Volume Title: Canada-U.S. Tax Comparisons

Volume Author/Editor: John B. Shoven and John Whalley, editors

Volume Publisher: University of Chicago Press

Volume ISBN: 0-226-75483-9

Volume URL: http://www.nber.org/books/shov92-1

Conference Date: July 26-27, 1990

Publication Date: January 1992

Chapter Title: Reflections on Canada - U.S.Tax Differences: Two Views

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Chapter URL: http://www.nber.org/chapters/c7489

Chapter pages in book: (p. 359 - 374)

12 Reflections on Canada-U.S. Tax Differences: Two Views

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It is not surprising that tax reform has followed rather similar patterns in the United States and in Canada. Geographic proximity and trade involvement alone prohibit extreme divergence, as do shared traditions of tax thinking. At the same time, important differences remain. Canada, as a relatively small and open economy, cannot afford strategic departures from U.S. practices, and quite different structures of fiscal federalism impose constraints on both settings. Nevertheless, common patterns dominate, and future reforms will also be subject to similar trends.

1940–1990: The Age of Income Tax

My comments will be directed at these common patterns, but first a word about what has happened in the past. The history of tax reform over the past half-century, from about 1940 to 1990, has been that of income tax. The central image has been one of personal taxation based on ability to pay and measured in terms of a comprehensive income concept, providing for horizontal equity and a progressive burden distribution. The vision began with Henry Simons's writing of 1938 and reached full bloom in the Canadian Carter Commission Report of 1967.[1] Before the Canadian Political Science Association that year, I assessed the Carter Report as follows:

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1. Canada, *Report of the Royal Commission on Taxation* (Ottawa, 1966).

> The Report is indeed as orthodox as it is novel and revolutionary in its conception. It is orthodox in that it follows the basic structure of tax reform first laid down by Henry Simons thirty years ago and expounded since by many if not most academic students of taxation. It is revolutionary in that these proposals, in their sweeping totality, are ingeniously applied to the Canadian setting and are made the content of a public document, presented by practical men for summary enactment. After sharing in many an effort to inch our own (U.S.) tax structure in this direction, I can only marvel at the courage of this frontal assault and wish it good-speed.[2]

What has happened since? I begin with the Canadian side, where the Carter Report opened (or hoped to open) the gate to conclusive income tax reform. At its center was the call for uniform taxation of all income sources, including those from extractive industries and from capital gains. The top marginal rate was to be cut to 50 percent, the corporation tax was to be integrated, and, reaching beyond income tax reform, Canada's manufacturing tax was to be converted into a retail sales tax. The framework of base broadening, equalization, rate cuts, and approximate revenue neutrality was thus set, to be followed twenty years later by the U.S. reform of 1986 and by reform in other countries. But Canada soon faltered in its pioneering role. The Carter Report was met by almost universal opposition (academics excepted) and got nowhere in application. It was watered down in a subsequent White Paper and once more in the 1971 legislation; the extractive industries, supported by their provinces, prevailed, and little of the original message remained. Instead, a decade of income tax deterioration and base loss followed. Only in 1987, and following the U.S. reform of 1986, did the Carter spirit revive. Substantial income tax reform was achieved, but the proposed overhaul of commodity taxation—with VAT in the place of retail tax—is still unresolved.

The story of reform in the United States is essentially one of income taxation. Ever since the elevation of the income tax to a mass tax at the outset of World War II, the U.S. personal income tax has provided the core of the federal tax system. Over most of the period, the system featured steeply progressive nominal rates which, combined with a deficient base, yielded a much flatter pattern of effective rates. Occasional attempts at improvement were made, but they were exceptions. In the early 1960s, for example, the investment tax credit was included in place of accelerated depreciation as an incentive device. Loopholes widened, and the inflation of the 1970s brought new distortions, with unfair taxation of purely nominal gains. A Carter-style Treasury document (referred to as *Blueprints*) appeared in 1977 but failed to gain official status.[3] Instead, the supply-side-inspired reform of 1981 reduced the top personal rate from 70 to 50 percent and added a distorting pattern of highly accelerated depreciation.

2. R. A. Musgrave, "In Defense of an Income Concept," *Harvard Law Review* 81, no. 1 (1967): 42–62.
3. U.S. Treasury Department, *Blueprints for Basic Tax Reform* (Washington, D.C., 1977).

