RATIONALIZING THE CANADIAN INCOME TAX SYSTEM

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Abstract

It is widely acknowledged that the Canadian tax system has become outdated. It is largely based on principles that go back to the Carter Report, and that have been increasingly challenged as circumstances have changed and ideas about tax policy have evolved. The personal tax system pays no more than lip service to the comprehensive income tax ideal, and the corporate tax is designed as a complement to a comprehensive tax system that does not exist. Canadian policy-makers face unprecedented challenges of globalization, an increasingly service- and technology-based economy and a growing inequality of income, wealth and opportunity. Modern principles of tax design have evolved significantly in the past several decades, many of which are reflected in recent tax reform proposals recommended by the Mirrlees Review in the UK. Major tax reforms have been undertaken in other OECD countries. Some significant innovations in tax policy have been implemented in Canada, such as RRSPs and TFSAs, the introduction of the GST/HST and of refundable tax credits, but these are largely piecemeal and uncoordinated. The corporate tax structure has changed only modestly. This paper explores options for feasible reform of the Canadian tax system that are both equity- and efficiency-enhancing.

Key words: Canadian tax system, tax reform, personal and corporate income tax

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1. INTRODUCTION

The Canadian tax system has undergone many piecemeal reforms since the landmark Royal Commission on Taxation (1966) (the Carter Report). Notable changes include the introduction of various devices for sheltering capital income; the replacement of the federal manufacturing sales tax and some provincial retail sales taxes with a partially harmonized value-added tax system; the change of most tax deductions to tax credits, and the introduction of some refundable tax credits; the devolution of revenue-raising from the federal to provincial governments and the institution of income tax collection agreements; the evolution of equalization and social transfers that has facilitated the effective decentralization of fiscal autonomy to the provinces and territories; and the streamlining of tax administration by the creation of the Canada Revenue Agency.

Taken by themselves, each of these changes have improved some aspect of the tax system. But, given the piecemeal process by which sequential reforms were introduced, the consequences for the system as a whole have been less coherent. The income tax system pays lip service to the Carter-inspired comprehensive income tax base ideal, but deviates from it in significant ways. Notably, as the system as a whole moves from income- to consumption-based taxation, the role of the corporate tax as a backstop to the personal tax loses relevance.

Moreover, circumstances have changed. The structure of the Canadian economy has moved increasingly toward production of services relative to goods, and information and knowledge-based industries have grown. Canada faces a much more globalized and competitive economy, in which capital and production becomes more mobile and in which domestic manufacturing industries are challenged by those of developing countries. Moreover, income and wealth inequality have risen as the share of national income going to capital rises and as productivity slows down. There has also been growing recognition of the extent to which windfall gains, or rents, contribute to inequality. At the same time, tax-transfer policies have become less effective at addressing market-driven inequality increases, owing in part to international tax competitiveness.

Tax policy principles and practices have also evolved. This includes views about the tax treatment of capital income relative to labor income, and the role of the tax-transfer system in mitigating inequality, particularly that resulting from windfall gains. It also includes a fundamental reassessment of the reform of business taxation to eliminate unnecessary distortions, and of the role of business taxation itself. In addition, alternative roles of taxes have been emphasized, including the pursuit of equality of opportunity and addressing the consequences of behavioral anomalies. Much current thinking can be found in recent tax reform commissions formed elsewhere, especially the Mirrlees Review (2011) and its wide-ranging in-depth background studies.

Our purpose is to review the Canadian tax system with this background in mind, and suggest some reforms that would improve the coherence of the system and make it more equitable and efficient. We begin by reviewing what we regard as inconsistencies and irrationalities in the existing system. We then summarize some fundamental tax reforms that draw on current widely held policy-relevant public finance principles and best practices. Finally, we propose directions of reform for the income tax system that would address existing anomalies and shortcomings and that are economically and administratively feasible. Our proposals develop some ideas that appeared in Boadway (2011, 2015).

2. Anomalies and Inconsistencies in the Canadian Tax System

The current Canadian income and sales tax system has evolved through a series of discrete and relatively small reforms over the past several decades. The reforms reflected tax priorities at the time they were undertaken, which themselves were adapted to changing circumstances and tax principles. The consequence is a tax system that is in many respects incoherent and contradictory. In this section, we recount the many ways in which the tax system has come to embed contradictory and irrational elements. Many of these involve the tax bases of personal and corporate income taxes, and their interdependencies. Others involve the rate structure. Of particular importance are the inconsistencies that exist in the treatment of different forms of asset income. We begin with these, and then turn to other issues.

Incoherent Asset Income Sheltering

The income tax system—and the tax law which underlies it—is nominally based on comprehensive income as espoused by the Carter Report (Royal Commission on Taxation 1966), and this is reflected in the benchmark system used by the Department of Finance (2018) to define tax expenditures. Gradually, the actual tax system has moved in the direction in the direction of a progressive consumption or expenditure tax system as increasing amounts of capital income have been sheltered. The sheltering has taken many different forms, no two of which are identical. Four forms of sheltering of capital income can be identified.

First, the combination of income taxation, which includes capital income, with sales taxation, which is based on consumption, implicitly results in a lower tax on capital income relative to earnings. That is, consumption alone is subject to one of the GST, HST or QST[1] depending on the province of consumption, whereas income taxation applies to consumption plus saving since this sum equals income. Moreover, if income were defined to include inheritances and gifts received, not even all income would be included in the income tax base (although bequests made are not deducted either, so to the extent that these are not regarded as consumption,

[1] Definitions of all acronyms are listed at the end of the paper.

the latter is over-taxed as well). The point is that even if there were no explicit sheltering of capital income, the system would effectively tax capital income preferentially.

Second, some assets are afforded registered or *tax-deferred* treatment. These primarily include savings held in RPP or RRSP accounts, both of which are intended to support savings for retirement. RPPs and RRSPs have in common that they have maximum contribution limits, but differ in that RRSPs, unlike RPPs, allow full carry-forward of unused deductions. The limits differ between the two, though the contribution limits of RRSPs do depend on the size of contributions to RPPs. As well, RRSPs can be withdrawn at will and with no financial penalty. In that sense, they are akin to a device for lifetime income averaging. RRSPs are based on defined contributions, whereas RPPs can be of the defined-benefit form. Compulsory contributory pension schemes in the form of the CPP and QPP also resemble tax-deferred savings vehicles. They are only imperfect defined-benefit schemes, and contributions are not income-deductible. Thus, even within the tax-deferred category of assets, tax treatment differs significantly. It should also be noted that human capital investment is treated roughly as a tax-deferred asset. Much of the cost of education consists of foregone earnings, which is effectively tax-deductible. The increases in earnings resulting from human capital investment are taxed when they accrue.

