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McGovernism in Canada

Reform

The Red Queen may well have been describing the plight of North American tax reformers when she said to Alice, "Now here, you see, it takes all the running you can do to keep in the same place. If you want to get somewhere else, you must run at least twice as fast as that." Nevertheless, George McGovern, the U.S. democratic presidential nominee, has leaped onto the treadmill of tax reform. The noise emanating from this device accompanied by the jeers and applause of the spectators also awakened David Lewis to the possibilities of tax reform as an issue in the forthcoming election. Consequently, Mr. Lewis is trying to mobilize public opinion by substituting a populist appeal for the low-key reasonableness of the Carter Commission.

The primary point raised by Senator McGovern, and echoed by Mr. Lewis, is that corporations must be taxed more heavily and bear their fair share of the tax load. However, the style of these two political leaders is poles apart. Senator McGovern is trying to reassure the American electorate that he is not really a radical, whereas Mr. Lewis is following the old populist slogan, "raise less corn and more hell". The difference can be better understood by looking at two quotations in which the two men say the same thing. Mr. Lewis asserts, "We are witnesses in Canada to the growth of a new kind of welfare rip off ... corporations that siphon hundreds of millions of dollars each year from the public trough while they pay a declining share of the income tax needed to finance Government services." In contrast, Senator McGovern suggests, "The time has come to end the dismantling of the corporation income tax and to re-establish a fair balance between personal and corporate income tax collections." Senator McGovern's ire is reserved for the cruel and wasteful war in Vietnam, while his economic policy is the handiwork of the cream of the American economics profession, men who would have felt very much at home working with some of their students on the Carter Commission Report. In Canada, however, it is not the NDP but, rather, the Liberals who have adopted the style of Senator McGovern. The Liberals may think that they have the Canadian patent on Senator McGovern's charisma and cool rationality. On the other hand, tax reform is a matter of substance and not of style.

The decline in the corporations' share of the tax burden has been a North American phenomenon. One of the main reasons for the fall has been the reduction in the effective rate of tax on corporate profits caused primarily by an erosion of the tax base.[1] The Financial Post, Canada's corporate Pravda, has lashed out at Mr. Lewis and presented an impressive, but irrelevant, panoply of figures in an attempt to cover up this important fact.[2] The best way to see what is happening to the tax burden on corporations is to look at the effective tax rate. This rate in the U.S. went from 41 per cent in 1951 after the Truman tax bill to 25 per cent in the first quarter of 1972 following President Nixon's latest tax concessions. In Canada, the effective tax rate dropped from 88 per cent in 1951 to 25 per cent in 1969, and the evidence indicates that the Trudeau Government's May benefactions combined with other post 1969 developments will lop off another 7 per cent. Canada's corporate Santa Claus is not to be outdone by his southern cousin. Meanwhile, the effective personal income tax rate in the U.S. remained stable at around 10 per cent of personal income, and, in Canada, it went from 8 per cent in 1951 to 16 per cent in 1971 (or 18 per cent if the Canada Pension Plan and Quebec Pension Plan are treated as an income tax). These summary figures support Senator McGovern and Mr. Lewis when they recommend corporate pockets as the source of funds for new programs (to paraphrase Mr. Lewis). Thus, no one can say that Mr. Lewis has imported an election issue that is on target in the U.S. but misguided in Canada. Senator McGovern originally thought that an additional $17 billion could be expected from corporations, but he has since retreated to $13 billion. He wants to return to the "level of special considerations that corporations had in the last year of the Eisenhower Administration" without returning to the 52 per cent rate. That means an effective rate of around 30 per cent. In recognition of greater inequity in the share of the tax load borne respectively by corporations and individuals in Canada, Mr. Lewis would raise $2 billion more from corporations, and $2 billion less from individuals. After an increase of this magnitude, the effective rate of tax on corporate profits would be 32 per cent. This would be roughly comparable with the American rate under a McGovern administration.

The sorties by Senator McGovern and Mr. Lewis against corporate treasuries are not exactly in the tradition of their spiritual predecessors, the Carter Commission. This may come as a surprise to those members of the public that believed the corporate propagandists when they stated that "equity" and "neutrality" were merely "confiscation" in its various disguises. One of the Carter Commission's most unorthodox recommendations was that the corporation and personal income taxes should be integrated. Under such a scheme, corporation income tax would be treated as a prepayment of the individual shareholder's income tax. In fact, this means that the corporation income tax would be abolished. It is perplexing to see tax reformers with good intentions, such as Senator McGovern and Mr. Lewis on the one hand, and the Carter Commission on the other, arrive at such widely differing conclusions, and it brings to mind an old quotation about the road to hell. Some economists believe that in the long run all of any taxes on corporations are paid by consumers in higher prices, or workers in higher wages, and others think that the owners of the corporation must absorb all or part of the tax. According to the first group, the corporate income tax has the same effect as the regressive sales tax. Whereas, the second would argue that it is equivalent to a progressive tax on income from property. The Carter Commission hedged its bet on the best way to make the tax system more progressive. That is why it accompanied its call for abolition of the corporation income tax with a call for a more progressive individual income tax. It may appear that a position on the issue of corporation tax reform requires a Kierkegaardian "1eap of faith". However, since the Carter Commission was principally concerned with developing a permanent tax system for Canada it tended to neglect the importance of the transition period between the old tax system and what was to be the new. In this period, which economists persist in calling "short run" even though it may be as long as five years, the tax is definitely paid by the owners of corporate capital in lower after tax profits. Thus, during the transition period before the tax can be shifted on to the backs of consumers or workers, any increase in the corporation income tax is a progressive tax on income from property. Consequently, an increase in the corporation income tax coupled with a reduction in income tax for low income earners, such as Mr. Lewis proposes, would in the interim promote a more equal distribution of income. Any long run burden of the tax on income is an extra dividend.

