REVIEW ARTICLES

THE REPORT OF THE ROYAL COMMISSION ON TAXATION*

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IT IS SAFE to say that no nation's tax system has been subject to an analysis as exhaustive as that of the Carter Commission. The recommendations of the majority of the Commission are bold and extremely far-reaching. To the academic student of taxation they appear to embody virtually all of the reform measures advocated by Professors Henry C. Simons and Robert Murray Haig and most of their followers, buttressed by the tenets of welfare economics and neo-Keynesian fiscal policy. The Commission's Report is, in consequence, a truly remarkable document, one that provides the critic with few substantial targets for his barbs. Even these few are, more often than not, at least implicitly recognized in the *Report* and generally remain because the Commission seems to have refrained at some points from pursuing with unrestrained boldness the directions dictated by its own basic premises.

It is clearly impossible to summarize, much less evaluate, all of the conclusions and recommendations contained in the six volumes and 2,600 pages of the *Report*. I shall focus briefly, first, on the objectives set forth by the Commission, then examine those recommendations that seem to me to be of greatest importance, and finally, I shall take issue with the Commission on some of its sins of omission.

I. POLICY OBJECTIVES

The broad objectives by the Commission are horizontal and vertical equity, efficiency in resource allocation, full employment without inflation, and "a free society and a strong, independent federation."[1] Where these objectives conflict equity is to prevail.

The basis for equitable taxation of individuals and families is defined as the "annual net gain or loss in the . . . power, whether exercised or not, to consume goods and services"[2] beyond the amounts needed to satisfy the basic necessities of life. Horizontal equity is to be achieved by requiring that all similarly circumstanced individuals in receipt of given amounts of discretionary economic power or income, as so defined, pay equal amounts in tax. Vertical equity is held to obtain when tax liabilities are proportionate to discretionary income. Discretionary income rises, of course, as a fraction of total income as income increases, so that vertical equity requires progression in tax rates applied to total income.

* *Report of the Royal Commission on Taxation* (Ottawa: Queen's Printer and Controller of Stationery, 1967). The *Report* is issued in six volumes and will be cited hereafter by volume number. The *Report* is well indexed and I shall, therefore, present only a minimum number of citations to specific volumes and pages. This review article was initially prepared for presentation before a conference held at the University of Western Ontario, May 11 and 12, 1967.

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1. 1, p. 3, and 2, p. 7.
2. 1, p. 6, and 2, p. 42.

Efficiency in resource allocation demands that taxes be neutral with respect to choices among investment opportunities, forms of business organization, alternative occupations or employments, inputs used in production, and consumer goods and services, and between consumption and saving, debt and equity financing, and work and leisure. Non-neutrality may be called for if non-tax forces give rise to imperfections in markets, but the Commission, quite properly, I think, assumes that such sources of deviation from efficiency lie beyond its purview and that the design of rational tax policy should proceed as though they did not exist.

Timely, aggressive employment of tax and expenditure policies is seen as necessary to the attainment and maintenance of full employment without inflation. The Commission lays its primary emphasis on changes in personal income tax rates, but calls as well for specific measures to deal with specific problems, such as taxation of inventory accumulation, variation in capital-consumption allowances, and increases or reductions in public expenditures. Built-in-flexibility of the tax structure is looked to as an important adjunct to discretionary policies, but its shortcomings, particularly its tendency to stabilize the economy at a fixed level, are recognized.

The maintenance and enhancement of individual rights and liberties and a strong, independent federation are objectives sought largely by indirection. They appear to be approached primarily by means of ensuring an adequate supply of job opportunities, encouraging Canadian ownership of Canadian resources, and improving tax harmonization or coordination between the federal government and the provinces and among the provinces.

II. Major Recommendations

The major recommendations for tax reform offered by the Commission follow from its statement of objectives. They comprise a closely interrelated set, most of which must be appraised and accepted or rejected as a unit. Clearly there is room for modification, but rejection of substantial elements of the proposed program would render much or most of the rest of it unacceptable.

Capital Gains. The keystone of the Commission's tax-reform program is found in its recommendations relating to the taxation of capital gains. Going much further than United States practice or recent British legislation, the Commission advocates the taxation of all capital gains at regular income tax rates together with deemed or constructive realization of gains on assets transferred to death or by gift. "Double taxation" of gains on corporate shares is to be avoided by permitting an increase in basis for undistributed earnings attributed to stockholders, and losses are to be deductible in full against income from all sources. They may be carried back two years and carried forward indefinitely.

The Commission rejects out of hand arguments against the taxation of capital gains.[3] The most troublesome arguments, those that insist on the illusory nature of gains attributable to inflation or a reduction of interest rates, are disposed of in two brief paragraphs.[4] The first of these arguments is found wanting on the ground that income for tax purposes is measured in terms of current dollars and a correction of price changes for one form of income and not others is unwarranted. Unfortunately the discussion of the effects of interest-rate changes relates only to bonds rather than to assets in general. Nevertheless, the Commission's position with respect to bonds,

3. As put forward most recently, for example, by Henry C. Wallich. See his "Taxation of Capital Gains in the Light of Recent Economic Developments," *National Tax Journal*, Vol. XVIII, No. 2, June, 1965.

