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Canadian Tax Reform: Economic and Political Implications

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An Intelligence Assessment

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Canadian Tax Reform: Economic and Political Implications

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An Intelligence Assessment

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**Canadian Tax Reform:
Economic and Political
Implications**

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Key Judgments

*Information available
as of 30 October 1987
was used in this report.*

The Canadian Government has decided to push ahead with a US-style tax reform that probably will improve its tax system but also may increase frictions with the United States and pose political dangers for the Mulroney government. For political reasons, Ottawa will implement the reform in two stages—one before and the other after the next election, which must be held by late 1989. The first stage—taking effect in early 1988—will lower income tax rates and broaden the tax base in a Tory effort to win support before the election. The immediate economic result is likely to be a contraction in growth; if not accompanied by the second stage, tax reform is unlikely to improve the tax system enough to provide more than a modest boost to growth over the longer run.

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More substantial economic benefits probably will result from the second stage—replacing the present manufacturers' tax with a new sales tax. This controversial new tax may never be enacted, however, because of the uncertainty of a Conservative victory in the next election. The Tories trail badly in the polls, and neither opposition party is likely to follow through on the sales tax reform.

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The Tories will benefit politically from reform only if they can focus the voters' attention on the immediate benefits of the personal income tax cuts and convince them that the reform will significantly improve the economy. We believe the Tories are underestimating the public's opposition to the sales tax proposal, and we doubt Prime Minister Mulroney—who has an unprecedentedly low credibility rating—can convince most voters that reform will result in a fairer tax system or a smaller tax burden. The opposition parties probably can capitalize on the Tories' reputation for raising taxes and skewing the tax system to favor the wealthy.

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Other economic results of the reform are likely to be mixed. By slowing the rate of revenue increases, the first-stage reforms will hinder Ottawa's efforts to cut its budget deficit over the next four years. Moreover, uncertainty over the implementation of the revenue-generating new sales tax puts longer range deficit reduction efforts in jeopardy. If the sales tax is not implemented, a continuing high deficit, in turn, will reduce Ottawa's ability to use fiscal policy to stimulate the economy when necessary and probably will undermine investor confidence in the government's ability to sustain economic growth. Stalled progress on deficit reduction also is likely to cause interest rates to remain high, curtailing investment, and probably renewing downward pressure on the Canadian dollar.

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[Redacted]

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Ottawa is selling its tax reform proposal as a means of encouraging growth, but the package as it is likely to be implemented probably will give only a small boost to the economy. In the short term, the first stage of reform will almost certainly discourage business investment more than it stimulates consumption. Over the longer term, the first stage of reforms is likely to lead to more rational investment decisions, which will improve the quality of the capital stock and increase economic efficiency. The later introduction of a broadly based sales tax would remove distortions present in the current system and probably would create a small upturn in real economic activity by encouraging resource allocation based on economic rather than tax considerations. [Redacted]

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Tax reform will increase the potential for friction between the United States and Canada, particularly if Ottawa applies the stricter tax-avoidance regulations it has in mind to US corporations doing business in Canada. And the likely weakening of the Canadian dollar would allow Canadian exporters to make further inroads into the US market. The constraints of the deficit on the government's ability to stimulate the economy through fiscal policy would also aggravate bilateral tensions if Ottawa, as is likely, follows its past practice of blaming US dominance of the Canadian economy for the government's shortcomings. Finally, federal-provincial negotiations on the details of a new sales tax regime may become heated and spill over into US-Canadian relations by making the provinces less willing to cooperate in implementing the recently signed free trade agreement. [Redacted]

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Canadian Tax Reform: Economic and Political Implications [Redacted]

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Introduction

After several years of internal party debate, Prime Minister Mulroney's government announced a two-tiered tax reform proposal in June designed to correct many distortions and inefficiencies in the old tax system. In the first stage of reform, effective in 1988, the Tories plan to improve the effectiveness of the Canadian income tax system by lowering income tax rates and broadening the income tax base. Ottawa plans to follow this step by replacing the exemption-riddled federal sales tax on manufactured goods with a more broadly based value-added sales tax in the early 1990s. The Mulroney government believes that a simpler, more equitable tax structure will improve Canada's competitiveness and encourage economic growth by removing barriers to efficiency. [Redacted]

The current manufacturers' sales tax creates even more distortions. Half of the revenue from the manufacturers' tax is derived from levies on goods used by businesses, which creates a cascading effect where taxes paid at several levels of production are included in the taxable value of a good. This cascading tax greatly increases investment costs and erodes Canada's export competitiveness. Moreover, because the manufacturers' tax is applied at varying rates—and to only one-third of consumption—similar products are subject to widely varying taxes, a situation which distorts consumption decisions. Finally, the system is biased against Canadian-made goods since no tax is levied on imports. [Redacted]