A change in direction began with the Treasury study of 1984 (referred to as *Treasury I*) and its comprehensive approach to income tax reform.[4] In Carter-like fashion, the goal was to combine base broadening, especially in relation to capital income, with a flattening of bracket rates. The number of brackets was to be reduced to three, with rates of 15, 25, and 35 percent. There was also to be a substantial increase in personal exemptions, so as to offset erosion by inflation since the late 1970s. In combination, the reform proposals would be essentially revenue neutral. Effective rates would be reduced at the lower end, but their pattern over the middle and upper range would be left more or less unchanged. The net outcome would be to improve horizontal equity and to reduce distorting effects. Indexing of rate brackets would protect against inflation.

Treasury I was followed by the administration's official recommendations (*Treasury II*), which offered a watered-down version, and then by the actual legislation of 1986.[5] The top rate was reduced to 28 percent, but capital gains were included in the base. Though falling far short of *Treasury I* or the Carter model, the legislation was nevertheless a major overhaul and was a high point of income tax reform, as was its Canadian counterpart of the following year. We now turn to consider whether this reform trend may be expected to continue or whether it will be followed by a change in direction, based on changing economic conditions, social climate, and new patterns of tax analysis. As in the past, any new trends affecting tax reform are likely to be shared by Canada and the United States.

The 1990s: New Patterns of Reform?

Among major elements of change, I will note (1) the emergence of consumption as a respectable tax base, (2) a flattening of upper-income progression, (3) a new perspective on corporation tax, (4) the rise of the payroll tax, and (5) adaptation of tax design to an open economy setting. These developments may have substantial bearing on the role of income taxation.

(1) I begin with the emergence of consumption as a respectable tax base. Ever since John Stuart Mill, economists have faulted the income tax base for penalizing late consumers and discriminating against saving. The optimal-taxation literature of the 1970s further stressed this point. At the same time, the consumption base gained in repute by a change in its image from an in rem commodity tax to a personalized expenditure tax. This helped to overcome earlier, equity-based objections. The case for the consumption base was strengthened by the compounding difficulties of income taxation. Many of these, especially those relating to the taxation of capital income under conditions of inflation, would be bypassed by an expenditure tax.

4. U.S. Treasury Department, *Tax Reform for Fairness, Simplicity , and Economic Growth* (Washington, D.C., 1984).

5. *President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity* (Washington, D.C., 1985).

All this added to the attraction of the consumption base, but the case for a personalized and progressive expenditure tax was too novel to seriously enter the public discussion. Instead, the love affair with the commodity base focused on the value-added tax, which would serve as a superior replacement for the turnover tax and a more practicable alternative to the retail sales tax. At the same time, it would retain traditional support from some quarters as preferable to progressive income taxation, while gaining new support from others as a politically feasible, if second-best, way of sustaining public services and social programs. As a result of these arguments, the United States may well follow Canada in adding a value-added tax to its federal revenue system.

Whereas a progressive expenditure tax would remain within the family of direct taxation, the trend toward VAT implies not only a change in base, but also a change from visible and personal to hidden and in rem taxation. It is this latter shift that is especially unfortunate. This trend is supported also in the context of optimal commodity taxation, with its focus on selected commodities as appropriate tax bases.

(2) Support for progressive rates had eroded with the shrinking of the tax base, and it took a drastic plunge in the reforms of the 1980s. Various causes may be noted. At the academic level, the case for rate progression was weakened by allowance for deadweight loss and its compounding burden as marginal rates rise. For any given social welfare function, the pattern of nominal rates needed to minimize aggregate welfare loss is thus flatter than had been concluded previously. Argued less rigorously, but more important in practice, was concern over detrimental effects of high marginal rates on growth and the dynamics of enterprise. In addition, reduced concern with progressivity received support from a change in political climate, reflected in a flattening of the social welfare function as perceived by the voting public. While effective rate progression over the lower-middle range of the income scale retained acceptance, support for extension over the middle-upper range fell off. With lower-end progressivity provided for by a personal exemption or credit (a better alternative, used in Canada), a more or less flat nominal rate would take care of the remainder.

To be sure, the steeply rising nominal rates that had prevailed previously in many countries were largely ineffective in application, offset as they were by an imperfect base. The reforms of 1986 and 1987, with their offsetting rate and base adjustments, thus had little effect on the pattern of effective rates over the middle-upper range. The U.S. cut in effective rates had been made in 1980. Nevertheless, it was the U.S. reform of 1986, with its drastic cut in the top bracket rate to 28%, that marked the strategic turning point. In order to verify the preexisting pattern of effective rates to some degree, the reforms might have combined base broadening with retention of some nominal rate progression. This would have given some credence to the previously existing pattern of nominal bracket rates. Instead, their failure was ratified, and the principle of effective rate progression was withdrawn.[6]

Whether the flat-rate perception of vertical equity is here to stay, time will tell. If so, the question arises whether there remains a raison d'être, under a flat-rate system, for a personalized income tax. The inevitably cumbersome and complex process of personal taxation was the inevitable price of a system seeking (even if not reaching) to extend effective rate progression over the upper range. Without this goal, a flat-rate tax on income at source, combined with a flat transfer, would be much the simpler solution. The same holds for the consumption base. Under a VAT, lower-end protection might again be built into the base or be provided via transfers. Needless to say, impersonal flat-rate and invisible taxes are not my dream of responsible taxation in a democratic society, but such may be the course of events.

