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THE CORPORATE INCOME TAX IN CANADA: DOES ITS PAST FORETELL ITS FUTURE?

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SUMMARY

Corporate tax reform has long been a contentious issue in Canada. Official commissions, academics and others have often proposed changes in the way we tax corporations. During the last 30 years, perhaps largely owing to concerns about international competitiveness, the corporate tax rate has been substantially reduced. Since revenues did not decline as a result, those concerned by increased inequality who believe that corporate taxes are paid mainly by the rich have suggested that corporate rates should be increased. Others, more persuaded by the increasing evidence that much of the burden of the corporate tax ultimately falls on workers and wages and that even to the extent it falls on capital the economic price paid in terms of reduced output and productivity for each corporate tax dollar collected is high have taken the opposite tack and argued that, if anything, corporate tax reform should be aimed at reducing even further the effective tax rate on corporate capital.

Both the technical and the political aspects of corporate taxation are thus at play in the current discussion of possible corporate tax reform. After a brief review of the history, we consider what is now known about the relation between corporate rates and revenue, the surprisingly complex question of who ultimately pays the tax, and the largely undesirable economic effects of corporate income taxes.

If all voters were economists and familiar with the evidence, it is unlikely any would favour big increases in corporate taxes. However, even economists who have read all the studies mentioned here (and more) do not agree about the best way to reform the corporate income tax. We sketch three recent major reform proposals Canadian experts have recently put forward (1) replace the existing corporate tax by a tax on 'rents' (above-normal returns on capital), (2) replace both it and the current personal income tax by a 'dual income tax' with a flat rate on all capital income (corporate

1 Professors emeriti, University of Toronto. This is a revised version of a paper originally presented at the Conference on Reforming the Corporate Tax in a Changing World, organized by The School of Public Policy, University of Calgary, and the Canadian Tax Foundation. We are grateful to Munir Sheikh and other participants at the conference, as well as to Sijbren Cnossen and two anonymous reviewers for comments. We have also benefited from draft versions of other papers presented at the conference that discuss in more detail, and often in different directions, some of the points made here.

and personal), or (3) adopt a more gradual approach to reform that would broadly keep the present system but make it more uniform in its treatment of investment. On the whole, we suggest that, although the 'rent' proposal is clearly the favourite in the academic horse race, and we think a much closer look should be taken at the second (dual income tax), the more incremental third proposal – improve what we now have – is perhaps not only the way we should go now but is also likely to be the politically most acceptable of these schemes.

Finally, since one reason corporate tax reform is so difficult is because it is closely related to a number of other issues that are often both technically complex and politically sensitive, we consider several such issues. Some, such as small business taxation, could be reformed independently of the sorts of more general reforms just mentioned. We sketch several reforms that would simplify the system, maintain some incentive for small businesses and reduce the extent to which the current system provides a shelter for the rich. But other issues cannot be dealt with separately. What is the appropriate level and nature of 'integration' between the corporate and personal income taxes? What is the appropriate role of federal and provincial governments with respect to the corporate income tax? And, assuming that we continue to use taxes to provide preferences (incentives) to specific sectors and activities, what is the best way in which to do so? Within entering too far in the 'dismal swamp' of the inner workings of the tax system, we suggest some possible directions for reform in these areas such as a 'sunset' clause for tax preferences to reduce the likelihood that they will be indefinitely preserved whether socially useful or not.

"Policy changes operate in an evolutionary manner; those made in one era clearly shape the context (ecology) in which future tax policy changes are made…. New ideas come to the fore because: a) older ideas are discredited by experience; b) a new political/economic context opens up new opportunities for innovation; or c) the political balance of power shifts, enabling those that are advantaged by certain policy ideas to push their agenda over others."[2]

1. INTRODUCTION

The corporate income tax in Canada today results from a century of uneasy compromises between economic concerns and political realities. The pressures of war finance led to the introduction of the first federal tax on corporation profits in 1916, followed in 1917 by the first federal tax on personal income. The federal government followed earlier provincial precedents with respect to both taxes. Quebec introduced its first general tax on corporations in 1882 and, by the time the federal government entered the field, all provinces already had some form of corporate taxation in place.[3] Two critical questions that have continued to echo in Canadian income tax policy — the relation between corporate and personal income taxes and federal and provincial co-occupancy of the tax base — were thus present from the start.

By the early 1960s the first of these questions — the relation between the corporate and personal income taxes — was at the top of the policy agenda owing to an avoidance technique known as "surplus stripping," which was one of the factors leading to the appointment of the Royal Commission on Taxation (the Carter commission).[4] The commission's report was not enthusiastic about corporate income taxation but accepted it as a way to compensate for the deferral of personal income tax.[5] However, as a member of the commission, Harvey Perry, later said, "the strongest practical argument for the tax (was) the fact that it represented a wholly justifiable levy on the many large foreign-owned companies that operated in Canada" that would otherwise simply pay the taxes over to foreign treasuries (or perhaps not at all). According to Perry, the commission would really have liked to abandon the corporate income tax completely, but felt that "… as close as we could come to abandonment was to propose the allowance of the tax as a credit against personal income tax, to be achieved through the gross-up and crediting device," an approach that had the additional virtue of dealing with both the capital gains and surplus-stripping problems.[6] Despite many slips between concept and reality, this critical component of the Carter report

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2 Sven Steinmo, "The Evolution of Policy Ideas: Tax Policy in the 20th Century," *British Journal of Politics and International Relations* 5, 2 (May 2003): 279.

3 J. Harvey Perry, *Taxes, Tariffs and Subsidies: A History of Canadian Fiscal Development* (Toronto: University of Toronto Press, 1955), vol. 1, 111-117.

4 Royal Commission on Taxation, *Report* (Ottawa: 1967). "Surplus stripping" refers to the tax-free treatment of distributions from the accumulated income of closely held corporations, which had become an issue in the 1962 federal election: Douglas G. Hartle, "Political Economy of Tax Reform: Six Case Studies," Discussion Paper No. 290 (Ottawa: Economic Council of Canada, November 1985).

5 J. Harvey Perry, *A Fiscal History of Canada — The Postwar Years* (Toronto: Canadian Tax Foundation, 1989), 288.

6 ibid.

survived the tortuous process of developing the 1971 income tax law and became, with the taxation of capital gains, perhaps the principal substantive legacy of that report.[7]

Time moves on, however, and ideas evolve. Some economists now see the corporate income tax as little more than an unnecessary encumbrance to the efficient functioning of the market economy and, like Nobel Prize-winner William Vickrey, favour its abolition.[8] Less drastically, in recent decades fundamental reforms in the structure of the tax and in particular its conversion to some form of cash-flow or "rent" tax have been recommended in various ways and to differing degrees in a number of major tax reviews around the world.[9] This approach, which would relegate the tax to an even more minor role than it currently plays — though arguably a more focused and desirable one — has received substantial empirical support from studies in a number of countries.[10] Similar ideas have been put forth recently in Canada by Robin Boadway, among others.[11]

Unaware of (or less persuaded by) the arcane models and the empirical studies, often difficult to interpret, that support such arguments, most Canadians continue to see the corporate income tax as an essential component of a democratic tax system, one of the few ways to tax the rich and powerful who have the potential to exert undue political influence and would otherwise bear too little of the cost of maintaining the state.[12] Consequently, as

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7 See Richard Bird and Thomas Wilson, "The Legacy of the Carter Commission," in *Rationality in Public Policy: Retrospect and Prospect, A Tribute to Douglas G. Hartle,* ed. Richard Bird, Michael Trebilcock and Thomas Wilson (Toronto: Canadian Tax Foundation, 1999), 43-60. An additional result of that legacy, not discussed further here, turned out to be the abandonment of all attempts to tax personal wealth in Canada, as discussed in Hartle, "Political"; Richard Bird, "Canada's Vanishing Death Taxes," *Osgoode Hall Law Journal* 19 (1978): 133-145; and Keith G. Banting, "The Politics of Wealth Taxes," *Canadian Public Policy* 17, 3 (September 1991): 351-367.

8 William S. Vickrey, "The Corporate Income Tax and How to Get Rid of It," in *Retrospectives on Public Finance*, ed. Lorraine Eden (Durham, N.C.: Duke University Press, 1991), 118-132.

9 For prominent examples, see, for the U.K.: the Meade report (Institute for Fiscal Studies, *The Structure and Reform of Direct Taxation: Report of a Committee Chaired by Professor J.E. Meade* (London: Allen & Unwin, 1978)); and the Mirrlees report (James Mirrlees et al., *Tax by Design: The Mirrlees Report* (Oxford: Oxford University Press, 2011)). For the U.S.: United States. Department of the Treasury, *Report of the Department of the Treasury on Integration of the Individual and Corporate Tax System: Taxing Business Income Once* (Washington, D.C.: 1992); and President's Advisory Panel on Federal Tax Reform, *Simple, Fair and Pro-Growth Proposals to Fix America's Tax System* (Washington, D.C., 2005). For Australia: The Henry Report (Australia Department of the Treasury, *Australia's Future Tax System* (Canberra, 2010)).

10 See, for example, Alan Auerbach, Michael Devereux, and Helen Simpson, "Taxing Corporate Income," in *Dimensions of Tax Design: The Mirrlees Review*, ed. James Mirrlees et al. (Oxford: Oxford University Press, 2010), 837-893; as well as the useful non-technical review of the empirical literature in Ken McKenzie and Charles Taylor, "Business Income Taxes," in *Tax Policy in Canada*, ed. Heather Kerr, Ken McKenzie and Jack Mintz (Toronto: Canadian Tax Foundation, 2012), 7:1-7:51.

11 See Robin Boadway and Jean-Francois Tremblay, *Corporate Tax Reform: Issues and Prospects for Canada*, Mowat Research Paper No. 88 (Mowat Centre, University of Toronto, April 2014); Robin Boadway, "Piecemeal Tax Reform Ideas for Canada — Lessons from Principles and Practice," *Canadian Tax Journal* 62, 4 (2014): 1029-1059; and Robin Boadway and Jean-Francois Tremblay, *Modernizing Business Taxation*, Commentary No. 452 (Toronto: C.D. Howe Institute, 2016).

12 As Hale notes, "…Canadians' views of the tax system and their support for tax reforms have been largely contingent on perceptions of equity and fairness: that those less well-off than themselves should pay lower taxes, that their own taxes should increase only a little or not at all, and that those better off than themselves, especially large corporations, should pay more." Geoffrey Hale, *The Politics of Taxation in Canada* (Peterborough, Ont.: Broadview Press, 2002), 127.

Geoffrey Hale has noted, "politicians from all parties have shown a keen sensitivity to the symbolic value of corporate income taxes."[13]

One reason they do so is because, as Reuven Avi-Yonah has argued, taxation plays three distinct and important policy roles: revenue, redistribution, and regulation.[14] All three reinforce the political importance of the corporate income tax:

- Corporate taxes produce revenue, which is presumably always a good thing — at least from the perspective of those who get to decide how the funds will be spent.
- Moreover, although no one knows who really pays the corporate tax (as we discuss later), most people think the rich do. So, getting revenue from corporate income tax may provide governments with useful redistributive cover.
- Finally, the corporate income tax is both a useful automatic stabilizer in macroeconomic terms and a tool that governments can use to influence the allocation of resources through tax incentives.

In the 50 years since the Carter report, economic research has provided substantial evidence that taxing corporate profits that represent only a "normal" rate of return on capital deters investment, hampers growth, and lowers productivity and, hence, real wages. As a result, most economists now think that the considerably more favourable view held by most non-economists of the corporate income tax rests to a considerable extent on unproven and, to some extent, illogical arguments. Nonetheless, since what people think matters in a democracy, such views not only play an influential role in shaping policy in this area but have been reinforced in recent years by the extent to which tax policy has failed to prevent increased inequality in the distribution of wealth and income.[15]

The world has changed over time, and so have the importance of various interests in shaping policy and the available empirical evidence about corporate income taxation. In Canada, as elsewhere, changes in corporate income taxation to some extent reflect the changing weights attached to these different perspectives about the tax. The changing political balance between groups with different objectives and perceptions will no doubt continue to shape corporate income tax policy in the future as in the past. However, the growing economic evidence supporting change and the increasing attention being paid to the important international dimension of corporate taxation in a more globalized and open

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13 Hale, *The Politics*, 299. An important characteristic of large modern corporations is the separation of ownership from management. The beneficial ownership of corporate capital (that is, who gets dividends or other forms of income from such capital) is distinct from the "control" of it (that is, who determines the use to which it is put). As Atkinson correctly states, "… much of the wealth that people own conveys little or no control over the productive activities of the economy beyond their front door": Anthony Atkinson, *Inequality: What Can Be Done?* (Cambridge, Mass.: Harvard University Press, 2015), 95. Nonetheless, even if corporations are owned by many, most operate in relatively competitive environments, and corporate income taxes are thought to be paid mainly by workers rather than shareholders, there may still be good reason for concern about the potential political influence of corporate income.