A third form of tax sheltered assets receives *tax-prepaid* treatment according to which asset income is not taxed (and contributions are not deducible). There are two main forms of tax-prepaid assets. One is owner-occupied housing, the return to which is implicit, or imputed, rent (including capital gains) and for which there is no maximum allowable size. The other is TFSAs, which carry an annual limit and allow unused limits to be carried forward. TFSAs can be withdrawn without penalty, so like RRSPs they deviate from a pure retirement-savings scheme. The absence of limits to housing investments implies that housing and TFSAs embed differential tax treatment. As well, the limits on TFSAs and RPPs/RRSPs are not comparable and are independent of one another, although contribution limits to TFSAs are lower than those to RPPs/RRSPs. That is, the limits to TFSA investments are not affected by the amount of combined RRP/RRSP savings, and vice versa. Tax-deferred and tax-prepaid assets differ in one further respect. The tax savings obtained from RRSPs and TFSAs depend on the difference between the marginal income tax rates at the time of contribution and withdrawal as well as the timing of contributions and withdrawals, and these can differ considerably. In particular, the tax savings on RRSPs are greater the higher is the tax rate at the time of contribution relative to the time of withdrawal, whereas the opposite applies for TFSAs.

Finally, by the capital gains exemption, a portion of capital gains (currently 50 percent) are tax-exempt. Two reasons are usually given for this. One is that the exemption roughly offsets the fact that some capital gains are due to inflation of asset values and do not represent real gains. The capital gains exemption might also be considered as a component of the integration of the PIT and CIT along with the dividend tax credit. Neither of these rationales is convincing. While it

is true that comprehensive income should be measured on a real basis, consistency would require that all forms of taxable capital income be indexed and not just capital gains. Moreover, since capital gains are taxed on realization rather than accrual, taxpayers can shelter them by postponing realization thereby offsetting the disadvantage of nominal gains being taxed. The integration argument is also unconvincing for reasons that we discuss further below.

One further important observation works against the capital gains exemption as well as against the tax-prepaid method of asset income sheltering. Capital income can include three components: a normal competitive return to capital, a return to risk, and a windfall return representing pure rent that has been unanticipated. From a tax policy perspective, one would like to tax rents even if it is desirable to shelter capital income because such a tax would be an efficient (and possibly an equitable) source of tax revenue. However, one cannot distinguish rents from returns to risk so exempting one necessarily exempts the other. Rents and returns to risk are captured both in unsheltered capital income and in the returns to tax-deferred savings plans (including implicitly the GST/HST/QST), but they escape taxation with tax-prepaid assets. There is evidence that rents constitute a significant share of capital income (e.g., Fagereng, Guiso, Malacrino and Pistaferri 2016; Kacperczyk, Van Nieuwerburgh and Veldkamp 2016; Power and Frerick 2016). Given that, the case for limiting the exemption of capital income from taxation using any of the tax-prepaid devices— capital gains exemption, TFSAs and housing—is compelling. Of course, taxing all capital income to tax rents implies taxing returns to risk and could discourage risk-taking. However, with generous loss-offsetting arrangements, taxing risk need not result in less risk-taking since the government effectively shares risk with taxpayers.

Not all assets can be sheltered. An important exception is assets in an unincorporated business. The returns to these are fully tax as individual income using a tax base defined in the same way as for corporations.

The consequences of these varied and uncoordinated forms of asset income tax treatment are many. Assets of different type and different forms of capital income are treated very differently. Thus, housing equity is fully sheltered, while personal business income is unsheltered; and capital gains, interest and dividends are treated differently. Assets sheltered to encourage saving for retirement are subject to different limits and rules, and are not penalized for withdrawal prior to retirement. And, some sheltering devices, such as TFSAs and housing, exempt all forms of capital income from taxation, while others, such as RRSPs, RPPs and the GST/HST/QST systems, implicitly tax rents all returns to risk.

Imperfect and Unnecessary integration of CIT and PIT

As discussed below, the CIT is designed to withhold taxes on corporate-source income accruing to shareholders to prevent them from postponing tax liabilities by retaining and reinvesting

income in the corporation. While this backstop role may have been necessary in earlier years, it is no longer warranted for two main reasons. First, most shareholder income is not liable for personal taxation, so withholding taxes on shareholder income at source is not necessary. Especially with the advent of TFSAs, most capital income of all but the wealthiest taxpayers can be sheltered. Recent estimates by Milligan (2012) and the Department of Finance (2013) suggest that if all taxpayers took full advantage of RRSPs, RPPs and TFSAs, 90 percent of taxpayers could shelter all of their capital income and 70 percent of all capital income could be sheltered. This alone means the need for integration is not compelling. Second, to the extent that personal capital income is taxable, the CIT would still not be an effective device for withholding. The reason is that with highly open international capital markets, the incidence of the CIT is largely shifted to labour, and empirical evidence bear this out. Recent studies estimate that between one-half and three-quarters of CIT changes are shifted to labor (Hassett and Malthur 2010; Zodrow 2010; Arulampalam, Devereux and Maffini 2012; Azémar and Hubbard 2015; McKenzie and Ferede 2017; Fuest, Peichl and Siegloch 2018).

In these circumstances, integration of the PIT and CIT is not warranted. Even if it were, the current instruments for integration are highly imperfect. The main mechanisms are the dividend tax credit and the capital gains exemption. On the one hand, these apply uniformly to all taxable dividends and capital gains regardless of the extent to which corporate taxes had actually been paid. On the other hand, no dividend tax credit applies to dividends received on sheltered asset returns. Moreover, the capital gains exemption has the additional disadvantage that it gives rise to costly tax planning, and this is exacerbated to the extent that the exemption also applies to stock options.

A further observation is that in an open economy setting where the investment and savings sides of the market are separated, the dividend tax credit and the capital gains exemption effectively subsidize personal unsheltered savings.[2] They cannot be interpreted as a refund of corporate taxes paid on the shareholders' behalf. Some might argue that these arguments do not apply with full force to the case of small corporations that do not raise funds on international capital markets, but that is not convincing. Even though small corporations might raise all their funds locally, and often from owner-operators themselves, local rates of return must comply with rates of return that apply elsewhere in the economy since creditors always have the option to buy assets whose rates of return are more directly influenced by international markets.

We conclude therefore that CIT/PIT integration serves no useful role, and that in turn has implications for the design of the CIT to which we now turn.

[2] For a formal analysis of the consequences of integrating the CIT and PIT in an open economy, see Boadway and Bruce (1992).

THE STRUCTURE OF THE CIT IS OUTDATED

The design of the CIT and its rationale have changed little since the landmark Carter Report (Royal Commission on Taxation 1966), and the same rationale was adopted more recently by the Mintz Report (Technical Committee on Business Taxation 1997). Based on the presumption that the intent of the PIT was to tax comprehensive income, but that capital gains could only be taxed on realization rather than accrual, there was a perceived need to tax corporate equity income at source so that shareholders could not shelter income within the corporation by retaining and reinvesting it. That rationale dictated that the base of the CIT should be shareholder income, which is the standard adhered to in the Income Tax Act as well as in the tax expenditure calculations (Department of Finance 2018).

