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The Impact of U.S. Consumption Tax Reform on Canada

*Arthur Cockfield**

I. Introduction.

The economies and capital markets of Canada and the United States have been closely entwined for many decades. Economic integration has been furthered by the passage of the North American Free Trade Agreement¹ ("NAFTA") which decreased barriers to trade and investment among Canada, the United States and Mexico (the "Member States"). As a result of these close ties, significant tax reform changes in the United States are likely to have spill-over effects on a relatively smaller trade partner like Canada. And yet, NAFTA has little to say on the issue of taxation - the Member States are generally permitted to develop and maintain any tax policy that they wish.²

This desire to preserve sovereign control over tax policy is understandable: each Member State uses its tax system to promote a variety of domestic economic and social policies.³ Still, the preservation of Canadian and Mexican tax sovereignty will be challenged if the United States enacts radical tax reform that replaces the income tax system with a consumption-based tax system like the flat tax or a national sales tax.⁴ Republicans

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1. North American Free Trade Agreement, *opened for signature* Dec. 8, 1992, U.S. - Can. - Mex., 32 I.L.M. 605 [hereinafter NAFTA].
 2. NAFTA generally leaves cross-border tax coordination up to the bilateral tax treaties negotiated among the Member States and indicates that "[n]othing in [NAFTA] shall affect the rights and obligations of any... [of the Member States] under any tax convention" and that the tax treaty provision will prevail in the event of any inconsistency between a NAFTA provision and a tax treaty provision. See NAFTA, *supra* note 1, art. 2103(2), 32 I.L.M. at 700. See Income Tax Convention, Sept. 26, 1980, U.S.-Can., Tax Treaties (CCH) [hereinafter U.S.-Canada Treaty].
 3. For a discussion of the economic/political debate surrounding cross-border taxation in North America, see Arthur Cockfield, *Tax Integration Under NAFTA: Resolving the Conflict Between Economic and Sovereignty Concerns*, 34 STAN. J. INT'L L. (forthcoming Winter 1998).
 4. Under this latter system, the consumption of goods and services is taxed, while savings and investment remain untaxed in many circumstances. See *infra* text accompanying notes 8 - 11.
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plan to re-introduce this type of reform in the debate surrounding the 1998 Congressional election as well as the 2000 Presidential race.⁵

This article argues that United States consumption-based tax reform would likely have an adverse impact on the Canadian economy by encouraging capital outflows since it would lower the cost of new investments in the United States. Further, the reform would provide incentives for multinational firms with operations in Canada to shift profits to the United States which would reduce Canadian tax revenues. Canada would thus have to react to ensure that its tax revenues and investment base are protected from the changes. The political cost would be steep, however, if Canada was forced to initiate tax reform that its citizens would otherwise oppose in order to counter the United States tax measures.⁶

The article is organized as follows. Part II reviews the United States consumption tax proposals as well as their likely impact on the cost of capital for domestic U.S. investments. Part III discusses the potential spill-over effects that the proposals would have on investment and financial behavior in Canada and elsewhere. Part IV offers a brief discussion on how Canada could react if one of the tax reform proposals is implemented. The analysis concludes that the Canadian government would have to take steps to protect its tax base and may have to initiate its own version of consumption-based tax reform.

II. Consumption-Based Tax Reform in the United States.

A. BACKGROUND.

Appendix A sets out the main sources for federal tax revenues in Canada and the United States and shows that the corporate and personal income tax systems of the two countries raise remarkably similar revenues from their federal income tax systems. Canada raises fifty-seven percent of its federal tax revenues from federal corporate and personal income taxes while the United States raises fifty-six percent from these same taxes.⁷

The United States tax reform proposals under scrutiny here place a much greater emphasis on taxing consumption instead of income in comparison to the tax system that

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5. See Mike McNamee, *Now That We've Made Taxes More Complex, Let's Simplify Them*, BUS. WK. SEPT. 1, 1997, at 45 (Beginning in September 1997, the Senate Finance Committee conducted hearings which blasted IRS abuses. It is thought that IRS bashing will provide momentum for consumption tax reform). See also James Carney, *We'll Get Killed on This*, TIME, Oct. 27, 1997, at 46 (describing the "Scrap the Code Tour" by Republican Majority Leader Dick Armey (supporter of flat tax) and Representative Bill Tauzin (supporter of national sales tax) to promote their consumption-based tax proposals).
 6. Canada not only uses different tax policy in comparison to the United States, in many cases, but raises significantly more tax revenues in order to support greater levels of government services. For example, in 1993, total government expenditures as a percentage of gross domestic product were 51.1% in Canada but only 38.6% in the United States. See Richard M. Bird, *Commentary: A View from the North*, 49 TAX L. REV. 745, 745 n.2 (1994).
 7. Canada already has a federal level consumption tax called the Goods and Services Tax, which brings in about 13% of federal revenues. See Appendix A.
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currently exists.⁸ The proposals discussed below would change the current United States system since the proposals try to achieve similar objectives: the proposals would generally exclude from taxation amounts that are saved or invested (what is left has been consumed). In other words, the proposals emphasize taxing people on what they take out of society (measured in part by what they consume) and less on what they contribute to society (measured in part by their income).⁹