(3) No major reform changes were made in the treatment of the corporation income tax, but recent proposals for a cash-flow type business tax fit the above pattern. As part of a withholding system for the purpose of a flat-rate income tax, the cash-flow tax is inadequate, since the larger part of capital income or its interest equivalent is excluded. Only rent and excess profits remain in the base. As a withholding tax on wage income, noting that a consumption tax is essentially similar to a tax on wage income, it may be seen as "prepayment" of a flat-rate consumption tax.[7] The idea of a consumption tax has appeal, but its shadow image as an income tax on wage income only will hardly pass congressional muster, and perhaps for good reason.

(4) It might be argued that transition from general and personal income taxation to wage income taxation is nothing new, but has been in process over the decades, based on the growth of social security finance. Perhaps so, but I feel uneasy viewing the payroll tax as part of the general tax system without also allowing for the benefits financed thereby. To the extent that the payroll tax is linked to social security finance, which is more strictly the case in the United States than in Canada, its otherwise objectionable nature as regressive and in rem gives way to its more meaningful role as an intergenerational benefit tax.

(5) Finally, there is the growing importance of open economy considerations. As initially visualized in the Tiebout model, a marketlike mechanism of voting by feet could be relied upon to secure an optimal adjustment among fiscal jurisdictions; this vision still underlies much of the discussion.[8] The

6. R. A. Musgrave, "Short of Euphoria," *Journal of Economic Perspectives 1*, no. 1 (1987):59–71.

7. Charles E. McLure, Jr., J. Mutti, V. Thuronyi, and G. R. Zodrow, *The Taxation of Income from Business and Capital in Colombia* (Bogotá: Ministerio de Hacienda y Credito Publico, 1990).

8. Charles Tiebout, "An Economic Theory of Fiscal Decentralization," in *Public Finances: Needs, Sources, and Utilization* (Princeton: Princeton University Press, 1969).

model, when presented in my Michigan seminar of 1955, was ingenious and later became the basic theorem of fiscal federalism. Nevertheless, its power rested on a set of rather restrictive assumptions, assumptions which do not readily permit transfer from the local to the international setting. Among the premises are that all factors are equally mobile and that all taxes are paid on a strictly benefit basis. As to the former, capital is vastly more mobile in the international setting than is labor. As to the latter, a case can be made that public services should be financed on a benefit basis, but they are not, and even if they were, distributional objectives of the fiscal system would still need to be accounted for. Their disregard may have justification at the level of local finance but becomes unacceptable at the national level.

For these and other reasons, the Tiebout model and its invisible-hand solution to tax coordination does not resolve the international setting. A statutory arrangement has to be provided for to secure an efficient and equitable solution. Such an order may take the form of equalization, in which each jurisdiction remains free to have its own system, but differentials are neutralized. Forced uniformity, in this as in other contexts, is to be avoided, so the coordination technique should be preferred. I was surprised, therefore, to find primary concern with equalization in the conference papers.

The principle of coordination is straightforward, requiring the country of residence to credit source-country withholding. But difficulties remain. Crediting does not apply to retained earnings, sources may be difficult to identify, choice of residency permits tax avoidance, and so forth. These difficulties do not arise with the consumption base. A destination-based value-added tax is neutral, and even a personal expenditure tax is less open to avoidance by foreign consumption than is an income tax by foreign investment. Once more, income taxation seems to be at a disadvantage.

There is, however, an important reason for its retention. A good system of international taxation should be not only efficient and equitable as applied to the particular taxpayer, but also equitable between jurisdictions. The principle of international equity should be observed, entitling the country of source to a share in the income tax base that originates within its borders but accrues to foreign-owned capital.[9] Considerations of benefit taxation aside, such an entitlement arises as a matter of fairness, based upon a concept of international property rights agreed to by the participating jurisdictions. The legal property order, in an increasingly open world economy, cannot be written in national terms only. Implementation of such an entitlement, unnecessary to add, is of particular importance to capital-importing developing countries.