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This paper provides an overview of the proposed changes to the Canadian tax system, along with an analysis of why Ottawa has undertaken reform at this time. It outlines the uncertainties involved in implementing both stages of the reform and assesses the shape of Mulroney's ultimate tax package. The paper examines the impact of the tax changes on economic growth, investment, and Ottawa's effort to control its budget deficit, as well as their political impact. Finally, it outlines some potential irritants to US-Canadian relations arising from tax reform. [Redacted]

The frequent granting of exemptions from both income taxes and the manufacturers' sales tax over the last decade has eroded the federal government's ability to raise revenue and has undermined economic efficiency. Increases in tax rates over the years have also encouraged tax evasion and delinquency of payments. Today, tax revenue as a share of GNP is about 17 percent—only marginally higher than when the Tories took office in 1984—despite efforts to broaden the tax base and raise revenues through a minimum income tax, surtaxes, partial deindexation of tax brackets, and three hikes in the manufacturers' sales tax. Finally, Ottawa's estimates of its tax revenues are often overstated, partly because of the tax evasion problem, and partly because unused corporate tax credits can be carried over from year to year. [Redacted]

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Why Tax Reform is Needed

The need to replace the present Canadian tax system with a simpler and fairer program has been debated for two decades. Years of tinkering with the income tax structure to encourage investment and regional development have created a complex and biased system that hinders economic growth. The present tax system's high marginal income tax rates, for example, discourage labor productivity and investment. Because of the many deductions and exemptions offered, both individuals and corporations often base their investment decisions more on tax considerations than on economic factors, thereby impairing efficiency. [Redacted]

Finance Minister Wilson has advocated measures to amend the tax system since 1985, but the problem-plagued Tory Cabinet has been reluctant to take the political risks involved in widespread reform. Wilson has pressed for lower tax rates, limited deductions, and a more progressive tax system: one that would shift the tax burden away from savings toward consumption. He has insisted, however, that tax reform must not undermine other economic objectives of the

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Note: All dollar figures are in US dollars. [Redacted]

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Canadian Government such as continued funding of generous social programs, encouragement of regional economic parity, and maintenance of a high savings rate—to cover the high costs of capital in Canada.

[redacted]

What finally helped Wilson convince his colleagues to push ahead with reform this year was the lowering of tax rates in the United States. Wilson argued that failure to narrow the gap between US and Canadian rates would drive both people and investment from Canada. He estimated, for example, that Ottawa would lose several million dollars in tax revenues annually from corporations shifting investments to the United States to take advantage of lower tax rates. This lost investment, he believed, would slow economic activity and job creation. On the political side, the Tories decided that further delaying tax reform would threaten their credibility. Moreover, they hope to use lower tax rates to enhance their chances in the next election, which must be held by the fall of 1989. They have designed the package to maximize its political benefits.

The Tax Reform Proposal

The first stage of the two-tiered reform package that Wilson introduced last June addresses shortcomings in the personal and corporate income tax structure. Effective in early 1988, the first stage will lower personal and corporate income tax rates, eliminate many deductions to simplify the system, and change others to tax credits to make the system more progressive (see inset). Removing deductions will also broaden the tax base—a necessary step to recoup some of the income lost through lower tax rates. Moreover, several of the proposed changes will force financial institutions, insurance companies, and real estate firms to bear their fair share of the tax burden; under the present system these companies pay no tax on investment income.

Ottawa, however, retained several tax incentives that encourage research and regional development, help maintain Canada's high savings rate, or aid key industries. The Tories plan, for example, to keep several deductions that lower the effective tax rate on savings and investment, hoping thereby to shift the burden of the personal tax system away from savings

toward consumption. In addition, preferential treatment for investment in the mining and petroleum industries will be continued, albeit on a smaller scale, and tax credits to companies investing in Atlantic Canada will be retained.

In an effort to keep the first stage of changes revenue neutral, the government will resort to temporary changes in the manufacturers' sales tax and will accelerate tax collection measures to recoup revenue lost by lowering tax rates. Ottawa will abandon these measures if and when the new sales tax is in place. Wilson also anticipates additional revenues from a strengthening of antiavoidance rules, although court challenges to the proposed legislation probably will gradually erode Ottawa's ability to raise revenues through these means. The proposed measures grant Revenue Canada—Ottawa's tax collection agency—broad power to examine company transactions and disallow those undertaken solely to reduce taxes.

Because the second stage of reform—the new sales tax—is likely to be unpopular, its introduction will almost certainly be delayed until 1990 or 1991. Although Wilson initially implied that substitution of a new sales tax for the manufacturers' sales tax would occur soon so as to maintain revenue necessary for budget reduction, he has since declared that the sales tax legislation would not be introduced before the next election. He apparently was overruled by Cabinet colleagues who did not want to defend a controversial new tax on the hustings.

