"Navigating Disruption: The politics of business tax reform as two-level game"

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A central challenge in structuring Canada's taxation system has been to attract and retain international corporate investment, including the promotion of regional and globally competitive Canadian businesses, while reducing incentives and opportunities for tax arbitrage, including both adverse income and cost shifting, by both Canadian- and foreign-based corporations.[1] During his career, Tim Edgar addressed these issues in the context of both incoming- and outgoing-investment in the context of wider international and domestic policies.[2]

International fiscal competition occurs when governments deliberately structure or design tax systems, in detail or as a whole, to enhance or preserve their jurisdiction's relative attractiveness as a destination for capital investment and other mobile factors of production, including highly-skilled individuals, when they respond to similar actions by other governments or to the organizational and operational decisions of companies seeking to minimize their tax liabilities within the law. As such, it may be proactive, defensive, or a combination of both.

Since the 1990s, successive federal governments have embraced an "open economy paradigm"[3] aimed at the navigation of cross-cutting political and economic interests, domestic and international, to enhance Canadians' economic opportunities A major element of this paradigm has been to promote the competitiveness of Canadian businesses in a context of North American and broader international market integration – notwithstanding growing constraints on this element of globalization in recent years. The concept of competitiveness may reflect

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[1] Arguably, federal tax policies in 2006-17 were designed to promote income shifting *to* Canada, including the location of head office and other operations in Canada rather than promoting capital import neutrality.

[2] For example, Tim Edgar (2003), "Corporate Income Tax Coordination as a Response to International Tax Competition and International Tax Arbitrage," *Canadian Tax Journal* 51(3): 1079-1158; Tim Edgar (2008), "Interest Deductibility Restrictions and Inbound Foreign Investment," Research Report prepared for Advisory Panel on Canada's System of International Taxation. (Ottawa: Finance Canada, October); Tim Edgar (2010), "Outbound Direct Investment and the Sourcing of Interest Expense for Deductibility Purposes," in *Globalization and Its Discontents: Tax Policy and International Investments,* ed. Arthur J. Cockfield (Toronto: University of Toronto Press), 60-83.

[3] Anthony Lake (2009), "Open Economy Politics: A Critical Review," *Review of International Organizations* 4:3 (September): 224-231; Richard M. Bird and Scott Wilkie (2012), "Tax Policy Objectives," in Heather Kerr, Kenneth McKenzie and Jack M. Mintz, eds. *Tax Policy in Canada* (Toronto: Canadian Tax Foundation), 2:24-25.

aggregate measurements of taxation and their impact on after-tax returns on investment, or key sector-specific metrics of disproportionate relevance to particular industries.

Of course, governments pursue this objective alongside other key political and economic priorities, particularly domestic fiscal sustainability: maintaining overall levels of taxation and spending in approximate balance to finance the provision of priority public services at levels consistent with maintaining economic growth, improved living standards, and constraining or reducing public debt relative to GDP. More explicitly political goals include facilitating Canadians' adaptation to changing social and economic realities and resilience in the face of periodic political and economic shocks, and – not least – sustaining a broad enough distribution of the benefits of economic growth to secure periodic re-election. As a result, whatever the prevailing (if not always observed) norms of tax policies, such as different forms of neutrality and other measures calculated to enhance economic efficiency, the tax system exists to serve broader clusters of public policy objectives which are often deeply embedded in public expectations and patterns of economic activity.[4]

This paper addresses the challenges of business taxation as an interactive series of two- (and sometimes multi-) level games, embedded in broader debates over international competition for investment and the distribution of fiscal costs and benefits within Canada. It draws on a mix of neo-institutionalist, public choice, and realist international relations theories of two-level games in international economic relations to explain the evolution of Canada's business tax system in relation to that of other major competitors for international investment – not least, the United States. It summarizes the historical and contemporary context for international tax competition, particularly that related to income shifting, the evolution of Canadian business tax policies in response to macro- and micro-challenges of tax arbitrage, and the challenges of managing the politics of taxation during a period of political and economic uncertainty possibly unrivalled since the 1970s. These issues have become particularly pressing with the long-deferred U.S. reaction to international tax competition in the Tax Cuts and Jobs Act of 2017, and other policy shifts which point to declining political commitment to an open economy paradigm among Canada's major trading partners.

Tax Policies as Two- (or Multi-) Level Games

The extent of North American and wider international economic interdependence reinforces the intermestic dimension of Canada's tax system – the blurring of traditional distinctions between

[4] For a discussion of major structural elements of the tax system as tantamount to conventional elements of an economic constitution, see Geoffrey Hale (2001), *The Political of Taxation in Canada* (Peterborough, ON: Broadview Press), 64-87.

primarily domestic and international policies[5] -- including but not limited to business taxation, reflecting "interlinkages between all parts of the tax system."[6] Scholars of international political economy note certain parallels between governments' efforts to manage international economic and security relationships, particularly in democratic countries. Political leaders and their senior officials enjoy a degree of autonomy in international relations. However, they also face significant domestic institutional and political constraints[7] -- not least of which is the reality that major firms and other investors are independent actors whose interests may overlap with but remain distinct from those of their countries of formal residence. The relative success of national governments' international economic policies, whether unilateral, the product of tacit policy convergence through various forms of parallelism, or of explicit negotiations depends in large measure on the capacity to achieve some degree of alignment between the interests of major economic actors, national interests, and ongoing relationships with other governments. However, the definition of national interests is heavily conditioned by the structure of national political institutions, including the capacity to secure the consent or acquiescence of formal and informal veto holders or blocking coalitions.[8]

Efforts to manage fiscal and trade relations and the interactions of national regulatory systems, among others, in this context help to create a series of two- and multi-level games embedded within broader governance processes which combine relations among governments, trans-national actors, and varied domestic interests inside and outside governments.[9] The restructuring of business tax systems, whether in conjunction with broader tax reforms during the 1980s, or in response to changing international and domestic business practices during the 2000s, typically requires a balancing of competing goals involving both external and domestic factors.[10]

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[5] Bayless Manning (1976), "The Congress, the Executive and Intermestic Affairs: Three Proposals" *Foreign Affairs*, 55 (2): 306–324.

[6] Michael Keen, Li Liu, and Peter Harris (2018), "Taxing Business in a Changing World," in *Canada: Selected Issues.* Country Report 18-223 (Washington, DC: International Monetary Fund, June 28), 18.

[7] Robert D. Putnam (1988), "Diplomacy and Domestic Politics: The Logic of Two-Level Games." *International Organization* 42(3): 427–460; Helen V. Milner (1997), *Interests, institutions, and information: Domestic politics and international relations* (Princeton, NJ: Princeton University Press); Eugénia Da Conceição-Heldt and Patrick A. Mello. 2017. "Two-Level Games in Foreign Policy Analysis." *Oxford Research Encyclopedia of Politics*. New York and Oxford: Oxford University Press. DOI: 10.1093/acrefore/9780190228637.013.496.

[8] Edward D. Mansfield and Helen V. Milner (2012), *Votes, Vetoes and the Political Economy of International Trade Agreements* (Princeton: Princeton University Press); Geoffrey Hale (2019), "Regulatory Cooperation in North America: Diplomacy navigating asymmetries," *American Review of Canadian Studies* 49:1 (March): in press.

[9] Putnam, "Diplomacy and Domestic Politics"; Milner, *Interests, institutions and* information; Geoffrey Hale (2013), "Transnationalism, Transgovernmentalism, and Canada-U.S. Relations in the 21st Century," *American Review of Canadian Studies* 43:4 (December): 494-511.

[10] Geoffrey Hale (2001), *The Politics of Taxation in Canada* (Peterborough, ON: Broadview Press), 38ff.

At its simplest, the concept of international economic relations as two-level games is rooted in the interdependence of international and domestic political, economic and policy processes in participating countries with one another and with largely market-driven economic processes and relationships.[11] At one level, governments seek to manage the ongoing interactions of national or central governments with one another and other international economic actors to mutual advantage within relatively stable legal and economic arrangements. These processes are punctuated by periodic negotiation or revisions of bilateral or multilateral agreements. However, tax policy and other major national regulatory processes remain primarily national due to asymmetries of power, institutional arrangements, and relative interdependence or vulnerability between and among countries, the primacy of domestic legislative authority and, senior policy-makers' desire to maintain control of their respective policy agendas.