4. 3, pp. 349-350.

that an increase in their price due to a fall in market rates of interest increases the owner's economic power, is as readily applicable to shares of corporate stock, real estate, and other income yielding assets.

One senses, however, that the Commission may be just a little too sanguine about the effects of taxing capital gains. Clearly, implementation of this recommendation will bring a tremendous improvement in vertical and horizontal equity, and in neutrality and efficiency in resource allocation. But at the same time it will make investment in high-risk ventures substantially less attractive and the opportunity afforded to postpone realization of gains is likely to produce some lock-in effect, reducing the mobility of capital.

Since the timing of the realization of gains and losses may be controlled by the taxpayer, except in the case of deemed realization upon transfer outside the family unit at death, it may be expected that the amplitude of fluctuations in asset values will be increased. This follows from the fact that taxation will encourage selling in a declining market as well as refraining from selling in a rising market.

In addition, because gratuitous transfers to a spouse are not to give rise either to deemed realization of gains or income tax liability, giving or bequeathing assets to adult children or grandchildren will become less attractive, with the result that more wealth will tend to concentrate in the hands of rich widows. And the latter are not generally among a nation's most active and enterprising or venturesome capitalists.

Thus there are costs attached to the proposals relating to capital gains. But, as the *Report* emphasizes, these proposals must be viewed in the context of the set of recommendations as a whole, in particular the very substantial reduction in marginal tax rates in the middle and upper income ranges, comprehensive averaging, generous provisions for loss offsets, and the integration of the income taxes. Moreover, it is clearly recognized throughout the *Report* that a number of trade-offs are necessarily involved. In this instance I have no doubt whatsoever that the gains far exceed the losses.

Integration of Income Taxes. Both neutrality and equity argue strongly against a tax on corporate income that is separate and independent from the personal income tax. There is no convincing case to be made in favor of the tax, irrespective of one's views on its incidence. It is either a capricious tax on factor payments or on final goods, it discriminates against equity financing, and it inhibits efficiency in resource allocation. The current approach to integration, through the dividend credit, is unacceptable because it strongly favors high-income relative to low- and middle-income shareholders. Moreover, the full taxation of capital gains ensures that all corporate-source income of residents will be reached through the personal income tax.

Thus, given its recommendations on capital gains, the Commission might have advocated the outright repeal of the corporate income tax. But four factors ruled out this approach and dictated the choice of alternative. Since it is impractical to tax capital gains annually as they accrue, repeal of the corporate income tax would permit postponement of tax on retained earnings; nonresident stockholders cannot be reached on capital gains on shares of stock; with respect to foreign corporations which are permitted to offset Canadian corporate-tax liability with a full or nearly full credit under their home tax laws, its repeal would mean a windfall for foreign treasuries at the expense of the Canadian treasury; and the taxation of distributions of corporate income to non-residents is severely limited as to rate under tax treaties.

Under the scheme recommended by the Commission, corporate income would be taxed at the maximum marginal rate of the personal income tax (50 per cent). Dividends received by stockholders would be grossed up at the corporate income tax rate and the grossed-up amount taken into income. Full credit would then be allowed to the individual resident taxpayer at the corporate rate of tax. Undistributed earnings

would be attributed to stock holders *pro rata,* grossed up and subject to credit. The amount so attributed would be added to the basis of shares for purposes of computing capital gains or losses.

This full-withholding approach to corporate-personal income tax integration has several appealing features. In contrast with the partnership approach, for example, it does not present the taxpayer with the problem of finding the cash with which to meet his tax obligation on undistributed earnings. Nor does it impose pressure on the corporation to increase cash distributions. In fact, of course, under this plan pay-out ratios could be reduced while leaving shareholder-taxpayers subject to less than the top rate with more after-tax income than they receive now (apart from the effects of the reduction in individual income tax rates).[5]

If, initially at least, prices of products and inputs remain unchanged, the net yield on shares in Canadian corporations to resident stockholders should rise substantially relative to present yields and relative to yields on foreign securities and domestic debt instruments, whereas the return to foreign investors should remain unchanged. The Commission places major emphasis on this aspect of the proposal as a means of stimulating greater Canadian ownership of equities in domestic corporations. Corporations with an eye on the net yield to their stockholders may feel free to reduce pay-out ratios. On both counts the effects on the rate of investment and hence economic growth should be markedly favorable, although a reduction in dividend distributions may have a minor adverse effect on nonresident portfolio investment.

Uncertainties with respect to the incidence of the corporate income tax make it difficult to trace prospective economic effects in greater detail.[6] The difficulties involved are intensified by the fact that nonresident shareholders, including foreign corporate parents of Canadian subsidiaries, will not be affected directly at all. The latter may encounter intensified competition from domestically owned corporations, but this is likely to be a long-run development.