Once the withholding rationale is discredited as discussed above, the use of shareholder income as the CIT base is not only unwarranted, but leads to problematic distortions. Given the openness of international capital markets, domestic investment decisions are effectively segmented from domestic savings decisions. In these circumstances the corporate tax serves to distort investment decisions, while integration measures subsidize saving (Boadway and Bruce 1992). Two important sources of distortion of the CIT can be identified. They arise from the fact that a CIT based on shareholder income taxes that part of the normal return to investment financed by equity. First, investment is discouraged to the extent that a corporation relies on equity finance as opposed to debt, and that can vary from firm to firm and even by type of capital. The plethora of estimates of marginal effective corporate tax rates bears that out (e.g., Boadway, Bruce and Mintz 1984; Technical Committee on Business Taxation 1997; Department of Finance 2005; Chen and Mintz 2015). Second, firms are encouraged to use debt rather than equity finance thereby increasing the possibility of bankruptcies.

The distortions of investment and financing decisions are specific to a CIT based on shareholder income. Other CIT distortions will also apply to other CIT bases. For example, location decisions by firms will depend upon average CIT rates, which unlike marginal ones will be positive for any CIT system. Also, the incentive for profit-shifting among countries depends on statutory CIT rates and not upon the CIT base, although the ability to deduct interest provides an important vehicle for profit-shifting. Finally, the CIT will discourage risk-taking to the extent that loss-offsetting is imperfect, although that effect might be greater when shareholder income is the CIT base rather than a narrower base that excludes competitive returns to investment as discussed below.

Small Canadian corporations (CCPCs) are also liable for the CIT, but in preferential terms. The SBD offers a reduced tax rate on all CCPCs whose taxable income, investment income and capital do not exceed prescribed upper limits. In addition, owners of CCPCs obtain the LCGE of over $800,000. From an economics perspective, the SBD is a response to the fact that the

income of new small businesses is risky, and that tax system does not fully cost that risk. In particular, losses are not refundable and can only be deducted against future income if the firm becomes profitable. Because small firms are taxed on any profits they earn but cannot fully recoup losses, especially if they go bankrupt, the CIT discriminates against them. The SBD is a partial response. The SBD may also be viewed as addressing to the fact that access to credit markets may be difficult for young small firms, although the SBD is of limited use in that regard since firms that are credit-contrained may also not be in a taxpaying position, so lower tax rates provide no relief.

However, the SBD is not restricted to small growing firms with risky prospects for success. It is available to all small firms as long as they remain small and regardless of their riskiness. The case of incorporated professionals is a particular example of businesses that are eligible for the SBD although they are not particularly risky or credit-constrained, and might do relatively little investment.

Small business owners also face some disadvantage in sheltering saving for retirement. Although they can invest in RRSPs and TFSAs, the assets of their firms cannot be part of their RRSP or TFSA portfolios. The LCGE is one vehicle for retirement income sheltering by small business owners. In addition, some passive investment income can be sheltered within CCPCs and be subject to preferential rates. As with other capital income sheltering devices, the limits of the LCGE and passive income sheltering are independent of limits on RRSPs, TFSAs and other devices. The use of any one sheltering device is subject only to limits prescribed for that device and is independent of the extent on sheltering in any other.

THE PIT RATE STRUCTURE IS ALSO INCONSISTENT AND COMPLICATED

The progressivity of the PIT depends on the structure of tax brackets and the tax rates within each bracket, but also on the various tax credits, both refundable and non-refundable. Progressivity also depends on differential treatment of various elements of the tax base and how they apply to different income levels. We highlight three anomalous features that affect the progressivity of the rate structure in questionable ways.

The first concerns the non-refundability of many tax credits, the so-called NRTCs. The concern applies mainly to tax credits that can be viewed as instruments for achieving vertical equity as opposed to those that are intended to influence behaviour or to achieve horizontal equity. For example, deductions for charitable and political contributions arguably serve to encourage taxpayers to make such contributions. There may be some question about the precise design of these, such as their size and how they vary with contribution, but their existence can be justified. As another example, deductions for medical expenses can be justified on horizontal equity grounds. Also, some smaller “boutique” tax credits, such as that for public transit, can be

questioned in terms of their cost-effectiveness. We are more concerned with those NRTCs that seem mainly to affect tax progressivity.

The most important of these is the basic personal amount. This is by far the largest NRTC and accounts for roughly two-thirds of the value of all NRTCs. The basic personal amount is equivalent to an equal per capita tax credit to all taxpayers eligible to claim it. However, it is worth less for those with low taxable income, and is of no value for those with no taxable income. The basic personal amount recognizes, following the Carter Report (Royal Commission on Taxation 1966), that at least some minimal amount of income is necessary for non-discretionary consumption. Those with no taxable income also have non-discretional consumption needs, and these could be met if the basic personal amount were refundable. As it stands, the non-refundablility of the basic personal amount implies that progressivity of the income tax is very low at the bottom of the income distribution, contrary to what is recommended in the optimal income tax literature (e.g., Tuomala 2016). Similar arguments apply to other NRTCs, most of which are more progressive than the basic personal amount since their amount depends on either individual or family income. Example of these include the spousal exemption, the dependent exemption and the age exemption.

The second concern is that the number of NRTCs is large, and many of them are effectively redundant given other element of the tax system. The age exemption largely duplicates the pension exemption and the OAS system. Similarly, the employment exemption accomplishes a similar objective to the CWB. Both give tax credits based on employment, albeit with different structures, and there is no good reason for having both of them. Some discriminate in favour of some groups for no good reason, like the age credit or the credits for volunteer firefighters and home-buyers. Finally, some credits are intended to compensate taxpayers for costs incurred or for contributions made and should be deductions rather than credits. The CPP contribution is an example of this as are education credits. The case for using credits is strongest when the objective is vertical equity as opposed to reimbursing taxpayers for contributions of expenses.

The third concern is that exemptions of some sorts of income are relatively more beneficial to higher-income taxpayers than others. The importance of capital gains rises with income level, including notably capital gains on owner occupied housing, so the value of the capital gains exemption rises with income. It is true that lower-income individuals can shelter most of their capital income using RRSPs. RPPs, and TFSAs, but these vehicles are also available to higher income persons. The preferential tax treatment of capital gains also influences the choice of the rate structure. The tax rate at the top is constrained by the relatively high elasticity of taxable income at high income levels, part of which is attributable to tax-planning opportunities. The preferential tax treatment of capital gains contributes to that.

The upshot of this discussion is that the PIT is characterized by a distinct lack of progressivity at lower income levels, and a narrower base and lower rates than necessary at the top.

The Exclusion of Inheritances from Taxation

One of the most conceptually challenging issues in tax design is the treatment of bequests and inheritances. There is no common international practice. Some countries tax bequests or estates, while others tax inheritances. Others, like Canada, tax neither. Virtually no countries offer incentives for bequests, despite it being common to give tax credits or deductions for charitable donations. In Canada, bequests are largely ignored in the tax system with the exception of deemed realization of capital gains on estates at death. This simply triggers capital gains taxation that would otherwise be postponed until actual realization at some later date.