14 Reuven Avi-Yonah, "The Three Goals of Taxation," *Tax Law Review* 60, 1 (2007): 1-28.

15 The "bible" for such concern is Thomas Piketty, *Capital in the Twenty-first Century* (Cambridge, Mass.: Harvard University Press, 2014); see also Atkinson, *Inequality*; and, for a particularly interesting overview, Branko Milanovic, *Global Inequality: A New Approach for the Age of Globalization* (Cambridge, Mass.: The Belknap Press of Harvard University Press, 2016). For explorations of this topic in Canada, see Nicole Fortin et al, "Canadian Inequality: Recent Developments and Policy Options," *Canadian Public Policy* 38, 2 (2012): 121-141; Michael Veall, "Top Income Shares in Canada: Recent Trends and Policy Implications," *Canadian Journal of Economics* 45, 4 (2012): 1247-1272; Kevin Milligan and Michael Smart, "Taxation and Top Incomes in Canada," *Canadian Journal of Economics* 48, 2 (2015): 655-681; and Richard Bird and Eric Zolt, "Taxes, Spending and Inequality in Canada and the United States: Two Stories or One?" *Osgoode Hall Law Journal* 52, 2 (2015): 401-427.

world suggest that it is time to reconsider seriously the appropriate role and structure of the corporate income tax in the Canadian tax system.

Serious attention has of course already been paid to this question in the past, notably in the 1998 Mintz report.[16] A decade later another committee was struck to review the international competitive aspects of the system.[17] Subsequently, some have urged further changes in this area, such as more favourable treatment for income from intellectual property (the "patent box").[18] More generally, the basic question of how and to what extent the traditional corporate income tax can function effectively in the global environment has been the subject of substantial and substantive international study and consideration, notably in the context of the OECD's massive BEPS (base erosion and profit shifting) initiative.[19]

This paper does not set out in detail our own prescriptions for the future. Its more modest task is to set the stage for the more substantive discussions of corporate taxation found in the other papers in this symposium. The next section summarizes three key aspects of the corporate income tax — the revenue it produces, its distributive impact, and its economic effects. Section 3 then sketches how we got to where we are today — from Carter to Mintz to now as it were — while Section 4 provides a capsule account of three paths for future reform discernible in the recent literature. Section 5 considers briefly several specific aspects of the present corporate income tax: the relation between federal and provincial corporate taxes the treatment of small business, the integration system, and tax preferences in general. Regardless of what changes are made in Canada's federal corporate income tax, Section 6 concludes that the basic problem of balancing its key roles in relation to the personal income tax, to provincial taxes, to Canada's international competitive position, and as a source of revenue, a player in the endless distributive debate, and an attractive (if not necessarily always well-focused or effective) regulatory tool, will continue to exist.

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16 *Report of the Technical Committee on the Reform of Business Taxation* (Ottawa: Department of Finance, 1998).

17 Advisory Panel on Canada's System of International Taxation, *Final Report: Enhancing Canada's International Tax Advantage* (Ottawa: Department of Finance, 2008). Another official report the same year considered some of the same questions from a different perspective: Competition Policy Review Panel, *Compete to Win: Final Report* (Ottawa: Department of Industry, 2008).

18 Nick Pantaleo, Finn Poschmann, and Scott Wilkie, "Improving the Tax Treatment of Intellectual Property Income in Canada," Commentary No. 379 (Toronto: C.D. Howe Institute, 2013); Boadway and Tremblay (*Modernizing*, 9-10), support this proposal. For a less favourable view, see, for example, Dhammika Dharmapala, *The Economics of Corporate and Business Tax Reform*, WP16/04 (Oxford University Centre for Business Taxation, March 2016), 9. A more general treatment of the basic issue is Steffen Juranek, Dirk Schindler and Guttorm Schjelderup, "Taxing Royalty Payments," Norwegian School of Economics, Discussion Paper FOR 16 2016 (September 2016). Incidentally, readers not deeply versed in the literature should perhaps note that "royalties" (like "rents" — see note 27 below) is another tax term that has two distinct meanings. The works mentioned here deal with royalty payments for intellectual property; elsewhere in this paper (e.g., in text at note 94) we discuss the totally different question of the "royalty deduction" allowed under the federal corporate tax for natural resource royalties paid to provinces.

19 For details, see OECD website, "Base erosion and profit shifting," http://www.oecd.org/tax/beps/. For an assessment of the OECD process, see Richard Bird, "Reforming International Taxation: Is the Process the Real Product?" *Hacienda Pública Española/Review of Public Economics* 2 (2016): 155-176. For an interesting argument (reminiscent of the Perry comment quoted at note 6 above) that the only real rationale for the corporate income tax is the political need and economic desirability of taxing the domestic economic activities of foreign enterprises, see Luzius U. Cavelti, Christian Jaag and Tobias F. Rohner, "Why Corporate Taxation Means Source Taxation," Swiss Economics Working Paper 0054 (April 2016). This paper suggests that the most feasible way to reach this taxable base is probably to apportion net income according to the expenses incurred in each jurisdiction. Although this suggestion resembles one put forward some years ago by Bird and Wilkie, we do not explore here the virtues and problems of this and other approaches to formula apportionment as a possible way of unravelling the knotty issue of international taxation. Richard Bird and Scott Wilkie, "Source vs. Residence Taxation in the European Union: The Wrong Question?" in *Taxing Capital Income in the European Union*, ed. Sijbren Cnossen (Oxford: Oxford University Press, 2000), 78-109.

Indeed, perhaps the only prediction that can be made with certainty about the future of the corporate income tax is that so long as corporations are the dominant economic entity, it will remain a topic of interest and controversy.

2. WHY CORPORATE INCOME TAX MATTERS

Corporate income taxes matter for many reasons, but only three key questions are discussed here: How much revenue do we get from this tax? Who pays it? And what are its main economic impacts?

How Much Revenue?

Perhaps the most striking development in corporate taxation in Canada in recent years was the sharp decline in the statutory federal tax rate from about 38 per cent in 1986 to only 15 per cent in 2012.[20] Although provincial tax rates have tended to be much "stickier" over time, the weighted average provincial rate has also declined from its peak of over 14 per cent in 1994 to a bit less than 12 per cent in 2016. Despite the decline in corporate tax rates, corporate tax revenues, although quite sensitive to economic cycles, have remained close recently to the level of three to four per cent of GDP (about 12 per cent of total tax revenues) that were achieved with much higher rates in the 1980s.[21] However, since provincial rates are now much higher relative to federal rates than before, more of this revenue goes to the provinces than in the past.

Noting that the modest changes in base that accompanied the steep cuts in federal rates were quite inadequate to maintain revenue, McKenzie, in a recent article, cites an earlier study by Dahlby and Ferede which estimated the short-run tax-base elasticity in response to a cut of one per cent in the corporate rate to be 2.3 with the long-run elasticity being 15.5.[22] These estimates would appear to imply that a cut of (say) 10 percentage points in the corporate rate would, over time, result in an increase of over 150 per cent in the tax base, thus more than compensating for the revenue cost of cutting the rate.[23] Although such a linear projection of what is likely a non-linear relationship is suspect, it is certainly plausible that, at least up to some point, reductions in the federal corporate tax rate may

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20 The average effective tax rate (AETR) and marginal effective tax rate (METR), both of which are lower than the statutory tax rate, decreased by more or less the same amount. A useful discussion of these concepts and the empirical literature making use of them may be found in Marcus Leibrecht and Claudia Hochgatterer, "Tax Competition as a Cause of Falling Corporate Income Tax Rates: A Survey of Empirical Literature," *Journal of Economic Surveys* 26, 4 (2012): 616-648.

21 Kenneth McKenzie, "The Corporate Income Tax in Canada — Past, Present, and Future," *Canadian Tax Journal* 63, 4 (2015): 1011-1036.

22 McKenzie, "The Corporate," 1018-1019. The study cited is Bev Dahlby and Ergete Ferede, "What does it Cost Society to Raise a Dollar of Tax Revenues?" Commentary no. 324 (Toronto: C. D. Howe Institute, March 2011). A subsequent study employs a similar model (though different data) to show that the short-run tax-base elasticity of changes in provincial corporate income taxes is (unsurprisingly) considerably higher — 3.76 on average — with, of course, much higher long-run figures ranging from a low of 6.08 in Quebec to a high of 17.56 for New Brunswick (Ergete Ferede and Bev Dahlby, "The Costliest Tax of All: Raising Revenue through Corporate Tax Hikes can be Counter-Productive for the Provinces," University of Calgary School of Public Policy Research Paper 9, 11 (March 2016).

23 Since an increase in corporate tax revenues may lead to lower dividend payouts, there would likely be some immediate offset in the form of reduced personal income tax revenues. However, if the lower rates on corporate capital induced increased investment in the long run, presumably capital gains would be generated, which would result in increased personal income tax revenues when realized.

increase corporate tax revenues. Indeed, Canada's experience in maintaining revenues in the face of substantial rate cuts was cited in at least one study as an argument for similarly cutting corporate rates in the United States.[24] Other studies using cross-country data have similarly suggested that there is a revenue-maximizing rate for the corporate income tax: estimates range from 28 to 57 per cent, with most around 30 per cent.[25] On the face of it, the implication of recent experience and such studies may seem to be that there was some "room" for increasing the federal tax rate.[26] However, given the almost certainly non-linear relationship between rates and revenues and the much higher efficiency costs associated with increasing corporate income taxes rather than other taxes, it would be rash to base policy on such studies even if revenue maximization were the only relevant policy objective, which it clearly is not.

Who Pays the Corporate Income Tax?

The Carter argument that the corporate income tax plays an important role as a withholding tax backstopping the personal income tax assumes that the incidence of the corporate income tax falls on shareholders. However, the predominant view in the current literature is now that much of the burden of the tax in open economies is actually borne by labour. If so, this rationale for the corporate income tax is weak, and increases in corporate taxes intended to "tax the rich" are likely not only to miss their target but to result in substantial collateral damage owing to the high cost of the economic distortions associated with the corporate tax. These costs were presumably reduced by the rate reductions over the last few decades. Nonetheless, as discussed below, a good argument can still be made that they are high enough to make it good policy to change the base of the tax to one limited solely to supra-normal returns on equity. Such a "rent" tax would provide such an efficient source of revenue that it would likely be possible, if desired, to impose such a tax at significantly higher rates than the present corporate income tax.[27]

Arguments like these baffle many people who understandably believe that corporations pay corporate taxes: after all, they send the money to the government — or, perhaps, manage to avoid doing so through complex and devious maneuvers. As economists see it, however, corporations cannot pay taxes in the sense of "bearing the burden" because they are simply

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24 See, for example, Chris Edwards, "Canada's Corporate Tax Cuts" (CATO Institute, 2012), http://www.cato.org/publications/commentary/canadas-corporate-tax-cuts although this view was subsequently countered by Toby Sanger, "Do Corporate Tax Cuts Really Pay for Themselves as Harper Claims?" *Huffington Post*, September 19, 2014, http://www.huffingtonpost.ca/toby-sanger/corporate-tax-cuts_b_5844710.html.

25 See the summary of such studies in Jane Gravelle and Thomas Hungerford, *Corporate Tax Reform: Issues for Congress* (Washington, D.C., Congressional Research Service, December 2011). This study nonetheless concludes that there is little theoretical reason or empirical evidence to support any clear conclusions about the existence or size of a revenue-maximizing federal corporate tax rate for the United States. Canada is both smaller and more open that the U.S., so real reallocation and profit-shifting behaviour are likely more significant than in the U.S., with the result that its revenue-maximizing corporate rate is likely lower than that of the U.S., whatever the latter may be.

26 As Ferede and Dahlby (*The Costliest*) show, elasticities are clearly even higher at the provincial level and indeed some provinces (especially the Atlantic provinces) may already exceed the revenue-maximizing level, so at least some provinces are more likely to lose rather than gain revenues by increasing their corporate tax rates. If provincial tax policies were more co-ordinated, the supply elasticity of financial capital would presumably be less responsive to rate differentials.