Deform

Just as Senator McGovern inspired Mr. Lewis to climb aboard the treadmill of tax reform, President Nixon prodded Prime Minister Trudeau to turn up the speed. On August 15, 1971, President Nixon rocked the foundations of the international economic order with his New Economic Policy. An intricate part of the New Economic Policy is tax deform (a neologism for the opposite of tax reform). Ta.x deform is generally reluctant to appear naked on the political stage, so President Nixon kindly clothed her in the garb of expansionary fiscal policy. Consequently, North America was presented with a 7 per cent investment tax credit, and the "asset depreciation range" which allows 20 per cent depreciation. Prior to August, the Domestic International Sales Corporation (henceforth called DISC) had been introduced to expand exports by reducing the tax on income from exporting. All of these measures share one common feature -- they shrink the corporation tax base. Prime Minister Trudeau's contribution to tax deform was in response to the Nixon gambit. The May 8 budget decreased the corporation rate on manufacturing and processing to 40 per cent from 49 per cent commencing January 1, 1973. The figure 40 per cent is the minimum possible corporation tax rate for Canada. The prime beneficiary of further largess would be the American Treasury. For the time being, corporations will have to content themselves with the 46.7 per cent rate provided for in the October 1971 mini-budget with its 7 per cent temporary corporation tax reduction. In addition, business will be able to write off machinery and equipment used in manufacturing and processing over two years at a 50 per cent rate, and the two year write-off for pollution equipment was extended. Accelerated depreciation has been a prime component of both tax deform programs, and its part in the erosion of the corporate tax base should not be underestimated. Instantaneous depreciation diminishes the effective tax rate on income from new investment to zero, and for an asset with a ten year life, a two year write-off reduces the effective tax rate on net income by much more than one half.

The May budget is justified by the Government as a stimulus to the economy, and as a protective response to the U.S. measures. A study published in July by the two B.C. economists, John Helliwell and John Lester, verifies the expansionary effect of the budget; the combined effect of both the U.S. and Canadian measures will increase employment by 18,000 in Canada, or reduce unemployment by 0.2 per cent,[3] this expansion being induced by increased investment. However, the increase in investment is roughly equal to the initial tax decrease. Consequently, such a scheme does not provide a very efficient stimulus. Much less revenue would be lost through a marginal investment tax credit such as Senator McGovern proposed in the U.S.[4] On these grounds alone this novel alternative is preferable. G. V. Jump and T. A. Wilson argue in a recent article that the Government should consider a 50 per cent cut in the federal sales tax or a 10 per cent cut in the personal income tax if the objective is to stimulate the economy.[5] The first measure is the most potent. It reduces unemployment by 0.6 per oent, and, as a bonus, brings down the consumer price index by 1.6 per cent. Thus, this measure would combat both inflation and unemployment. Further, it involves the reduction of a regressive tax; hence, individuals with lower incomes would benefit more than those with higher. If the Government intends to get the economy moving again, a marginal investment tax credit or a sales· tax reduction is appropriate - not a reduction in corporation taxes.

The other objective of the May budget was to counter the effect of the U.S. moves on the Canadian balance of trade. The most discussed threat to the Canadian balance of payments is the DISC. Any American exporter can set up a DISC, and he can channel up to half of his export profits through the DISC. On the half of his profits that are allocated to the DISC, he can defer corporation profits tax. As a result, the actual statutory rate of tax on export earnings could be reduced to 87.5 per cent if the normal rate was 50 per cent. However, American businessmen are finding DISC'S cumbersome vehicles of tax avoidance in contrast to other less complex loopholes such as the Western Hemisphere Trade Corporation. Mr. Helliwell and Mr. Lester have simulated the effects of DISC alone, and they conclude that DISC will increase imports into Canada by between $20 and $55 million per quarter, and will, at the very maximum, raise the unemployment rate 0.1 per cent. Shocks to the economy of this magnitude are not sufficient excuses for tax deform.