There are a number of key issues of principle that arise with the tax treatment of transfers of wealth, both at death and inter vivos. On equity grounds, the presumption is that inheritances are a form of income and ought to be taxed as such, especially given their windfall nature to recipients. The issue is whether a bequest is analogous to consumption by the donors. If it is, a bequest would give simultaneous benefit to donors and recipients so no credit would be given to donors, but recipients would be taxed. Many reject this form of double-counting (Hammond 1987 and Mirrlees 2007), and argue that taxation should occur only in the hands of the recipient. The Canadian case is very roughly equivalent to this since no credit is given for forgone consumption by donors and no tax is paid by recipients, so the two roughly cancel. However, this view is complicated by a further consideration. In the case of large bequests, there is some likelihood that a significant amount of the value of the bequest represents a windfall gain or a rent accruing to the underlying assets. On these grounds, an argument can be made for taxing inheritances in their own right.[3] As well, arguments can be made for breaking up large estates on grounds of equality of opportunity and the dilution of the power that comes with wealth (Piketty 2014). According to this view, a tax on inheritances with no relief for donors could be justified (Boadway, Chamberlain and Emmerson 2010).

There are also efficiency issues with inheritance taxation. For one, if bequests benefit both the donor and the recipient, there is an externality: donors take into account the altruistic benefits they obtain for themselves from making a bequest but not the additional benefit to the recipients. This has led some authors to suggest subsidizing bequests on efficiency grounds (Kaplow 2001). In addition, even if there is no double-counting so the benefits to donors are

[3] An alternative would be to tax wealth annually instead of taxing it once when it changes hands. The case for an annual wealth tax is not an easy one as discussed in Boadway and Pestieau (2018). Of course we already do have an annual property tax, but it serves mainly to finance municipal government services and education.

ignored, taxing inheritances will discourage donations and that must be taken into account in deciding on tax treatment (Cremer and Pestieau 2006).

Clearly, there are difficult conceptual issues involved in determining the tax treatment of bequests and inheritances, and these will apply also to other voluntary transfers.

3. Some Principles for a Modern Tax System

The literature on the design of an optimal tax system has burgeoned in recent years. Much of it is a result of the development of optimal income tax theory and its application to tax policy.[4] Optimal income tax analysis takes a utilitarian approach to tax design; that is, it studies the tax system that optimizes final outcomes summarized in a social welfare function with standard properties.

The utilitarian approach is in contrast to that taken by the Carter Report (Royal Commission on Taxation 1966) that dominated public finance for the first half of the twentieth century, and that was summarized in the monumental synthesis of Musgrave (1959). The latter is also the approach that informs the design of much of the income tax system to this day. This approach emphasizes individuals' ability-to-pay—summarized as comprehensive income—as the ideal tax base, and looked to the notion of equal sacrifice to guide tax progressivity. The ability-to-pay/equal sacrifice approach, in contrast to the utilitarian one, emphasizes command over resources—or spending power—as the ideal base rather than utility, and takes into account both initial and final positions in determining progressivity.

More recently, the equality of opportunity approaches of Roemer (1998) and Fleurbaey and Maniquet (2011) have offered other command-over-resource based alternatives to utilitarianism. These authors emphasize the multi-dimensional heterogeneity of individuals. They can differ in characteristics over which the have no control, such as innate ability and family background, as well as those over which they may have control, such as preferences. The ideal tax-transfer system ought to compensate individuals for differences in given characteristic, but lets them assume responsibility for how they use the abilities and resources made available to them.[5]

The tax principles we outline below combine utilitarianism with equality-of-opportunity approaches. We adopt from both principles what they have in common combined with what

[4] An early summary of optimal income and commodity tax analysis is found in Atkinson and Stiglitz (1980). More recent innovations are found in Banks and Diamond (2010), Boadway (2012) and Piketty and Saez (2013).

[5] A critique of the problems faced by utilitarianism as a sole basis for tax design are discussed in detail Boadway (2012). In addition to the problem of dealing with multi-dimensional characteristics, some of which individuals can influence, utilitarianism faces challenges in dealing with aspects of behavioral economics and with judging what sorts of preferences should count from a social welfare point of view (e.g., altruism and other forms of interdependent utility).

they separately bring to the table. Our emphasis is weighted heavily toward utilitarian principles, augmented by equality of opportunity where useful. Our focus is on tax design as it applies to individuals, though the complementary roles played by corporate and commodity taxation are relevant. The following subsections summarize the set of principles that we shall use to inform the subsequent tax reform suggestions.

Individual Income Taxation

The key policy issue in individual income tax design is the treatment of capital income. Two alternative frameworks dominate the historical discussion: comprehensive income taxation and personal consumption taxation. The former is associated with the Carter Report (Royal Commission on Taxation 1966), while the latter has subsequently been advocated by the United States Treasury (1977), the Meade Report (1978), the Economic Council of Canada (1987), the President's Panel (2005) in the U.S.A., and most recently the Mirrlees Review (2011). An important innovation in the Mirrlees Review was to stress that some returns to capital are above the normal competitive return and ought to be taxed both in a consumption tax system and in a comprehensive income one. Their Rate-of-Return Allowance, which proposed taxing returns to shares in excess of a normal rate of return was a means of doing this. The use of tax-deferred sheltering, such as by RRSPs and RPPs, accomplish the same thing.[6]

While the Mirrlees review recognized importance of including consumption finance by rents, it differed from the advice given by Banks and Diamond (2010) as part of its background research. Notably, Banks and Diamond argued for at least partial taxation of all capital income. We adopt elements of both the Mirrlees Review and Banks and Diamond as part of our principles. In particular, the latter argued for retaining some progressive capital income taxation, but at preferential rates compared with earnings. In addition to those principles, we adopt a few more. First, there is a case for sheltering capital income to encourage saving for retirement, given the observed tendency for individuals to save too little for retirement. Undersaving is socially costly since the government typically has to support persons in their retirement whose income is low. Such sheltering should apply as consistently and comprehensively as possible across various possible sheltering instruments. Second, we explicitly recognize the importance of exempting above-normal returns or rents from capital income sheltering, and the implications this has for sheltering by tax-prepaid relative to tax-deferred vehicles. Rents are included as part of accumulated earnings that are taxed when tax-deferred accounts are drawn

[6] The economic argument is technical, but its essence is as follows. Consumption services cannot be taxed directly since they cannot be observed. However, over the lifetime of an individual, the present value of consumption expenditures on a case-flow basis is equivalent to the present value of consumption services. Equivalently, an income tax with tax-deferred sheltering of capital income is equivalent in present value terms to consumption. However, tax-prepaid sheltering does not give the same equivalence. It would do so if above-normal returns to capital were included in the tax base, as in the Mirrlees Review's Rate-of-Return Allowance.

down, but are exempt from taxation with tax-prepaid assets. Finally, since the sheltering of capital income is intended to encourage saving for retirement, some penalties for early withdrawal are warranted. These principles are mainly for policy guidance purposes. In practice, it will be difficult to achieve all of them fully.

Some other principles relate to personal income taxation more generally. The progressivity of the rate structure needs to be rationalized. This is particularly the case for those at the bottom of the income distribution. The existing system of NRTCs is of little use to the lowest-income persons, and that could be addressed by making them refundable. Such a reform would be a natural evolution of a system that was last changed in the 1980s when most tax deductions were converted to credits. Given that many NRTCs are meant to contribute to the vertical equity of personal taxation, that objective can be fulfilled by allowing refundability. More generally, there is a case for rationalizing and simplifying the many NRTCs that exist so that the PIT is fairer and more transparent.