27 Economists, for theoretically logical reasons, persist in calling such returns "rents," thus guaranteeing confusion in the minds of non-economist readers. In addition, it does not help the argument to learn that, as Boadway correctly says, we are not yet able to measure such "rents" with sufficient precision to tax them directly. Robin Boadway, "Tax Policy for a Rent-Rich Economy," *Canadian Public Policy* 41, 4 (2015): 253-264.

acting as agents for their owners (shareholders) and any income they have belongs to shareholders. This point may carry little weight with those who think that corporations are owned by the rich (and managed by the slightly less rich). They are unlikely to care if the rich, whether rentiers, managers, or even entrepreneurs, are taxed directly through personal taxes or indirectly through corporation taxes.

However, even if one assumes that all corporate taxes are borne by shareholders, there is no necessary correlation between the income of a corporation and the income of its shareholders or managers. A billion-dollar company may be owned largely by a few rich people and managed by a small group of less rich people. But such a corporation may also be owned by many less affluent shareholders, sometimes directly (including by employees), but more often indirectly as when shareholders are members of pension funds or participants in other financial institutions. Small corporations pay much lower tax rates than do big corporations in Canada but are often owned and controlled by rich people and used to shelter some of their personal income from personal tax.[28] In contrast, big corporations may largely be owned — though not controlled — by people with much lower incomes.

The corporate income tax may nonetheless perhaps contribute to some extent to the progressivity of the tax system.[29] If so, however, it does so blindly and imperfectly. Even to the extent the tax is ultimately borne by shareholders, unless it falls entirely on "rent" it gives rise to the problematic economic effects discussed below.[30] No persuasive analysis suggests that all corporate income taxes are paid by shareholders. Moreover, in a general-equilibrium framework, to the extent the tax lowers the normal return on capital — the result suggested in the seminal Harberger model[31] — the main problems with the corporate income tax arise not from its immediate distributional impact but rather from its long-term effects on savings (inter-temporal distortion), investment (inter-sectoral, inter-asset, and debt-equity distortions), growth (risk-taking and location distortions), and productivity (which in turn is closely related to real wages).

Nonetheless, the distributional issue remains important for several reasons:

- First, to the extent there is some forward (to consumers) or backward (to workers) shifting of the tax, a significant part of the tax burden may fall not on capital but on wages (or employment) or consumption. Studies in the U.S., a larger and less open

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28 See Michael Wolfson and Scott Legree, "Private Companies, Professionals, and Income Splitting — Recent Canadian Experience," *Canadian Tax Journal* 63, 3 (2015): 717-738; and Michael Wolfson et al., "Piercing the Veil — Private Corporations and the Income of the Affluent," *Canadian Tax Journal* 64, 1 (2016): 1-30.

29 In a careful review of the theoretical and empirical literature, Gravelle and Hungerford (*Corporate*) conclude that, for the most part, the incidence of corporate taxes falls on capital income in the United States so that such taxes are progressive because capital income constitutes a much larger share of higher incomes than of lower incomes. A subsequent study by Jennifer Gravelle updates and modifies the results of this study but does not fundamentally challenge the result that most (perhaps 60 per cent) of the burden falls on capital in the U.S.: Jennifer Gravelle, "Corporate Tax Incidence: Review of General Equilibrium Estimates and Analysis," *National Tax Journal* 66, 1 (2013): 184-214.

30 Gravelle and Hungerford (*Corporate*) find that "rent" (above-normal profits) constitutes only a small part of the corporate tax base in the U.S.; Boadway ("Tax Policy") suggests that such rents may be relatively more important in Canada, although no reliable data are available on this issue.

31 Arnold Harberger, "The Incidence of the Corporation Income Tax," *Journal of Political Economy* 70 (1962): 215-240. An extensive subsequent literature has refined this analysis, in particular extending it to encompass cross-border capital flows (see references in notes 9 and 10).

economy than Canada, suggest that the share borne by labour is at least 40 per cent.[32] It seems likely that the extent to which the tax is borne by labour is even higher in Canada.[33]

- Second, to the extent the tax falls on capital, it falls on all capital and not simply corporate capital. Some of the corporate tax burden may thus be borne in the form of lower rates of return on capital invested in housing and other non-corporate assets.[34]
- Third, even to the extent corporate income taxes are borne by corporate owners (shareholders), the extent to which the tax is borne by shareholders is at best only roughly related to their personal income, even though, as discussed later, the present integration system combined with the tax treatment of capital gains brings some accrued corporate income into the personal tax base. The favourable treatment of small corporations (see later discussion), as well as the greater leeway the rich have in determining when and in what form they actually have to "pay" tax at the personal level, make the personal-corporate connection even more tenuous.

All in all, this brief review of the murky question of the incidence of the corporate income tax suggests that whoever "pays" the corporate income tax, if that tax is altered along some of the lines discussed below, considerable changes in, for example, integration and capital gains taxation would be necessary to maintain even whatever mild degree of "rough" fiscal justice one may think is currently achieved through the corporate tax system. Those concerned primarily with achieving a degree of distributive justice through the tax system need to pay close attention to the tax treatment of personal capital income and how it relates to proposed corporate tax reforms.[35]

Economic Effects of Corporate Income Tax

Corporate income taxes affect economic efficiency and growth in a variety of ways.[36] Some of these effects, such as the allocation of resources between corporate and non-corporate sectors (e.g., housing) are related simply to the existence of differential treatment of corporations as a means of carrying on business. Others relate more to how

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32 Gravelle, "Corporate." For a recent international comparison, see Celine Azemar and Glenn Hubbard, "Country Characteristics and the Incidence of Capital Income Taxation on Wages: An Economic Assessment," *Canadian Journal of Economics* 48, 5 (2016) 1762-1802. It concludes that " … a one percentage point increase in corporate tax rates reduces wages by 0.1% in the manufacturing sector for 13 OECD countries (including Canada) over the period 1980-2004" with the burden increasing with the degree of capital openness and the degree of unionization and decreasing with the size of the economy (p. 1795).

33 Crisan, McKenzie and Mintz suggest that up to 70 per cent of corporate income taxes in Canada are borne by labour through lower real wages: Daria Crisan, Kenneth McKenzie and Jack Mintz, *The Distribution of Income and Taxes/Transfers in Canada: A Cohort Analysis*, University of Calgary School of Public Policy Research Paper 8, 5 (2015). That result is close to a recent estimate for Germany in Clemens Fuest, Andreas Peichl, and Sebastian Siegloch, *Do Higher Corporate Taxes Reduce Wages?* IZA Discussion Paper No. 9606 (December 2015).

34 In 2011, for example, 34.4 per cent of all the national stock of non-financial assets consisted of residential housing and consumer durables (CANSIM table 378-0049).

35 Considerable attention is paid to this issue in such major reviews of the U.K. tax system as the Meade and Mirrlees reports (cited in note 9), as well as in the post-Mirrlees proposals of Atkinson, *Inequality.* Interestingly, one result is that each of these studies pays close attention not only to the taxation of income flows at both the corporate and personal levels, but also to how personal wealth, including housing, is or is not taxed. This issue has perhaps received less attention than it deserves in the Canadian context, possibly because Canada has no explicit tax on personal wealth and no government has, understandably, dared to raise the question of taxing the imputed income of owner-occupied householders.

36 The Mintz report (*Report of the Technical Committee*) provides an excellent discussion of these issues.

the tax is designed: for example, the differential taxation of returns to different types of physical assets (e.g., differing depreciation rules for different types of machinery and equipment, structures, land and inventories) and intangibles (e.g., advertising, research and development). Asset differentiation not only directly affects the mix of assets chosen within a firm but also, because different activities typically employ different asset mixes, alters the allocation of capital across industries. Different treatments of different activities (e.g., manufacturing, oil and gas production, services) or sizes of firm (e.g., small business) add to the potentially deleterious effects of the corporate tax on the efficiency with which scarce investment resources are allocated.[37] Additional financial distortions associated with corporate income taxes include effects on the debt-equity ratio (since earnings on equity are taxed and interest is deductible) and the payout ratio (as a result of the incentive to delay the realization of capital gains, which in itself generates a further distortion — the "lock-in" effect).[38]

All these effects undoubtedly exist, and all reduce economic efficiency if one assumes that, in their absence, all such decisions would be made in a fully competitive market operating in a world with no externalities and no need to finance state activities. This is clearly not the world in which we live. Nonetheless, it is equally clear that corporate income taxes reduce the level of economic well-being in general compared not only to the ideal of a completely neutral revenue source but also when compared to such viable alternatives as personal income taxes and sales taxes. If a country like Canada increases the effective rate of its corporate tax relative to the average rate generally found in countries with which it has economic relations, the result will almost certainly be some reduction in the level of investment, which in turn will result in lower real wages. The Mirrlees report argues that replacing corporate income tax revenues by direct taxes on wages in the U.K. "… would allow the same revenue to be collected with more capital per worker and hence more output per worker — a more efficient outcome that would also leave domestic workers better off, notwithstanding the higher tax rate on labour income."[39] That is, many people (though perhaps not all) would likely be better off if higher taxes were imposed directly on them than on corporate income, as paradoxical as that may seem. The report supports this conclusion by citing empirical studies of European countries that suggest replacing the existing corporate income tax by an ACE (an allowance for corporate equity: a type of "rent" tax discussed later) and increasing a broad-based consumption tax would, for the U.K. case, result in a long-run increase of 6.1 per cent in investment, 1.7 per cent in wages, 0.2 per cent in employment and 1.4 per cent in GDP, leaving the "representative consumer" better off. Moving to a rent-based (or equivalent cash-flow tax) and making up for any revenue loss by raising GST thus seems like a clear winner: more growth, more jobs, higher wages, and everybody — or so it might seem — is better off.

In fact, however, most economic models — such as those just cited — assume a "representative consumer" and hence say nothing about the wide range of potential

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37 As Lester and others have shown, such problems often arise even when the differential policies are intentional: John Lester, "Benefit-Cost Analysis of R&D Support Programs," *Canadian Tax Journal* 60, 4 (2012): 793-836.

38 The "lock-in" effect is damaging not simply because it may hinder investors from portfolio diversification, but because it alters market conditions and hence reduces the efficiency with which resources are allocated.

39 Mirrlees et al., *Tax by Design*, 494. Much the same result emerges from a recent Australian Treasury study: Michael Kouparitsas, Dinar Prihardini and Alexander Beames, "Analysis of the Long Term Effects of a Company Tax Cut," Treasury Working Paper 2016-02 (Australian Treasury, May 2016).

distributive outcomes. It is thus not surprising that, since the problem is complex and economists always have their "other hand" ready, not all experts agree with this rosy scenario. In a careful review and critique of the empirical evidence for the U.S., for example, Gravelle and Hungerford estimated that the combined welfare costs of all the distortions mentioned above are probably no more than 10 to 15 per cent of corporate income tax revenues.[40] Given the costs of transition, they questioned whether basic structural changes in the domestic corporate tax would be worthwhile on welfare grounds. Similarly, although there is close to a general consensus in the academic literature that the present corporate income tax is a costly loser and that other, more attractive ways of raising revenue from the corporate sector (e.g., through the "rent" taxes discussed below) and from society in general (e.g., a more neutral GST or payroll tax) are feasible and preferable, the matter is by no means settled. Certainly, Canadians seem unlikely to believe that the evidence is persuasive that a radical change in corporate taxation would be a clear net gain for society, let alone a win for all.

The available evidence does suggest strongly that reducing marginal effective tax rates on capital will stimulate investment. But corporate taxes are hardly the only factor affecting investment. Interest rates, credit conditions, and current and anticipated demand for output — and sometimes "irrational exuberance" (or its opposite) — all affect investment also, just as the impact of increased investment on output is itself influenced by many factors. People understandably tend to believe what they have seen over the last decade or two — corporate tax rates going down while real wages and employment have not increased — and find it difficult to understand that most of them would in all likelihood have been even worse off if corporate taxes had been increased instead of reduced. Equally, of course, many firmly believe that trade liberalization has also not worked. In both cases, the human tendency to search for simple "post hoc ergo propter hoc" explanations of undesired outcomes — especially perhaps when it can be combined with a good conspiratorial twist and seems to be supported by some simple graph or correlation — makes it hard to sell the inevitably conditional and nuanced outcomes of the more complicated multi-variate regression analysis required to disentangle cause and outcome in a complex environment.

