federal sales tax should be traded off for tax points with the provinces. But the federal-provincial dimensions of this option are widely viewed as precluding such a move. If the federal government were to use a retail sales tax, that would be seen as an intrusion into the tax field of the provincial government. So this is widely viewed as not feasible.
So then we start moving to some of the options which you have perhaps seen discussed in the press. One is a so-called credit invoice value-added tax. The credit invoice value-added tax is the type of tax they have in Europe. It is equivalent in terms of its final effect to a retail sales tax, except that it is administered in a different way. With a retail sales tax, you tax the final delivery of products. For instance, you tax a car when it is sold. With a value-added tax what you do is to tax the car as it is being constructed. So the effect is the same if tires are taxed when they are made by the tire manufacturer, the windshield is taxed when it is made by the people who make the windshield, and so on. The way it is administered is by taxing the total value of output, but allowing a tax credit on any taxes paid on inputs. That is the definition of value-added. Taxing at each stage of production, you add that all up and in effect you are taxing the total value of sales. It is an administrative device commonly used in Europe which has a different administrative impact than a retail sales tax.

The credit invoice value-added tax was one of the options that the Goodman committee recommended the government consider, along with the sales tax. My understanding is that the government was looking at that option, but in the budget speech last year, the minister made a statement to the effect that now they were looking more heavily at the business transfer tax, which is the next option I will discuss.

One of the problems with the credit invoice value-added tax is the appearance of
administrative complexity. What you do is to tax the total value of sales, but allow a tax credit on inputs. In effect producers pay money to the government, but then get it back in the form of a credit. A central concern is how large is the compliance burden imposed on small business. Most of the European countries have found when they have introduced the credit invoice value-added tax that they have to have a cut-off for small business. The amount of record-keeping which is imposed on very small business can be onerous, and therefore if your turnover is below a certain amount, the cut-off implies you are no longer liable for the tax.

The final option is the one that is being discussed quite extensively in the press: the business transfer tax. The business transfer tax is yet another administrative device for doing the same thing as a retail sales tax. In the more technical public finance literature it is called a subtraction method value-added tax. The subtraction method value-added tax works in the following way. Under a credit invoice value-added tax you tax the total value of sales, and allow a credit for any taxes paid on inputs. Under a subtraction method value-added tax you do not tax the total value of sales. All you do is instruct each firm that they have to file a tax return that reports the total value of sales, and the value of material inputs (i.e. excluding labour). One then takes the difference between the two, and firms are taxable on the difference. That is the same as taxing value-added. In the debate thus far in Canada that is what is being referred to when the business transfer tax is discussed. One of the arguments in its favour is its relative adminis-
F. Evaluating Sales Tax Options

There are a lot of design and implementation issues within this list of sales tax options. First of all, if you go with a broadly based option, whether it is a value-added tax of the credit invoice or subtraction type or retail sales tax, how broad is the base going to be? You run into a lot of areas that are undoubtedly contentious. Would food be fully taxed? Would clothing be fully taxable? Is housing going to be fully taxed? How would agriculture, non-profit institutions, schools, universities, hospitals be treated? And what about financial institutions?

The trade-off is that the broader you make the base in whatever replacement tax you use, the lower the rate. You are trying to get the lower rate to realize efficiency gains. But the perception, and a very strongly held perception, is that many of these items are heavily bought by the poor. The fraction of income spent on these items by lower income Canadians is significantly higher than for high income Canadians. So if you bring these items into the tax base, this will produce a tax change that is regressive, and therefore you should not do that on income distribution grounds. In fact, it is a quite complex issue because for the food, clothing and housing categories, and particularly the clothing category, what is covered is not only basic clothing but expensive clothing items. If you look at household expenditure share data, the fraction of income spent on the
broad category of clothing actually increases with income range.

Food is undoubtedly regressive, but not as regressive as one might think because a lot of expensive foods are taxed as well as basic foods. And then on top of that, under an elimination of the sales tax and a replacement by some value-added tax scheme, a lot of service items are going to be taxed. These would include entertainment and other things that are heavily purchased by the rich. So the precise income distribution effects are somewhat contentious.

Agriculture is a difficult issue because of the current situation in the farm community. Also, if you look at the European experience with value-added tax, the tax treatment of farmers has turned out to be one of the most difficult areas, largely because of the number of taxpayers involved. In some of the European countries, several hundred thousand taxpayers are suddenly brought into the tax system by including agriculture. The administrative arrangements for that are complex and it is a difficult issue.