The broadening of the tax base so that all non-sheltered capital income is treated comparably would enhance fairness at the top. In particular, given the weak case for integration of the CIT and PIT, the preferential treatment of dividends from Canadian corporations and capital gains is not warranted. Eliminating those tax preferences would not only enhance tax fairness but would reduce tax planning opportunities.

Recent optimal income tax analysis has emphasized the role of participation incentives at the bottom of the income distribution (Saez 2002; Brewer, Saez and Shephard 2010). In Canada, the CWB serves that purpose, but it is of limited size. An enhancement of the CWB combined with refundability and rationalization of NRTCs would at the same time provide a reasonable basic income guarantee for those with no earnings augmented by a larger transfer for those who obtain low-paid employment. As discussed in Boadway, Cuff and Koebel (2018a,b) and Koebel and Pohler (2018), this could be the prototype for a more substantial basic income guarantee that the federal government and the provinces could provide collaboratively in a manner analogous to the income tax collections agreements. At the same time, the benefits of enhancing the CWB can be overstated. Encouraging labor market participation is valuable to the extent that employment is actually achieved, and that depends on the demand side of the labor market. Given the difficulties that low-skilled persons might have in obtaining employment, the premium paid by an enhanced CWB to those who succeed should not be excessively high compared with transfers received by those unable to land a job.

Finally, the tax treatment of unincorporated business income should be similar to that of corporations to which we turn next. In anticipation, all real business income should be taxed on a cash-flow—or cash-flow-equivalent—basis so that normal returns are exempt. This implies

that personal investments in unincorporated businesses would be fully sheltered unless they are passive investments.

Corporation Income Taxation

As mentioned earlier, the CIT base is designed to be shareholder income measured on an accruals basis. Revenues, measured as accounts receivable, are included while current costs and accrued capital costs are deducted, where the latter include among other things interest payments and depreciation charges (capital cost allowance). This choice of shareholder income as the base reflects the view of the CIT as a backstop device for the PIT. It is intended to withhold tax against shareholder income as it is earned in the corporation to preclude the shareholder from using the corporation as a sheltering device. Given this withholding intent, shareholders are reimbursed by the dividend tax credit and capital gains exemption. As we have argued, this rationale is dated. A significant proportion of shareholder income is sheltered at the individual level. And, much of the incidence of the CIT is shifted to labor, except that reflecting rents, so withholding is ineffective and integration is unnecessary. Given the segmentation of investment and savings in international markets, the CIT essentially distorts investment decisions regardless of any relief given by integration.

There is ample evidence that a substantial share of corporate income reflects rents or windfall profits arising from monopoly power or unexpected gains (de Mooij 2011; Boadway and Tremblay 2014; Power and Frerick 2016). In these circumstances, a more cogent rationale for the corporate tax is as a tax on rents. This was the approach taken by the Meade Report (1978) and subsequently by the Mirrlees Review (2011) when it revisited the latter. It was also recommended for the European Union by the Institute for Fiscal Studies (1991), and more recently has been advocated for Canada by Boadway and Tremblay (2014, 2016).

The classic design of a rent tax is a cash-flow tax, also known as a Brown tax after Brown (1948). The cash-flow tax base is simply total cash receipts less total cash outlays, with no distinction between current and capital expenditures. In particular, investment is expensed and no further deductions are given for interest or depreciation. Provided positive and negative cash flows are treated symmetrically, for example, by refundability or carry-forward of tax losses with interest, such a tax is neutral with respect to both investment and financing.[7] The Meade Report proposed either that the cash-flow tax apply only to real transactions—the R base—or that is apply to both real and financial transactions—the R+F base—in order to get at the rents earned by financial institutions.

[7] Strictly speaking, investment neutrality only applies if the tax rate is not expected to change, as shown by Sandmo (1979).

The cash-flow tax is the simplest form of rent tax to implement, but it has the disadvantage that it deducts all costs upfront before revenues are obtained. This results in significant negative tax liabilities for firms engaging in large investments and the postponement of tax revenues for others. If governments are reluctant to make tax losses refundable, other options are available that are equivalent to cash-flow taxation in present-value terms. In fact, any tax base such that the present value of future deductions arising from an investment equals the value of investment itself will be equivalent to cash-flow taxation (Boadway and Bruce 1984). An example of such a cash-flow-equivalent tax base that has been applied in a number of countries is the ACE corporate tax initially recommended by the Institute for Fiscal Studies (1991). It involves a relatively straightforward reform of the existing tax, which allows firms to deduct from their corporate tax base a normal rate of return to equity times the amount of their investments that have been financed by equity. Assuming that the existing corporate tax base measures shareholder income relatively accurately (e.g., that CCA deductions approximate actual capital depreciation), allowing a deduction for the cost of equity finance converts the tax base from shareholder income to above-normal profits. These will include both rents and returns to risk. To the extent that the corporation is risk-neutral, because its shareholders have been able to diversify fully their risk, the ACE corporate tax will be neutral with respect to investment and financing, just like a cash-flow tax. The ACE tax has the additional advantage that it is relatively easy to phase in beginning with the existing CIT.[8] It can be applied to both real and financial corporate incomes so as to capture rents from financial intermediaries.[9]

A problem with a cash-flow-equivalent tax, as with the existing CIT, is that losses that are carried forward with interest are not refunded for firms that go out of business. This is likely to be a particular problem for small growing firms who are involved in risky investments and who may in addition face credit barriers. As mentioned above, this might be addressed by giving preferential tax treatment to young, small, growing businesses. Ideally, refundability of tax losses would address the problem, but since governments are reluctant to implement refundability, preferential corporate rates for small corporations is a second-best response. However, the rate reductions should be targeted as much as possible to young firms engaged in risky investments rather than established small firms. One way to do this would be to impose a cumulative limit on taxable income to remain eligible for the rate reduction (as opposed to imposing annual taxable income limits as in the current Canadian case). However, preferential treatment should not be extended to passive investment income of small firms since the firm owners may well be high-income persons for whom personal capital income is fully taxable.

[8] Other forms of cash-flow equivalent taxes exist. One is the Resource Rent Tax implemented temporarily in the Australian mining industry by the Commonwealth. See Boadway and Tremblay (2014) for a description of this tax.
[9] For further discussion, see Claessens, Keen and Pazarbasioglu (2010).

A natural implication of taxing corporations, including CCPCs, on a rent tax basis is that unincorporated businesses should receive the same treatment. That was one of the recommendations of the Mirrlees Review. Doing so would turn small personal businesses into tax-sheltering vehicles akin to tax-deferred instruments. There would then be no need to provide special vehicles like the LCGE to shelter family business incomes. Of course, unless some limits were placed on the ability to shelter income in personal businesses, they would have an advantage over other tax-sheltering devices like RRSPs, RPPs and TFSAs. Imposing comparable limits on the sheltering of normal capital income through personal businesses by taxing them on a rent tax basis would likely be administratively complicated.