Suppose first that the countries concerned do not impose a classical corporation tax. They nevertheless agree on a mutually acceptable sharing rate and impose a corresponding withholding tax as profits are repatriated. To assure

9. P. B. Musgrave, "Interjurisdictional Coordination of Taxes on Capital Income," in *Tax Coordination in the European Community,* ed. S. Cnossen (Antwerp: Kluwer Law and Taxation Publishers, 1987).

neutrality, the country of residence will then grant a credit against the shareholder's income tax. The same principle applies in a regime of classical corporation tax. A sharing rate will again be agreed upon, with the withholding rate now equal to the excess (plus or minus) of the sharing rate over the source country's rate of corporation tax. Once more the country of residence will credit the withholding tax against its own corporation tax. In this way, considerations of both neutrality and equity are reconciled, while each country retains the freedom to choose its own rate of corporation tax. Contrary to the so-called nondiscrimination rule, setting the sharing rate becomes independent of the countries' own rates. Whether or not a classical corporation tax is applied, it remains necessary to determine taxable profits to which the sharing rate applies. Such remains the case even if domestic taxation is placed on a consumption base. While a VAT automatically permits the country of residence to tax the consumption of its foreigners, this is hardly an adequate allowance for base sharing.

Other elements of change might be noted, which may condition the tax climate of the 1990s and shape future tax reform. In both Canada and the United States, the reforms of the late 1980s may well have marked the end of a period. The traditional focus on income, on horizontal equity, and on effective rate progression may yield to new directions. Only time will tell whether they will bring reform or deform.

Thomas A. Wilson

This paper presents a brief comparative review of the tax systems of Canada and the United States. Although I will emphasize the differences, it should be borne in mind that the two countries' fiscal systems have many features in common, and that the Canada-U.S. tax treaty effectively harmonizes the treatment of most cross-border income flows.

I begin with a broad overview of the relative importance of the major taxes, and then examine how the two systems deal with several key issues: the treatment of income from equities; the treatment of savings and investment; rate schedules; and federal/provincial arrangements. The final two sections of the paper review the effects of recent and proposed tax reforms in Canada and consider possible future fiscal developments as the Canada-U.S. free-trade agreement is phased in.

The "Tax Mix": The Role of Major Taxes as Revenue Sources

Table 12.1 compares the relative importance of the major revenue sources—personal income taxes, corporate income taxes, indirect taxes,

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Table 12.1 **Relative Importance of Major Taxes, 1987 (Tax Revenues as % of GDP/GNP)**

Tax Source	Canada	U.S.	OECD Average
Personal Income	13.4	10.9	12.0
Corporate Income	2.8	2.4	3.0
Indirect (Sales & Excise)	10.0	5.0	11.8
Social Security (Payroll)	4.6	8.6	9.5
Wealth	3.2	3.1	2.1
Total (Excluding Social Security)	29.9	21.4	29.3
Total (Including Social Security)	34.5	30.0	38.8

Source: David Perry, "International Tax Comparisons," *Canadian Tax Journal* 37, no. 5 (1989): 1347–57.

wealth taxes, and social security taxes—for Canada, the United States, and the OECD, on average. These data are revenues for all levels of government in each country, expressed as percentages of GDP/GNP.

Two striking differences between the U.S. and Canadian revenue systems appear. Indirect taxes are twice as important in Canada as in the United States, reflecting the absence of a federal sales tax in the United States, and somewhat higher provincial retail taxes in Canada relative to state retail taxes in the United States. At 10 percent of GDP, the role of indirect taxes in Canada is somewhat below the OECD average of 11.8 percent.

On the other hand, payroll taxes to finance social security programs are much more important in the United States than in Canada. At 8.6 percent of GDP, U.S. social security taxes are close to the OECD average (9.5 percent), and well above the Canadian level.

Both Canada and the United States rely on the personal income tax (PIT) as a principal revenue source, with Canada collecting somewhat more than the United States and somewhat more than the OECD average. The relative importance of the PIT has increased in recent years in both countries. Currently, the effective PIT burden in Canada is almost 25 percent higher than in the United States.

As for corporate income taxes, in recent years this revenue source has been declining in relative importance in most countries, including the United States and Canada. Current effective rates in Canada and the United States are 2.8 and 2.4 percent of GDP, respectively, just below the 3.0 percent OECD average.

Wealth taxes are surprisingly similar as a revenue source in the two countries. Canada has no estate tax, and U.S. estate taxes are not an important source of revenue, yielding only 0.2 percent of GNP. In both countries, the most important wealth taxes are taxes on real property, with revenue yields of 2.7 percent in Canada and 2.8 percent in the United States.