The Tories have purposely left their proposals for the new sales tax vague. Wilson outlined three sales tax options in his June speech—a national sales tax, a European-style value-added tax (VAT), and a goods and services tax—and has said he will choose one after discussions with the provinces this winter (see inset). Replacing the separate federal and provincial tax systems with a single national tax appears to have the most support at present, but the provinces' reluctance to cede some of their tax autonomy to a central system could force Ottawa to choose one of the federal-only options. Whatever the form, Wilson will

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Highlights of the Tax Reform Package**Personal Income Taxes**

Tax Rates. Effective January 1988, the number of brackets is reduced from 10 to three; new tax rates ranging from 17 percent for incomes below \$20,625 to 29 percent for incomes above \$41,250 replace old rates of between 6 percent and 34 percent; rates to drop further when new sales tax implemented.

Exemptions/Deductions. Interest and employment deductions eliminated; all exemptions—personal, marital, child, old age/disabled—replaced with tax credits; deductions for medical expenses, tuition fees, unemployment insurance premiums, contributions to Canada and Quebec Pension Plans changed to tax credits worth 17 percent of expenses/contributions.

Capital Gains. Lifetime capital gains exemption reduced from \$375,000 to \$75,000 for all Canadians except farmers and small businessmen; tax rate on taxable portion of capital gains rises in 1988 from 50 percent to 66.6 percent, and to 75 percent by 1990.

Sales Tax Credit. Credit rises from \$37.50 to \$52.50 for adults, \$18.75 to \$26.25 for children.

Corporate Income Taxes

Tax Rates. Reduced from 36 percent to 28 percent on 1 July 1988; rate for manufacturers drops from 30 percent to 26 percent next year and to 23 percent by

1991; rate for small businesses declines from 15 percent to 12 percent; 3-percent surcharge to be dropped when new sales tax is introduced.

Capital Cost Allowances. Reduced to 25 percent of declining balance for manufacturers; by 1990 capital cost allowance only claimable in year asset put into use; earned depletion allowances for natural resources phased out by 1990.

Financial Services. Funds transferred to reserves made taxable; claims discounted to present value; tax on investment income accruing to fund insurance liabilities of life insurance companies.

Capital Gains. Same as for personal income.

Other Measures

Manufacturers Tax. Levied 10-percent tax on telecommunications services; raised from 8 percent to 12 percent tax on paint, varnish, and wallpaper; switched tax on selected goods from the manufacturers' to the wholesale level; temporary until new sales tax implemented.

Cash Flow Manipulation. Starting April 1988, large corporations to pay sales and excise taxes every two weeks rather than monthly; in 1990 remittances for source deductions accelerated to four times a month.

press for a tax covering almost all goods and services, including politically sensitive goods like food, partly because such a measure can be implemented at a much lower rate than the present manufacturers' tax. Ottawa estimates that every percentage point of a more broadly based tax would raise \$1.5-2.3 billion annually for the government; therefore, a 5- to 7-percent tax would yield the \$11 billion the present 12-percent tax raises. Wilson also promises that

broadening the tax base will enable him to provide a refundable, prepaid tax credit to low-income Canadians to offset the regressivity of the tax.

Prospects for the Reform Package

The Mulroney government will find it easier to impose the initial reforms than the proposed sales tax. Although there has been widespread criticism of the first-stage tax measures, it has generally been muted.

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The Sales Tax Options

The three options are all variations of a multistage value-added tax (VAT). Since all three probably would introduce a common tax rate applied to virtually all goods and services, any of the alternatives would benefit the economy by minimizing distortions of consumption preferences. The differences among the three options lie mainly with the methods of calculating the tax and the costs of its administration.

The national sales tax appears to be the favorite with the Tory Cabinet because it replaces both the federal and provincial sales taxes with one system. According to Wilson, however, the tax—applied at a common federal rate and individual provincial rates—would be flexible enough to allow provinces to opt out of their portion of the tax. A national tax would complicate a businessman's paperwork because sales invoices would be needed for every transaction, but this added burden would be partially offset by the integration of the existing federal and provincial tax systems.

A goods and services tax—formerly called a business transfer tax—is a subtraction-style VAT where the tax base is determined by subtracting the cost of purchases of goods and services, including investment, to which the tax is already applied, from the

value of the goods and services sold. The tax would be administered at the federal level, and would not in itself affect provincial tax rates. To make the effective tax rate on exports zero, their value would be subtracted from the value of a company's sales. The main advantage of this option is that it is simpler for businesses to administer because it uses sales and cost figures from a company's books rather than separate invoices to calculate tax owed.