The greater the political visibility or prospective economic impact of significant changes to tax policies, whether arising from domestic or international considerations or a mix of both, the greater the relative importance of the "second level" of the "game": the capacity of governments to create a supportive consensus with (or, at least, conditions necessary to diffuse the prospective or actual opposition of) public opinion and/or key domestic stakeholders to proposed changes. Writing almost forty years ago, David Good observed that (federal tax policy) "insiders make tax policy by anticipating the outside world and, to the extent desirable and feasible, by accommodating tax policies to their anticipations."[12] The greater the technical complexity (or relative obscurity) of actual or proposed measures, the greater the relative autonomy of bureaucratic policy-makers[13] – as long as they enjoy the confidence and support of their political "masters." Federal Finance officials have substantially increased their engagement with major stakeholders and other attentive actors, institutionalizing their consultation processes since the political fiasco of the 1981 tax reform budget.[14] Since that time, they have also convened periodic advisory panels, usually involving both private and (former) public sector

[11] The degree of politicization of these relationships depends on the extent to which they are intertwined with national security considerations, as with nuclear materials and export controls over defence-related technologies, or with the relative power (and related electoral calculations) of central and sub-national governments over particular economic sectors as instruments of economic development, distributive power, or both – as currently with several provincial electric utilities, Saskatchewan's potash sector, or the persistent anomaly of supply-management of selected agricultural commodities. Tax considerations in these sectors are typically derivative of other policy considerations.

[12] David A. Good (1980), *The Politics of Anticipation: Making Canadian Federal Tax Policy* (Ottawa: School of Public Administration, Carleton University), xi.

[13] Eric O. Nordlinger (1981), *On the Autonomy of the Democratic State* (Cambridge, MA: Harvard University Press).

[14] Hale, *The Politics of Taxation*, 162-174.

experts on more technical and/or controversial issues, as with the Advisory Panel on Canada's International System of Taxation (2007-08).[15]

However, these debates are typically centered within the confines of a tax policy community comprised of economists and other policy professionals within the Department of Finance, and their interaction with a select group of tax lawyers, accountants, and academic economists, and other attentive actors generally interested in particular segments of tax policy rather than the system as a whole. Good's observation that "attentive actors … are separate and isolated components … distinguished from each other by a highly particularized interest in taxation"[16] appears to be as true as it ever was – particularly in highly technical, specialized fields like international taxation. Broader public engagement generally occurs only when the debate becomes politicized, whether as a result of divisions within the tax policy community or policy-makers' failure to anticipate adequately the disruptive effects of proposed policy changes on entrenched interests or ordinary citizens.[17] Two-level games focused on particular policy initiatives may turn into multi-level games when they affect competing sets of institutional interests and objectives within governments interacting with those of corresponding economic and/or societal interests.

Policy-makers and disciplinary experts within the tax policy community seek to balance institutional objectives of maximizing overall revenues – as opposed to those from particular revenue sources – in ways least disruptive to economic activity with the competing interests and objectives of governmental and societal interests (including governments' prospects of periodic re-election).[18] Good has described these processes as "the politics of anticipation."[19] Savoie and others have characterized as the institutionalized competition of "guardians and spenders."[20] Within this framework, the "guardian" role of the Department of Finance, particularly its tax

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[15] Canada. Advisory Panel on Canada's International System of Taxation (2008). *Final Report: Enhancing Canada's International Tax Advantage* (Ottawa: Department of Finance, December).

[16] Good, *The Politics of Anticipation*, xii-xiii.

[17] Good, *The Politics of Anticipation*; Hale, *The Politics of Taxation in Canada.*

[18] Three elements of this internal debate in which advocates of "open economy" paradigm within the Canadian tax policy have come to different conclusions than prevailing outlooks in the United States involve the role of corporate income taxation ("withholding tax" and "backstop" as opposed to primary instrument of redistribution), the ultimate incidence of capital taxation (its eventual distribution among workers, consumers, and shareholders), and the efficiency effects or "deadweight loss" of different forms of taxation in different economic settings. Richard M. Bird and Thomas A. Wilson (2016), "The Corporate Income Tax in Canada: Does its past foretell its future?" *SPP Research Paper* 9:38 (Calgary: School of Public Policy, University of Calgary, December); Geoffrey Hale (2017), "Cross-Border Fiscal Competition and Tax Reform," paper presented to Association of Canadian Studies in the United States," Las Vegas, NV, October 20; Geoffrey Hale (2018), "Institutions Matter: Fiscal Competition and Tax Reform in the United States and Canada," paper presented to Western Social Sciences Association, Houston, TX, April 7.

[19] Good, *The Politics of Anticipation.*

[20] Savoie, *The Politics of Public Spending*; Good, *The Politics of Public Money*.

policy branch, is largely defensive – whether in anticipating and limiting risks of tax arbitrage and other unintended consequences of prospective tax policy decisions, or reacting to aggressive tax arbitrage and avoidance strategies used to exploit past policy decisions or leverage modest policy anomalies into much broader fiscal crevasses.[21] Other governments face similar challenges, including relative centralization or diffusion of responsibility for oversight of comparable policies files across governments, differences of legal or institutional processes to be navigated, and the presence of prospective veto players whose consent must be negotiated by governments or through cross-national policy coalitions.[22]

However, international tax policies of particular governments are typically embedded within and largely dependent on the structures of national tax policies, as noted above. Their major features are relatively durable and are shaped by domestic institutions, slowly-evolving balances of economic and social interests, political and bureaucratic perceptions of national, institutional, and political (self-)interest.[23] Pantaleo and Smart observe that "Canada uses all three patterns (of international taxation): worldwide, territorial, and remittance basis (or deferral) … depend(ing) on the nature of both the taxpayer and the income."[24] Notwithstanding significant structural reforms in the 1980s, the central elements of Canada's tax system were designed during a period of more limited international interdependence, although the formally worldwide character of its business tax system has evolved into a "*de facto* territorial form of international taxation for active (business) income."[25]

The growth of Canada's interdependence with the North American and global economies since the 1980s has reinforced cross-cutting forms of fiscal and tax competition at several levels

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[21] The two most notorious examples of such exploitation in recent memory are probably the Scientific and Research Tax Credit (SRTC) fiasco of the mid-1980s and the spectacular growth of income trusts between 1999 and Finance Minister Jim Flaherty's preemption of this technique outside the real estate sector on Hallowe'en 2006. Current Finance officials point to the rapid growth of self-incorporation by members of professional firms which prompted the federal government's controversial efforts to contain access to small business tax preferences in 2016 as a growing form of tax arbitrage. Alexandra Posadski, Eric Atkins, and David Parkinson (2017), "Small business, big trouble," *The Globe and Mail*, September 16, B6-7; Keen et al, "Taxing Business in a Changing World," 5-6.

[22] Hale, "Regulatory Cooperation in North America"; Mansfield and Milner, *Votes, Vetoes, and the Political Economy of International Trade Agreements.*

[23] Hale, *The Politics of Taxation in Canada*, 63-87. Douglas Hartle (1982), "The Revenue Budget Process of the Government of Canada: Description, Appraisal, and Proposals," *Canadian Tax Paper* # 67 (Toronto: Canadian Tax Foundation); Donald J. Savoie (1990), *The Politics of Public Spending in Canada* (Toronto: University of Toronto Press); David A. Good (2014), *The Politics of Public Money,* 2nd ed. (Toronto: IPAC and University of Toronto Press).

[24] Nick Pantaleo and Michael Smart (2012), "International Considerations," in *Tax Policy in Canada,* eds. Heather Kerr, Jack M. Mintz, and Kenneth McKenzie (Toronto: Canadian Tax Foundation): 12:4.