The proper reaction to a sophisticated tax deform export subsidy is the threat of a similar subsidy - not the slashing of corporation tax rates. When theU.S. in 1968 was toying with the idea of a 2 per cent import tax and a 2 per cent export subsidy, then Finance Minister Mitchell Sharp stood firm and indicated that Canada would respond in kind. The plan was dropped. The Canadian Government should take a similar stand against any new improved form of DISC that the U.S. Treasury is reportedly trying to concoct. Of course, a country as dependent on foreign trade as Canada is the loser in any trade war. But a hard bargaining position should be the first line of defence for Canadian interests in the free flow of goods. If this line is broached, then there is always the floating exchange rate to fall back on.

The May budget is, thus, a clumsy and ham-handed way to achieve theGovernment's twin objectives of stimulating the economy and compensating for the U.S. tax deform. Moreover, there are other important objectives which the May budget ignores. Such an aim is maximizing the benefits going to Canada from foreign investment. The Watkins Report has said that one of the most important benefits from foreign investment is the share in the earnings that the Canadian Government collects for the people of Canada through the tax system. Certainly, the way to maximize the benefits accruing to Canada is not to reduce the Canadian share of the earnings. Corporation tax relief is bound to minimize the benefits from foreign investment. Public opinion in Canada being what it is, this is only recognized when the prefix American is added to the epithet "corporate welfare bums". The Government's proposed bill to screen foreign takeovers does little to increase Canadian benefits from foreign investment in comparison with the loss from the corporation tax reduction.

Economists may not be agreed on who actually pays the corporation income tax in the long run. Nevertheless, they are, as a group, agreed on one thing; namely that reducing the corporation tax rate on income from existing capital assets will not lower prices to consumers. Prices to consumers can be lowered by taxing new capital at lower rates than old, or by investment tax credits; these measures are supply expanding in contrast to a reduction in the rate on income from old capital which just provides a windfall gain to the owners of a capital. An overall corporation tax reduction only benefits consumers because it is partly a reduction in taxes on new capital. The size of this windfall gain can be measured by the increase in the market value of corporate capital. In so far as this capital is foreign owned, external indebtedness is inflated.

Reform Again

The foregoing case study of the New Economic Policy and the May budget documents the assertion that American corporation tax deform has begotten its counterpart in Canada. Now is the time to consider whether American corporation tax reform can facilitate Canadian.

Senator McGovern has taken a strong stand against the concessions on his side of the border. His program to restore the corporation tax base includes the abolition of DISC and the accelerated depreciation gimmicks. With the current high unemployment in the U.S., he was understandably reluctant to suggest the abolition of the 7 per cent investment tax credit, but he would prefer that it be transformed into a marginal tax credit Therefore, Senator McGovern's program includes the scrapping of the major u.s. concessions that have contributed to the recent Canadian tax deform.

An additional matter of some importance to Canadians is Senator McGovern's stand against the favourite tax dodge of the extractive industries, percentage depletion. If he was elected and was able to do away with this venerable North American institution, it would be absolutely necessary for the Canadian Government to follow suit. Otherwise, the tax concessions to the mining and petroleum industries in Canada, that supplied Mr. Lewis with his most striking examples of "corporate welfare bums", would be compounded by the lower levels 6f output of these industries in the U.S. following the withdrawal of capital in search of higher after tax profits elsewhere. Lower levels of U.S. output would mean that demand for Canadian resources would be greater, and the extractive sector of the Canadian economy would become even more disproportionately large than it already is. Tougher tax treatment would be required to offset the distortion in profit incentives and to restore balance to the economy.

Although the implementation of Senator McGovern's proposals would strengthen the case for corporation tax reform in Canada, there is no need to wait for the U.S. to lead off. Thus, Mr. Lewis deserves a rousing cheer for his recommendation that the Government start redressing the imbalance in tax burdens by withdrawing the gratuities in the October 1971 and May 1972 budgets. By his calculations, that would yield $675 million. This would be an excellent beginning for corporation tax reform, and it surely does not require running "twice as fast as that".

FOOTNOTES

[1] The effective rate of tax is obtained by dividing corporate income taxes by the sum of corporate profits before tax and capital consumption allowances. Capital consumption allowances are included in the base, even though in theory the repayment of capital should not be subject to an income tax, because many of the concessions to the corporate sector involve increased capital consumption allowances. The relevant statistical sources are System of National Accounts - National Income and Expenditure Accounts and Corporate Taxation Statistics or their antecedents published by Statistics Canada. The American figures are updated versions of those in Joseph Pechman, Federal Tax Policy (New York: W. Norton and Co., 1971), p. 118.

[2] "Plain Words on Jobs, Taxes - and the Lewis Hoax", Financial Post, August 26, 1972, p. l.

[3] John Helliwell and John Lester, "Reviewing the Latest DISC: Simulation of its Aggregate Impacts on Canada", Canadian Tax Journal, July - August, 1972.

[4] A marginal tax credit is only payable on investment over some previously specified level; so businessmen are only subsidized to the extent that investment exceeds some target. Consequently, it stimulates as much investment, but costs less than its non-marginal kin.

[5] G. V. Jump and T. A. Wilson. "Tax Policy Options for Increasing Employment Without Inflation", Canadian Tax Journal, March-April, 1972.