A final issue of corporate tax policy is the treatment of foreign-source income. Recently, a proposal has been put forward by a group of international public finance economists to change the U.S. corporate tax into a destination-based cash-flow tax (Auerbach, Devereux, Keen and Vella 2017). The cash-flow aspect is, as above, intended to make the tax neutral with respect to investment and financing. The destination base would be achieved by deducting the value of exports from a firm's tax base and including imports, analogous to a destination-based VAT. This would effectively transfer a corporation's tax on rents from countries where the rents originate to those where the final output of the corporation is purchased. The argument for doing this is entirely administrative. The use of the destination base largely eliminates the incentive for corporations to shift profits to low-tax countries. This would essentially allow the tail to wag the job. There is no compelling economic or fairness case for allocating rent tax revenues to countries of final demand destination. On the contrary, to the extent that rents arise from conditions in countries of origin, such as resource endowments or legal and market institutions, it makes more sense for the rents to accrue to the country of origin. That is, a territorial approach to corporate tax liability is reasonable, and it is the one we propose. Of course, enforcing the territorial approach is challenging given the ability of firms to shift profits, and that remains a work in progress that is worth continuing to pursue.

SALES TAXATION

The GST/HST/QST system is a major component of the tax mix. Apart from exemptions and zero-rated goods, the federal GST is roughly speaking a proportional tax on consumption, including consumption financed by rents. The fact that many provinces have not adopted the HST implies that it is a very imperfect consumption tax. In those provinces that maintain retail sales tax systems, business inputs are taxes that lead to production inefficiency, which is a feature that one would like to remedy (Smart and Bird 2009). Apart from that, the main overall consequence for tax policy from the sales tax system arises from the fact that it is based on consumption rather than income. As we observed earlier, this implicitly implies that the entire tax system favors normal capital income relative to labor income. (Above-normal capital

income is implicitly taxed under general sales taxation.) This is consistent with optimal income tax analysis that suggests that capital be taxed preferentially. Given that this preferential treatment is achieved by the mix of sales and income taxation, there is further no need to treat capital income preferentially through the income tax system apart from a desire to encourage saving for retirement. To the extent that capital income is still taxed relatively heavily compared with earnings, the mix between the GST/HST/QST and the income tax could be changed.

The tax system still relies on the income tax to achieve progressivity, and that is reasonable. There is no compelling reason to make sales taxation more progressive by differentiating more commodity tax rates in favor of goods consumed by low income persons. Progressivity is more efficiently achieved through the income tax system.[10] As we have argued, it does this through the rate structure as well as through refundable tax credits, and we have argued that the use of the latter should be enhanced.

There are some detailed design issues with the GST/HST/QST system that could be further investigated. For example, a strong argument could be made that all types of e-commerce should be liable for the tax even where the platform is located abroad. As well, the tax treatment of financial services could be revisited. These are not crucial issues, and raise questions of tax administration.

INHERITANCE TAXATION?

Although taxation of bequests or inheritances was eliminated in Canada over three decades ago, the issue has re-emerged internationally in recent years as an area of serious policy interest. Recent evidence has emphasized the growth in wealth inequality, and the extent to which that inequality is passed from one generation to another. Piketty (2014) has argued that the growth in asset wealth relative to earnings is a natural consequence of growth in normal periods given the tendency for the return on capital to exceed the rate of growth of the economy. This is exacerbated by the fact that larger wealth holdings tend to have especially high rates of return, a phenomenon that may well reflect the importance of windfall gains or special advantages. The Mirrlees Review (2011) recommended a progressive lifetime inheritance tax separate from income taxation, and they based their argument largely on equality of opportunity grounds. Piketty had proposed a world wealth tax to address inequality, but that is utopian in the extreme. In any case, annual inheritance taxation—which applies to

[10] Technically speaking, the Atkinson-Stiglitz (1976) theorem tells us that progressive income taxation is more efficient for redistributive purposes than differential commodity taxes if goods are weakly separable from leisure in individual utility functions. Although weak separability may not strictly apply, nonetheless the administrative costs of adopting differential commodity tax rates likely outweighs any redistributional advantage.

an intergenerational transfer only once—seems a more appropriate instrument than an annual wealth tax, as discussed in Boadway and Pestieau (2018).

The case for a tax on cumulative lifetime inheritances with a moderately high threshold is equally applicable to Canada. Such a tax would be motivated by equality of opportunity and would complement the existing income tax. The threshold would recognize the view that a least some large estates reflect windfall gains either to those who accumulate them or to previous generations that have inherited large amounts of wealth. It would also take account of the argument that power and influence, including over political outcomes and public opinion, accrue to holders of large accumulations of wealth.

4. Implications for Reform of the Canadian Tax System

The above discussion suggests an agenda for tax reform that would lead to a fairer and more efficient tax system, would address the international circumstances Canada now faces, and would correspond with best practices and modern tax policy principles. We have already hinted at most of the directions of tax reform we favor, and we can be relatively brief in summarizing them here. We focus on general directions for tax reform without specifying the full details.

Following recent tax research (Banks and Diamond 2010), tax practice in many European countries, and the Mirrlees Review, we propose that the overall personal tax base include both labor and capital income, but that capital income be taxed generally more favorably than labor income. This would be analogous to the dual or Nordic tax systems in the Scandinavian countries, except that the tax on capital income would be progressive. The Nordic dual income tax system is progressive with respect to earnings, but capital income is taxed at a low linear rate (Boadway 2004). This facilitates collection and compliance because with a linear capital income tax rate, the tax can be withheld by financial institutions. A progressive rate of tax on capital income would be fairer and could capture some of the rents associated with capital income that accrue especially to higher income taxpayers.

Such a schedular approach to income taxation would be different from the Carter Report benchmark of comprehensive income taxation, but it would not represent a fundamental change in current practice. The mix of broad-based income taxation with a consumption-based GST/HST/QST system implies that tax rates on normal capital income are lower than on labor income, that above-normal returns on capital are fully taxed, and that capital income is taxed progressively. However, neither the capital income tax nor the sales tax systems are completely broad-based so further reform would be desirable.

In the case of sales taxation, although the GST includes most consumption purchases, there are exceptions such as e-commerce purchases from abroad as well as financial services that are of the consumption sort. More important, the HST system does not apply in five provinces of

whom four maintain outmoded and inefficient retail sales tax systems. A priority for ongoing federal tax policy is to continue to pursue HST agreements for provinces that have yet to join. Otherwise, the HST and its QST equivalent in Quebec are appropriate mechanisms for achieving preferential taxation of capital relative to labor income. The HST is a tax-deferred equivalent to a sheltering device that exempts normal capital income but includes unexpected or windfall returns to assets.

With respect to capital income taxation, important exceptions to the uniform taxation are exemptions due to either tax sheltering or special treatment of particular types of capital income. We have argued that tax sheltering is warranted to the extent that it encourages saving for retirement. The existing system, which includes RRSPs, RPPs and TFSAs, has some structural deficiencies that detract from its purpose. Contributions to RRSPs and RPPs together are limited, but their limit is independent of contributions to TFSAs, and vice versa. Contribution limits to TFSAs tend to be less than for RPPs and RRSPs, and that is reasonable given that above-normal returns are not taxed in the former. Ideally, tax sheltering of imputed returns to owner-occupied housing ought to be subject to a limit, though that would be administratively complex. We deal with housing separately below.