Compared with the recommendations on the taxation of capital gains and income tax integration, the other major proposals of the Commission are likely to have much less far-reaching effects on both equity and resource allocation. Nevertheless, they are essential either as complements to those recommendations or because they are necessary for the attainment of the Commission's broad tax-policy objectives, or both.

The Unit Subject to Tax. Income of individuals in Canada has generally been taxed to the recipient, without regard to the role of the family or household as the fundamental economic unit. Thus under present law the family's tax liability is allowed to turn in large part on the number of income recipients in the family, clearly in abrogation of the rule of equal treatment of equals. The Commission advocates moving to the family and unrelated individual concept of the unit for taxation. The family is defined as husband, wife, and dependent minor children, or unmarried parent and children.[7] Up to $500 of a child's earnings (not property income) may be excluded and

5. This effect may be illustrated in the case of a taxpayer subject to a marginal individual tax rate of 25 per cent holding shares in a corporation that distributes none of its earnings. Corporate tax of $50 would be paid on earnings of $100. The remaining $50 would be attributed to the stockholder, grossed up to $100 and subject to tax in his return of $25. He would then take a $50 credit, leaving him with a net cash gain of $25. At the extremes, a non-taxable shareholder would realize $50, whereas one subject to the proposed top individual marginal of 50 per cent would find his position unchanged.

6. At some points in the *Report* it is assumed that one-third of the tax is shifted forward and at others one-half. Whatever the overall proportion may be, however, it seems clear that it must vary widely, from zero where prices are determined in foreign or world markets, to 100 per cent for regulated industries.

7. Children aged 21 to 25 may, on election, remain part of the family unit if they are in full-time attendance at an institution of post-secondary education.

gifts received by children, as well as earnings in excess of $500, may be placed in an "Income Adjustment Account" and not taxed until withdrawn or the child leaves the family unit. Otherwise mandatory joint returns are called for, except that a husband and wife may choose to pay tax at rates applicable to double their separate incomes and file separately.

Families and individuals would be subject to different rate schedules under which rates applicable to individuals are higher than those payable by families on income up to $40,000, beyond which they are the same.

The Commission's approach to the definition of the taxable unit seems to me to be preferable to the various alternatives. I am uneasy, however, about the rate differentials proposed for family units and unattached individuals. The rationale for this will be taken up in my discussion of rates, but I should note here that any such differentiation raises some important questions about the tax treatment of households that do not contain a married couple or a parent and dependent child. Two or more related unmarried people living together in one household, such as an adult child and dependent parent, or two or more adult siblings, may constitute an economic unit quite as much as a married couple or single person with a dependent child. Under the Commission's recommendations a tax penalty would be imposed if only one of the members of the household received most or all of the income, whereas if it is divided more or less evenly among two or more of its members the total tax payable is likely to fall substantially short of the amount payable on the same total income by a family unit as defined by the Commission. Unequal tax treatment is involved, yet there does not appear to be any obvious way out. A single rate schedule *and* mandatory joint returns for all households would undoubtedly impose an excessive penalty on many single adults who choose to share living quarters with parents or siblings if they and their relatives receive income. But modification of the plan contained in the *Report,* to permit family status to single individuals supporting parents or other close adult relatives and living with them in the same household, appears to me to be warranted.

Income Tax Rate Schedules. The differential in the rate schedules applicable to family units and unattached individuals is a product of the reasoning process under which the structure of tax rates was built. The Commission lays heavy stress on its conception of "ability to pay" as the basis for both horizontal and vertical equity. Ability to pay is held to be determined by "discretionary economic power," defined as "the product of the tax unit's total economic power [essentially consumption plus change in net worth, realized and deemed] and the fraction of the total economic power available for the discretionary use of the unit." That fraction is the proportion of the unit's total economic power that does not have to be used "to maintain the appropriate standard of living of the family or unattached individual relative to others."[8] Taxation according to ability to pay is then said to be achieved when each taxpaying unit contributes an equal proportion of its discretionary economic power.

We are then presented with the "rule" that defines ability to pay and its increase with income. The first $195 of total income is entirely non-discretionary; beyond that level, as income increases the fraction of the increment that is discretionary increases by equal absolute amounts with each doubling of income. Thus the bracket $195 to $390 is assumed to be discretionary to the extent of one-tenth, $390 to $781, two-tenths, $781 to $1,562, three-tenths, and so forth, until we reach $100,000 and over, at which point 100 per cent of increments to income are available for discretionary use. The "ideal" rate structure is then obtained by multiplying the top marginal rate, in this instance 50 per cent, by the assumed fraction of income in each bracket that is available for discretionary use. The actual rate structure recommended is a modifi-

8. 3, p. 5.

cation of the one so produced, to take into account existing regressive property and sales taxes and other factors such as the desire to bring "middle income" rates into line with U. S. rates.