It is also apparent that the overall tax burden is higher in Canada than in the United States, particularly if social security taxes are omitted.[10] Without social security taxes, the total tax burden in Canada is 29.9 percent of GDP, just above the OECD average and well above the U.S. level of 21.4 percent of GNP.

When social security taxes are included, the gap between Canadian and U.S. tax burdens is narrowed. Canada is then 4.5 percentage points below the OECD average, but still 4.3 percent above the U.S. level. I shall return to the issue of overall burdens after review of certain key differences in the tax structures of the two countries.

The Treatment of Income from Equities

As is well known, the United States has a "classical" corporate income tax—a separate tax on corporate income that is generally not integrated with the personal income tax.[11] The Canadian system, by contrast, involves partial integration of dividend income (and full integration of dividends from small firms). This integration is effected by a "gross-up and credit" applied to dividend income. At the present time, dividend income is grossed up by 25 percent before calculating tax and is subject to a 25 percent credit. This effectively reduces the marginal rate of tax on dividend income, providing partial relief from the corporate taxes presumably borne by that income.[12]

Of course, dividend income is not the only component of income from equities. The other major component is capital gains on sale of shares. In the United States, since the 1986 tax reform, capital gains are subject to tax on realization at full marginal rates. In Canada, a lifetime exemption was introduced prior to the 1987 tax reform. Under tax reform, the exemption was limited to $100,000, and the inclusion rate for other capital gains was raised in two stages to 75 percent.[13] Effective marginal tax rates on capital gains are therefore three-quarters of the rate applicable to other income.

Overall, it is clear that Canada treats income from equities of Canadian firms considerably more favorably than other income under its PIT. This is a difference between the Canadian and U.S. tax systems that has persisted over time. It represents a deliberate use of the tax system to encourage equity investment in Canadian companies by Canadian residents, perhaps as an out-

10. Some would argue that, since social security taxes pay for identifiable benefits, they do not constitute a burden (or at least as large a burden) as do other taxes. See Boadway and Bruce (ch. 1 in this volume).

11. The exception is the tax on small corporations when all stockholders elect partnership treatment under Subchapter S.

12. For example, an individual with a combined top marginal rate of 48 percent would pay approximately 35 percent on dividend income. Since the dividend gross-up and credit mechanism applies to *any* dividends paid by Canadian corporations to Canadian residents, dividends from corporations that do not pay tax get a credit for "phantom" corporate tax.

13. Capital gains on shares of small business corporations and capital gains on the sale of family farms receive an exemption of $500,000. Prior to the 1987 reforms, the inclusion rate for capital gains was 50 percent; this was increased to 66 2/3 percent for 1988 and 1989, and to 75 percent in 1990.

growth of public concern about the role of foreign ownership and control of Canadian enterprises.

Tax Treatment of Savings

The double taxation of savings, like the double taxation of equity income, has long been an issue in the public finance literature. Indeed, proponents of consumption-based taxes rely heavily on their advantages in avoiding this double taxation and thereby reducing the dead-weight losses associated with taxation.

Both the Canadian and U.S. PITs involve significant departures from the Haig/Simons definition of income as a base. Some of these departures—the omission of imputed rental income from the tax base and the deductibility of contributions to pension plans—move the PIT in the direction of a direct tax on consumption.

Overall, the Canadian PIT has moved further in this direction than the U.S. PIT has, although some of the recent "reforms" in Canada have moved the Canadian system back toward an income base.

Both systems exclude imputed income from owned consumer assets from the tax base, as is appropriate under a consumption-based tax. However, the United States, by permitting deduction of interest paid to acquire these assets, effectively encourages acquisition of consumer assets relative to other assets, moving the U.S. system away from a pure tax on consumption.[14]

Both systems also allow for favorable treatment of retirement savings, but the Canadian RRSP deductions are more generous and more widely available than U.S. IRA deductions, and Canada allows deductions for individual contributions to pension plans, whereas the United States does not.

Although the 1987 tax reform moved the Canadian PIT away from a consumption base, it nevertheless remains closer to a consumption base than its U.S. counterpart.[15] It is fair to conclude that the marginal rate of return earned by many savers in Canada is the before-tax rate of interest, whereas the typical saver in the United States earns the after-tax rate of interest.[16]

Tax Treatment of Investment

In recent years, both countries have moved (unwisely, in my opinion) to eliminate or reduce many of the incentives for investment that had previously been introduced. The course of corporate tax reform in Canada was charted in a White Paper issued in 1985, which proposed the phaseout of the general

14. Although currently the deductibility of interest on loans to finance personal assets is limited to mortgages or housing equity loans, it is nevertheless relatively easy for U.S. residents to finance acquisition of consumer durables, as well as housing, through such loans.