[25] Keen et al, "Taxing Business in a Changing World," 7; compare: Simon Richards and Dylan Gowans (2017), **"**Corporate Income Taxes in Canada: Revenue, Rates and Rationale," *Hill Notes* (Ottawa: Library of Parliament, March 21): 1.

in allocating the costs and benefits of government activities: between citizens (or "residents") and governments, individuals and corporations (as well as large and small firms), national and foreign governments, and their citizens who benefit to varying degrees from different kinds of international investment. In some cases, as discussed in the next section, major tax policy changes accompanied or followed fundamental changes in Canada's international relationships – most notably the negotiation of the Canada-U.S. Free Trade Agreement in 1986-87 and the subsequent rapid growth in both inbound and outbound stocks of Foreign Direct Investment relative to GDP. In other cases, they have responded to incremental changes in the international policy environment including, but not limited to changes to marginal tax rates, thin capitalization rules, and debates over whether (and how) to restrict the deductibility of arms-length interest payments on international transactions which were the object of much of Tim Edgar's research.[26]

Changes to domestic tax policies in Canada and its major trading partners, especially the U.S., create policy externalities, both for other governments and particularly for businesses who often incorporate tax considerations in their allocation of investments, organization of supply chains, and choice of transactional forms across jurisdictional boundaries[27] – a "bottom-up" form of tax competition. Cockfield has observed that growing international economic integration, combined with differences in national tax rules, have increased competition between national governments and multinational firms by encouraging the latter to "shift the location of their investments and operations to countries that impose relatively lower … tax burdens,"[28] and to engage in tax arbitrage between and among countries through sophisticated tax planning, financial, and transfer pricing strategies.[29]

As a result, governments have become increasingly sensitive to the use of income shifting and other forms of tax arbitrage to reduce their tax bases – a major concern raised by the 1997 report of the Technical Committee on Business Taxation. Federal tax policies since 2000 have been aimed at reducing Canada's vulnerability to such activities, creating a relatively favourable environment for internationally competitive Canadian companies, and welcoming inward foreign investment outside a handful of protected sectors.[30]

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[26] Edgar, "Interest Deductibility Restrictions and Inbound Foreign Investment"; Tim Edgar, "Outbound Direct Investment and the Sourcing of Interest Expense."

[27] Edgar, "Corporate Income Tax Coordination," 1081.

[28] Arthur J. Cockfield (2010), "Introduction: The Last Battleground of Globalization." In *Globalization and Its Tax Discontents: Tax Policies and International Investments,* ed. Arthur J. Cockfield (Toronto: University of Toronto Press), 5.

[29] Cockfield, "Introduction," 6; Edgar, "Corporate Income Tax Coordination."

[30] Geoffrey Hale (2018), *Uneasy Partnership: The Politics of Business and Government in Canada,* 2nd ed. (Toronto: University of Toronto Press), 291-315.

The multi-level game of tax competition functions within a dynamic environment characterized by a mixture of inter-governmental competition, cooperation in navigating differences between national tax systems, and evolving strategies of adaptation to changing fiscal and other competitive conditions by Canadian- and foreign-based multinational corporations with implications for investment flows, employment and government revenues. Governments may cooperate selectively to limit both double taxation and arbitrage resulting in tax base erosion resulting from tax competition and differences among national tax systems. Such arrangements may take the form of "hard law," as in bilateral tax treaties, or "soft law" dependent on integration with national legal systems such as the recent OECD Multilateral Convention[31] and its International VAT/GST Guidelines of 2017.[32] Even so, Arnold notes that such measures are "essentially products of domestic law . . . that affect cross-border transactions,"[33] as with many other forms of international regulatory cooperation.[34]

As a result, Canadians governments have tended towards the incremental adaptation of domestic tax policies to changing international conditions. Higher profile measures such as the elimination of capital taxes on non-financial corporations (2002-08) and phased reductions in corporate tax rates (2006-12) have been combined with broader reductions in personal income or consumption tax rates intended to maintain rough balance between levels of personal and business taxation, and other measures intended to meet broader fiscal targets such as balanced budgets or gradual reduction in federal net debt to GDP ratios.

Foreign Investment and International Tax Competition

> The main policy challenge (in tax reform) is to develop effective international tax rules and processes within what is essentially a non-cooperative government setting.[35]

International tax competition takes place in different dimensions due to differences in the structures of national tax systems (and related domestic political expectations) and different rates of taxation for different types of economic activity. Governments may engage in tax competition in numerous ways: by setting marginal tax rates below those of major competitors, by privileging various forms of economic activity, or through alterations to tax structures such as the creation of territorial tax structures which tax domestic but not active offshore business income.

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[31] Organization for Economic Cooperation and Development (OECD). 2017. *Multilateral Convention to Implement the Tax Treaty Measures to Prevent Base Erosion and Profit Shifting* [OECD, *Multilateral Convention*].

[32] OECD. 2017. *International VAT/GST Guidelines* (Paris: April 12).

[33] Brian J. Arnold (2018), "Canada's International Tax System: Historical Review, Problems, and Outlook for the Future," *Canada's International Law at 150 and Beyond: Paper # 8* (Waterloo: Centre for International Governance Innovation, February).

[34] Anne-Marie Slaughter (2004), *A New World Order* (Princeton: Princeton University Press).

[35] Cockfield, "Introduction: The Last Battleground of Globalization," 8.

Policy-makers must decide how to integrate or prioritize different forms of tax neutrality: the application of equal or similar tax rates on businesses (and other taxpayers) in similar circumstances. In principle, governments may seek to pursue capital import neutrality (CIN), in which foreign- and domestically-based firms are taxed at similar rates on business operations in the same jurisdiction, or capital export neutrality (CEN), in which foreign source income of domestically-based multinationals (MNCs) is taxed at comparable rates to their domestic business activities.[36] CIN is typically associated with source-based or territorial tax systems – as well as a "level-playing field" between domestic businesses and affiliates of foreign-based firms.[37] CEN is associated with residency-based or worldwide tax systems and, in principle, the pursuit of global production efficiency in the international allocation of capital.[38]

In practice, many countries, including Canada have hybrid systems which recognize the difficulty if not impossibility of achieving capital import and export neutrality simultaneously.[39] The growing of international economic integration and expansion of multinational corporations based in multiple countries, including Canada, has led to the spread of a third concept of neutrality that come to support source-based (territorial) taxation of active business income. The object of capital ownership neutrality (CON), sometimes called "market neutrality," is that "taxes should not distort competition . . . between any companies operating in the same market."[40] Canadian governments seeking to promote internationally competitive Canadian-based MNCs in the absence of effective coordination of international taxation regimes have embraced CON for active business income, if not without controversy among champions of other normative tax principles within the tax policy community.[41] At the same time, they have used evolving Foreign Accrual Property Income (FAPI) rules to preserve their capacity to tax passive international income by limiting the conversion of active to passive income of Canadian-based firms' foreign affiliates.

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[36] Canada. Technical Committee on Business Taxation ("TCBT") (1997), *Report* (Ottawa: Department of Finance, December)," *Report*, 6:3-4; Canada. Advisory Panel on Canada's System of International Taxation (2008), *Final Report: Enhancing Canada's International Tax Advantage* (Ottawa: Department of Finance, December), 12-13; Jane G. Gravelle (2017), "Reform of U.S. International Taxation: Alternatives," *CRS-Report RL-34115* (Washington, DC: Congressional Research Service, Library of Congress, 1 August), 3-7.

[37] Michael P. Devereux (2008), "Taxation of Outbound Investment: Economic Principles and Tax Policy Considerations," Research Report prepared for Advisory Panel on Canada's International System of Taxation (Ottawa: Department of Finance, July), 4-5, 9-10.

[38] Devereux, "Taxation of Outbound Investment," 6.

[39] Pantaleo and Smart, "International Considerations," 12:4; David A. Weisbach (2014), "The use of neutralities in international tax policy," Working Paper # 697 (Chicago: Coase-Sandor Institute for Law and Economics, University of Chicago Law School, August 18).

[40] Devereux, "Taxation of Outbound Investment," 11.

[41] For example, Arnold ("Canada's International Tax System," 11) criticizes the deductibility of interest on funds loaned to foreign affiliates of Canadian-based firms to generate active business income which is effectively tax-exempt in Canada as a dubious policy of subsidizing offshore investment by Canadian multinationals."