Taxpayers could manage the mix of tax-prepaid and tax-deferred assets so as to average incomes over the life-cycle (although we propose a general form of income averaging below that would to some extent remove the need for self-averaging). Moreover, given that the rationale for tax sheltering is to encourage saving for retirement on the basis that individuals do not save enough if left to their own devices, some penalty should apply on early withdrawals. Note should also be taken of the fact that tax-prepaid instruments like the TFSA and housing differs from tax-deferred instruments like the RRSP and RPP. Since the latter shelter only normal capital income, while the former shelter all capital income including windfalls, there is a case for favoring tax-deferred devices over tax-prepaid ones. This can be achieved by imposing significantly lower limits on TFSA contributions than on RPPs and RRSPs.

One form of tax-prepaid sheltering that is anomalous is housing. Returns to housing, which can include windfall capital gains, are fully sheltered without limit. Housing is also an important component of intergenerational transfers. Housing (along with small businesses) is also an asset that households use to save for retirement. To that extent, one could support limited sheltering. The taxation of housing returns above some limit is warranted. Since measuring the full imputed returns to housing is difficult, and since housing is to some extent taxed already through the property tax, a pragmatic approach would be to tax capital gains in excess of some threshold. As with other capital gains, deemed realization would apply on death, although this would have to be coordinated with an inheritance tax that we propose below as a longer-run tax reform.

Three further reforms to individual capital income taxation follow from our proposal for reforming business taxation into a tax on rents that we discuss below. First, as we have argued, the case for integrating the PIT and CIT is weak given the estimated shifting of the CIT to labor income earners and the fact that much capital income is sheltered from the PIT, and it becomes even weaker given our proposal to reform the CIT into a rent-based tax. The implication is that the dividend tax credit largely serves to shelter equity income and encourage saving, so should be eliminated. By the same token, there is no strong case for the capital gains exemption, and it too should be abolished. The argument that preferential treatment of capital gains is needed to avoid taxing inflationary gains is not convincing. Although nominal capital gains are taxed, this is at last partly offset by the benefits of sheltering given that accrued capital gains are not taxed until they are realized. This is also consistent with our proposal to tax fully housing capital gains above some limit. Second, personal unincorporated businesses would be taxed on a rent tax basis using a similar approach as for corporations discussed below. This implies they are sheltered on a tax-deferred basis. Third, the LCGE could be abolished since its main purpose is as a tax-sheltering device, which is no longer necessary if business income taxation is takes the form of a tax on rents.

Turn now to the tax treatment of business income. The intent of the current CIT system is to tax at source income earned by the corporation on behalf of shareholders, although it achieves this with limited success. The tax base of unincorporated business income follows the same aspiration. The rationale for using shareholder income as the base is that the CIT should be a withholding device for the PIT, taxing at source income earned on behalf of shareholders who could otherwise shelter income within the corporation. As more and more shareholder income becomes sheltered at the personal level, and as evidence mounts that much of the CIT is shifted to labor, the withholding rationale loses force. At the same time and as noted above, evidence accumulates that a substantial share of corporate income consists of above-normal returns (de Mooij 2011; Boadway and Tremblay 2014; Power and Frerick 2016). This suggests that while the CIT is not needed as a withholding device against shareholder income, it is useful as a device for taxing rents at source. A tax on rents represents a fully efficient source of tax revenues. Using actual rents—or pure economic profits—as a tax base would be administratively infeasible since it would involve measuring true costs as they accrue (e.g., true depreciation of tangible and intangible assets, and imputed costs of risk). Fortunately, in the case of risk-neutral corporations, the stream of cash-flows has the same present value as the stream of rents (Boadway and Bruce 1984). Thus, a cash-flow corporate tax or its present value equivalent is analogous to a rent tax, where annual cash flows include annual revenues less annual expenditures, including actual investment spending. No further deductions would be given for either depreciation of assets or the costs of financing, and accounting could be in cash rather than accrual terms thereby simplifying the tax system. However, negative and positive cash flows would have to be treated symmetrically to maintain neutrality of the CIT, either by

offering refundability or more likely by carry-forward of tax losses indefinitely with interest. To the extent that corporations are risk-averse, the cash-flow tax applies to the risk premium. This cannot be avoided but its effects can be mitigated by full loss-offsetting.

A tax that is analogous to cash-flow taxation in present-value terms is the ACE tax discussed above. It differs from the current system by allowing a cost-of-finance deduction for all equity-financed investments using a normal cost of finance, as well as by allowing tax losses to be carried forward with interest.[11] It has the advantage of being a fairly straightforward reform of the existing system, but is has two disadvantages. It retains accrual accounting and it requires the use of a normal cost of finance for the cost of equity deduction.

Cash-flow taxation or its equivalent removes the distortions that the existing tax system imposes on the extent of investment and the form of financing of the firm. However, it does not eliminate the effect of the CIT on corporate location or on the shifting of profits. These depend on the average tax rate and the statutory tax rate, respectively. The recent proposal for a destination-based cash-flow tax by Auerbach, Devereux, Keen and Vella (2017) was intended to remove the incentive for corporations to locate their profits in a tax-favored country. However, the destination principle would entail that rents generated by the attributes and institutions of one country would accrue to countries where final sales happen to be made, and this violate reasonable tax principles. Our preference would be for territorial taxation of corporate profits, with tax compliance and enforcement being pursued by other means. Note that while the destination-based corporate tax was adopted by the Republican party in the US Congress, the 2018 tax reform largely legislated a cash-flow-type corporate tax, but opted for the territorial principle.

The cash-flow principle would also apply to small businesses, both corporations and unincorporated businesses. A convincing case can be made for preferential treatment of CCPCs, with targeted provisions. Small corporations that are new and growing are typically highly risky. They have significant probabilities of being unsuccessful and face credit constraints. The CIT can exacerbate these problems to the extent that loss-offsetting is imperfect. If governments are only willing to allow tax losses to be carried forward and offset against future income, unsuccessful firms that go out of business with tax losses on their books will face a disadvantage. The tax system will tax positive gains but may not refund losses, so the tax system increase riskiness. In these circumstances, taxing small businesses at preferential rates reduces the disadvantage in ways that other incentives, such as faster investment write-offs, do not. Thus, the SBD is a useful instrument, but should be designed to target small growing firms and not established ones who face little risk. To achieve this, eligibility for the SBD should be subject to a cumulative income limit rather than simply an annual one. As well, the carry

[11] The mechanics of the ACE are discussed in more detail in Boadway and Tremblay (2014).

forward of losses should be with interest, and of long duration. To further address the financing and riskiness issues faced by small firms, consideration could be given to allowing refundability of at least some of the costs of hiring labor by firms eligible for the SBD.