A European-style, credit-invoice VAT probably is the least likely to be selected because its reliance on invoices to determine the taxes owed adds to the complexity and administration costs of such a system. Under this option, the tax is calculated on the value shown on the invoices of a business's sales of goods and services. To avoid double taxation of inputs included in the final value of the good or service being taxed, a credit is given for the tax shown on invoices that the company already has paid. For exports, a tax rate of zero would be applied and the taxes paid and recorded on invoices would be fully deducted. This option is more flexible than the others in that it allows selected goods to be exempted from the tax or different tax rates to be set for various goods and services.

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The business sector is unhappy with the raising of effective corporate tax rates, but is also relieved that the reforms are not as extensive as many had privately feared. After several months of public hearings, the House of Commons Finance Committee approved the general thrust of Wilson's reform measures in mid-November, and released many recommendations to smooth out the package's rough edges. While most of the recommendations are technical fixes, two major criticisms emerged: that the tax burden falls too heavily on middle-income families, and that financial institutions still escape from contributing a fair share to government revenues. We expect Wilson will make some minor changes to the tax legislation so as to

appear receptive to public concerns, but he is likely to reject major revisions such as the Committee's recommendation of a minimum tax on financial institutions. The Tories want to present the tax package to Parliament in December—using their large parliamentary majority to pass the legislation quickly—and the tight time frame precludes major changes.

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Implementation of the second stage of tax reform is far less certain. Ottawa would have liked to push ahead quickly with the national sales tax option, but the need to negotiate with the provinces—because it

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cannot unilaterally replace the provincial tax systems—and the unpopularity of a tax on food have forced the government to move more cautiously.

[redacted]

Negotiations with the provinces promise to be complicated as the various governments try to merge provincial tax rates ranging from 0 to 12 percent into a more uniform system. ¹ In mid-July, federal and provincial officials agreed on a list of issues that had to be discussed before a national sales tax could be implemented. One thorny problem will be agreement on a uniform list of taxable goods. Each province has certain goods that it would like exempted—most would hesitate to tax food, for example—and several, particularly Quebec, have reservations about losing their provincial tax autonomy. ² Another potential roadblock is the sharing of revenues from taxes collected on financial services and interprovincial transportation where it is not clear in which province the service is sold. In order to succeed, Ottawa must prevent negotiations over these tax revenues from degenerating into a battle between the well-endowed central provinces and economically depressed Atlantic and Western Canada. On balance, we believe Mulroney can win provincial support for the national sales tax. [redacted]

After winning the support of the provincial leaders, Ottawa will face an even more difficult challenge in convincing voters of the benefits of the new sales tax. Mulroney knew the tax would be tough to sell; a poll commissioned by the Tories last March showed only 7 percent of the public favored a new sales tax, particularly one that taxed food. Negative public sentiment has already forced Ottawa to postpone introducing the new tax until after the next election, and the two opposition parties undoubtedly will add to the pressure on the government by reminding the public of past Tory tax hikes. Moreover, postponing

¹ Alberta, which levies no retail sales tax, has rejected the national sales tax option, but Ottawa believes a national tax can be flexible enough to allow some of the provinces to opt out if necessary. [redacted]

² Under a national sales tax, a province could not unilaterally add or exempt goods from the tax, although one could alter its portion of the tax rate independently of the others. [redacted]

the tax until after the next election endangers its implementation because neither of the two opposition parties—which are currently thrashing the Tories in the polls—is inclined to implement such a tax if—as seems likely—the Tories are ousted from power.

[redacted]

We suspect that even a reelected Mulroney government would bow to public pressure and decide against including food in the new sales tax. The Tories' reputation as the party of the rich will undermine their argument that the promised refundable sales tax credit for low-income families will correct the regressivity of the system. Many Canadians also fear that sales tax reform is just a grab for more revenues since a relatively small increase in the new tax would generate a great increase in income for the government. Therefore, to minimize the public outcry, we believe Ottawa will be careful to start with a relatively low sales tax rate. [redacted]

Impact on the Tax System

Many Canadian economists and financial analysts have applauded the reform package for taking steps to lessen the distortionary effect of the tax system on consumption and investment decisionmaking, but they lament that the reform package is not as bold as is needed to correct all the problems with the system. ³ Lower personal and corporate tax rates, for example, probably will restore Canada's tax competitiveness with the United States and enhance Ottawa's ability to accurately estimate tax revenues by making tax evasion less attractive. Tax reform will be less effective, however, in shifting the tax burden onto corporations, in simplifying the tax code, or in making the personal income tax system more equitable. [redacted]