However, Canadian governments face cross-cutting pressures in managing international tax competition, as noted above, which impose limits on their effective autonomy. At the level of domestic politics, they are constrained by public expectations, rooted in normative principles of vertical equity, that corporate income taxation should contribute to public services, income transfers, and other redistributive functions. Three major policy considerations have disciplined policy-makers' responses to these pressures. First, there is strong economic evidence for the relatively higher adverse effects on economic growth of higher taxes on capital in relatively small, open economies.[42] Second, unlike the U.S., there is widespread recognition among Canadian tax economists that a sizeable share of capital taxation is ultimately borne by workers in lower wages and by consumers in higher prices rather than falling primarily on shareholders.[43] Third, while varying across types of businesses, available data indicate that more than half of business tax costs are incurred through profit-insensitive taxes.[44] The Technical Committee suggested that these tensions be managed by closer alignment of profit insensitive taxes with benefits received by the businesses that pay them**.**[45] However, the enthusiasm with which federal officials resorted to user fees during Ottawa's fiscal restructuring of the 1990s recommendation led Finance Minister John Manley to impose strong parliamentary checks on the introduction of new user fees in 2002 following strong pressure from business groups.[46]

Second, Canada's relatively open, trade-dependent economy has long constrained governments in taxing mobile factors of production by enforcing relatively competitive effective

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[42] M. Baylor and L. Beausejour. 2004. Taxation and Economic Efficiency: Results from a Canadian CGE model. *Working Paper 2004-10* (Ottawa: Department of Finance); Kevin Milligan (2014), "Tax Policy for a New Era: Promoting Growth and Fairness," *2014 Benefactor's Lecture.* Toronto: C.D. Howe Institute, November).

[43] TCBT, *Report,* 1:3; Jonathan R. Kesselman and Ron Cheung (2004), Tax Incidence, Progressivity and Inequality in Canada," *Canadian Tax Journal* 52:3: 709-89; Richard M. Bird and J. Scott Wilkie (2012), "Tax Policy Objectives," in *Tax Policy in Canada*, eds. Heather Kerr, Ken McKenzie and Jack Mintz (Toronto: Canadian Tax Federation); Robin W. Boadway and Jean-François Tremblay (2016), Modernizing Business Taxation. *Commentary # 452* (Toronto: C.D. Howe Institute, June); Kenneth J. McKenzie and Ergete Ferede (2017), "Who Pays the Corporate Tax? Insights from the literature and evidence for Canadian provinces," *SPP Research Paper* 10:6 (Calgary: School of Public Policy, University of Calgary, April).

[44] The CIT's share of total business taxation varies widely with cyclical levels of corporate profitability and shifts in the overall federal-provincial tax mix. CIT's share of total business taxation increased from from 22 percent in 1995 to about 37 percent in 2015 and 43 percent in 2016. Technical Committee on Business Taxation, *Report*, 2:19; Van Dyck, Peter and Andrew Packman (2018), "Total tax contribution and the wider economic impact: Surveying Canada's leading enterprises" (Toronto: PricewaterhouseCoopers).

[45] Technical Committee on Business Taxation, *Report*, 1:7, 10-11.

[46] For discussion of the *User Fees Act* of 2002 and the effective constraints it imposed on the expansion of user fees by the federal public service before its replacement by the Service Fees Act of 2017, see Connie Hache (2015), "Financing Public Goods and Services through Taxation or User Fees: A Matter of Public Choice?" Ph.D. Dissertation. Ottawa: School of Political Studies, University of Ottawa). A 2017 Senate report criticized the *Service Fees Act* for "removing all meaningful transparency and consultations" from proposed increases in user fees. Andrew Griffith (2017), "Bill C-44 Division 21: Risks and Implications of the *Service Fees Act*," Brief to Senate Committee on National Finance (Ottawa: Senate of Canada).

corporate income tax (CIT) rates, particularly in comparison with the United States.[47] These constraints were decisive in Canada's shift to value-added taxation since the early 1990s, gradually followed by sales tax harmonization in the six provinces east of Manitoba – contributing to sharply lower METRs in participating provinces.[48] However, a trans-ideological taxpayers' revolt, which resulted in the reversal of a harmonization agreement in British Columbia in 2010,[49] along with continuing public resistance to higher consumption taxes symbolized by widespread political opposition to rising carbon taxes, demonstrate the practical political limits of such a strategy, especially if introduced without equivalent fiscal compensation to taxpayers.[50]

Third, efforts to reduce corporate taxes in response to wider international trends (as well as the efficiency arguments noted above) are constrained domestically by public expectations that such tax reductions will be matched or exceeded by comparable tax reductions for individuals and households, with due attentiveness to distributive considerations. Since the political fiasco of Allan MacEachen's tax reform budget of 1981, Canadian political leaders have typically been unwilling to pursue substantive tax reform initiatives unless they can be packaged as broadly-based tax reduction for most Canadian taxpayers.[51] Moreover, unlike the U.S., substantial changes to federal tax policies involving tax reduction have typically been conditional on fiscal sustainability, whether based continued economic growth or strict spending discipline. These constraints help to explain the relatively targeted character of initial federal responses to U.S. business tax reforms of 2017 in its *Economic Statement* of November 2018.[52]

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[47] Canada. Department of Finance (1978), *The Tax Systems of Canada and the United States* (Ottawa: November); Canada. 2009. "Role of Marginal Effective Tax Rates in Canadian Tax Policy," presentation to MENA-OECD Investment Program, Paris. Ottawa: Finance Canada, January; Hale, *Uneasy Partnership,* 302-311.

[48] Hale, *The Politics of Taxation*, 302-305.

[49] George M. Abbott (2015), "The Precarious Politics of Shifting Direction: The introduction of a harmonized sales tax in British Columbia and Ontario," *BC Studies* 186 (Summer): 125-148.

[50] The Trudeau government has tacitly recognized this reality in responding to growing political resistance to the introduction of carbon taxes in several parts of Canada by crafting his carbon tax "backstop" for provinces withdrawing from or refusing to participate in the federal scheme to recycle most revenues to residents of provinces to which it will apply. "For the Liberals, a spoonful of sugar helps the carbon tax go down," *The Globe and Mail*, October 24, 2018: A1. Federal support for "emissions-intensive trade-exposed" (EITE) industries reflects similar efforts to mitigate competitive effects of introducing carbon taxes in the absence of comparable actions by Canada's major trading partners. Sarah Dobson and Jennifer Winter (2018), "Assessing Policy Support for Emissions-Intensive and Trade-Exposed Industries," *SPP Research Paper* 11:28, The School of Public Policy, University of Calgary, vol. 11(28), October.

[51] The introduction of the federal Goods and Services Tax in 1990 was the exception that has proven the rule. Finance Minister Michael Wilson made the tax visible at point-of-sale to discourage his successors from raising it in future (conversation with author, 1994), whatever its effects on the Mulroney government's prospects for re-election.

[52] Canada. Department of Finance (2018), "Investing in Middle Class Jobs: Fall Economic Statement 2018." Ottawa: November 21.

The Evolving Context for International Tax Competition

Canadian governments have always been sensitive to international tax competition – whether in setting marginal tax rates or adjustments to major business tax incentives – particularly as it affects investment and employment in major Canadian industries. [53] At the same time, they have acted repeatedly, if often with limited success, to limit the erosion of Canada's income and consumption tax bases from various forms of tax arbitrage. These factors reflect major elements of the "macro," sectoral, and "micro" dimensions of tax competition.

Although the scale of Canada's relative international interdependence has fluctuated, maintaining competitive effective tax rates for traded sectors has been a major objective of Canadian policies for many years. Ottawa's approach to CIT rate-setting strategies and restrictions on income shifting practices has generally been defensive, responding to incremental trends (or periodic tax reforms) in other countries. Since 1989, it has been more innovative in addressing competitive issues related to consumption taxes – in large measures due to competitive pressures and opportunities created by the absence of a national sales tax in the United States.

Federal and provincial governments have also sought to address competitiveness issues in dealing managing the evolution of environmental taxation, whether in paralleling U.S. federal and/or state policy initiatives before 2010[54] or its subsequent inaction on carbon pricing measures. The Trudeau government's decision to implement a national carbon pricing strategy in response to Canada's 2017 Paris Accord commitments (but without corresponding U.S. action) illustrates the numerous challenges of balancing environmental objectives, competitiveness issues, and trade-offs imposed by Canada's decentralized federal system and regionally diversified energy endowments.

Canada has tracked effective U.S. tax rates, particularly for manufacturing, to varying degrees since the 1970s, although more as an informal than formal policy goal until the Harper government committed itself to achieving "the lowest tax rate on new business investment in the G7" in 2006.[55] Successive efforts at reforming the antiquated federal sales tax, culminating in its

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[53] Canada. Department of Finance (1978), *The Tax Systems of Canada and the United States* (Ottawa: November); Canada. Technical Committee on Business Taxation (1997), *Report*. (Ottawa: Department of Finance, December); Canada (2009), "Role of Marginal Effective Tax Rates in Canadian Tax Policy," presentation to MENA-OECD Investment Program, Paris (Ottawa: Department of Finance, January).