As suggested in the earlier quotation from the Mirrlees report, for example, much of the recent literature on corporate tax policy focuses on the effects of changes in a world in which capital can and does flow freely across borders. The potential impact of corporate tax changes on international capital flows, however, is often exaggerated. For example, Gravelle and Hungerford are again cautious, suggesting that for the U.S. such effects are likely to be insignificant because the differences in average and marginal effective tax rates are now relatively small across developed countries and because international capital mobility is in fact relatively limited and the extent to which it is tax-related reflects mainly the way in which (through deferment) investment abroad benefits from a particular feature of the tax.[41] Capital mobility is clearly relatively more important in Canada than in the U.S. but the other factors mentioned still give reason for caution in drawing definite policy conclusions.

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40 Gravelle and Hungerford, *Corporate*, 33.

41 Gravelle and Hungerford, *Corporate,* 34. Although we cannot discuss this point further here, it should be noted that the deferral dimension of international tax policy is much greater in the U.S. than in Canada.

For example, Mintz has similarly noted that the extent to which international capital markets are integrated is commonly overstated in the literature.[42]

Nonetheless, international aspects definitely need careful consideration when designing and implementing any corporate tax reform. Firms may move their headquarters, their research, their office, and their production facilities from country to country. Since such decisions are discrete — a particular facility is either here or there — they respond to the expected average effective tax rate (AETR) over the life of the facility.[43] On the other hand, how much is invested in general, and in any particular facility and location, depends in principle on the marginal effective tax rate (METR).[44] In addition, where firms report their profits (and deductions) depends on the statutory rate and the precise specifications of the tax law in each jurisdiction (e.g., source rules, thin-capitalization rules, transfer-pricing rules) as well as any relevant treaty arrangements and how well different countries administer their rules. No country is an island unto itself when it comes to corporate income taxes.

3. THE CORPORATE INCOME TAX SINCE THE CARTER REPORT

The Carter report has been lauded by many economists and tax scholars. Shortly after the report was published, for example, a leading American public finance expert called it "a landmark in the annals of taxation."[45] Almost 50 years later, Neil Brooks, one of Canada's leading tax law scholars, referred to it as "brilliant, imaginative, and one of a kind."[46] The report's central thrust was to subject all personal income, including capital gains (when realized, or at death, or upon giving up Canadian residence) to a progressive personal income tax. As noted earlier, the primary role seen for the corporate income tax in this system was as a withholding mechanism for the personal income tax for Canadians (as well as a tax on foreign stockholders). To serve this role more effectively, the report recommended eliminating the favourable small-business rate and taxing all corporate income at a uniform rate equal to the top personal income tax rate. The corporate tax would then be fully creditable against personal income tax applied to a base income, including the share of corporate retained income attributable to each person.[47] The report's full-fledged advocacy of "full integration" of the corporate and personal income taxes — something

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42 Jack Mintz, "Commentary" in Mirrlees et al., *Dimensions*, 906.

43 Devereux and Griffin show that the relevant AETR is a weighted average of the statutory rate and the METR, weighted by the estimated profitability of the investment. (Note that AETR, unlike METR, takes location and other "rents" into account.) Michael P. Devereux and Rachel Griffin, "Evaluating Tax Policy for Location Decisions," *International Tax and Public Finance* 10 (2003): 107-126.

44 See, for example, Duanjie Chen and Jack Mintz, *The 2014 Global Tax Competitiveness Report: A Proposed Business Tax Reform Agenda*, University of Calgary School of Public Policy Research Paper 8, 4 (February 2015).

45 Arnold Harberger, "A Landmark in the Annals of Taxation," *Canadian Journal of Economics*, supplement (1968): 183-194.

46 Words that appear in the title of his presentation to a conference on the report held at Dalhousie University's law school in September 2012. See Dalhousie University website, "Tax Conference: The Carter Commission 50 Years Later," September 28-29, 2012, http://www.dal.ca/faculty/law/news-events/conferences/tax-conference--the-carter-commission-50-years-later.html.

47 Actually, as McLure argues, although a significant withholding rate should be imposed at the corporate level on dividend payments, full integration would still likely be feasible without strictly limiting the top personal rate to the corporate rate (and vice versa): Charles McLure, *Must Corporate Income Be Taxed Twice?* (Washington, D.C.: The Brookings Institution, 1979), 150-154.

long discussed in the literature but not previously thought to be achievable — was a principal reason for its enthusiastic reception in academic circles.

But academics do not make policy decisions. Several years later, following a change of government, a federal white paper proposed reducing the scope of both integration and the personal income tax in general by taxing gains on shares of widely held companies at only half rates and reducing the creditable amount and limiting it to dividends, while at the same time replacing deemed (constructive) realization at death by a U.S. type of "carryover of basis" at death (while mitigating the "lock-in" effects of the latter move to some extent by requiring shareholders in such companies to revalue shares to market value every five years).[48]

In the end, however, neither the accrual provision nor the carryover of basis appeared in the 1971 tax reform. The main change directly attributable to the Carter report was that capital gains were taxed at half rates and a dividend credit on grossed-up dividend income was established to offset roughly the same share of tax on dividends for resident shareholders. Since the favourable small-business deduction continued to exist, the Carter vision of full integration of the corporate and personal income taxes was achieved only to the limited extent that small resident Canadian-controlled private corporations (CCPCs) chose to distribute all their earnings as dividends. For most companies, the net outcome of the 1971 reform, apart from the important partial taxation of capital gains (including at death or the fiscal equivalent of leaving the country) was to leave the economic impact of taxing corporate source income more or less as before.[49]

The Mintz Report and After

Twenty-five years later, in 1996, the Technical Committee on Business Taxation (the Mintz committee) was appointed with a broad mandate to review taxes on business and capital, including the corporate income tax. The committee's stated objective was to achieve "neutrality with internationally competitive tax rates," which it considered to be the best way to achieve the job creation, economic growth, simplification and fairness with which it was tasked.[50] Its major recommendations with respect to the corporate income tax were to lower corporate income tax rates to reduce the inter-temporal distortion (reducing slightly — but not eliminating — the favourable rates applied to small business) and to reduce inter-asset and inter-sectoral distortions by gradually reducing incentives such as capital cost allowances in excess of economic depreciation and special R&D and regional credits, as well as restructuring the treatment of the resource sector. These recommendations provided support for the further reductions in the corporate tax rate that followed after 2000: the federal rate (including surtaxes in some years), which had earlier been reduced from about 38 per cent in 1986 to 29 per cent in 1989, was again cut to 22 per cent by 2004 and then to the current 15 per cent in 2012.[51] However, not much was done to broaden the tax base.

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48 E.J. Benson, *Proposals for Tax Reform* (Ottawa: 1969). For a detailed account of the peregrination from the Carter report to the 1971 act, see Meyer Bucovetsky and Richard Bird, "Tax Reform in Canada: A Progress Report," *National Tax Journal* 25, 1 (1972): 15-41.

49 A flat dividend credit had existed since 1948 and a credit for dividends had existed in some form since 1917.

50 *Report of the Technical Committee*, Chapter 1.

51 McKenzie, "The Corporate," 1014-1015.

Two further aspects of the Mintz report are worth noting here. The first is its emphasis on the importance of internationally competitive tax rates. The Carter report had essentially treated the international dimension of corporate taxation as an "add-on" after designing its central recommendations on corporate taxation in a closed-economy framework.[52] In contrast, the central recommendations of the Mintz report were driven by the perceived need to balance facilitating international trade and investment with protecting the domestic revenue base. Although the report recommended significant tightening of some key international elements of the tax system related to thin capitalization, interest deductions, and the like, little was done along these lines. A decade later, yet another committee was struck to consider the tax treatment of cross-border investment flows.[53] Again, little was done as a result of this report, perhaps in part because the issues are inherently controversial and complex, and in part because Canada's particular concerns about international taxation were soon submerged by the avalanche of international meetings and paper related to the OECD's BEPS initiative.

A final interesting aspect of the Mintz report is that, although it considered the then rapidly expanding literature suggesting that countries, particularly relatively "open" countries like Canada, should consider much more fundamental reforms in how (if at all) they taxed corporations, in the end the report deliberately and explicitly set all such proposals aside. Discussion of the cash-flow approach, for instance, is confined to an annex that similarly treats such very different alternative approaches as financial-transaction taxes and wealth taxes. None of these alternatives were judged worth serious consideration because, in the words of the report, "none … appeared to offer sufficient advantages to justify their introduction into Canada's business tax system."[54] Not all agree with this dismissal of the prevailing economic wisdom, however, as discussed further in the next section.

4. THE WAY FORWARD?

As Boadway notes in a recent stimulating discussion of tax reform ideas for Canada, thinking about income taxation, especially at the corporate level, has changed substantially since the Carter report's strong advocacy of the comprehensive income tax ideal, both because ideas have changed and because examples of alternative approaches may be found in other countries.[55] The first big challenge to the idea that comprehensive income was the ideal tax base — and that the main role of the corporate income tax was to serve as a withholding agent in furtherance of this ideal — actually preceded Carter in a book by Kaldor, which put forward as a better ideal the concept of a progressive expenditure tax,

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52 This argument, which holds even though the Carter report included an extensive section on international tax issues, is developed at length in Mitsuo Sato and Richard Bird, "International Aspects of the Taxation of Corporations and Shareholders," *International Monetary Fund Staff Papers,* 22 (July 1975): 384-455; see also Richard Bird, "International Aspects of Tax Reform in Australia," in *Australian Tax Reform: Retrospect and Prospect*, ed. John G. Head (Sydney: Australian Tax Research Foundation, 1989), 161-183.

53 Advisory Panel, *Final Report*.

54 *Report of the Technical Committee*, A1. This conclusion is close to that reached by a U.S. report (Gravelle and Hungerford, *Corporate*) a decade later (see text at note 40 above).

55 Boadway, "Piecemeal," 1031.

which, he argued, could perhaps also largely replace the corporate tax.[56] Although traces of Kaldor's proposal have recently re-emerged in some of the extensive literature generated by the marked increase in inequality in recent years, for the most part it was soon lost in the avalanche of "welfarist" (optimal tax) literature launched by James Mirrlees and others in the early 1970s (and expertly summarized in a recent book by Boadway[57]) that still dominates the tax discussion in economics. This approach revolutionized economic thinking about taxation. So far, however it has had surprisingly little direct impact on actual tax policy, no doubt in part because it is inherently formal and mathematical and hence largely incomprehensible not only to the public but to most policy-makers (though not, of course, to at least some of their advisers).

Harberger once observed that since economics is essentially about the efficient use of resources, economists are well-advised to stick to their professional expertise when it comes to policy design.[58] Their opinions on such matters as the appropriate distribution of income and other possible national policy objectives have little or no claim to be superior to those of others. Still, what economics tells us *is* important when it comes to tax design. In recent decades, economics has provided us with a much better understanding of the extent to which people may and do respond to tax changes by altering their behavior and the constraints that such reactions impose on tax policy. As a result, most economists have become increasingly convinced that reductions in corporate taxes are more likely to enhance growth and employment than they are to simply to provide a bonus for rich shareholders. At the same time, as Milligan has recently emphasized, economists are also increasingly recognizing the need to confront the problems arising from the increasing concentration of income and to deal with the public perception that the immediate impact of corporate tax reductions may well benefit most those who already have the most.[59]

Several ways of dealing with this set of problems are sketched here in a brief review of three recent proposals for corporate tax reform recently suggested for Canada: a "rent" tax, a more incremental or gradualist reform, and a "dual income tax." These proposals both illustrate three different approaches to reforming the corporate income tax and indicate some of the difficult issues that need to be dealt with in any corporate tax reform.

Taxing Rents

The proposal most attuned to the recent economic literature is undoubtedly that by Boadway and Tremblay.[60] Like most of that literature, the authors appear to basically agree with the position taken in the U.K.'s Meade report that the best tax on corporations is one on "rent" rather than income.[61] Whatever the form of personal taxation we have, they

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56 Nicholas Kaldor, *An Expenditure Tax* (London: George Allen & Unwin Ltd., 1955), 171. The expenditure tax may, of course, be traced further back to John Stuart Mill and others, but its modern revival is largely attributable to Kaldor.

57 Robin Boadway, *From Optimal Tax Theory to Tax Policy* (Cambridge, Mass.: MIT Press, 2012).

58 Arnold Harberger, "Three Postulates for Applied Welfare Economics: An Interpretive Essay," *Journal of Economic Literature* 9, 3 (1971): 785-797.