One may view this means of arriving at a structure of tax rates as a commendable effort to avoid arbitrariness and to lend a rational air to the proposed schedules. But the crucial assumption regarding the behavior of discretionary income relative to total income is entirely arbitrary in itself, having no apparent empirical foundation whatsoever. The implication to be drawn from the rate schedule for family units, for example, is that for a unit with an income of $30,000 only $14,554 is available for discretionary use,[9] and $15,446 is non-discretionary. This seems to me to suggest a rather peculiar definition of non-discretionary use of income.

The same kind of approach is employed in justifying an exemption of $1,000 for single individuals and $2,100 for married couples, as well as the selected relationship between the two rate schedules. The Commission somehow finds that there are economies of scale available in marriage, except at the lowest income levels where "start-up" costs more than offset them, and as income reaches $40,000 marginal tax rates, higher up to this point for individuals, become equal. Thus, at the bottom of the income scale, marriage is rewarded with a minor tax advantage that gradually disappears and becomes a penalty. Thus two single individuals who each earn $1,500 would save $3 if they married, but at $10,000 each marriage would cost them $67, and at $20,000 the penalty rises to $1,047, or almost 10 per cent of the family unit's tax liability on the total income of $40,000.

Neither ability to pay nor vertical equity can be supported on any basis other than one's judgment as to the desirable degree to which the income tax is to serve as an instrument for redistribution of income. The Commission's arithmetic is not in itself convincing and its assumptions are purely arbitrary. The rate schedules arrived at are virtually unchanged from present-law rates for individual taxpayers with incomes of up to $9,000 and married couples (assuming all of the income is attributable to one spouse) with incomes of $6,000 or less. On the other hand, at over $100,000 the reduction is from a range of 65 to 80 per cent to 50 per cent. The sharp reduction in tax rates in the middle and upper income brackets is justified on three main grounds. One is that full taxation of capital gains would be unacceptable except at very much reduced tax rates. Another is that Canadian tax liabilities should be more closely in line with those imposed in the U. S. And the third is the Commission's conviction, admittedly without supporting evidence, that high tax rates dull work incentives.

In light of the available evidence on the relation between income tax rates and work effort and the sharp reduction proposed in the tax load to be borne by corporate-source income, none of these reasons is convincing. Nor is the estimate that high-income taxpayers *as a group* will pay higher total taxes while low-income taxpayers will enjoy a tax reduction.

Each of several recent studies conducted in the U.S. and the U.K. casts serious doubt on the hypothesis that work incentives are dulled by high rates of income tax.[10]

9. Tax liability is $7,277, which presumably represents 50 per cent of discretionary income. See Table 11-6, 3, p. 174.

10. For the U.K. see George F. Break, "Income Taxes and Incentives to Work: An Empirical Study," *American Economic Review*, Vol. XLVII, No. 4, September, 1957; Sidney E. Rolfe and Geoffrey Furness, "The Impact of Changes in Tax Rates and Method of Collection on Effort: Some Empirical Observations," *Review of Economics and Statistics*, Vol. XXXIX, No. 5, November, 1957; and Royal Commission on the Taxation of Profits and Income, *Second Report*, Cmd. 9105 (London: Her Majesty's Stationery Office, 1954), pp. 91-124. U.S. Studies include Thomas H. Sanders, *Effects of Taxation on Executives* (Cambridge: Harvard University, Graduate School of Business

Yet the Commission chose to ignore these findings and insist on the need to reduce the maximum rate of tax to 50 per cent in order "to minimize disincentive effects,"[11] and because "We think there is a psychological barrier to greater effort, saving and profitable investment when the state can take more than one half of the potential gain."[12] As a result, a married couple with $25,000 of earned income would pay more than $2,200 less, almost 30 per cent, under the proposed rates than under present law, at $40,000 the saving would be more than $4,000 and 27 per cent, whereas at $5,000 it would be $51 or 10 per cent.[13] This seems a rather high price to pay in loss of redistributive power of the income tax in response to unsupported predilections regarding the influence of tax differentials on the so-called "brain drain" and disincentive effects of high income-tax rates, and in order to buy full taxation of capital gains.

Allowances for Dependents. The Commission did not extend its "estimates" of discretionary relative to total income as far as it might have. Had it done so it might have calculated the amounts by which successive dependent children reduce the relevant ratio at each level of total income and based allowances for such dependents on these calculations. Instead it appears to have arrived quite arbitrarily at the figure of $100 as the tax credit to be allowed for the first child and $60 for each additional child, arguing that much of the cost of rearing children is "fixed." The allowances, in terms of exemption equivalents, range from approximately $800 for the first child when the taxable income of the family unit is $2,900 to $3,000 to $120 for the second and each succeeding child when income exceeds $100,000. Except perhaps at the lowest end of the income scale, allowances or credits for dependents of these magnitudes appear to be excessively low, either to add much progression to the tax system or to take into account differences in taxpaying capacity attributable to family-size differences.