[54] Geoffrey Hale (2010), "Canada-US Relations in the Obama Era: Warming or Greening," in *How Ottawa Spends: 2010-2011,* ed. G. Bruce Doern and Christopher Stoney (Montreal-Kingston: McGill-Queen's University Press), 48-67.

[55] Canada. Department of Finance (1978), *The Tax Systems of Canada and the United States* (Ottawa: November); Canada. Department of Finance (2006), *Advantage Canada: Building a Strong Economy for Canadians* (Ottawa: October), 14, 73-78.

replacement by the federal Goods and Services Tax in the 1970s, sought to limit progressive base erosion while achieving neutrality in the tax treatment of domestic and imported goods and services in an economy characterized by growing disaggregation of business activity.[56] Major tax reforms in the U.S. and Great Britain, which significantly reduced marginal income tax rates for individuals and businesses in the mid-1980s, created both demonstration effects and political imperatives for other industrial countries, including Canada.[57] More recently, the rapid growth of digital commerce has created challenges over the enforcement of value-added taxes on cross-border commerce, and intensified debates over registration requirements for large-scale offshore vendors.[58]

Canada remains among the world's most open economies as illustrated by the relative importance of international trade and investment as a share of its GDP – increasing the relative importance of its tax competitiveness and fiscal sustainability. Two-way trade accounted for 64 percent of Canada's GDP in 2017, fourth in the G-20 after Germany, Korea, and Mexico.[59] At 90.1 percent of GDP, Canada's total stock of outward foreign direct investment (FDI) is the largest among G-20 nations, as is the total value of inward FDI, based on the OECD definition of equity plus net loans to enterprises in foreign economies resulting in at least 10 percent foreign ownership. Keen et al estimate that U.S.-based multinationals have generated about 15 percent of corporate income tax revenues in recent years[60] – a figure that is subject to significant erosion depending on the effectiveness of Canadian federal responses to recent U.S. tax reforms.

Table 1 outlines outward and inward stocks as shares of GDP for Canada and the world's largest economies between 2005 and 2017. Table 2 points to longer-term trends in inward and outward FDI, using Statistics Canada's equity-based measurement. Differences between the two benchmarks illustrate the relative importance of related-party debt in the structuring of foreign affiliates.

Canada's average outward and inward flows of FDI in 2008-17 have also been among the largest among G-7 and G-20 countries – averaging 3.7 and 2.6 percent of GDP respectively

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[56] Hale, *The Politics of Taxation,* 207-223.

[57] Hale, *The Politics of Taxation*, 192-198; U.S. Congressional Budget Office (2005), "Corporate Tax Rates: International Comparisons," (Washington, DC: U.S. Congress, November 1).

[58] Bruno Basalisco et al (2017), "E-commerce imports into Canada: Sales tax and customs treatment" (Copenhagen: Copenhagen Economics, March); PricewaterhouseCoopers (2017), *Rise in Canada's de minimis threshold: economic impact assessment.* Toronto: Retail Council of Canada, December; Rosalie Wyonch (2018), "Competitive digital taxation for federal budget 2019," (Toronto: C.D. Howe Institute, December 12); Jack Mintz, (2019), "Who dares to tax the flix?" *Financial Post*, January 22, FP9.

[59] World Bank, "Trade: % of GDP," (Washington, DC: 2018); https://data.worldbank.org/indicator/NE.TRD.GNFS.ZS; accessed July 18, 2018.

[60] Keen et al, "Taxing Business in a Changing World, 28, fn. 7.

Table 1
Inward and Outward Direct Investment: Canada in International Context

% of GDP	Outward			Inward		
	2005	2011	2017	2005	2011	2017
Canada	**59.2**	49.9	**90.1**	**54.6**	**48.2**	**65.2**
U.K.	49.1	**65.6**	61.7	31.2	43.9	61.2
E.U.	34.6	48.0	66.5	29.9	38.4	57.4
Germany	29.1	38.1	43.5	22.6	26.3	25.8
United States	27.8	29.1	40.4	21.5	22.6	40.5
Japan	8.3	15.2	30.7	2.1	3.7	4.1
China	2.8	5.6	12.3	20.6	25.2	24.3

Source: OECD (2019), "FDI stocks (indicator)," doi: 10.1787/80ecalf9-en; accessed January 14, 2019.

Table 2
Canada's Outward/Inward FDI

% of GDP	1990	2000	2005	2011	2013	2017
Canadian Direct Investment Abroad	14.2	32.3	31.9	38.3	41.0	52.4
Foreign Direct Investment	18.9	28.9	28.1	35.6	36.3	38.6

Sources: Statistics Canada (2019), *CANSIM Table* 376-0051, 384-0038; author's calculations.

between 2008 and 2017 (substantially above the G-7 averages of 1.9 and 1.2 percent, respectively).[61] However, non-tax considerations – not least the global takeover boom of 2005-07 and the ebb and flow of international energy investments (or disinvestment in 2016-17) have typically played larger roles in these developments than tax considerations – with two major exceptions discussed later in this section.

Although both the U.S. and Canada raised taxes during the 1990s as part of broader budget balancing strategies, the 1997 Technical Committee Report noted that Canada's marginal effective tax rates were substantially above international norms, creating both opportunities and incentives for income shifting through the accumulation of debt financing in Canadian operations of multinational firms. A key structural challenge in limiting income shifting is that Canada's income tax system (as with the U.S. before 2018) makes financing expansion through debt "inherently tax-preferred to equity."[62]

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[61] OECD (2019), "FDI flows (indicator)," doi: 10.1787/99f6e393-en

[62] Keen et al, "Taxing business in a changing world," 10. At the same time, the capacity to shelter retained earnings in (small) Canadian Controlled Private Corporations creates an inherent bias to retained earnings financing. This bias is reinforced by the typically more generous spreads between general corporate and small business tax rates in most provinces, except Quebec, in addition to those of the federal tax system. Average provincial small business rates outside Quebec were 10.3 percentage points below comparable general corporate rates in 2018,

The Committee identified several areas in which Ottawa could engage in base broadening and limiting opportunities for tax arbitrage, such as the tightening of thin capitalization ratios, while functioning within "international norms." However, it also recommended continued effective exemption of active business income of foreign affiliate taxation, but with tighter restrictions on deductibility of interest in Canada used to finance international inter-affiliate transactions.[63]

The Technical Committee's most significant long-term impact was in drawing attention to the importance of *aggregate* business taxation in the form of marginal effective tax rates (METRs) on international capital flows. Although the Chrétien and Martin governments began this process with phased CIT and capital tax reductions after 2000, the Harper government formalized this process between 2007 and 2012 by introducing major reductions to marginal CIT rates and providing provinces with incentives to harmonize their sales taxes with the GST. As a result, Canada's average METR fell from 43 percent in 2000 to 26.5 percent in 2013.[64]

Canadian governments have gradually, if perhaps belatedly, tightened thin capitalization rules since the 1980s: reducing permitted debt to equity ratios from 3:1 in 1987 to 2:1 in 2000, following the Technical Committee report, and 1.5:1 in 2012, following the Advisory Panel report. In addition, disallowed interest paid by non-resident investors is taxable as dividends under the terms of relevant tax treaties.[65] However, successive governments have preferred incremental changes and the expansion of anti-avoidance measures to major structural changes suggested by Tim Edgar such as following Australia, New Zealand and the United Kingdom in applying thin capitalization rules to arms-length borrowing, or much tighter restriction on deductibility of interest borrowed by Canadian-based multinationals to lend to foreign affiliates.[66]

The issues of inter-affiliate financing and the deductibility in Canada of funds borrowed for investment abroad has been reinforced by the scale of outbound FDI in international financial centres and other low-tax jurisdictions – particularly as dividends from such affiliates are often

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compared with 4 percentage points in Quebec (2018; 4.9 percent 2019), and 5 percentage points (6 percent in 2019) for the federal spread.

[63] Technical Committee on Business Taxation, *Report,* 1:4, 3:26, 6:11-30.

[64] Chen and Mintz define Marginal Effective Tax Rates (METRs) as "the portion of capital-related taxes paid as a share of the pre-tax rate of return on capital for marginal investments Duanjie Chen and Jack M. Mintz (2015), "The 2014 Global Tax Competitiveness Report: A Proposed Business Tax Reform Agenda," *SPP Research Paper* 8:4 (Calgary: School of Public Policy, University of Calgary, February), 1.