³ Analysis of the impact of the reform package on the tax system and on the economy is difficult as a result of its two-stage implementation and the uncertain form and timing of the new sales tax. For purposes of this paper we assume that the first stage reform proposals are accepted and implemented as scheduled. In addition, we assume that the Tories will pass a new broadly based national sales tax of about 9 percent—exempting food for political reasons—in late 1990 or early 1991. [redacted]

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Making the System Fairer. Although low-income taxpayers will face a lighter tax burden, lowering marginal tax rates across the board gives a proportionally larger benefit to high-income earners. The parliamentary Finance Committee's major criticism of the tax package is that it places an unfair burden on middle-income families. Moreover, we believe the greater progressivity introduced into the personal income tax system by the switch from deductions to tax credits will be offset if the regressive sales tax is introduced in the second stage of reform. Implementation of the sales tax would hit low-income Canadians hardest even if—as is likely—it exempts food. In fact, without a tax on food, we would expect Ottawa to greatly reduce the planned refundable sales tax credit, arguing that there is less need for one and less revenue available to fund it. Moreover, exempting food is likely to force the government to adopt a higher tax rate, further increasing the regressiveness of the sales tax. [redacted]

We believe, however, that the changes to corporate income taxes will make the system more equitable by reducing the variability of corporate tax burdens across industries and capital assets. At present, the effective tax rate applied to business income ranges from 15 percent in mining to 24.5 percent for the wholesale sector. By eliminating many deductions, the reform package will reduce the variation in effective tax rates to between 15.5 percent and 22.6 percent. The reform package will also reduce the disparity among the various sectors in the percent of income that is taxable. Finally, tax reform will smooth out tax treatment of different capital investments strategies. [redacted]

Shifting the Tax Burden. Our analysis of the tax bill suggests that Wilson is wrong in claiming that he is shifting a significant portion of the tax burden to corporations. Under the first stage of reform, the personal income tax share of total tax revenue drops from 65 to 63 percent by 1991, while the corporate income tax share increases just 1.6 percentage points to 17.2 percent. The personal income tax burden would drop further if, as Wilson argues, the new sales tax allows future reductions in tax rates. In our opinion, however, the likelihood that the new sales tax will exempt food and the need to reduce the budget

deficit will prevent another cut in income tax rates. Wilson is likely to find it politically expedient to reduce the deficit by maintaining tax rates rather than by other possible measures such as cutting expenditures for popular social programs or by reducing aid to farmers. [redacted]

Restoring Tax Rate Competitiveness. The new tax system, in our view, will bring personal tax rates close enough to US levels to prevent an exodus of people and investment from Canada. Although the top combined federal/provincial personal income tax rate will be about 3 percentage points higher than in even the more heavily taxed US states, this will be partially offset by the fact that many of the deductions eliminated by the United States were kept as tax credits by Ottawa. Moreover, Canadians historically have accepted higher rates to support more generous social programs. [redacted]

We believe that corporate rates also will be low enough to stem any outflow of capital caused by US tax reform. Under the new system, Canada's federal corporate tax rate will fall below the federal tax rate in the United States, but the combined federal/provincial tax rate will remain at least 2 percentage points higher than the combined federal/state rate in the bordering US states. Wilson is putting pressure on the provinces to join Ottawa in lowering tax rates, and we believe the two most heavily industrialized provinces, Ontario and Quebec, will comply. With lower provincial rates and the slightly more generous deductions maintained by Ottawa, Canadian companies probably will enjoy a slight advantage over those in the United States. The preferential tax rates granted to small businesses and manufacturers will allow these companies a substantial tax advantage over their US competitors. [redacted]

Improving Revenue Estimates. The new tax package will enhance the government's ability to accurately estimate tax revenues. Lower rates will discourage tax evasion and delinquent payments, while fewer deductions and stronger antiavoidance measures will broaden the tax base and reduce the variability in tax collections. The sales tax, after it comes into effect,

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Table 1
Budget Deficits Under the Tory Government

	84/85	85/86	86/87	87/88 ^a	88/89 ^b	89/90 ^b	90/91 ^b	91/92 ^b
Deficit (<i>billion US \$</i>)	28.7	25.8	23.3	22.0	21.7	21.5	19.6	17.6
Deficit (<i>percent of GDP</i>)	8.5	7.1	6.1	5.4	5.0	4.7	4.0	3.4

^a Estimate.