59 Kevin Milligan, *Tax Policy for a New Era: Promoting Economic Growth and Fairness* (Toronto: C.D. Howe Institute, 2014).

60 See Robin Boadway and Jean-Francois Tremblay, *Corporate*; see also the later version in Boadway and Tremblay, *Modernizing*.

61 See the extensive review of the literature and related empirical evidence in the background paper prepared for the Mirrlees report by Auerbach, Devereux and Simpson, "Taxing."

argue that the present corporate income tax is obsolete. It is no longer needed to backstop the personal income tax because, they say, it is now so easy to shelter savings that the personal income tax has effectively become a tax on consumption for most Canadians. Moreover, as they see it, with integrated international capital markets, most corporate tax is really paid by workers and not shareholders.[62] Given these two assumptions — that the personal income tax is really a tax on consumption and that the corporate tax is largely borne by labour — it follows, as they argue, that the proper design of the corporate tax can and should be considered quite separately from how we decide to tax at the personal level. Moreover, the present corporate income tax is clearly economically inefficient, not only fostering debt financing and thus increasing the risk of bankruptcy,[63] but also taxing the normal return on capital and hence discouraging investment, innovation and productivity. It clearly needs reform.

How to do it? Drawing, in a characteristically Canadian fashion, on foreign examples in part to support their case, Boadway and Tremblay note that recent major tax reviews in the U.S., the U.K. and Australia have all recommended a fundamental reform largely for these reasons, proposing to replace the present corporate income tax with a "rent-based" tax that will fall only on "above-normal" profits.[64] Although they do not discuss the reasons why none of these countries have so far made any such changes, they mention that several smaller countries, most notably Belgium, have done so, reportedly with the expected beneficial effects on investment.[65] After reviewing various approaches to such rent taxes,[66] Boadway and Tremblay recommend that Canada should adopt an allowance on corporate equity (ACE) — that is, allowing firms to deduct an estimated risk-free (normal) interest rate for investment financed by equity — as a way of removing the tax on normal capital return (and the current subsidy for debt finance), while at the same time taxing capital gains

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62 Although the issue is not yet definitively resolved (see, for example, note 29 above), many recent empirical studies support this assertion: see, for example, on Germany: Fuest, Peich and Siegloch, "Do Higher;" and on the U.S.: Li Liu and Rosanne Altshuler, "Measuring the Burden of the Corporate Income Tax under Imperfect Competition, *National Tax Journal* 66, 1 (2013): 215-238. An important point that is perhaps not sufficiently emphasized in many such studies, but is stressed by Boadway and Tremblay (*Corporate,* 24) is that it takes a long time for such shifting to occur. Of course, even if one decides to "untax" normal returns from new capital, there is a strong case for taxing rents from existing capital (Boadway, "Tax Policy"). However, as already mentioned, it is difficult to measure such rents with much precision, including the transitional rents that may accrue on "old" capital when the tax treatment of "new" capital (investment) is altered.

63 Although this point is not discussed further here, it has recently been emphasized in, for example, R. de Mooij, M. Keen and M. Orihara, "Taxation, Bank Leverage, and Financial Crises," Working Paper 13-48 (International Monetary Fund, 2013).

64 See the reports cited in note 9 above. "Rent" in this context strictly means "the difference between a firm's revenues and the opportunity costs of all inputs, including the manager's or entrepreneur's time and risk-taking" (Boadway and Tremblay, *Modernizing*, 3), but is often more simply characterized as profits above the average risk-adjusted real interest rate established in global capital markets. If properly constructed, as Boadway and Tremblay (*Corporate*) show, a tax imposed on this base would raise revenues (for example, from monopoly profits, locational rents, windfall profits, and returns on land and other fixed factors) without discouraging investment.

65 See, for example, Nils aus dem Moore, "Corporate Taxation and Investment Evidence from the Belgium ACE Reform, 2015," available at http://hdl.handle.net/10419/112888 (accessed April 14, 2016), which estimates an increase of about three per cent in the rate of investment following the introduction of an ACE in Belgium.

66 Alternative ways of taxing rents include the cash-flow system originally proposed in the Meade report in the U.K. and the resource-rent tax proposed for the mining sector in the Henry report in Australia. For a good recent discussion of these alternatives as well as the CBIT (comprehensive business income tax) proposed in the 1992 U.S. Treasury report (which assures the equal treatment of equity and debt), see Sijbren Cnossen, "What Kind of Corporate Tax Regime?" *Osgoode Hall Law Journal* 52, 2 (2015): 517-555.

fully and eliminating the dividend tax credit in part to make up the revenue loss.[67] This package of reforms, they argue, would have the added benefit of ensuring that corporate taxes — since they would now be levied only on rents — will be more likely to stick where they are intended to be: on shareholders, rather than being passed on to workers (or, perhaps, consumers).

Incremental Reform

Despite proposing the fundamental reform just discussed, Boadway has recently noted elsewhere that tax reform in Canada is more likely to come in small pieces than through fundamental reform.[68] Like Boadway, Mintz has written extensively and informatively about issues of corporate taxation in Canada and elsewhere for many years. The 1998 report of the Technical Committee he led remains an important touchstone in the development of both corporate tax policy and scholarly research on the corporate income tax in Canada. Interestingly, in a recent review of corporate tax reform, as in the earlier Technical Committee report, Mintz takes a much more incremental and gradualist approach to something approaching "optimal" corporate tax reform than the sweeping revision proposed by Boadway and Tremblay.[69]

The principal aim of his recent study is stated to be to improve the "neutrality" of the system in terms of "the extent to which the same rules apply across business sectors, and between large and small companies."[70] Given this aim, it is not surprising that his principal conclusions are that rules favouring specific sectors, such as accelerated depreciation, investment credits, and resource deductions, should be reined in and the small-business deduction significantly reduced. In addition, he urges the provinces to adopt uniform corporate tax rates (with no favourable treatment of small business) and, as one would expect from his previous work, suggests the federal government should not raise its corporate rates but rather keep them "internationally competitive."[71] Essentially, he argues that "tax neutrality achieves a better allocation of capital investment by putting decisions on which projects offer the best return in the hands of businesses rather than governments, which are all too often swayed by non-economic considerations."[72] Theory, most empirical studies (such as the 2012 study by Dahlby, which Mintz cites)[73], and considerable Canadian experience with earlier ill-conceived government attempts to shape investment policy tend

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67 Boadway and Tremblay, *Corporate*, 52. In contrast, Milligan (*Tax Policy*, 28), argues that both capital gains and dividends should be taxed at the same uniform rate, largely because he thinks full taxation of gains would lead to a very strong response from high-income earners that might lead to a flight of capital abroad. As always, it is easier to draw on conclusions on such matters from theory than it is to provide conclusive evidence that the conclusions are not only right for the case being considered, but significant enough to warrant policy change.

68 Boadway, "Piecemeal."

69 Jack Mintz, *An Agenda for Corporate Tax Reform in Canada* (Canadian Council of Chief Executives, September 2015).

70 Mintz, *An Agenda*, 3.

71 For example, Chen and Mintz, *The 2014 Global*.

72 Mintz, *An Agenda*, 5.

73 Bev Dahlby, "Reforming the Tax Mix in Canada," University of Calgary School of Public Policy Research Paper 5, 14 (2012).

to support this argument.[74] Politicians often support such efforts on the grounds that they will yield more jobs. However, if government policies direct investment into less productive activities, then even if some politically salient jobs are created transitorily, the long-run effect is almost certain to be to reduce productivity and hence real wages, jobs, or both.[75]

Despite his belief that corporate rate reductions are unquestionably productive of jobs and growth, Mintz does not recommend an ACE or other form of rent tax for four reasons:

- Most importantly, as rent-tax advocates often recognize, this form of "rent" tax at the corporate level would be practical only if there were also substantial changes in personal income taxes to avoid the obvious mismatch between allowing corporate deductions for the cost of equity financing while bringing the income into tax only when capital gains are realized. Mintz does not believe that any feasible changes in the treatment of personal capital income are likely to compensate fully for giving up the important role of the corporate income tax in providing some check on the ability to circumvent the personal income tax.[76]
- This problem would be aggravated by the fact that allowing the deduction of equity costs would increase tax losses, provide an even more attractive "haven" from personal taxes, and lead to the politically unpalatable outcome that many more corporations would pay no tax at all.
- Moreover, moving to a rent tax would have two undesirable international effects. First, assuming that the U.S. retains its present tax, Canadian corporate taxes would likely not be creditable against U.S. taxes, which would doubtless discourage U.S. investors (who currently own about 50 per cent of Canada's capital stock).[77]
- In addition, but working in the other direction, foreign investors, who would be able to deduct financing costs in Canada as well as interest deductions abroad, would have an advantage over domestic investment and ownership.

For these reasons, Mintz makes the considerably more modest proposal that Canada should maintain its present corporate tax rates at the competitively low levels achieved in

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74 Indeed, it may be argued that the main impact of the "optimal" tax approach on practical tax reform in most countries has been to support exactly this sort of "broad-base low-rate" (BBLR) approach: see Richard Bird, "The BBLR Approach to Tax Reform in Emerging Countries," in *Public Economics: Theory and Policy*, ed. M. Govinda Rao and Mihir Rakshit (New Delhi: Sage Publishers, 2011), 37-63.

75 Of course one can only make estimates of the magnitudes involved by making a series of theoretical and empirical assumptions that may be questioned. For example, Mintz (*An Agenda*, 17) cites previous work to estimate that the economic cost of inter-sectoral allocative distortions alone arising from the corporate tax are in the range of 50 to 85 per cent of the revenue raised. In comparison, Gravelle and Hungerford (*Corporate*, 33) estimate that the same costs (plus those arising from financial distortions) were likely not more than 10 to 15 per cent of revenues for the United States. Though Canada is, of course, a more open economy, divergence of this magnitude again underlines the dependence of all such estimates on a wide range of specific choices about model specification and the value of various and inevitably somewhat uncertain parameters.

76 Mintz ("Commentary," in Mirrlees et al., *Dimensions*) earlier also stressed the value of the corporate income tax as a kind of proxy user charge for benefits received by corporations. Boadway and Tremblay (*Corporate Tax*, 28) dismiss the importance of this argument, noting that the corporate income tax is not a very good benefit tax. This criticism is correct. Bird and Mintz long ago suggested a better alternative; in the absence of such an alternative, however, one should perhaps not be quite so quick to dismiss the benefit-tax point: Richard Bird and Jack Mintz, "Tax Assignment in Canada: A Modest Proposal," in *The State of the Federation, 2000-01: Toward a New Mission Statement for Canadian Fiscal Federalism*, ed. Harvey Lazar (Montreal: McGill-Queen's University Press for School of Policy Studies, Queen's University, 2000), 263-92.

77 Mintz (*An Agenda*, 20) estimates that only about 10 per cent of Canadian corporate tax revenues are now credited against U.S. tax because only about 40 per cent of profits of U.S.-owned corporations are remitted home and roughly two-thirds of the recipient corporations are in an excess credit position.

recent years, while making the system more economically efficient (neutral) by imposing more uniform rates on businesses of all sizes (which would also increase progressivity by reducing the present use of small corporations to shelter high personal incomes) and especially by broadening the base by restricting such distorting incentives as resource deductions and sector- or asset-specific accelerated depreciation as well as investment credits. This proposal is obviously much simpler to understand and to implement than leaping to an ACE or other form of rent tax. It would, in all likelihood, be considerably easier to explain and sell to the public, particularly if one stressed the small progressive component (which may not be easy since it rests on the apparently paradoxical reduction in favouritism to small business). Serious reform thus seems unlikely until most people accept the idea that taxing corporations, both foreign and domestic, much more heavily than at present is not a good idea because, even if the tax is not shifted to workers immediately, the sensitivity of investment to the corporate tax means that it will still fall on workers in the long run because there will be lower growth and lower productivity, with consequently negative effects on real wages or employment or both.

On the other hand, while people may only understand statutory rates when it comes to taxes, experience everywhere suggests that it is more difficult to broaden the base than to change the rate. Those who benefit from such long-established tax treatments as the small-business rate or the resource deduction are understandably often prepared to fight to the death to maintain the "rights" to which precedent has, they feel, entitled them — and they have, in the past, generally managed to win the day. If this continues to be the case, then arguably Mintz's proposal essentially amounts to a plea to maintain Canada's relatively favourable international status quo when it comes to the three critical corporate income tax rates — the AETR, the METR, and the statutory rate — rather than risking everything on a new, untried, and undoubtedly hard-to-sell proposal that many will see as yet another gift to the rich.