Also recommended is a credit to be allowed to working mothers of dependent children aged 16 and under. The amount of this credit would be $80 plus an additional $120 if one or more of the children is under seven years of age. Unlike the similar child-care allowance under U. S. law, the proposal takes no account of whether or not there is a working husband, contains no cutoff provision in terms of family income, provides no additional credit for any child beyond the first, and gives no recognition to the case of the father of motherless children or the husband whose wife is incapacitated.

Averaging. A truly comprehensive income tax, such as that envisaged by the Commission, requires, as a matter of equity and as a means of encouraging risk taking, generous loss offsets and income averaging. Both are recommended. In general, business and capital losses would be afforded a two-year carryback and indefinite carry-forward, as well as being offsettable against income from other sources. In addition, a system of block-averaging is proposed, as well as an arrangement under which a portion of the taxpayer's income could be placed in a non-interest-bearing Income Adjustment Account, to be taxed only when withdrawn.

Administration, Clarence D. Long, "Impact of the Federal Income Tax on Labor Force Participation," in U.S. Congress, Joint Committee on the Economic Report, *Federal Tax Policy for Economic Growth and Stability*, 84th Congress, 1st Session (Washington: U.S. Government Printing Office, 1955), pp. 153-166; James N. Morgan, Robin Barlow, and Harvey E. Brazer, "A Survey of Investment Management and Working Behavior among High-Income Individuals," *American Economic Review*, Vol. LX, No. 2, May, 1965; and Robin Barlow, Harvey E. Brazer, and James N. Morgan, *Economic Behavior of the Affluent* (Washington: The Brookings Institution, 1966), pp. 134-150.

11. 3, p. 154.

12. 3, p. 163.

13. 3, p. 179.

The unfettered deductibility of capital losses may be questionable as long as the taxpayer may postpone taking gains until death. The remedy is not obvious, however, unless one is prepared to support a surtax or interest penalty on the actual or deemed realization of gains that have accrued over a period of more than one year, allowing the taxpayer, at his option, to step up the basis of assets and pay tax as gains accrue. But even with this modification it is all too easy to envisage unfortunate political repercussions when, in a year of declining stock market prices, some very wealthy people pay no income taxes or even claim refunds under the averaging or carry-back proposal.

Gifts and Bequests. In one of its boldest departures from the "conventional wisdom" on tax policy, but clearly in line with its own equity objectives, the Commission urges the repeal of existing estate and gift taxes and inclusion in income of all gifts and bequests received from outside the family unit. Moreover, on leaving the unit, a dependent or formerly dependent child would be required (subject to a lifetime exemption of $5,000 and minor annual exemptions) to include gifts or bequests received from a parent in his taxable income. With an adequate averaging system and a maximum marginal income-tax rate of 50 per cent this approach appeals vastly more than any of the various forms of wealth-transfer taxation, particularly since it is accompanied by recommendations that promise to minimize, if not eliminate, the use of trusts as a means of avoiding or unduly postponing tax liabilities that would otherwise arise.

In his recent study of estate and gift taxes Professor Shoup has noted that they may be employed as means of 1) taxing windfalls, 2) taxing property once a generation, and 3) taxing to reduce concentration of wealth and economic power.[14] All of these objectives may be well served by inclusion of gifts and inheritances in income. This approach, moreover, has the further advantage of making the tax liability depend in part on the economic well-being of the transferee, rather than solely on the total value of the decedent's estate, the amount of the gift, or, as in the inheritance tax, the amount transferred and the relationship between the decedent and the heir.

Fringe Benefits. The Commission proposes a thorough-going overhaul of the tax treatment of "fringe benefits" enjoyed by employees, ranging from employer-paid medical-hospital insurance premiums through pension-plan contributions and excessive travel and entertainment expenses. The suggested inclusion of virtually all such benefits in current income and limiting deferral on contributions to pension plans to amounts sufficient to provide a pension of $12,000 per year at age 65 appear to offer rational solutions to an increasingly important set of problems in income taxation. In implementing these proposals, however, it may be found desirable to introduce some *de minimus* rules if bookkeeping costs wholly disproportionate to the amount of tax liability involved are to be avoided.

Income from Oil and Mineral Properties. A three-year exemption from income tax for new oil and mineral properties, so-called depletion allowances equal to one-third of net income, and expensing of exploration and some development costs now result in relatively light taxation of income in the extractive industries. Primarily in the name of achieving greater efficiency in resource allocation through more neutral tax treatment of these industries, the Commission boldly calls for repeal of the three-year exemption, conversion of the depletion deduction to an amortization charge limited in the aggregate to the cost basis of the property, giving no recognition to "discovery value," and continued generous write-offs of exploration and development costs.

14. Carl S. Shoup, *Federal Estate and Gift Taxes* (Washington: The Brookings Institution, 1966), pp. 100-101.

Clearly the present provisions of the tax law in this area are indefensible. But since near-term prospects for reform along similar lines in the U.S. appear to be virtually nil, a nagging question remains as to whether, in oil and iron ore, for example, Canadian development may be seriously impeded by the withdrawal of important tax advantages. At any rate on the southern side of the border, in the course of helping to frame tax policy in Minnesota and at the U.S. Treasury, I have been made forcibly aware of the importance alleged to be attached to Canada's generous tax provisions by corporate enterprises interested in exploring for and developing oil and mineral deposits. I have no doubt but that the Commission has been subject to similar arguments on its side of the border. And someone has to be the first to act. As Canadian Minister of Finance, one might well wish that the U.S. had acted first!