^b Projections included in tax reform white paper.

also will provide Ottawa with greater potential to raise revenues. Although Wilson insists the initial reform package will be revenue neutral, the government could raise much revenue with only small hikes in the sales tax, and it may be difficult for future governments to resist this lucrative source of funds as they struggle to reduce the budget deficit. [redacted]

Negative Impact on Deficit Reduction

We believe the prospects for continued deficit reduction will worsen as the government moves to change the tax system. The Mulroney government has reduced the federal deficit by an average \$2.7 billion per year since taking office in 1984, but Wilson himself estimates that the average annual decrease in the budget deficit will slow to \$1.1 billion after the reform is implemented (see table 1). We believe, moreover, that much of this improvement will be illusory. Wilson manages to keep next year's target at \$22.0 billion only through extensive cash flow maneuvering, such as accelerating the collection of some taxes from corporations. In addition, although lower personal income tax rates take effect in January, the government will continue withholding taxes at the higher, old rate until July, thus taking in \$1.4 billion in additional revenues in 1987/88. These withheld revenues must then be refunded to the taxpayer the following spring, thereby preventing any large decline in the deficit in 1988/89. The key to further deficit reduction, therefore, is the new sales tax, but delays in its introduction and the likely exemption of food will almost certainly erode the ability of the government to meet its deficit targets in the next decade. [redacted]

Although the Tories have won credit for their past fiscal performance, the likelihood that Ottawa will further delay or back away from the sales tax threatens to undermine this hard-won reputation for fiscal responsibility. Important representatives of the business community have expressed concern, for example, that the pace of deficit reduction is too slow and that Ottawa is making overly optimistic assumptions about growth, interest rates, and inflation in forecasting its deficit targets. Slower deficit reduction, in our view, will discourage private-sector investment by eroding investor confidence in Ottawa's management of the economy. A high deficit—and more particularly the need to finance the growing public debt—also reduces the government's ability to shift spending priorities in response to changing economic conditions. Furthermore, the Canadian dollar's strength earlier this year derived largely from the fact that Canada reduced its budget deficit as a proportion of GDP more than the United States. Less fiscal restraint would renew downward pressure on the Canadian dollar. [redacted]

Meager Economic Benefits

Ottawa is selling its tax reform proposal as a means of enhancing growth, but the overall package as it is likely to be implemented probably is not far reaching enough to give more than a modest boost to the economy. The effects will almost certainly be mixed. Initial changes to the income tax system—particularly the reduced investment incentives—are likely to slow slightly the real level of economic activity. The

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boost to growth from the first stage of reforms will come through the less tangible mechanisms of labor supply responses and the increase in the quality of the capital stock. The later replacement of the manufacturers' sales tax with a more broadly based national sales tax, however, probably will create a small upturn by removing many distortions that now influence consumer and corporate decisionmaking. [redacted]

Growth Prospects. The initial changes in the personal and corporate income tax systems will have some positive implications for growth. For example, lower personal tax rates will increase net take-home pay, putting \$8.3 billion back in consumers' pockets over the next five years; this in turn is expected to increase both consumer spending and savings. Moreover, consumer spending should increase further in 1989 when tax payers receive large refunds as a result of Ottawa's budgetary cash flow manipulations. Improvement in economic efficiency resulting from removing distortions from the corporate tax system will also enhance growth, especially over the longer term. In particular, the variability of tax burdens across industries and capital assets will be reduced (see appendix). After reform, we believe businesses will gradually base their decisions more on economic fundamentals and less on tax considerations, thus improving the quality of capital stock. [redacted]

We believe, however, that other aspects of the first-stage reforms will negate these potential benefits, and the tax package will cause a slight decline in the real level of activity over the next few years. Although corporate tax rates will be lower, the average Canadian company probably will pay more tax because of the reduction in writeoffs. In addition, the higher tax bill is likely to have a dampening effect on business investment largely because we expect that by 1991 the tax reform measures will chop \$2.5 billion annually from corporate profits. Moreover, higher interest rates resulting from a slowdown in deficit reduction would further discourage investment activity. Businesses undoubtedly will try to shift some of their higher tax burden to consumers through higher prices, which would reduce the overall benefits of the anticipated increase in take-home pay. The temporary hikes in the present manufacturers' tax also cancel out much of the increase in take-home pay. [redacted]

The prognosis for growth will improve somewhat if the new sales tax is implemented, because consumer and corporate choices will be much more efficient. The present manufacturers' sales tax, applied at varying rates to a limited number of goods, is riddled with illogical exemptions that distort relative prices. By removing these distortions, the new sales tax would reduce the costs of capital investment, strengthen Canada's competitive position, and provide additional flexibility to fight the budget deficit. [redacted]

Employment. We believe the expected increase in consumer spending resulting after the implementation of the first stage of the tax package will boost demand and encourage companies to hire more workers, leading to an additional drop in the unemployment rate of between 0.1 and 0.2 percent by 1991. Much of the expansion will come because labor-intensive industries will benefit most from tax reform; Wilson plans to eliminate several tax exemptions that bias the system in favor of capital investment. In addition, the Mulroney government hopes that higher take-home pay will be an added incentive to work. In our judgment, however, the higher pay is unlikely to make much difference to many of Canada's unemployed—now about 9 percent of the population—many of whom live in outlying regions with structural employment problems and who also enjoy substantial unemployment benefits. [redacted]