15. The most important 1987 Canadian change in this respect is the elimination of the $1,000 investment-income deduction. Other measures have limited the ability to defer receipt of interest income (e.g., by the purchase of deferred annuities).

16. Canadian taxpayers who have mortgages on their residences typically earn the before-tax rate of interest when they pay down their mortgages. Furthermore, many Canadian taxpayers have not reached their RRSP contribution limits.

investment tax credit over a three-year period, reductions in capital cost allowance rates, other base-broadening measures, and substantial reductions in statutory rates.[17] The first step was implemented in the 1986 budget, and subsequent steps were included in the 1987 tax reform package.

In the United States, the 1986 tax reform act swept away the general investment tax credit and sharply limited allowable depreciation rates. Coupled with other base-broadening measures, these changes permitted substantial reductions in statutory rates.

Both countries have probably somewhat reduced the interindustry and interasset distortions under their corporate income taxes, but at the cost of increased intertemporal distortions. As I noted in a previous paper[18] the tax reforms shifted the tax burden from old capital to new capital, thereby increasing the effective tax rate on investment.[19]

Tax Treatment of the Family

A salient difference between the two personal income tax systems is the definition of the taxpaying unit. In the United States, because of income splitting through joint returns, the basic unit is effectively the nuclear couple; in Canada, the personal income tax is largely on an individual basis.[20]

Taxing income on an individual basis can reduce tax disincentives for the lower-income spouse. Canada's recent tax reform, by replacing the spousal exemption with a credit, has further reduced such tax disincentives. Under the current Canadian tax system, the "secondary" earner faces tax initially at the lowest bracket rate. In contrast, under the U.S. system, the effective marginal rate of tax for the lower-income spouse is the appropriate marginal rate on the couple's combined income.

Like many issues in taxation, this advantage to the Canadian system entails a cost in the form of extraordinarily complex "attribution" rules to prevent shifting of property income from the higher to the lower-income spouse. The obvious solution is to combine the best features of the two systems. For example, earned income could be taxed on an individual basis, as in Canada, and property income on a pooled basis, as in the United States.[21]

The two countries have also adopted very different treatments for dependent

17. Hon. Michael Wilson, *The Corporate Tax System: A Direction for Change* (Ottawa: Department of Finance, Government of Canada, 1985).

18. Thomas A. Wilson, "The Corporate Income Tax Proposals: Reform or Retrogression," in *Report of the Policy Forum on Reform of the Corporate Income Tax System*, ed. Jack M. Mintz and Douglas D. Purvis (Ontario: Queen's University, Nov. 1985).

19. This is strictly true for investments made by taxable firms. For risky investments by firms who are, or may be in tax loss positions, the reduction in statutory rates may outweigh the removal of tax credits. See Vijay Jog and Jack Mintz, "Corporate Tax Reform and its Economic Impact: An Evaluation of Phase 1 Proposals," in *The Economic Impacts of Tax Reform*, ed. Jack Mintz and John Whalley, pp. 83–124. (Toronto: Canadian Tax Foundation, 1989).

20. The Canadian PIT is no longer strictly on an individual basis. Certain credits are transferable between spouses, and the child tax credit is clawed back on the basis of family income.

21. An alternative method would be joint returns, coupled with adequate earned-income credits for the lower-income spouse.

children. The U.S. PIT provides the same exemption for a child as for an adult. Until recently, the Canadian PIT provided a much smaller exemption for a child, coupled with refundable tax credits and taxable transfers (family allowances). Following tax reform, the Canadian system now provides a mixture of nonrefundable tax credits, refundable tax credits that are clawed back, and taxable transfers that are proposed to be clawed back.[22]

The Canadian system clearly delivers better child benefits for lower- and lower-middle-income families than does the United States system. But as income rises, at some point middle-income families find their benefits beginning to be clawed back, and at a higher income level, all child benefits except the nonrefundable tax credit would be totally clawed back.[23]

Rate Schedules

Following the 1986 and 1987 tax reforms, both countries reduced the number of rate brackets and lowered their top marginal rates. In the United States, what appears on the surface to be two brackets, with a top rate of 28 percent, is in reality four brackets with a top rate of 33 percent (applied to the third, but not the final, bracket). In Canada, what was proposed to be three rate brackets has since become four brackets (because of the high-income surtax). Furthermore, effective marginal rates in the Canadian system are also affected by the various clawbacks of refundable credits and transfer payments, so that the number of true tax brackets is even larger.[24]

Providing fewer brackets has been justified on grounds of tax simplification, but I do not accept this argument. While there is no denying that a single rate would permit a vast simplification of the system, two brackets imply almost the same degree of complexity as fifteen! The problems of tax shelters, income splitting, and income averaging arise as soon as there is more than one effective marginal rate.