Like other reform proposals, incremental reforms inevitably rest on theoretical and empirical arguments that, like most in economics, are not rock solid. Nonetheless, proposing a mildly reformist package may prove the best way to induce Canadians to muddle along in the uncertain years to come, even if it is a package that is unlikely to be accepted in full, as will certainly be the case for reducing the small-business deduction or tampering with resource deductions. For the last century, we have generally responded to changing circumstances cautiously and with care rather than leaping into the unknown with the panache that some would prefer. Circumstances would need to change radically before we are likely to alter this pattern.

Dual Income Tax

However there is another possible path to fundamental reform that perhaps deserves more attention in Canada than it has received and that has important implications for how we view the corporate tax: the "dual income tax" suggested recently by Kevin Milligan.[78] This approach to reforming both the taxation of personal capital income and the corporate

[78] Milligan, *Tax Policy.*

income tax is worth looking at more closely in Canada.[79] Income tax fans often see the dual income tax approach to be a step backward — a "deform" rather than a reform — not only because it is a schedular tax imposing distinct taxes on capital and labour income rather than a Carter-style comprehensive income tax, but also because it imposes a uniform flat tax on capital income and a progressive tax on labour income. Nonetheless, the fact that dual income taxes have operated successfully for some years in a number of countries makes it a bit surprising that economists have paid so little attention to the idea, compared to the flow of proposals for as yet largely untried "rent" taxes like the ACE discussed earlier.[80] The latter ideas are intellectually coherent and fun to think about, but there is at yet little evidence on the ground as to how well they work in practice.[81] In contrast, there are decades of experience with the dual income tax in countries not all that unlike Canada in many important respects.

One reason the idea has been neglected may be because, in itself, the dual income tax seems to do little to reform the major failure of capital income taxation as economists see it, namely, its undesirable impact on saving and investment. This is a misconception, however, since a dual income tax can substantially reduce and even eliminate many of the distorting effects usually attributed to corporate and capital income taxes and can moreover, as Milligan has recently noted, readily be combined, if desired, with taxing corporations on a rent basis.[82]

Taxing all capital income including all income received by corporations at the same moderate uniform rate would have many advantages, making tax arbitrage less attractive and reducing tax-induced distortions in financing arrangements (including clientele effects affecting ownership patterns).[83] At the same time, however, the corporate tax would still serve as a withholding tax on corporate payments to individuals and foreigners and would also reach firm-specific and location-specific rents. Importantly, it could do all this independently of the tax systems of other countries and without requiring any major changes in business or tax accounting practices. Finally, many complex aspects of the current system, such as integration and the current capital gains tax treatment, could be abolished. These are not small virtues.

No silver lining comes without clouds, of course, and several clouds occlude the Nordic sun of the dual income tax. First, it is not always easy to distinguish capital from labour income. Fortunately, several countries with dual income tax systems have wrestled with this problem over the years and have found acceptable solutions — solutions that are neither ideal nor fool-proof but are good enough for practical purposes. The current Norwegian regime, which in effect subjects only the "normal" return on capital to the capital tax rate,

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79 See also Cnossen, "What Kind"; and Peter Birch Sorensen, "The Nordic Dual Income Tax: Principles, Practices, and Relevance for Canada," *Canadian Tax Journal* 55, 3 (2007): 557-602.

80 For example, McKenzie and Taylor ("Business Income") do not even mention the dual income tax.

81 The main exception is with respect to taxing the very large "rents" often generated by exploiting non-renewable resources associated with resource exploitation. For a good introduction to this topic, see Philip Daniel, Michael Keen, and Charles McPherson, *The Taxation of Petroleum and Minerals: Principles and Practices* (London: Routledge, 2010).

82 Milligan (*Tax Policy*) suggests combining a corporate rent tax with a flat capital tax on dividends, capital gains, and other personal capital income.

83 See Cnossen, "What Kind;" and Sorensen, "The Nordic."

with excess returns being combined with "labour" income and taxed under the progressive schedule, is particularly neat and also reduces the distortion of investment decisions.[84]

Another problem (at least in terms of perception) with the dual income tax is that the level of the uniform rate of capital income is perhaps more likely — for international reasons — to be set at the lower end of the progressive rates applied to other income (as is the case in the three Nordic countries — Finland, Sweden and Norway — with dual income taxes) than at the higher rate (as the Carter report had suggested in its integration proposal). As Milligan notes, however, if the combined rate of the corporate tax (even one imposed on rents only) plus the flat rate on personal capital income is approximately the same as the top rate of the progressive tax on non-capital income, high-income people will be discouraged from hiding some of their labour income in a corporation — a practice by no means unknown in Canada.[85]

Still, given the current concern with inequality and the correct perception that capital income generally flows upward, the optics of the distributive outcome are a hard sell. For example, the supposedly lower level of progressivity of a dual income tax is the main objection cited by Boadway and Tremblay.[86] There are two responses to this objection. First, as Cnossen notes, trying to impose progressive taxes on capital income in a world of capital mobility usually ends up with "complex, fragmentary, and ineffective taxes on capital and income" so that a flat tax on all sources of capital income … even at lower rates than labor income is taxed, ensures a greater degree of effective equity."[87] That is, striving for unattainable progressive perfection should not be allowed to get in the way of more effectively taxing the rich. Secondly, to paraphrase a remark made by Neil Brooks in a different context, if Canadians really want to overcome any additional inequity arising from a low uniform tax on capital income, they could and should consider re-introducing at least a modest explicit tax on wealth rather simply trying to swim against the tide of globalization by increasing the current fragmented set of disparate rates, including the corporate income tax rate, that purport to serve this purpose.[88]

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84 Sorensen ("The Nordic," 593) suggests that self-employed people could be given the option of including an imputed return on capital in their income, which would be taxed at the uniform rate. In contrast, Mirrlees et al. (*Tax by Design*, 446) opt instead for what they call a "Rate of Return Allowance" for all capital income, which in effect extends the ACE approach of exempting the normal rate of return from corporate income tax to cover all capital income.

85 Milligan, *Tax Policy*, 34. This argument is developed further in Christian Keuschnigg and Martin Dietz, "A Growth Oriented Dual Income Tax," *International Tax and Public Finance* 14 (2007): 191-221. See also the suggestion for a DPIT (dual progressive income tax), with different schedules for labour and capital income, with the capital income schedule being more mildly progressive but with the same top rate as the labour schedule in Bert Brys, Sarah Perret, Alastair Thomas, and Pierce O'Reilly, *Tax Design for Inclusive Economic Growth*, OECD Taxation Working Papers, No. 26 (Paris: OECD), 41. On hiding personal income in small corporations, see the references in note 28 above.

86 Boadway and Tremblay, *Corporate Tax*, 20.

87 Sijbren Cnossen, *Taxing Spillovers by Taxing Corporate Income in the European Union at Source*, CESifo Working Paper No. 5790 (March 2016), 26.

88 Neil Brooks, "An Overview of the Role of the VAT, Fundamental Tax Reform, and a Defence of the Income Tax," in *GST in Retrospect and Prospect*, ed. Richard Krever and David White (Wellington, New Zealand: Thompson Brookers, 2007), 597-658. At the very least, forcing people to think more seriously about this possibility as a more efficient and effective way to achieve whatever distributional goal is socially desired may prove a useful way to simultaneously induce rethinking about the common (and largely mistaken) perception that one of the simplest ways to tax the rich more effectively is by increasing corporate tax rates.

5. A FEW KEY ISSUES

Few aspects of taxation are more technical and convoluted than corporate taxation. Apart from a brief look at the important intergovernmental aspect of corporate taxes, however, this section touches on only two of the many important issues that are likely to be on the agenda in the near future — the outlook for the integration system and the much-discussed small-business deduction — before concluding with a few words on the apparently eternally fascinating issue of the use of the corporate income tax as a way to shape private investment decisions.

The Federal-Provincial Dimension

Problems arising from co-occupancy of the tax base were a major focus of the Rowell-Sirois Commission, which saw the best solution to be the complete withdrawal of the provinces from the corporate tax field.[89] Although the pressures of war finance soon produced this outcome, the realities of post-war politics eventually led to the present system in which the federal government, through the Canada Revenue Agency (CRA), now administers provincial corporate taxes for eight provinces at rates set by the provinces, while Alberta and Quebec administer their own corporate taxes. Following many years of often-contentious federal-provincial discussions, all parties have since 1958 agreed on a uniform system of allocating the tax base among provinces.[90]

Despite the apparent calm, however, the relative importance of provincial corporate taxes has increased over time and it is probably still true that, as was said some years ago, "the most unpredictable element in business taxation is the relationship between federal and provincial tax policies."[91] A few possible reasons for concern may be worth noting:

- First, although Ontario decided in 2006 to turn over the administration of its corporate tax to the CRA (beginning in 2009), the prospect that the remaining provinces will also do so (as Quebec had been considering) may have been damaged by recent developments that re-emphasized the somewhat anomalous position of the CRA as a supposedly joint federal-provincial body (with a board dominated by provincial appointees) that is really answerable only to the federal government.[92]
- Second, differences in provincial corporate rates combined with the allocation rules may at times lead corporations to move operations between provinces, as happened some years ago when most oil companies moved their head offices to Calgary. If

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89 Royal Commission on Dominion-Provincial Relations, *Report* (Ottawa: King's Printer, 1940), II, 114.

90 See Ernest H. Smith, *Federal-Provincial Tax Sharing and Centralized Tax Collection in Canada* (Toronto: Canadian Tax Foundation, 1998). The general formula gives equal weight to payrolls and sales in each province, although some industries (transport, finance) are treated differently. As McLure observed long ago, what this formula means is that provincial corporate taxes are not really levied on corporate profits but on payrolls and sales. Although this issue cannot be explored further here, such a tax is unlikely to increase tax progressivity by much, if at all: Charles McLure, "The State Corporate Income Tax: Lambs in Wolves' Clothing," in *The Economics of Taxation*, ed. Henry J. Aaron and Michael J. Boskin (Washington, D.C.: The Brookings Institution, 1980), 327-346.

91 Hale, *The Politics*, 316.

92 Mowat Centre, *Back from the Brink: Lessons from the Federal-Provincial Dispute about the Ontario Retirement Pension Plan* (January 2016).

fundamental changes in corporate taxation are considered, close attention would have to be paid to any such possible outcomes.

- Third, co-occupancy of the corporate tax base creates both horizontal and vertical fiscal interdependence between governments (externalities), which would also need to be taken into account with respect to any reform.[93]
- Fourth, given the propensity of both provincial and federal governments to attempt to influence investment decisions through various incentives, tensions are bound to continue to arise from time to time on this front also. However, such tensions could perhaps be reduced if all concerned would agree to follow the few rules specified below when playing this game.
- Finally, the treatment of the resource sector, with its obvious highly differential regional impacts, is as important with respect to corporate taxation as in other areas of federal-provincial relations. Specifically, as both Mintz and Boadway have recently noted, regardless of whether the basic corporate income tax is reformed or not, the current treatment of the resource royalty deduction needs to be re-examined.[94]

Individually, each of these difficulties can no doubt be handled. Together, however, they provide additional reasons to think that a really "fundamental" corporate tax reform may perhaps be feasible only in response to a major crisis.

Integrating Corporate and Personal Income Taxes

As mentioned earlier, one of the major results of the Carter report was to introduce a degree of integration between taxing corporate income at the corporate level and taxing income from corporate sources at the personal level. At present, Canada's system provides close to full integration for dividends. While the precise degree of integration varies across provinces, to adjust for the favourable treatment of small business discussed in the next section, separate gross-up and credit rates apply to qualifying dividends (paid from income not subject to the small-business deduction) and non-qualifying dividends. The result is that full integration is achieved for small Canadian-controlled private corporations (CCPCs) — those with income less than $500,000 — so that unincorporated and incorporated businesses are treated in more or less the same way, provided the latter pay out all their net income as dividends.

As Milligan mentions, there has been some move away from integration in a number of countries in recent years.[95] Curiously, the United States, a country that has never seriously considered integrating its personal and corporate income taxes, probably now comes closer to the Carter system than any other country owing to the increasingly large number of

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93 See, for example, Bev Dahlby and Leonard S. Wilson, "Vertical Fiscal Externalities in a Federation," *Journal of Public Economics* 87, 5-6 (2003): 917-930; and Ann Cavlovic and Harriet Jackson, *Bother Thy Neighbour? Intergovernmental Tax Interactions in the Canadian Federation*, Department of Finance Working Paper 2003-09.