The Sales Tax. Having decided so insistently that discretionary economic power is the sole acceptable basis for taxation and that where the objectives of tax policy are found to be in conflict equity must prevail, the Commission nevertheless manages to recommend that a sales tax estimated to yield roughly half as much as the income tax be imposed. To its credit the *Report* calls for repeal of the manufacturer's sales tax and the selective excise taxes on everything other than liquor and tobacco products. Most of the lost revenue is to be recovered by a retail sales tax under which intermediate goods and food would be exempt. But why any sales tax?

In answer it is pointed out that a sales tax need not be regressive; that income tax rates needed to offset the revenue loss would be unacceptable; and that a sales tax should be kept by the federal government as an instrument for use in bargaining with the provinces for a larger federal share of income and wealth-transfer taxes.

Despite its plea for equity and neutrality in taxation the Commission is willing to tolerate a differential of 13 per cent (now 8 per cent in Quebec) in tax on the consumption of taxable commodities and services as compared with food, shelter, and other exempt items. The sales-tax credit, under which the open-ended feature of the food exemption, as well as its compliance difficulties, would be avoided, would be capable of achieving both greater equity and neutrality. It has proved workable in Indiana, Colorado, Hawaii, and is now part of the Massachusetts sales-tax structure, but the Commission rejects it for the entirely unconvincing reason that not all Canadians are required to file income tax returns on which they might claim the sales-tax credit. Thus it is held that it is "not practical" to adopt a credit *now*.

Neither the Commission nor anyone else can be certain of anything in the matter of the effects of taxation on economic variables. But on the matter of whether or not high-income tax rates stifle incentives, we have much experience and considerable evidence to support a negative conclusion. Still, the Commission is able to state, "If we could be reasonably certain that there would be no adverse economic effects from a sudden and massive increase in income tax rates . . . we would recommend that sales taxes be replaced by higher federal income taxes."[15] This is said despite the fact that no evidence whatsoever is presented to support the implied conclusion that the Commission *is* "reasonably certain" that the adverse effects of raising income tax rates to a level higher by about 50 per cent than those proposed, that is, to a range of from 19 per cent to 75 per cent, would be greater than those stemming from a 7 per-cent retail sales tax with food exempt.

The third argument offered involves a judgment on the matter of appropriate federal strategy to be used in negotiating fiscal arrangements with the provinces. Whether or not it is valid, it, together with the recommendation that the federal and provincial sales taxes should be collected by the provinces, seems in conflict with the

15. 5, p. 6.

ancillary argument offered in support of the sales tax that suggests that the federal administrative machinery should be maintained so that it would be available for use in case of emergency.

In view of its own stated objectives and preferences and the heavy reliance of eight of the ten provinces on the retail sales tax, as well as the importance attached by the Commission to the major role to be played by the income tax in federal stabilization policy, its position on the sales tax is difficult to accept or to understand. It would have been more consistent and, in my judgment, would have produced a more equitable, more neutral proposed tax structure if it had been willing to make up the estimated $1.4 billion revenue yield of the sales tax by adjusting its suggested income-tax rates upwards to a maximum of perhaps 60 per cent. The alternative schedule of income tax rates might even have been so designed as to produce the same incidence as the Commission's income tax *cum* sales tax.

The *Report* contains a great many more recommendations, far more than can be discussed here. On the other hand, there are some major issues in tax policy on which it fails to offer proposals for change, proposals that appear to me to follow from the Commission's statement of principles and objectives. It is to these that I turn now.

III. Some Sidetracked Issues

Each observer, however sympathetic to the *Report* of the Carter Commission, is bound to have his own list of issues on which he regrets that recommendations were not included in the large number offered. My own list is rather short. It concerns imputed rental income on owner-occupied homes, the tax treatment of charitable contributions, and depreciation or capital-cost allowances. In addition, I believe that questions may properly be raised as to whether or not a tax on business as such should have a role to play in the Canadian federal tax structure.

Imputed Rental Income. The Commission holds that "To ensure that all taxpayers bore their fair proportion of the total tax burden, it would be necessary to impute rental income. . . ."[16] It also recognizes that the amounts involved "are not immaterial and that they are growing more rapidly than total personal income."[17]

Discrimination in favor of home ownership is not as extensive in Canada as it is in the U.S., where not only is imputed net rental income excluded but mortgage interest and property taxes are deductible as well. But failure to allow the deduction of mortgage interest introduces an important inequity *among homeowners,* favoring owners with large equities relative to those whose homes are heavily mortgaged. Equal treatment of all owners and tenants would, therefore, require the inclusion in income of an imputed yield on owners' equity.