The top marginal income tax rate has been lowered significantly over the past ten years. Currently, the top U.S. federal rate is 33 percent, and the top Canadian federal rate will soon be 32 percent. Although the top marginal rates of the federal PITs are quite similar, significant differences emerge when state and provincial income taxes are taken into account. Data provided in Vaillancourt (ch. 11 in this volume) indicate that the typical top marginal rate for U.S. state income tax is 6.6 percent (deductible from federal tax), whereas

22. For a detailed discussion of the Canadian and U.S. treatments of dependent children, see Kesselman (ch. 3 in this volume).

23. A measure in the 1990 federal budget would claw back family allowances at a 15 percent rate, starting at an individual income level of $50,000 for the higher-income spouse. A single-earner family with two children would see its family allowance payments totally clawed back at an income level just above $55,000.

24. The refundable sales tax credit is clawed back at a 5 percent rate, starting at a family income level of $18,000. The refundable child tax credit is also clawed back at a 5 percent rate, but the clawback begins at a family income of $24,750. OAS and family allowance payments are proposed to be clawed back at a 15 percent rate on an individual basis, starting at an individual income of $50,000.

the typical top marginal rate for provincial income tax in Canada is 17 percent. As a result, the combined marginal rate of federal plus provincial tax in Canada is typically much higher than the combined rate in the United States. Indeed, in most provinces the combined top marginal rates approach 50 percent, whereas the highest combined marginal rate in the United States is about 42 percent.[25]

Federal/Provincial Fiscal Arrangements

There are two features of the Canadian federal tax system that have no counterpart in the United States. First, the federal government has entered into collection agreements with nine of the ten provinces for personal income taxes, and with seven provinces for corporate income taxes. This has led to much greater subnational harmonization of the income tax systems in Canada than in the United States. It may also have lowered the political cost of raising provincial taxes, since individuals see only one line for income tax withheld on their payroll statements and write only one check to settle their balances each April.

Second, and more important, are the equalization arrangements, under which the federal government equalizes the revenue yield of taxes in lower-income provinces up to the average yield of the five richest provinces; seven out of ten provinces currently receive equalization payments.[26] Equalization clearly reduces the cost of public goods relative to private goods in those provinces.[27]

Effects of Recent Proposed Tax Reforms in Canada

The income tax reforms of the past four years have moved the Canadian income tax system somewhat away from a consumption-based tax and have removed or lessened tax incentives for investment. It is reasonable to conclude that the net effect of the income tax reforms has been an increase in the tax burden on savings and investment.[28]

Phase II of tax reform was originally designed to do two things: to replace the antiquated manufacturers' sales tax with a new consumption-based value-added tax; and to shift the tax mix from direct to indirect taxes by reducing personal income taxes and increasing sales taxes.

25. For 1990, the combined top marginal rate equaled or exceeded 48 percent in all provinces except British Columbia, Alberta, and Nova Scotia.

26. *Provincial and Municipal Finances, 1989* (Toronto: Canadian Tax Foundation, 1990), table 13.2.

27. The provision of certain public goods has been encouraged under federal/provincial shared-cost programs. However, the most important of these—medical care and higher education—have been subsumed under the "Established Programs Financing Arrangements," under which they have, in effect, become unconditional transfers.

28. For an analysis of the economic effects of the income tax reforms, see Peter Dungan and Thomas Wilson, "Macroeconomic Effects of Tax Reform in Canada," *Canadian Tax Journal* 36, no. 1 (1988): 110–24.

In fact, the government has implemented the second objective by successive increases in sales taxes, without reducing income taxes. The current plans for the new Goods and Services Tax (GST) entail no significant income tax reductions, aside from the sales tax credits needed to offset the regressivity of the GST. The proposed new sales tax system, on balance, will bring in the same net revenue as the old, but the burden will be shifted from investment and exports to consumption.

The government's tax reform proposals have therefore worked at cross purposes, by increasing the tax burden on savings and investment through the income tax reforms of Phase I, and by reducing the tax burden on savings in the sales tax reforms of Phase II. We might have done as well with a simple reform of the sales tax system alone.