[65] Evelyn Moskowitz (2010), "Financing Issues: The Thin Capitalization Rules," (Ottawa: Canadian Bar Association, May 29), 4, fn. 7; John M. Campbell (2012), "Thin Capitalization Regime," International Tax Newsletter (Toronto: Miller Thomson, November).

[66] Edgar, "Outbound Direct Investment and the Sourcing of Interest Expense";

tax exempt in Canada.[67] For example, Bermuda and four other Caribbean tax havens have accounted for an average of 16.5 percent of outward Canadian FDI and 2.3 percent of inward FDI since 2013 – reflecting their frequent uses as venues for international financial transactions.[68] The 2007 federal budget announced plans ("Section 18.2") to restrict so-called "double-dip" transactions involving the use of funds borrowed in Canada to "obtain at least two interest deductions on money borrowed" through foreign affiliates located in low-tax jurisdictions by 2011.[69] Given the persistence of measures favourable to "tax-efficient" inter-affiliate financing by foreign affiliates of U.S., British and Dutch-based MNCs, among others, the onset of the global financial crisis and (possibly) the record number of foreign takeovers of major Canadian firms in 2007-08, strong corporate resistance to this measure convinced the Advisory Panel on international taxation to recommend the withdrawal of this measure in its final report. In response, Finance Minister Jim Flaherty rescinded Section 18.2 in his February 2009 budget.[70] This incident suggests that the nature of international tax competition effectively limits the capacity of smaller countries like Canada to introduce major structural changes to its international taxation system without some degree of coordination with (or clear demonstration effects of policy changes made by) major economic powers without the risk of increasing relative financing costs for their resident MNCs.

A second cross-cutting challenge in achieving international tax equity is a by-product of domestic tax changes within Canada. The Chrétien-Martin governments' gradual phasing-out of Income Tax Act (ITA) restrictions on international investments by pension funds and other retirement savings vehicles in the early 2000s (combined with prudential pressures for diversification of their investments) contributed to the rapid growth of offshore investments by major public sector (and other) pension funds. Foreign holdings of Canada's ten largest pension investment managers were estimated at 55.4 percent of their $ 1.2 trillion assets under management in 2014.[71] The economic interactions of pension fund investments with tax policies – particularly for offshore investments – and variations of ownership structures is sufficiently

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[67] François Lavoie (2009), "Canadian Direct Investment in 'Offshore Financial Centres,'" *Cat. # 11-621M-21* (Ottawa: Statistics Canada, November 12); Brian Mustard (2013), "Canada's System of International Taxation: A look back, a look forward," *Canadian Tax Journal* 61 (Supp.): 259.

[68] Statistics Canada 2019. "Foreign Direct Investment: Inward and Outward Stock." *CANSIM Table 376-0051*. Ottawa: January 16.

[69] Canada (2002), *Report of the Auditor General of Canada* (Ottawa: December), Chapter 11; http://www.oag-bvg.gc.ca/internet/English/att_20021211xe03_e_12291.html (28/01/18); Canada. Department of Finance (2009), "ITA 18.2 -- Explanatory Notes relating to the Income Tax Act, the Excise Tax Act, 2001, and the Excise Tax Act (Ottawa: February 20); https://www.fin.gc.ca/drleg-apl/biafeb09n-eng.asp (28/01/19); Edgar, "Taxation of Outbound Foreign Investment."

[70] Canada. Advisory Panel on Canada's International Tax System, *Final Report,* 50-53; Mustard, "Canada's System of International Taxation," 259.

[71] Boston Consulting Group (2015), *Measuring Impact of Canadian Pension Funds* (Toronto: October), 11.

complex to deter broad generalizations about their economic effects.[72] The sizeable role played by tax-exempt investors in both domestic and international capital markets[73] is a significant constraint on expanded taxation of active business income by foreign affiliates of Canadian MNCs without risking significant issues of horizontal equity. At the same time, the Canada-U.S. Tax Convention allows for reciprocal exemptions from withholding taxes on cross-border investment income paid to non-resident pension funds.[74]

However, concerns over the sheltering of investment income in foreign tax havens in recent years have attracted the shared interest of governments in many major industrial countries to limit the erosion of their personal and corporate income tax bases and increasing their effectiveness in combatting outright tax evasion. The OECD base erosion and profit shifting (BEPS) project inaugurated in 2013 has benefited from three major factors critical to overcoming previous political and bureaucratic obstacles to intergovernmental cooperation. First, the unilateral action of the U.S. Congress in passing the Foreign Account Tax Compliance Act (FATCA) of 2010 required foreign financial institutions to provide the Internal Revenue Service with information on accounts held by U.S. clients. These provisions – an effective policy reversal intended to preserve U.S. policy discretion (a.k.a. "sovereignty") outside constraints imposed by previous multilateral processes – provided a model for the OECD's Global Forum on Transparency and Exchange of Information in framing model Tax Information Exchange Agreements (TIEAs) and, ultimately, the 2017 Multilateral Convention, to enable participating countries to combat aggressive tax planning without triggering domestic U.S. concerns over the erosion of domestic sovereignty.[75]

The BEPS project and TIEA rely on amendments to existing tax treaties and the implementation of varied national laws, consistent with traditional conventions of horizontal

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[72] Vijay Jog and Jack Mintz (2012), "The 30 percent limitation for pension ownership in companies: policy options," *Canadian Tax Journal* 60(3): 581-86 [FULL: 567-608].

[73] Jog and Mintz note that in 2004 "tax-exempt investors (held) 40 percent of total (Canadian) corporate assets," Canadian taxable investors (held) 20 percent, and the remainder (were) held by non-residents." "The 30 percent limitation," 583. Conversely, the "top 10" Canadian pension investment funds accounted for almost 60 percent of the stock of Canadian direct investment abroad in 2014. Boston Consulting Group, "Measuring Impact of Canadian Pension Funds"; OECD, "FDI stocks (indicator). Rosenthal and Austin estimate that retirement accounts and plans held 37 percent of taxable holdings in U.S. "C" corporations in 2015, foreign residents about 26 percent, U.S. household investors (including partnerships) 24.2 percent, and non-profit organizations about 4.9 percent. However, pass-through vehicles now account for more than half of taxable U.S. business income. Steven M. Rosenthal and Lydia M. Austin (2016), "The dwindling taxable share of U.S. corporate stock," *Tax Notes*, May 16: 923-934. Pass-through entities now account for a majority of taxable U.S. business revenues.

[74] Jack M. Mintz and Stephen R. Richardson (2014), "Not Just for Americans: The case for expanding reciprocal tax exemptions for foreign investments by pension funds," *SPP Research Paper* 7:34 (Calgary: School of Public Policy, University of Calgary, November), 1.

[75] Arnold, "Canada's International Tax System," 9.

("soft law") international cooperation.[76] As such, they limit the political challenges of harmonizing diverse national legal institutions – a traditional barrier to international tax *policy* cooperation -- while enabling expanded cooperation through trans-governmental networks to enhance enforcement of domestic tax laws. The BEPS process has also enabled the Canada Revenue Agency to facilitate its international enforcement by requiring country-by-country disclosure of Canadians' international corporate income and transactions, including those of investment funds and data on transfer pricing, and the exchange of information among national tax collection authorities since 2016.[77]

U.S. Tax Reforms of 2017: Consequences for Cross-Border Tax Competition

Major structural challenges to the U.S. tax system approved by Congress in 2017 have resulted in both significant corporate income tax (CIT) rate reductions and many technical tax policy innovations which have changed the competitive environments for investment and tax planning in Canada and other countries. Passage of the 2017 Tax Cuts and Jobs Act (TCJA) on a party-line vote followed several years of debates over whether U.S. corporate income tax rates had become uncompetitive relative to major trading partners and investment destinations.[78] Many observers expressed concerns that U.S. residence-based (worldwide) CIT system had provided U.S.-based MNCs with significant incentives for income shifting, particularly the use of corporate inversions to shift the head offices to other countries (see Figure 1), including Canada, notwithstanding periodic efforts to tighten anti-avoidance rules.[79] Table 3 contrasts the composition of financial sources of U.S. outbound and inbound FDI in 2016, noting the much higher proportion of intra-company debt in the latter.