The Commission rejects this approach because of its conviction that it involves excessive uncertainty and that it would entail "detailed administrative examination." It cites the unsatisfactory experience of the U.K. prior to 1962 in support of its position. But it may fairly be said that the British tax authorities, at least in recent years, never really tried to enforce the provisions of their income tax law relating to imputed rental income. Moreover, the relatively rapid turnover in Canadian owner-occupied housing, contrasted with past experience in the U.K., renders the comparison somewhat less than useful. Compared with such valuation problems as are involved in deemed realization of capital gains and losses on closely-held corporate stock, partnerships and sole proprietorships, the difficulties to be encountered in requiring the taxpayer to compute the net imputed yield on his equity in his home, assuming an

16. 3, p. 48.
17. *Ibid.*

arbitrarily fixed rate of return, seem modest indeed. And federal-local cooperation in assessing property values could be mutually very fruitful.

A rough-and-ready calculation suggests that the imputed net yield on owners' equity in owner-occupied residences (including farm residences) may amount to $400 million to $500 million. This is by no means "immaterial" and may carry with it a potential tax yield of some $80 million. A subsidy to homeowners in this amount, one that varies directly with the owner's equity and income, seems to me to be far too large to be ignored solely on the basis of the questionable belief that the attempt to bring this element of income into the tax net is administratively doomed to failure.

Charitable Contributions. Gifts are viewed by the Commission as involving the disposition of discretionary income. As a general rule, therefore, they are not to be deductible. An exception to this rule is advocated, however, for gifts to charity because of the belief that "charitable contributions perform a worthwhile social purpose."[18] Thus it is recommended that taxpayers be permitted to deduct charitable contributions in amounts up to 10 per cent of income or to take an optimal $50 "standard deduction."

No evidence is presented in support of the implied hypothesis that deductibility effectively stimulates charitable giving, or that the cost of deductibility to the treasury falls short of the incremental receipts of charitable organizations attributable to deductibility.[19]

I am not aware of any data on the distribution of charitable gifts in Canada by type of recipient organization, nor are any presented by the Commission. But it may not be too far-fetched to assume that patterns of charitable giving in Canada are similar to those found in the U.S. If so, some 60 per cent of deductions can be expected to be for gifts to religious organizations, 4 per cent to educational institutions, 1 per cent to hospitals, and 34 per cent to other charitable organizations and private foundations.[20] The question not faced by the Commission, therefore, is whether the private allocation by indirection of what would otherwise be treasury tax receipts to religious purposes can be justified to the extent suggested, if at all. This is not to question the "worthwhile social purpose" served by the church. It is, rather, a matter of whether or not the government should help to finance it. Surely religion is a private affair and the taxpayer's conscience is no concern of the treasury.

Even if we accept the assumption, contrary to the findings cited, that deductibility is an effective stimulant to charitable giving, it does not follow that each dollar contributed should be afforded equal treatment. Rather, it is the taxpayer who responds with more-than-average generosity who may well be rewarded with the privilege of deductibility. And this calls for the provision of a floor, with contributions being deductible only to the extent that they exceed, say, 2 or 3 per cent of income. But this proposal is rejected out of hand by the Commission because of its view that it "might tend to restrain giving by upper income taxpayers. . . ."[21]

Alternatively a credit rather than a deduction would seem preferable, in order to avoid having the treasury match the rich taxpayer's contributions dollar for dollar

18. 3, p. 222.

19. For evidence to the contrary in the case of U.S. experience, see presentations by Harry C. Kahn, Michael Taussig, and Harvey E. Brazer in Raymond L. Finehout, ed., *Taxation and Education* (Washington: The American Alumni Council, 1966), pp. 15-22, 24-27, and 44-50, and references cited therein.

20. U.S. Treasury Department, Internal Revenue Service, *Statistics of Income, 1962, Individual Income Tax Returns* (Washington: U.S. Government Printing Office, 1965), pp. 6-7.

21. 3, p. 224.

while absorbing only 12 to 13 per cent of the cost of giving for the low-income taxpayer, and then only if his gifts exceed the $50 standard deduction.

Capital-Cost Allowances. In lieu of depreciation charges designed to reflect the actual reduction in value over time of machinery, equipment, buildings and other "depreciable assets," Canadian businesses have long been permitted to deduct capital-cost allowances from income. These allowances are computed at a small number of specified rates, each of which is applicable to a broad class of assets, such as machinery and equipment, steel or concrete buildings, and so forth. The rates, 20 per cent (on a declining base) for machinery and equipment, for example, define the maximum deduction that may be taken. In any one year the taxpayer may choose to defer deducting the allowance completely and he is free to use any alternative method of reflecting depreciation for non-tax purposes.

The Commission found that this approach to depreciation for tax purposes has resulted in deductions far in excess of depreciation charged in the accounts of large corporate taxpayers. Not surprisingly, taxpayers appear to be well satisfied with it. The system has the virtue of being simple and certain, and it provides a substantial reduction in the effective rate of tax, especially for growing concerns. Apart, therefore, from some minor technical changes, the *Report* does not call for change in this area.