There are other details of corporate tax design that could be pursued if space allowed, including the taxation of natural resource rents and the harmonization of natural resource taxes and the CIT, tax incentives for research and development, and the tax treatment of patent income. We have discussed these elsewhere (Boadway and Tremblay 2014, 2016; Boadway and Dachis 2015; Boadway, 2017).

We return to the PIT and its progressivity. While the current system has a progressive rate structure, overall progressivity is undermined by exemptions from the tax base at the top and by a remarkable absence of progressivity at the bottom, except for seniors and children. The proposals for reforming the taxation of capital income we have made above—especially eliminating the capital gains exemption and the dividend tax credit and taxing large housing capital gains—would significantly improve progressivity at the top. At the bottom, we propose a fundamental reform of the system of NRTCs. This would involve three elements. One would be to consolidate those credits that serve mainly a redistributive role, such as the age and pension credits, the employment credit, and several minor credits. Some of these credits are redundant with other aspects of the tax-transfer system (e.g., the age credit duplicates OAS/GIS and the employment credit duplicates the CWB), and others are discriminatory. A second element would be to make them refundable so that they are of benefit to those who need them most. Finally, they should be made progressive by conditioning them on income. Many of them are income-contingent, but the basic personal amount, which is the NRTC of the greatest value, is of equal per capita value to all taxpayers regardless of their income. This reform of the NRTCs would effectively represent the beginning of a basic income guarantee, which if combined with reform of provincial social assistance systems as proposed by Boadway, Cuff and Koebel (2018a), would result in a federal-provincial income guarantee of substantial size. Such a system would combine a basic income guarantee with a tax-back rate, and would be superimposed on the PIT system and delivered through the tax system.

For those economists, like Kesselman (2014, 2018) and Osberg (2018), who worry that a basic income guarantee would be too focussed on providing income for those who choose not to work, the CWB could be enhanced and integrated with the above refundable tax credit system. (See Koebel and Pohler (2018) for the details of such a scheme.) At the same time, as we have stressed earlier, the CWB only operates on the supply side of the labor market. Its success depends on those who choose to participate in the labor force actually finding jobs so it cannot displace the need for an income guarantee for those who are not employed.

A further suggestion for enhancing the effective progressivity and fairness of the income tax system would be to re-institute general income averaging. The feasibility of this is enhanced by the computerization of tax administration. And, the case for it is apparent given the recent finding by Garcia-Medina and Wen (2018) that the Canadian tax-transfer system has become less effective at reducing market induced income volatility since the mid-1990s. A design feature of income averaging that would have to be chosen would be the period of time, that is, the number of tax years, over which averaging should apply. Presumably, it would be less that a lifetime, so methods of self-averaging through the mix of tax-prepaid and tax-deferred sheltering devices would be useful supplements.

As a final and perhaps longer-term thought, the time has come to revisit inheritance taxation in Canada. The Mirrlees Review (2011), following the Meade Report (1978) recommended a cumulative lifetime inheritance tax separate from the income tax, with a sizable exemption level and possibly progressive rates. The case for inheritance tax is partly based on equality of opportunity, especially the extent to which wealth inequality is transmitted across generations. As Piketty (2014) argued, capital income is growing relative to labor income, and this translates into growing wealth accumulation and wealth inequality. The proportion of saving that is going to bequests as opposed to life-cycle smoothing is increasing. Moreover, a significant proportion of the returns on large estates represent past rents. Introducing an inheritance tax would be a major reform, and would probably face political obstacles. It would therefore be a longer-term tax policy objective, but it is worth putting it on the agenda for discussion.

5. Summary

We have reviewed a number of perceived inconsistencies and outdated features of the Canadian tax system in light of modern tax principles and practices, and have proposed some basic reforms to address them. The suggested reforms are best thought of as ideas for reforms in the sense that the full details remain to be worked out. Despite the lack of detailed proposals, we regard the reform ideas as being feasible from an administrative and compliance point of view. To recollect, our main ideas for reform are as follows.

- Maintain the system of preferential taxation of capital relative to labor income that is achieved by the combination of comprehensive income and the GST/HST/QST system, and pursue HST adoption by those provinces that retain retail sales taxation
- Tax all capital income with the exception of tax sheltering intended to encourage saving for retirement, including housing
- Maintain significantly lower contribution limits on TFSAs relative to RPPs and RRSPs
- Penalizing withdrawals from sheltered savings plans before retirement
- Tax capital gains on owner-occupied housing beyond some threshold

- Eliminate integration of the PIT and CIT by abolishing the dividend tax credit and the capital gains exemption, as well as the LCGE
- Tax all business income, both corporate and unincorporated, on a rents tax basis, either by cash-flow taxation or by its equivalent such as the ACE tax, and allow carry-forward of losses with interest
- Tax corporations according to the territorial principle
- Retain the SBD, but restrict it to young, growing firms by imposing a cumulative income limit
- Rationalize the NRTCS by combining those that serve a vertical equity objective into a single credit that is refundable and income-tested, and eliminate smaller NRTCs that are ineffective or discriminatory
- Enhance the CWB and integrate it into the reformed system of refundable and income-tested tax credits
- Institute general income averaging
- In the longer run, contemplate a cumulative lifetime tax on inheritances received separate from the income tax but with a reasonable exemption level

Critics of these proposals will focus especially on two concerns. The first is the cost. Some proposals will reduce the tax base, such as the move from shareholder income to rents or cash flows as the business tax base, and the making of NRTCs refundable. Others will increase tax revenues, such as the elimination of the dividend tax credit and the capital gains exemption and the taxation of capital gains on housing above some limit. On balance, the revenue consequences can go either way depending on the details of the reforms. In previous studies, partial implementation of some of these reforms were roughly revenue-neutral. For example, Boadway and Tremblay (2014) found that the combination of a move to a rent-based CIT and the elimination of integration measures was roughly revenue-neutral. Also, Boadway, Cuff and Koebel (2018a) showed that implementing a basic income guarantee could be financed by making NRTCs both refundable and income-contingent and using revenues from provincial welfare systems.

The second concern is political feasibility. The reforms proposed would improve the efficiency of the economy, but they would also make the tax system more progressive overall. Higher-income taxpayers would generally be worse off, and lower-income taxpayers better off. It is, of course, not unheard of that tax reforms might make taxpayers with political clout worse off. Indeed, many recent reforms have made the tax system more regressive. Whether the political will does or can be made to exist to enact progressive tax reforms is an open question. Given the many concerns expressed about some of the adverse consequences of growing inequality, progressive reforms are not out of the question. In any case, putting them on the table surely serves a useful social purpose.

Glossary of Acronyms

CCPC: Canadian controlled private corporation

CIT: corporation income tax

CPP: Canada Pension Plan*

CWB: Canada workers benefit

GIS: guaranteed income supplement

GST: goods and services tax

HST: harmonized sales tax

LCGE: lifetime capital gains exemption

NRTC: non-refundable tax credit

OAS: old age security

PIT: personal income tax

QPP: Quebec pension plan

QST: Quebec sales tax

RPP: registered pension plan

RRSP: registered retirement savings plan

SBD: small business deduction

TFSA: tax free savings account

VAT: value-added tax

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