Another issue is how to treat the non-profit institutions. For hospitals, universities and schools and so on, the issue is whether they are to be taxable on the inputs they use, even though they are unable to pass those taxes on to customers.

Tax treatment of financial institutions is also a difficult area, from a technical point of view. The European countries generally exempt financial transactions because the definition of value-added in such areas as
banking and insurance and other areas is difficult. The New Zealanders in their value-added tax reform announced that they would try to tax financial institutions. My understanding is that they have since decided not to do that. A few other countries have attempted to introduce taxes on financial institutions in other ways. Israel at one time entertained a proposal to do that in their value-added tax. But it is widely agreed that it is a technically difficult area.

G. Regressivity

Next I will turn to the regressivity issue. This is a central design issue, but the regressivity issue is more complex than I have indicated thus far. There is a widespread perception that sales taxes in general are regressive and one of the difficulties with the business transfer tax is how regressive the change would be.

If one is simply replacing the existing sales tax by a business transfer tax or a value-added tax, the argument would be that the overall level of indirect taxes in the economy would not change and there would be no regressivity impact per se. The regressivity issue thus focusses more on what happens in terms of the previously excluded items that are now brought into the tax base. There is a perception that more broadly based sales taxes themselves are regressive and therefore any new tax is a tax to be resisted.

It is here that there is academic literature which is relevant. One of the things that Edgar Browning has stressed heavily in his own work in this area, is that many people
think that sales taxes are regressive because they assume that the taxes are paid out of current consumption. So you pay taxes when you buy commodities, but if you save, you do not pay the tax.

If you look at income distribution data you will find that a large fraction of household savings in the economy is accounted for by the top tail in the income distribution. The rough numbers for Canada, I think, are that around 40-50 percent of household savings is accounted for by the top 10 percent of income recipients. As a result, if you view the tax as being tax borne solely out of consumption, you will view the tax as regressive because people in the high end of the income distribution do not pay the taxes since they save. Browning's work argues that this is an illusion because if you save today you will dissave in the future. And when you dissave you will consume. So eventually you will pay the tax. In fact a uniform sales tax should be viewed as distributionally neutral because you are taxing dollars of income uniformly, independently of the timing of consumption. If you get a dollar and you consume today you pay the tax. If you get a dollar and you save and then you consume, again you pay the tax.

H. Federal Provincial Aspects

There are also some complex issues as to how the federal and provincial sales tax systems might co-exist under a change to a BTT or VAT, and there are a number of different considerations here. This all depends on what may or may not happen in terms of how provinces might react.
If one of the arguments for making changes in the federal tax is to try and move the country toward one single sales tax system, then one has to think in terms of options that would integrate federal and provincial taxes. And of course any such change would have to be done with federal-provincial co-operation and approval and that itself is difficult. But if you were to move to, say, a subtraction method value-added tax, it is widely agreed that a multiple rate subtraction method value-added tax is difficult to administer. This is because taxes are rebated on exports, and taxes applied on imports, under a subtraction method value-added tax. Taxes on exports are rebated on the basis of the taxes that have been paid as the product moves through the production process. So if you have multiple rates there is a problem as to how you calculate these rebates. Also if you have a system, as we now have, with provinces using different provincial sales tax rates, and if they were to participate in a joint system which in effect produces different rates by province (on a combined basis) that would be a big problem.

I. Personal Tax Reform

With regard to personal income tax matters, the big issue seems to be rate reduction. There are the pressures coming from the U.S., changes which I mentioned before, and there is the concern that there will be large pressures for outward migration from Canada if we do not follow the U.S. reforms.

On this issue I will make the following comments. First of all in terms of large numbers of people leaving Canada and going to the
U.S., you have got to recognize U.S. immigration controls which are in place. And so, I think the prospect of large numbers of people migrating to the U.S. is unlikely. Equally, the U.S. tax changes are portrayed by the people who worked on them in Washington as distributionally neutral changes. That is they have no overall effect on the distribution of tax burdens. The changes lowered marginal personal tax rates, but once the additional corporate taxes are factored in there is really no change in the combined average rates. Migration is an all or nothing choice, based on comparison of average, not marginal rates. And so, if the U.S. introduced lower marginal rates but raised revenues elsewhere, that should not have as large an effect on migration decisions as some commentators are currently suggesting.