This may, on balance, be the preferred position. But perhaps the Commission has given way excessively to the appeal of simplicitly and certainty. The present system of capital-cost allowances fails to recognize differences among firms and among industries in the expected economic lives of their depreciable assets. Thus for firm A in industry X the implied 10-year average life for its machinery and equipment may be much shorter than expected economic life or average replacement period, whereas for firm B in industry Y, subject to rapid obsolescence or simply employing short-lived equipment, it may be far too long. As a consequence the effective rate of tax will be substantially higher for firm B than firm A. The system is unneutral not only between firms and industries and therefore likely to give rise to departures from efficiency in resource allocation, but within firms as well it provides a major incentive to substitute long-lived for short-lived assets. Furthermore, the advantage enjoyed by some firms is much more than a mere postponement of tax liability; for the firm growing rapidly enough lower taxes now may never be followed by higher taxes in the future.

The Commission may have believed that the discriminatory aspects of the present system are preferable to the complexities and perhaps uncertainties involved in possible alternatives. It may wish to favor such industries as pulp and paper or steel, as compared with electronics or women's wear, and economically durable as against less durable assets. But there are substantial costs involved in doing so, and it failed to recognize these costs explicitly. Instead, the Commission concludes that "While such simple and arbitrary rules are unlikely to reflect accurately the annual loss in value of the assets, they at least ensure a minimum common standard available to all taxpayers, and the ultimate allowance of all cost provides for a final reckoning."[22] This conclusion is simply not valid. Standard rules and rates do not provide a "common standard" for non-standard groups of assets, and for growing firms the "final reckoning" may never come.

The Role of Business Taxation. The Commission's view of the role of the taxation of business appears to suggest that that role is solely one of serving as a conduit through which individuals may be reached. Irrespective, however, of the fact that taxes initially paid by business firms are ultimately reflected in higher product prices or lower returns to factors, there may be a valid case for taxing business units as such.

22. 4, pp. 239-240.

This case is based on the premise that businesses use or consume government services in varying amounts. These services are essentially intermediate goods. To the extent that the costs of resources used in their supply do not enter explicitly into business costs and supply functions departure from efficiency in the allocation of resources is inevitable. Thus, on efficiency grounds, businesses should be required to pay taxes commensurate with their use of public services.

If this much is granted, the problem that remains is one of finding the appropriate tax "handle." Obviously the corporate income tax does not qualify. It seems to me, however, that a value-added tax, while admittedly imperfect, may come close enough to warrant more serious consideration than is afforded it by the Commission. It has the merit of being neutral with respect to form of business organization, input mix, and capital structure, and it does not penalize efficiency in the manner of the income tax. Furthermore, it does not seem entirely unreasonable to assume that government services are employed more or less in proportion to inputs of labor, capital, and natural resources or "land." The aggregate price paid by the firm for private inputs is, of course, the base of the tax on value-added.

The Commission, having given some consideration to the value-added tax,[23] tends to regard it as an inferior substitute for a retail sales tax, which too may be viewed as a tax on value-added in the production of consumer goods and services. In many respects this is a valid position, not least, perhaps, because the latter tax is likely to be less hidden to the ultimate taxpayer and may be simpler to comply with and to administer. The value-added tax, however, has the appeal of not appearing to involve an incursion into a tax field that has hitherto been ploughed exclusively by the provinces, and there may be merit in imposing a rough kind of benefit levy on business firms.

IV. Conclusions

As I indicated at the outset, the *Report* is a remarkable document. Enactment of its recommendations would give Canada a tax system more equitable and more conducive to efficiency in resource allocation than that of any other national government. I trust that I have made it clear that I believe that some room for further improvement would remain, but my differences with the majority members of the Commission are really minor.

It is inevitable that the product of a group of individuals should contain a number of apparent inconsistencies and, on a subject as controversial as tax policy, even more inevitable that in arriving at compromise solutions to difficult problems, principle may occasionally have to be bent somewhat. Perhaps the most remarkable attribute of the *Report* of the Carter Commission is the fact that it contains so few inconsistencies and adheres so closely to the principles of rational tax policy. Undoubtedly the majority members of the Commission faced a difficult dilemma. Clearly the Commission's recommendations would have carried more force if they had been endorsed unanimously. But acceptance of the views, particularly on the taxation of capital gains, of the two members who chose to submit separate dissenting minority reports would have involved compromising with fundamental premises regarding the appropriate objectives of tax policy. It is, I believe, to the great credit of the majority that it preferred to stand its ground. Its decision to do so is not only a measure of its own integrity but, I believe, a fine and well-merited tribute to its staff.

23. 5, pp. 44-51. Most of the discussion in these pages is devoted to alternative forms of the tax and possible administrative difficulties. In contrast with most other parts of the *Report*, little attention is paid to conceptual and economic issues.