94 Mintz, *An Agenda*, 23; Boadway, "Piecemeal," 1056.

95 Milligan, *Tax Policy*, 26. For an early, skeptical appraisal of the case for integration, see Richard Bird, "Corporate-Personal Tax Integration," in *Tax Coordination in the European Community*, ed. Sijbren Cnossen (Deventer, Netherlands: Kluwer, 1987), 227-251.

corporate entities that elect to be taxed as "S" corporations so that all net income, gain or loss, and whether distributed or not, is flowed through to shareholders.[96]

In contrast, although Carter recommended full integration of both dividends and retained earnings, the current integration system in Canada is only partial because corporate retained earnings are not integrated. However, since only 50 per cent of capital gains are subject to personal income tax upon realization, there is some rough degree of integration for realized capital gains on the sale of corporate shares. The combined corporate-personal tax rate on capital gains approximately equals the marginal personal rate for individuals in the top marginal rate bracket. However, for those in lower rate brackets the one-half inclusion rate for capital gains means that gains received by those subject to less than the top marginal rate receive less relief than those received by top-bracket people.

Some would say integration simply has no place in Canada's income tax system.[97] Others might not go that far but would still like to improve the present system in various ways. One such way might be to simplify the existing system by removing the present special treatment of dividends for small CCPCs. A more radical approach would be to go back to Carter and integrate retained earnings as well as dividends. With such a system, each shareholder would receive a statement of income at the end of the year, including "earnings retained on your behalf." These retained earnings would then be subject to the same gross-up and credit as dividends and, of course, would be added to the cost basis of the value of the shares. If the shares are then sold at a value equal to their original cost plus reported retained earnings over the holding period, no capital gains tax would be payable upon realization; if the sales value is less than the original cost plus retained earnings, there would be a capital loss; and if the sales value exceeded the adjusted cost base — that is, there is what Carter called a "goodwill gain" — there would be a taxable capital gain.

An obvious advantage of such a fully integrated system is that it would eliminate the incentive to shelter income within corporations. However this system has its own problems: in particular, as mentioned above, because the statutory corporate tax rate is likely to be lower than the marginal personal rates for many shareholders, they would be liable for tax on income accrued but not received.[98] A less radical approach could avoid this problem by including in income all capital gains realized upon sale of shares while at the same time applying to such gains the same gross-up and credit scheme as dividends. The result would

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[96] "S corporations" (so-called because they are permitted under sub-chapter S of the Internal Revenue Code) are corporations that elect to be treated in effect as a non-publicly traded partnership in respect of current income, gain or loss, but for other purposes are generally treated as a corporations. Such corporations must have no more than 100 shareholders and only one class of stock. Such "pass-through" corporations now account for about a third of U.S. corporate income (Auerbach, Devereux and Simpson "Taxing," 866).

[97] To mention a prominent recent example, Boadway and Tremblay (*Modernizing*, 11) state that "the case against integration is compelling." That case rests primarily on the arguments discussed earlier about the incidence of the corporate income tax — an argument that was long ago contested in an unduly neglected paper by Peter Mieszkowski, "Integration of the Corporate and Personal Income Taxes: The Bogus Issue of Shifting," *Finanzarchiv* 31, 2 (1972): 287-297. A secondary argument is that, in line with the case for taxing only "rents," any integration should in principle be applied only to above-average returns but that it would not be practical to do so. This point is similar to the many objections to the Carter full-integration proposal owing to the difficulty of tracking retained earnings. Actually, with modern information technology, as U.S. experience with S corporations demonstrates, it does not seem to be all that difficult to attribute retained earnings to shareholders. However, it is still a bridge too far to attempt to separate out the "rent" element of such earnings.

[98] This was not a problem under the original Carter integration proposal, because the corporate rate was equal to the top personal rate. Shareholders in the top bracket would pay no additional tax, and shareholders in lower brackets would receive rebates. (See also note 47 above.)

be that shareholders would not pay any taxes on earnings retained by corporations prior to disposition of their shares. Moreover, although those in the top personal brackets would pay approximately the same tax under this scheme as under the current 50-per-cent inclusion rate for capital gains, those in lower brackets would pay somewhat lower taxes under this gross-up and credit scheme.

The extent and nature of corporate-personal tax integration — its desirability, its practicality, and its effects — is an important structural feature that has to be dealt with in the context of corporate tax reform in Canada. Extreme solutions ranging from abolition to full integration as well as a wide range of possible compromises in between, like those just mentioned, need careful consideration. One cannot simply ignore the critical linkage (or lack of it) between the corporate and personal tax treatment of corporate source income and the related issue of how that linkage fits with however we decide to tax other forms of personal income, whether from capital (e.g., interest, capital gains from non-corporate sources, etc.) or other sources.

Taxing Small Business

Along similar lines, a study for the U.K.'s Mirrlees report noted that the taxation of small business raises issues that:

> … are highly complex and pervade the design of the entire tax system. They affect the interaction between taxation of income from labour and that of income from capital. They are at the interface between the taxation of incorporated and unincorporated firms and also go to the heart of the relationship between personal and business taxation. … (I)t is impossible to design a sensible personal or corporate tax system without taking them into account.[99]

The extensive, well-documented and convincing review of the evidence and issues in the study cited clearly demonstrates the truth of this proposition. [100] It also makes it clear that there is no convincing case that supports blanket tax relief for small business. At the most, only very limited and specific tax reliefs, tightly and effectively targeted to offset certain limited problems (notably for exceptional cases of market failure or unwarranted compliance) may be warranted. The message is convincing. Nonetheless, no one, anywhere, seems to be convinced. Canada is no exception.

Both the federal and provincial corporate income taxes provide lower tax rates for small Canadian Controlled Private Corporations (CCPCs) through a "small business deduction" (SBD) that imposes a lower rate on income up to a maximum threshold. The current federal SBD is 17.5 per cent, which lowers the statutory corporate tax rate from 15 per cent to 10.5 per cent — that is, by 30 per cent — for income up to $500,000. The provincial small-business threshold is the same, except in Nova Scotia ($350,000) and Manitoba ($450,000), and in most cases the rate cut is even greater. In 2016, for example, British Columbia offered a low rate of 2.5 per cent (a 77-per-cent reduction from the standard rate of 11 per cent), Alberta was almost as generous (three per cent compared to 12 per cent) and even Ontario (4.5 per cent compared to 11.5 per cent) was more than twice as generous

[99] Claire Crawford and Judith Freedman, "Small Business Taxation," in Mirrlees et al., *Dimensions*, 1031.

[100] ibid, 1018-1099.

as Quebec (8.0 per cent compared to 11.9 per cent), which is a bit less generous than the federal cut.

These lower rates offer an obvious temptation for people subject to higher personal income tax rates to shelter income within corporations. To limit such actions, the maximum threshold for the SBD begins to be phased out (clawed back) when the assets ("taxable capital") of a CCPC exceed $10 million and is eliminated when assets reach $15 million. This phase-out of the SBD is arguably a disincentive for growth when firms approach the $10-million threshold, although a recent estimate suggests that this effect is not that significant.[101] An additional deterrent to accumulating financial assets within a CCPC is the imposition of a refundable tax of 6.7 per cent on investment income, with the tax being refundable to the corporation when the investment income is subsequently paid out as dividends. Another aspect of the tax treatment of small-business income is, as mentioned earlier, that dividends paid from active business income subject to the SBD ("non-qualifying dividends") are subject to a lower gross-up and credit rate than other dividends ("qualifying dividends").[102]

All this adds considerable complexity to the corporate tax system.[103] Yet even some advocates of fundamental business tax reform, such as Boadway and Tremblay, assume that we should continue to provide favourable tax treatment for small businesses.[104] These authors suggest two possible modifications: restricting the SBD to new firms (for example, by defining the threshold in cumulative rather than annual terms); and making professional firms ineligible for the low rate. Mintz, on the other hand, suggests that the generosity of the SBD should be halved as one way to finance a general cut in the corporate rate while at the same time encouraging investment by smaller firms by permitting the expensing of the first $2 million in investment expenditures.[105] Given the long history and the strongly political context within which small-business tax policy appears to be determined in all countries, no matter how the corporate tax is reformed, tax preferences for small business are likely to persist.

Nonetheless, as already mentioned there are clearly some problems with the existing SBD, such as income sheltering (perhaps particularly for professionals), imperfect integration (especially for capital gains), and perhaps some deterrent to growth, so alternatives to the present SBD deserve consideration. One, which has not apparently received much

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101 Benjamin Dachis and John Lester, *Small Business Preference as a Barrier to Growth: Not so Tall After All*, Commentary 425 (Toronto: C.D. Howe Institute, 2015), which also discusses the "enhanced" SR&ED investment tax credit on R&D expenditure for small firms.

102 In 2016, the federal dividend tax credit is 15.0198 per cent for eligible dividends and 11.0169 per cent for non-eligible dividends.

103 For example, although Dachis and Lester (*Small Business*, 23) conclude that, on balance, the SBD appears to achieve its apparent objectives at least to some extent by inducing more investment by small firms and permitting more internal financing of such investment, they also note that if one assumes, as seems reasonable, that the SBD is financed by imposing a higher general corporate rate, the net effect of the SBD is still to make Canadians worse off than they would otherwise be.

104 Boadway and Tremblay, *Modernizing*, 14.

105 Mintz, *An Agenda*, 23. This recommendation resembles the Mirrlees report, which emphasized the need to reduce the existing degree of difference in the tax treatment of small versus larger businesses but suggested that small firms should be permitted not only to expense investment expenditure, broadly defined, from taxable income, but even to deduct more than 100 per cent of the cost (Mirrlees et al., *Tax by Design,* 468).

consideration in Canada, would simply be to adopt U.S. style chapter “S” treatment.[106] If CCPCs could elect to be treated like partnerships, Carter-like integration would be accomplished. Moreover, to the extent there is a deterrent to incorporating startup ventures as a result of the inability to deduct corporate losses from other income, this problem would be mitigated.[107] On the other hand, as Canadians learned from earlier experiences with “flow-through” arrangements — the SRTC (scientific research tax credit) in the 1980s[108] and the “income trust” episode early in the 2000s[109] — steps in this direction need to be very carefully considered.

As noted above, another reform — one originally recommended by the Carter commission and recently suggested by Mintz — would be to replace the SBD with expensing of new investment up to an annual limit.[110] Such expensing could of course also be applied to S corporations, thus offsetting the possible barrier to investment arising from taxing retained earnings. Perhaps expensing could be extended to include working capital (inventories) and acquisition of active businesses. An alternative move in the same direction would be to provide an investment credit for small CCPCs for new investments up to, say, $500,000 annually to replace the SBD. Such a credit at a rate equal to the existing difference between the corporate statutory rates for large and small businesses would provide the same tax reduction as the SBD for a firm that reinvests all its net earnings.

With either of these approaches, the general federal corporate rate (currently 15 per cent) would then apply to small CCPCs, thus eliminating the need to segregate non-qualifying dividends from qualifying dividends. The resulting more generous tax treatment of dividends paid by small CCPCs would offset the effect of elimination of the SBD for dividends paid by small corporations. The only small CCPCs that would be adversely affected by replacing the SBD with an appropriate investment credit would be firms using retained earnings to invest in financial assets (or real property not used in an active business). Like the Carter-Mintz expensing proposals, an investment tax credit would also eliminate the barriers to growth generated by the existing SBD system. Either the expensing or investment credit approach would reduce the METR on investments made by small CCPCs as well as for firms currently within the $10-15 million transition zone.

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106 Recently, some proposals to remove the “pass-through” treatment of many S corporations have been discussed in the U.S. as one possible way to broaden the corporate tax base and lower the rate. See Mark P. Keightley and Molly F. Sherlock, *The Corporate Income Tax System: Overview and Options for Reform*, CRS Report 7-5700 (Washington, D.C.: Congressional Research Service, December 2014). Of course, Canada’s past experience with flow-through shares has hardly been all positive: see Canada, Department of Finance “Flow-Through Shares: A Statistical Perspective,” in *Tax Expenditures and Evaluations 2013* (Ottawa).

107 Whether there is a “tax bias” against risky ventures is difficult to determine. Individuals who anticipate losses during the early years may delay incorporation in order to deduct the losses against other income. Currently, capital losses can only be offset against capital gains, but can be carried forward indefinitely. Moreover, there is a lifetime capital gains exemption (currently $813,600) on disposition of CCPC shares. Since the CRA does not fully participate in the upside of risky ventures involving CCPCs, it would not be appropriate to allow full loss offsets against other income.