Effects on Trade. The first stage of tax reform is likely to cause a moderate deterioration in Canada's trade balance. Increased consumer spending is likely to boost imports, although this will be partially offset by a decline in demand for investment-related imports. We expect a modest decline in Canada's export competitiveness. Canada already suffers from low labor productivity compared to many of its major trading partners, and faces higher capital costs, both of which are likely to be exacerbated by the reduction of depreciation allowances and removal of investment deductions in the tax reform package. [redacted]

We believe the eventual implementation of the new sales tax would more than counteract this negative effect on the trade balance. Countries that rely heavily on indirect taxes such as a sales tax enjoy a trading advantage because the GATT allows indirect taxes to

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be deducted from an exported good's value, while disallowing a similar adjustment for direct taxes. More important, when the sales tax is introduced, an existing bias against domestically produced goods will be eliminated. The manufacturers' sales tax currently taxes Canadian-made goods at a rate one-third higher than imports. The temporary changes to the manufacturers' tax that switch the collection point of the tax from the manufacturer to the wholesaler will help reduce this discrepancy somewhat, but the full benefits will not be felt until the VAT is adopted and businesses are no longer taxed on their inputs to production. Canada's international competitiveness will be improved by the removal of the cascading effects of the present tax system. [redacted]

Inflation Prospects. Despite these advantages, however, we believe that the reform package will increase the price level. The interim increase in the manufacturers' tax and attempts by business to shift their higher tax burden to the consumer through higher prices will cause a one-time rise in the consumer price index of about 0.5 percentage points in 1988. An even greater rise will result from the new sales tax. In our view, the resulting expansion of the tax base will greatly outweigh the lowering of the overall sales tax rate, and this will create a strong upward pressure on prices. Technical factors also will reinforce this trend; the Consumer Price Index, as calculated in Canada, is weighted toward services, which will be taxed much more heavily. Overall, we expect that the rise in consumer prices will be between 1.5 and 2.0 percent—large enough to boost wage demands despite the higher take-home pay provided by the cut in income tax rates, and this will add further to inflationary pressures. [redacted]

Political Impact

The Tories hope to use tax reform—along with the new constitutional accord and the free trade agreement—to increase their standings in the polls. The tax package is clearly designed to boost Tory support in the next election, but it falls far short of the sweeping reforms that a more politically popular and less fumbling government might have implemented. The government's political design can be seen in the benefits it provides for key interest groups, particularly the lower taxes for most Canadians and postponement of new taxes until after the election. Lowering

income tax rates in January, but postponing the reduced withholding taxes until July, also gives the Tories more options in timing the election. An election could be held in the fall of 1988, after paychecks begin to show the benefits of lower taxes, or in the late spring of 1989 after most voters have received their large refunds. In our opinion, however, voters' memories probably will not be so short, nor their outlook so shortsighted, as to completely dismiss the prospect of higher sales taxes after an election. [redacted]

Mulroney's efforts to revive his diminished political support will backfire if tax reform is not handled carefully. Tax reform is a very touchy issue in Canada; in the 1960s and again in 1981 Ottawa was forced to back away from proposed reforms because of public dissatisfaction. We believe the government will persevere with the bulk of this package, although it will accept some of the Finance Committee's recommendations to demonstrate some flexibility to the public. Lower income tax rates, however, probably will not alter the perception of many voters that the Tories tend to favor the rich. Although Wilson is one of the few well-respected Conservative Cabinet ministers, he will probably be undermined by the fact that hefty tax hikes in previous budgets have largely hit the lower and middle classes. Memory of this has made voters skeptical of promises that most Canadians will pay less tax once both stages of the reform are complete. The opposition parties will almost certainly try to focus the debate on the Tories' overall tax record, arguing that the tax reform package does not negate past Tory tax hikes and that the average Canadian is not as well off as when the Conservatives took office in 1984. In the face of such arguments, we doubt that the Tories will achieve enough of a popular success to alter significantly their reelection prospects, and any political benefits from tax reform probably would be overshadowed by the contentious debate over the recently signed free trade agreement with the United States. [redacted]

Implications for the United States

Although the Canadian tax package is similar to US reforms introduced last year, some aspects of the proposal have the potential to increase friction between the two countries. Wilson probably has sufficiently narrowed the gap between US and Canadian

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tax rates to stem any outflow of investment set off by US reform last year, but some multinational firms are likely to continue to adjust their investments as a result of changes in the tax code. Bilateral disputes would probably arise if Ottawa applied the stricter antiavoidance measures included in the tax package to US firms that it believed had chosen particular investment plans solely to avoid taxes. In particular, the new measures greatly enhance the federal government's ability to declare business activities—including cross-border activities such as transfer pricing—to be tax avoidance. [redacted]