There is also the concern about the disincentive effects of our high tax rates. In part this reflects the evolution of the public finance literature I was stressing earlier, with higher estimates than before of tax disincentive effects on labour supply and savings.

In addition to rate reduction there is also the issue of base broadening. So, where do we stand on base broadening? In the 1981 budget there was an attempt to broaden the base of the personal income tax. That budget, as you know, tried to restrict various kinds of expenses and remove some of the erosion of the tax base. The political reaction to the budget forced the government of the day to drop many of its proposals. The evidence seems to be that there are difficulties in
terms of the political reaction to base broadening.

And if you look beyond the smaller changes that were attempted in 1981, the kinds of areas you are looking at are high profile areas where there are presumably some further political difficulties. Changing capital gains treatment was one way in which the U.S. has broadened its tax base. But we are currently in a situation where the government introduced a $500,000 lifetime exemption in the 1985 budget, and for a tax reform exercise to change this treatment would be a major change in policy. Registered retirement savings plans are one of the biggest areas where potentially one could look at base broadening. But again we are in the middle of the implementation of the new pension rules which were announced in the 1984 budget. These are currently being phased in and it would seem unlikely at first sight that such a big change could be made.

Outside of these two areas one is left with changing basic deductions in the tax system. Reducing their size is not really the kind of base broadening that most public finance economists have in mind. So the basic design issues are how much rate reduction should occur and how much rate reduction is feasible.

J. Package Changes and Other Options

In terms of reform strategies, given that we are not looking at a major new approach to taxation such as a consumption tax, or a version to a kind of Carter type doctrine or Haig-Simons type income tax (a broadly based
income tax) one could look at three separate revenue-neutral changes. At the corporate level there could be a package that involves rate reductions, and the investment tax credit and other investment incentives being removed. This is along the lines already outlined in the 1985 discussion paper. The discussion thus far of federal sales taxes clearly indicates the desire to remove the existing sales tax because of its various problems, and use some sort of broadly based replacement. The business transfer tax has been widely discussed as has the value-added tax. At the personal level, if there were to be personal changes incorporated on a separate package basis, you would have to have some reductions in rates that were financed by base broadening.

But these are not the only alternatives. You could have revenue being raised by one change or being used in some way to finance other changes. I refer to this here as a change in "tax mix". One could, for instance, have an elimination of sales tax and have a change using some broadly based alternative to raise sufficient revenue to finance a reduction in personal rates. Or, you could have a loss in revenue (or a gain) at the corporate level being similarly used in some other way. The overall change presumably is to be revenue-neutral in terms of the desired impact. Again, the issues here come back to some of the concerns I have already voiced. How much base broadening in personal taxes may be possible? What about some other ways of raising revenue?

The minimum corporate tax in the U.S. is a potentially significant revenue source. We
have a very large number of companies in Canada, admittedly largely small companies, in a position of loss carry-forward. A minimum corporate tax as a way of raising revenue is another option to be considered, no matter what other problems it brings (and I wouldn't necessarily advocate it personally).

There are questions of the regressivity involved if there is to be a tax mix change. If, for instance, there is heavy reliance on indirect taxes, as has happened in other countries, that would be seen as a regressive move. Independently of how you argue the Browning point I mentioned above, the key issue is whether you should view savings as bearing the burden of sales taxes. If you reduce the revenues at the personal level, you are weakening progressivity and that component of the tax change is undoubtedly regressive.

Questions of the impact on provinces raise several difficulties. For instance, if you remove the federal sales tax and replace it by a value-added tax, the provincial retail sales taxes would show reduced yield. Provincial sales taxes are calculated on a gross of federal sales tax base. To the extent that the federal tax moves into areas where there is no current provincial sales tax, for service items for example, there will be a loss of revenues in the provinces from that change.

If one changes the mix of taxes, there are other more direct implications for provinces. The provinces currently raise taxes at the personal level, but these are calculated as a fraction of federal taxes collected. At the corporate level we have got an add-on pro-
vincial rate to the federal rate. With sales taxes there is no explicit piggyback formula. So if you start collecting, say, less tax at the personal or corporate level and more tax at the sales level, the result is a reduction in revenues for the provinces. Thus, if you start changing the pattern of these taxes, there are some complicated issues that will come into the debate in terms of calculating adjustments in intergovernmental finances.