One other issue, incorporated in the 1981 U.S. tax reforms but ignored under the Canadian proposals, is adjusting the tax system for inflation. Up to 1985, the Canadian tax system incorporated more complete adjustment to inflation than did the U.S. system, as income tax brackets and exemptions were fully indexed to the CPI.[29] Although asset values were not indexed, it was possible to get indexed treatment of equity investment by holding equities in registered plans (ISIPs). The only assets for which the U.S. system provided better adjustment for inflation were inventory investments, since LIFO valuation provided near-complete exemption of phantom inventory profits.[30] In Canada, a 3 percent inventory allowance provided only partial relief from the impact of inflation on inventory profits.

In 1985–86, the positions were reversed. The Canadian federal budget of 1985 limited the indexation of brackets and exemptions to the rate of inflation less 3 percent, and the ISIPs were abolished. The 3 percent inventory allowance was eliminated in the first phase of corporate tax reform the following year. In the United States, on the other hand, full indexation of exemptions and rate brackets came into effect in 1985.

As neither Canada nor the United States indexes asset values or capital cost allowances, inflation will continue to affect the incidence of the tax system on capital income in both countries.

Issues for the Future

The key issue is whether the phase-in of the Canada-U.S. free-trade agreement (FTA), prospective lowering of trade barriers with other countries, and increased "globalization" of financial and product markets will necessitate increased harmonization of tax systems. This, fortunately, is an area in which public finance theory provides useful insights. The key is the mobility of the factors bearing the tax.

29. During the federal government's "6 and 5" program of public-sector wage restraints, the indexation factors were limited to 6 percent for 1983 and 5 percent for 1984.

30. If inventories are financed by debt, LIFO valuation is an overly generous offset to inflation.

Factors of production that have perfect international mobility can in the limit be taxed on a benefit basis. Where similar public benefits are provided to such factors in two countries, we should expect tax rates to be similar, if not the same. Less mobile factors of production can be taxed more heavily than the rates consistent with benefit taxation, and perfectly immobile factors can bear tax as if they were located within a closed economy.

The above remarks apply to the direct taxation of factor incomes at source. Increased tax harmonization will therefore likely occur for those factors that become more mobile as a result of globalization and the FTA. As capital was already highly mobile between Canada and the United States, there would appear to be little that the FTA could do to increase capital mobility. However, when the mobility of intangible assets is taken into account, the FTA should increase, or at least protect, the cross-border mobility of business enterprise. The one area in which international capital mobility has clearly been less than perfect is foreign direct investment (FDI). FDI is associated with technology transfer and with the earning of returns on intangible assets. FDI has also been subject to government controls, generally in Canada and in selected sectors in both countries. The FTA, by limiting general government intervention in Canada and preventing it in the United States, should increase the cross-border mobility of FDI. Furthermore, since the FTA increases the cross-border mobility of certain individuals, the mobility of enterprises as "going concerns" should also be increased.

What one would predict is that the FTA and globalization will serve to reinforce the trend toward harmonization of corporate tax systems. The harmonization of corporate systems is not a new phenomenon. It is noteworthy that effective corporate tax rates are much more equal both internationally and within the Canadian and U.S. federations than are the other major taxes.[31] Given the importance of cross-border direct and portfolio investments, the governments of Canada and the United States should consider more effective coordination of taxes bearing on these investments, for the reasons stated by Gordon (ch. 2 in this volume).

My final comment has to do with indirect taxation. Typically, sales taxes are established on a "destination basis." However, such taxes are avoided by cross-border purchasing. Within a country, it is virtually impossible to prevent some leakage from high-tax to low-tax jurisdictions. Between countries, cross-border purchasing can be better controlled at border-entry monitoring points. Nevertheless, the cross-border mobility of buyers remains important.

Harmonization of VATs has become an issue in Europe, where it is recognized that the dismantling of internal border controls would permit wide-

31. Corporate taxes within the OECD countries range from 1.3 to 7.5 percent of GDP. By contrast, the range of personal income taxes is from 5.7 to 25.6 percent of GDP; social security taxes from 0.0 to 22.2 percent of GDP; and indirect taxes from 3.9 to 19.4 percent of GDP (David Perry, "International Tax Comparisons," *Canadian Tax Journal* 37, no. 5 [1989]: table 2, p. 1352). For Canada and the United States, see the data in Vaillancourt, (ch. 11 in this volume).

spread cross-border shopping. This is not yet an issue in the North American context, since the FTA falls short of a common market or even a customs union. But with the increased mobility of individuals, and with the proposed extension of the Canadian federal sales tax to services, the degree of tax harmonization of indirect taxes may yet become important.