The likelihood of a continued high Canadian budget deficit resulting from the tax changes would also increase bilateral tensions in several ways:

- It would lead to higher interest rates and raise questions about Canada's economic soundness, which, in turn, probably would create downward pressure on the Canadian dollar. [redacted]

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[redacted]

- It would inhibit the government's ability to use fiscal policy to stimulate economic growth or encourage development of key sectors. In such circumstances in the past, Ottawa has often lashed out at the United States, blaming the dominating economy of its southern neighbor for Canada's economic ills and taking out its frustrations by becoming more nationalistic in trade and investment dealings.
- It would call into question Ottawa's ability to fund planned increases in defense spending. [redacted]

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Another potential irritant might arise from Ottawa's discussions with the provinces on the national sales tax this fall. Although it is unlikely that the provinces would hold a free trade agreement with the US hostage to concessions from Ottawa on the sales tax, heightened federal-provincial bickering over the form of the new sales tax could create resentments that would undermine federal-provincial cooperation on the implementing legislation needed for the free trade agreement. Regional tensions are already rising because of the trade accord, and Ottawa will have to tread lightly so as not to exacerbate the problem with the new sales tax. [redacted]

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Appendix

Canada's Winners and Losers:
Impact of Tax Reform on
Various Sectors of the EconomyTable A-1
Average Effective Tax Rates

	Before Reform		After Reform	
	Average Tax Rate	Percent of Income Taxed	Average Tax Rate	Percent of Income Taxed
Agriculture, forestry, and fishing	16.9	91.3	15.5	94.5
Mining	15.0	49.8	16.6	63.9
Oil and gas	21.4	67.9	20.3	75.4
Manufacturing	18.9	77.1	19.7	89.1
Construction	20.1	96.1	18.8	102.4
Wholesale trade	24.5	94.7	22.6	101.0
Retail trade	21.2	98.9	19.5	103.8
Financial institutions, insurance, real estate	14.5	48.7	21.3	74.0
Services	20.4	94.1	18.9	98.8
Total, all industries	18.7	72.4	19.6	84.1

This table, based on information released with Wilson's tax proposals, provides data on the average effective tax rates applied to various sectors of the economy both before and after the proposed changes to the corporate income tax system. This data illustrates how the proposed changes will narrow the disparity among effective tax rates in the different sectors. The data also allows us to assess the impact of tax reform on different industries to determine which will benefit from the reform proposals and which are subject to less favorable tax treatment after reform.

Ottawa proposes to reduce the variability of tax rates among sectors of the economy by removing deductions, exemptions, and incentives that caused the widely varying rates. Under reform, the average effective federal corporate tax rate will rise by about 1 percentage point to 19.6 percent, but several sectors

that have escaped taxation in the past will see their effective rates rise by much more than the average. There undoubtedly will be shifts in investment resulting from the new tax rules, but we do not anticipate massive disinvestments from those industries hardest hit. The service sector, for example, anticipated measures requiring it to bear more of the tax burden, and reportedly is relieved that the reform package is not as bad as was feared.

Winners under reform will be mainly those sectors that presently cannot take advantage of exemptions. They range from the *agriculture, forestry, and fisheries* sectors, who already enjoy the lowest effective tax rates, and *retail* and *wholesale traders*, who are among the most highly taxed. Because most of the income of these industries is already taxable, they

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benefit most from the lower overall rates. Other winners are industries where deductions and incentives have been retained. Although the *oil and gas* industry loses some of its preferential treatment for flow-through shares, it retains resource allowances and deductions for exploration, research, and development. Since the cut in tax rates more than makes up for the loss of deductions, the effective tax rate for the industry will drop slightly. The tax package also favors labor-intensive industries.

The biggest *losers* are companies in the *financial services* sector, which currently are subject to the lowest effective tax rates. Most of the deductions eliminated under the reform applied to financial services. The reform package clamps down, for example, on tax-free dividends on preferred shares and the way *banks* treat loan-loss expenses, thus greatly increasing the taxable income of financial institutions.

Insurance and *real estate* companies also face sharply reduced deductions. Although the *mining* industry retains much of its preferential treatment, this will be offset by cutting the earned depletion allowance to 100 percent rather than 130 percent of the amount actually spent on exploration and development. The average tax rate on *manufacturing* probably will rise slightly because of the proposed limitations on depreciation allowances. Nonetheless, manufacturers will still enjoy a preferential tax rate, and will benefit more when the sales tax is expanded to other sectors of the economy: not only will their goods be taxed at a lower rate, but they will also no longer be the only industry subject to the tax.

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