Finally, there are issues of macro impact under the change. Again, I think the calculation would be that if one is dealing with a revenue-neutral change, the broad macro impacts in terms of unemployment and so on would be fairly small. But a change in tax mix that moves more towards indirect taxes will have the effect of a once and for all increase in the price level. And depending upon one's views as to how the inflationary process works, there may or may not be concerns on that score. There will also be some impact on savings that would occur under tax mix type changes or changes in the corporate tax. Under a sales tax, the double taxation of savings that you have under an income tax disappears. Thus if you change the balance between those two taxes, there will be an effect on savings.

K. Broader Considerations

Before I conclude I would like to raise some broader issues and here I am deliberately being a little bit provocative. One of the basic questions is how important is all this reform anyway. We are looking at a broadly-based set of tax alternatives that are revenue-neutral. But recent public finance
literature suggests that the issues at stake are really two-fold. One is how you change the tax structure to raise a certain amount of revenue and the other is how you change the level of taxation, to meet financing requirements of particular levels of governments.

We now have a federal deficit, which as I indicated earlier is running at something around 25 percent or so of federal tax collections. If a tax reform exercise is undertaken and does nothing about the deficit, then one can argue that the deficit really should be treated as a component of the tax system. The deficit represents taxes that, in effect, will have to be paid tomorrow in order to service and eventually repay the debt. And if you think in terms of the fraction of current income that eventually will be surrendered to the government in order to finance its expenditures then you have to look really at the value of expenditures by the government not at the current taxes collected. You have to have some way to factor the deficit into discussions of tax reform, and there is an issue of whether or not the deficit component is more important than worrying about issues of tax structure. This is a central question: deficit reduction versus yield neutral change.

Second, if we are looking at tax reform should we be thinking deeply about a new basic philosophy for the tax system. If so, one is perhaps talking of an exercise reminiscent of the Carter Commission which presumably takes several years and is different from the process currently being discussed. But there are many academic economists who would say that our tax system has evolved, particularly since the days of Carter, in an ad hoc fashion. We
have to think deeply about what we are trying to do through the tax system, and we have to look at all the implications rather than simply accepting that there are three existing groups of taxes - corporate, personal and sales - and we should realign those in some way and change pieces within them. Perhaps we should be looking more deeply at the whole of the tax system.

A further issue here is the desirability of following those tax changes abroad. I have already mentioned some of my thoughts on that front. I think the argument at the personal level that it is somehow necessary for us to follow rate reductions abroad otherwise we will have massive out-migration is overstated. At the corporate level the need to follow rate reductions abroad because of these financing issues I was mentioning seems to me to be strong, but the concern that the reduction in tax rates at the corporate level would result in windfall gains to owners of existing assets is equally a concern.

Also, in the reform discussion this far both in the U.S. and in Canada, there has been little focus on what revenue could be raised by new taxes. Should we be looking at that? No one likes to think of new taxes, and it may be that the amount of revenue that could realistically be raised from these kinds of taxes is small. But since 1971 when we introduced the capital gains tax, Canada has been one of very few countries having no federal inheritance or estate tax. Because of the way the capital gains changes in 1971 worked, we, in effect, grandfathered in a whole generation of intergenerational transfers that suddenly became tax free. That may be something that one
wants to look at in terms of a revenue source. As I say, it is not something that would necessarily raise huge amounts of revenue, but it illustrates that there are alternatives to simply taking the existing configuration of taxes and saying we have just rearranged those.

Finally, there are a lot of linkages within the tax system to other components of government activity. Inevitably in a tax reform process one gets involved in these. I already mentioned some of the possible implications of a change at the sales tax level for the provinces. That would suggest that any reform exercise is going to have some cross-over into intergovernmental transfers. If there is a concern over regressivity of a tax change then you get involved in the implications for the poor, and possible changes in transfer arrangements and welfare programs. This may sound very much like an academic talking; academics love to look at grand designs rather than specific detail. But the thrust of this remark would be that perhaps we need to stand back and say how does the tax system fit into all these other policies that are in our wider system of public sector activity.

I will stop there. I hope these thoughts are of some interest. I look forward to seeing the results of the current tax reform initiative, which might in itself provide a basis for a further lecture!

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