108 Patrick Grady, “Tax Incentives for R&D in Canada: A Review of the Recent Experience” (June 1986), http://mpra.ub.uni-muenchen.de/21506/.

109 Canada. Department of Finance, *Tax and Other Issues Related to Publicly Listed Flow-Through Entities (Income Trusts and Limited Partnerships)* (Ottawa: 2005); see also reference in note 106 above.

110 Royal Commission on Taxation, *Report*, Vol. 4, 276-282; Mintz, *An Agenda*, 23.

Tax Preferences

The persistence of tax preferences favouring small business is just one instance of how politics inevitably shapes tax policy. There can be no policy in a democracy without politicians. Most tax experts would perhaps be delighted if politicians were content simply to spend tax proceeds rather than endlessly — and often pointlessly or, even worse, damagingly — inserting all sorts of special incentives, reliefs and preferences into the tax system to show that they are on side with this or that currently trendy issue or in response to demands from some particular pressure group or other. But this is like wishing that no clouds should ever hide the sun: it will not happen. Rather than lamenting the inevitable and seeking the impossible, a more rewarding approach to tax preferences is probably to figure out how to maintain a good tax system given the inevitable need of politicians to tinker. One way to accommodate political necessity while maintaining conceptual integrity and feasibility of administration as much as possible may be to set out a framework within which corporate taxes can be to some extent varied in accordance with specific political preferences without ruining the system.

For one brief and shining moment Canada actually seemed to be leading the world in this respect. Unfortunately, it is far from clear that the final results of this experience were wholly positive. At the end of the 1970s, a new budgetary system (PEMS, the Policy and Expenditure Management System) was introduced by the federal government.[111] One aim in doing so was to rein in the growth of "tax expenditures" by including in the budgetary process a formal evaluation of a "resource envelope" for different government functions (e.g., social development) that would include not only direct expenditures but also tax expenditures.[112] In other words, Canada proposed to be the first government in the world to recognize formally and effectively that a dollar given up through a tax concession was equivalent to a dollar spent directly.[113]

An important part of this new approach was the publication for the first time of an official set of tax expenditure accounts.[114] The idea was that tax expenditures in a particular sector were to be added to the direct expenditures in these sectors and budgetary allocations made accordingly. Such expenditures would include, for example, the $175 million corporate income tax expenditure in the form of "excess" depreciation allocated to the transport sector in 1979, or the $860 million of excess depreciation and other fast write-offs and investment credits allocated to the resource sector in the same year. Unlike direct expenditures, however, tax expenditures were to be dealt with by both the minister of finance and by the relevant policy committee — a so-called "two-key system." As it turned out, Finance kept tight control over the key by determining that, although any increases in

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[111] Canada. Department of Finance, *The New Expenditure Management System* (Ottawa: December 1979).

[112] In principle, even the use of regulatory and legislative devices as substitutes for direct expenditures in achieving policy objectives were to be encompassed in the envelope, but this — unsurprisingly — turned out to be even less achievable than the inclusion of tax expenditures.

[113] Of course, the two are most unlikely to be precise economic equivalents — but then one can say the same thing about dollars spent directly on different activities.

[114] Canada. Department of Finance, *Government of Canada Tax Expenditure Account* (Ottawa: December 1979).

tax expenditure would be fully chargeable to the relevant envelope, any reductions would be credited to reserves at the discretion of Finance.[115]

The results were twofold. First, since tax expenditures in practice remained solely under the control of Finance, they soon completely disappeared from all discussions of allocating budgetary expenditures. Secondly, and perhaps more unexpectedly, the initial discussions about PEMS resulted in at least some spending departments becoming more familiar with how tax expenditures played a potential role in their field.[116] Consequently, over time they may have ended up pushing particular tax-expenditure initiatives more strongly than they had previously done. The overall outcome of this experience might still have been positive in efficiency terms because annual federal reporting of corporate (and other) tax expenditures continues to this day. Unfortunately, as the recent flourishing of "boutique" tax credits suggests, this increased transparency does not seem to have had much effect in reducing either the number or amount of such expenditures. A measure intended to increase budgetary transparency and the efficiency of resource allocation in the public sector may have — perhaps not for the first or last time — ended up producing some perverse effects.

But even if people are not interested or willing to pay attention to information, in principle it is surely always better in a democracy for governments to be open and transparent about what they are doing, why they are doing it, and what the results turn out to be. The evidential basis for tax incentives is usually so weak that it is far from clear why governments at all levels (and in all countries) seem driven to tinker continually with these frail levers in usually futile (and almost never cost-efficient) attempts to shape the level, pace and nature of market-driven economic development. However, since they are likely to continue to do so, more care should be taken in determining how to accommodate the apparent political necessity for tax incentives without undue damage to the tax system, just as more attention needs to be paid to the economic and political aspects of the inevitable adjustments needed when policies change.

A more practical way to do so than the abortive 1979 initiative may be simply to follow three rules with respect to corporate tax preferences:[117]

1. Keep any tax concession intended to attain a particular economic objective as simple as possible. For example, investment credits — explicit percentage offsets to investment costs — applied (in, so to speak, the second-last line of the tax return) as an explicit deduction against the full tax that would otherwise be due on taxable income are clear, simple, and understandable. Every taxpayer and every shareholder and worker should know exactly how much tax benefit every firm that benefits from such provisions receives.

2. Keep records and make them public. Who gets exactly what incentives? For how long? At what estimated cost in terms of revenue foregone? And with what results in terms of increasing investment, employment, or whatever else is of interest? There is (or

[115] Richard van Loon, "The Policy and Expenditure Management System in the Federal Government: The First Three Years," *Canadian Public Administration* 25, 2 (2003): 256-285.

[116] G. Bruce Doern, "Tax Expenditures and Tory Times: More or Less Policy Discretion?" in *How Ottawa Spends 1989-90: The Buck Stops Where?* ed. Katherine A. Graham (Ottawa: Carleton University Press, 1989), 75-105.

[117] For a useful recent review of these and other ways countries may provide tax incentives while still protecting the tax base, see Eric Zolt, *Tax Incentives: Protecting the Tax Base*, paper for Workshop on Tax Incentives and Base Protection (New York: United Nations, April 2015).

should be) nothing "private" about such information. Every government should publish an annual "sunshine" list of who gets what, why, and what offsetting public benefits have been achieved as a result. Obviously, there are many problems in recording and/or estimating such information. But if one cannot show something is worth the cost, why should we waste tax dollars on it?

3. When the sun shines, it also sets. There is no obvious reason why any particular taxpayer should receive benefits from a particular concession forever unless there are clear public gains as a result. No tax preference should be put into law without a provision for periodic review — say, every three or five years at most — and for sunset (the abolition of the incentive) after (say) five or 10 years, unless there is a positive balance in the account (adjusting for the economic cost of taxes, of course).

Anyone who thinks that corporations (and unions) should be barred from giving large sums to political parties should also look carefully at the other side of the budgetary coin. If governments and corporations are not prepared to be transparent about either the contributions they receive from private parties or the costs and benefits of tax preferences intended to encourage private actors to behave in certain ways (including to make political contributions), then there would seem to be no good case for either permitting such contributions or publicly financing such activities.

6. CONCLUSION

Over a century ago, the leading economist of the day, Alfred Marshall, reportedly noted that every short statement about economics is wrong. Much the same could be said about corporate income taxation. Everyone would like to have a simple, clear way to fix the tax. Unfortunately, since corporations are at the heart of our complex and uncertain economy, the outcome of any reform cannot be easily predicted without making many assumptions about a variety of conditions that are sometimes difficult to specify in detail, let alone to measure, and are also likely to differ from time to time and place to place. One conclusion seems clear, however: so long as corporations exist, they will be taxed. Whether we are receiving income, spending it or saving it, in the modern world most of us do so through interactions with the organized and record-keeping enterprises called corporations. It is both technically and politically easier for governments to deal with corporations when collecting taxes than to always be facing-off directly with the individuals whose incomes will, in the end, be reduced by the taxes collected. Indeed, one might argue that the existence of corporations (including banks and other financial institutions) is what has made the modern tax system possible. Some have even suggested that technology may end up resulting in all taxes being imposed at the corporate level — a sort of combination of a VAT and payroll tax, perhaps modestly "personalized" in a progressive way.[118] Others have argued that tax administrations may be much better able to police the fiscal world in the future as a result of increased access to electronic data flows,[119] although some think that this task will remain difficult no matter how much success we might seem to see at first in

[118] For such a proposal, see Daniel S. Goldberg, *The Death of the Income Tax* (Oxford: Oxford University Press, 2013).

[119] Ira Grinberg, "Taxing Capital income in Emerging Countries: Will FACTA Open the Door?" *World Tax Journal*, (October 2013): 325-367.

such initiatives as the U.S. FATCA (Foreign Account Tax Compliance Act), which has (in effect) imposed itself on much the world, or the OECD's BEPS effort.[120]

Whatever the very long run might hold, however, it seems unlikely that any sustainable leak-proof international tax regime is likely to be achievable in the near future. How and to what extent countries can and will tax corporate entities is likely to continue to be, in the end, a matter decided by each country individually. No country, and certainly not Canada, can ignore what is going on abroad. But solutions to corporate tax problems are more likely to emerge from the imperfect and conflicting ideas, interests and institutions that determine and shape the national tax system than from the universal acceptance of some more rational structure.

Since Canada is an active but relatively small player in the international capital market, the rate of the corporate income tax may well be determined largely by international factors. But most key characteristics of corporate taxation will continue to depend in part on whether, how, and to what extent the gap between how corporate income tax is perceived by most economists and tax experts, on one hand, and by most politicians and voters on the other, is bridged. Those familiar with the current literature on corporate income tax often see little reason to keep the tax at all because they believe it is not particularly useful as "back-up" for the personal income tax — because most personal capital income is or can be easily sheltered from the latter tax; because there are few good arguments for taxing "normal" returns on capital, which are set largely in the international capital market; and because, in open economies, most corporate income tax is shifted to wage earners in the end. All these arguments seem correct to some extent with respect to Canada. But none is theoretically correct in all circumstances and, most importantly, none is conclusively supported by evidence considered credible by voters.

One important factor that needs to be taken into account when major changes to the corporate income tax are contemplated is that the impacts of any changes will take a long time to be fully realized. The economic effects of changes in corporate taxes that raise or lower the marginal effective tax rate (METR) on capital will, over time, affect investment and result in changes in the capital stock and capital-labour ratio and hence changes in growth, real wages and employment. But such changes may take a decade or more — the life of several parliaments — before having noticeable effects. Moreover, over this long transition period, changes that affect "old" capital, such as changing the statutory corporate tax rate, will generate windfall gains and losses for existing owners of corporate equities. Although other changes — like acceleration of depreciation of new investments, expensing of new capital investments, or investment tax credits for new investments — will favour "new capital" without raising the return to old capital, the transitory and windfall effects of capital-tax reform can be important politically and need to be explicitly taken into account in formulating policy. This is just one reason why the most acceptable approach to corporate tax reform at present still seems to be something close to the gradual and targeted approach to a more optimal system recommended years ago by the Mintz committee, with the first objective being to reduce or eliminate inter-asset, inter-regional and inter-industry disparities in METRs (and AETRs) by reducing those rates that are higher than average.

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120 For a generally skeptical view of such proposals, see E. Morozov, *To Save Everything, Click Here* (New York: Public Affairs, 2013).

Life has taught most voters that their small savings do not escape tax while the rich are not only getting relatively richer, but seem to be — and often are — doing much better over time in this respect. It is no surprise that many people see the corporate income tax as one important way to impose taxes on the large, rich organizations that they think can and should pay a larger share of the cost of the public institutional structure of the country within which they operate. Debate on the appropriate level and structure of corporate income tax in Canada is unlikely to be definitively resolved in the near future, but in all likelihood we will continue to have some kind of "corporate income tax" rather than an ACE or other "rent" tax (except perhaps in the resource sector, if the serious federal-provincial barriers to reform in that sector can ever be overcome). Nonetheless, Canada could definitely do better by making its corporate income tax more uniform along the lines suggested above. And even if a full-fledged move to a rent-equivalent tax base is off the political table for the immediate future, it may still be that a more attractive path to corporate tax reform may be to move towards a dual income tax approach — not least because, if all goes well, it may prove possible to slip a corporate rent tax into the package in a way that may prove both economically rational and politically acceptable. One can always hope.

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