The TCJA reduced U.S. top federal marginal CIT rates from 35.3 percent (39 percent including average state tax rates) to 21 percent, and average combined METRs from an average 35.3 percent to 18.9 percent, with significant sectoral variations, eliminating a previous average Canadian advantage across sectors and provinces estimated at 14.2 percentage points.[80] It

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[76] Slaughter, *A New World Order.*

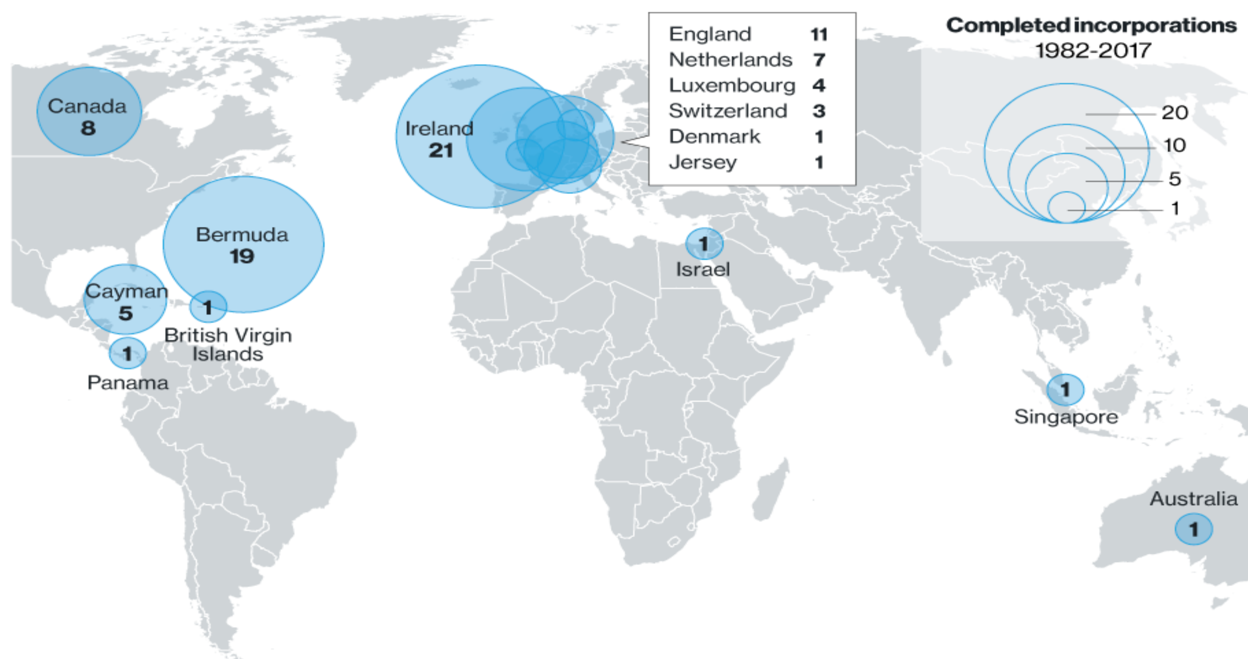
[77] OECD (2015), "Article 13 Country-by-Country Reporting Implementation Package," (Paris); Canada Revenue Agency (2018), "Guidance on Country-by-Country Reporting in Canada" (Ottawa: November 23).

[78] Hale, "Cross-Border Fiscal Competition and Tax Reform."

[79] Neely and Sherrer, "A look at corporate inversions: inside and out"; Marples and Gravelle, "Corporate Inversions, Expatriations and Mergers." The 2016 anti-avoidance regulations designated any "foreign acquiring company" as a domestic entity if 80 percent or more of its equity is held by former U.S. owners of the business (or of multiple firms acquired in "serial" transactions), with other penalties applying to firms with 60 percent or more U.S. ownership. Paul Seraganian et al (2016), "Major U.S. anti-inversion regulations impact Canadian companies both in and out of the inversion sandbox," (Toronto: Oslers, April 11).

[80] Mintz and Chen, "The U.S. Corporate Effective Tax Rate"; Philip Bazel and Jack Mintz (2018), "Tax Policy Trends: Canadian tax policy-makers consider response to U.S. tax overhaul." (Calgary: School of Public Policy, University of Calgary, October).

Figure 1
Where U.S. Corporate Tax Inversions Have Gone



Source: Neely and Scheerer (2017), "A look at corporate inversions."

Table 3
Composition of Financial Sources of U.S. Direct Investment Abroad and Foreign Direct Investment in the United States, 2016

	U.S. Direct Investment Abroad	Foreign Direct Investment in U.S.
Equity capital	10.0%	53.0%
Reinvested Earnings	95.8%	20.4%
Intra-Company Debt	- 5.8%	26.6%

Source: James K. Jackson, "Foreign Direct Investment in the United States: An Economic Analysis," *CRS Report # R-21857* (Washington, DC: Congressional Research Service, Library of Congress, June 29).

converted the U.S. tax system from its previously worldwide (residence-based) structure, with credits for foreign taxes paid and deferral of taxes on non-repatriated profits, to a broadly

territorial system, with one-time transitional taxes based on deemed repatriation of liquid and illiquid assets earnings and payable over eight years.[81]

More significantly for ongoing tax competition, U.S. tax reforms create significant incentives for the repatriation and attraction of capital to the United States and for shifting the costs of income shifting and other tax planning measures to other countries, suggesting tactics used in strategic trade policies rather than merely pursuing capital import neutrality.[82] Indeed, the TJIA may be the most aggressive exercise in tax competition and engineering to increase domestic investment and international income shifting seen in many years, although some of its sharp edges may be blunted by phase-out periods on particular measures, growing fiscal exigencies, and partisan shifts in coming years. Macro-economic incentives for the reallocation of international investment are reinforced by Congress' decision to fund "permanent" business tax rate reductions by increasing deficits (and, implicitly, international borrowing given relatively low U.S. savings rates) rather than offsetting rate cuts with more extensive base broadening, as well as substantially increasing U.S. federal spending in separate budgetary actions. Mintz and others have noted several key elements of critical importance to Canadian businesses in each country:

i) Expensing of investment in assets with recovery of less than 20 years through 2022, with plans for phasing-out by 2027.
ii) Accelerated (5 year) amortization of research and development expenditure;
iii) An exemption for dividends received from foreign affiliates with at least 10 percent ownership by the U.S. parent, paralleling existing Canadian policies;
iv) A new Base Erosion and Tax Avoidance Tax (BEAT) on adjusted taxable income of foreign affiliates operating in the United States, with significant restrictions on related party transfers; and
v) New Global Intangible Income (GILTI) tax rules on both foreign and domestic income of U.S.-based multinationals.[83]

These measures are partly offset by limits on the deductibility of interest expenses to a maximum 30 percent, excluding real estate investments – with the additional effect of discouraging income shifting through increased debt financing of U.S. affiliates of foreign-based multinationals. Taken together, at a macro-level, these measures have eliminated the Canadian METR advantage over most sectors. They have created significant incentives to shift

[81] Erica York (2018), "Evaluating the Changed Incentives for Repatriating Foreign Earnings," (Washington, DC: The Tax Foundation, September 27).

[82] Jack M. Mintz (2018), "Global Implications of U.S. Tax Reform." *EconPol Working Paper* 08.2018 (Munich: Ifo Institute, March); Keen et al, "Taxing Business in a Changing World."

[83] Mintz, "Global implications of U.S. tax reform," 3-4.

investments, particularly in intellectual property, to the U.S., and reallocate debt financing to other countries, including Canada**.**

The GILTI rules have been described as a "foreign minimum tax" on "supernormal" (over 10 percent) investment returns – sometimes labelled "excess profits."[84] The are designed to limit the sheltering in low-tax jurisdictions of profits generated by U.S. technology industries, in particular, which account for a disproportionate share of U.S. exports and services trade. These measures also complement U.S. strategic trade policies, including tighter intellectual property rules negotiated under the U.S.-Mexico-Canada Agreement (USMCA) of October 2018.[85] Some observers suggest that they are also intended to pre-empt or "guide" prospective outcomes of OECD discussions of "digital taxation," including but not limited to international apportionment of taxes on major global technology firms, many of which originate in the United States.[86]

Ideological and partisan polarization in Washington make the durability of these measures after 2020 an open question. However, the cumulative effect of what certain observers have described as the "weaponization of uncertainty"[87] in international trade and economic relations creates an ongoing threat to Canada's investment climate and competitiveness. Fiscal countermeasures announced by Canada's Finance Minister, Bill Morneau, in November 2018 matched the TCJA's provision for the expensing of capital investment in assets with expected lifespans of less than 20 years, and the subsequent phasing out of these measures by 2027. Morneau also announced the tripling of initial depreciation rates for a range of other assets to address assorted issues of supply chain competitiveness within Canada. Taken together, these measures are expected to reduce average federal METRs from 17.0 to 13.8 percent (see Figure 2).

Ottawa's November 2017 measures are a stopgap, comparable to if more extensive than provisions for accelerated depreciation introduced by the Harper government following similar U.S. measures approved by Congress as part of the Obama administration's 2009 stimulus bill. However, as the likelihood partisan gridlock in Congress following the 2018 midterm elections limits the prospects for much U.S. policy innovation before the 2020 Presidential elections, Canada has time to consider options for a broader range of policy measures to sustain its competitiveness in an evolving global environment.

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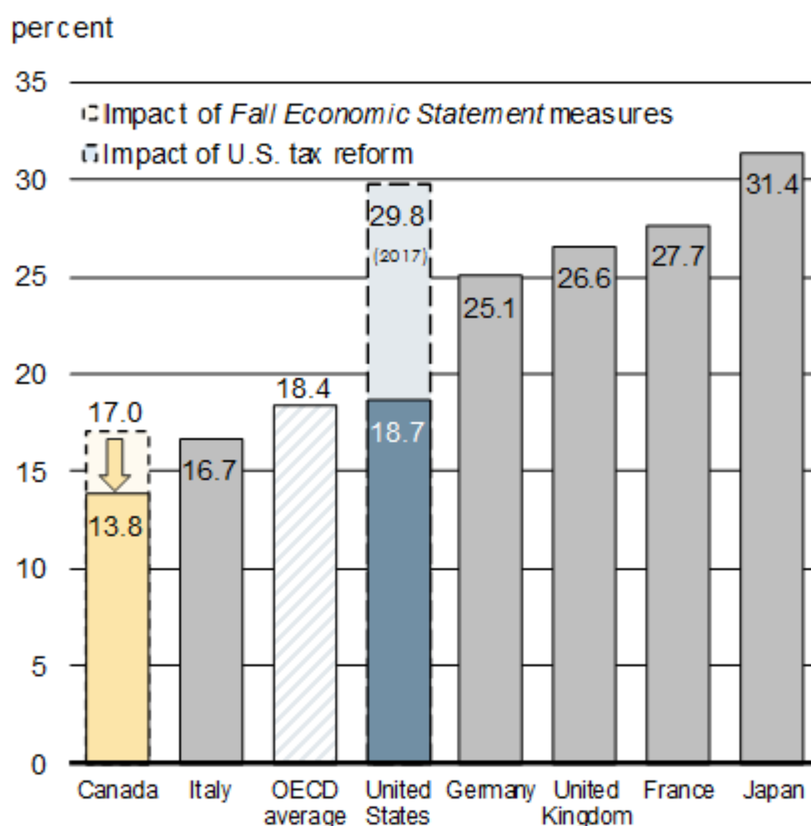
[84] Bazel and Mintz, "Tax policy trends."

[85] Junyi Chen (2018), "USMCA (NAFTA 2.0): What's new for intellectual property in Canada" (Toronto: Blaney McMurtry, October 10).

[86] G. Charles Beller, 2019 forthcoming. "GILTI: 'Made in America' for European Tax – Unilateral Measures, Excess Profits, and the International Tax Competition Game." *Virginia Law Review*, 2-3.

[87] For example, see Meredith Crowley and Dan CIuriak (2018), "Weaponizing uncertainty" (Toronto: C.D. Howe Institute, June 19), 7.

Figure 2
Corporate METRs across G-7 Countries: Impact of U.S. Tax Reforms (2017), Canadian responses (2018)



Source: Canada. Dept. of Finance. 2018. *Fall Economic Statement* (Ottawa: November), 59.

Conclusion: Evolving Canadian Tax Policies for an Uncertain World

The broader federal strategy for international tax competitiveness which crystallized over the decade following the Technical Committee report of 1997 and subsequently implemented under the Harper government, was contingent on a broader domestic strategy for fiscal sustainability, debt reduction, and widespread improvements in domestic living standards which paid careful attention to distributive considerations. Various scholars have suggested broader blueprints for comprehensive or structural corporate tax reforms.[88] However, historical experience suggests any such exercise is likely to be too economically and politically disruptive to reward any government with the temerity to initiate it within the extended timeframe required for effective policy design and implementation. Proposals for major changes in overall levels and distribution

[88] For example, see Milligan, "Tax Policy for a New Era: Promoting Growth and Fairness"; Chen and Mintz, "The 2014 Global Tax Competitiveness Report: A Proposed Business Tax Reform Agenda"; Robin W. Boadway and Jean-François Tremblay (2016), "Modernizing Business Taxation," *Commentary # 452*. Toronto: C.D. Howe Institute, June.

of taxes must begin with the tax system as it is, not as we might wish it to be in the best of all possible worlds.[89]

The existing tax system is embedded within the economic lives and expectations of Canadians – often in contradictory ways, as demonstrated by the recent political fiasco over the Trudeau government's proposed restrictions of 2016-17 on access to the small business deduction.[90] Levels of public trust for political, economic – and academic – elites are sufficiently tenuous that achieving politically sustainable tax reform depends, as it always has, on achieving a consensus of affected societal interests whose consent depends on broadly distributed reductions in overall levels of taxation without disrupting valued public services, not merely revenue neutrality.[91] However, tax and spending measures must be kept in balance to ensure fiscal sustainability in light of ongoing trends in demographic aging.

To achieve public consent to significant tax policy changes while maintaining the overall competitiveness of Canada's tax system – the two-level game which has been the focus of this paper – the government which emerges from the upcoming federal election should set broad policy goals which recognize the interaction of various elements of the tax system including, but not limited to corporate or international tax levels.

Two key priorities can maintain the balance between competitiveness and consent. First, governments should use the personal tax system as their principal tool for addressing issues of distributive equity, while making incremental changes to the corporate tax system which contribute to greater efficiency, growth, and business competitiveness. Secondly, it should continue the trend of recent years to maintaining competitive METRs for Canadian businesses relative to major global competitors while redressing major sectoral anomalies which undermine competitiveness and incrementally extending measures to limit base erosion consistent with broader international norms.

To achieve these objectives, the Department of Finance should:

- maintain levels of accelerated depreciation at levels broadly competitive with the United States, while attempting to limit distortions in their application across industry sectors;
- align profit insensitive taxes on businesses more closely with the costs of providing related public services, subject to transparent justification of direct costs and services;

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[89] Hale, *The Politics of Taxation*, 27.

[90] Posadski, Atkins, and Parkinson, "Small business, big trouble."

[91] Edelman (2018), "Edelman Trust Barometer 2018 – Canada," (Toronto: February); Hale, *The Politics of Taxation,* 26-27.

- review of patent box models to encourage innovation within Canada, based on expert analyses of evolving models in other industrial countries;[92]
- consider expansion of thin capitalization rules to include arms-length debt transactions in the financing of foreign affiliates of Canadian-based firms, subject to careful examination of the effects of such measures in other countries;
- limit competitive pressures from "carbon leakage" by monitoring impacts of carbon taxation to maintain balance between ongoing progress towards overall reductions in carbon emissions while mitigating impacts on particularly "trade-exposed" industries;
- limit base erosion and addressing the growing challenge of offshore internet commerce by tightening GST/HST requirements for offshore vendors, with a reasonable *de minimis* threshold, following Quebec, Saskatchewan, and the recent *Wayfair*[93] decision in the United States.

Purposeful incrementalism of this sort which addresses aggregate levels of taxation while identifying sectoral opportunities for and vulnerabilities to international tax competition is likely to be more practically achievable and sustainable than theoretically ambitious approaches with the potential to disrupt existing economic relationships and trigger substantial political conflict.
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[92] For example, see John Lester (2018), "An international comparison of tax assistance for R&D: 2017 update and extension to patent boxes," *SPP Research Paper* 11:13 (Calgary: School of Public Policy, University of Calgary, April)

[93] South Dakota v. *Wayfair*, Inc., 585 U.S. ___ (2018)