The principles behind consumption taxes has been around for some time in both Canada and the United States. In 1966, the Royal Commission on Taxation (known as the Carter Commission) in Canada discussed the principle of moving toward the taxation of consumption.¹⁰ Other government reports in Canada, the United States, and elsewhere have suggested that tax burdens should be shifted from income to consumption.¹¹

A recent Republican sponsored report (known as the Kemp Commission's Report on Tax Reform) recommended that the current Internal Revenue Code be repealed and replaced with a single low rate consumption-based tax.¹² Of interest, the editorial board of *The Wall Street Journal* came out in support of flat taxes¹³ while the editors of Canada's national newspaper took a position against flat taxes.¹⁴ The debate surrounding consumption-based

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8. See, e.g., WILLIAM A. KLEIN & JOSEPH BANKMAN, *FEDERAL INCOME TAXATION* 76 (10th ed. 1994) (income tax policy in the United States and Canada currently follows the the Haig-Simons definition of income, which includes the market value of goods and services consumed, the market value of goods and services that were given to another, and the change in the market value of the total net assets).
 9. An analysis of the merits of consumption-based tax reform is beyond the scope of this article. These merits have been given considerable attention in the United States in recent years. See, e.g., MICHAEL BOSKIN, *AN ECONOMIST'S EVALUATION OF THE POLITICAL DISCOURSE ON FUNDAMENTAL TAX REFORM PROPOSALS* (CEPR Pub. No. 446, 1996). Consumption tax proponents argue that this form of taxation is superior to others since it encourages savings and investment, is less distortionary, and assists in export strategy. Critics suggest that the tax is regressive, will reduce tax revenues and claim that the taxes would not reduce tax complexity. See, e.g., Alvin Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?*, 89 *YALE L.J.* 1081 (1980); see also John S. Nolan, *The Merits of an Income Tax Versus a Consumption Tax*, 12 *AMER. J. TAX POL'Y* 207 (1995).
 10. ROYAL COMMISSION ON TAXATION, REPORT (1967).
 11. See Robert Brown, *The Competitive Edge: The Impact of Taxes on a North American Free Trade Area*, 12 *CAN.-U.S. L.J.* 299, 301 (1987) (The Meade Commission Report in the United Kingdom in 1978, the U.S. Treasury Department's Blueprint for Tax Reform in 1977, and the MacDonald Commission Report in Canada in 1985 all advocated, in various ways, that tax burdens should be shifted from income to consumption).
 12. See The National Commission on Economic Growth and Tax Reform, *Unleashing America's Potential: A Pro-Growth, Pro-Family Tax System for the 21st Century*, 70 *TAX NOTES* 413, 416 (1996) [hereinafter Kemp Commission].
 13. See *The Flat Tax: Why Not?*, *WALL ST. J.*, Jan. 30, 1996, at A14 (concluding that a flat tax would encourage savings and investment and could encourage progressivity through exemptions at the household level).
 14. See *Flat Tax, Flat Earth (I)*, *GLOBE & MAIL*, Feb. 2, 1996, at A12; *Flat Tax, Flat Earth (II)*, *GLOBE & MAIL*, Feb. 3, 1996, at D6 (concluding that the flat tax would be revenue losing, would close incentives that serve a useful social purpose, and would not be progressive).
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tax reform in the United States has been driven by domestic concerns thus far with little attention being paid to potential international implications of such reform.¹⁵

B. THE CONSUMPTION-BASED TAX PROPOSALS.

This section presents a brief overview of three of the more prominent consumption-based tax reform proposals in the United States and touches on the international aspects of each proposal.

1. National Sales Tax.

Senator Richard Lugar and the House of Representatives Ways and Means Chairman Bill Archer proposed a national sales tax that would replace the current income tax system. Under this proposal, a seventeen percent tax would be imposed at the point when goods and services are purchased.¹⁶ This type of tax is a good example of taxing consumption - taxes would only apply when the end consumer purchases a good or service. Tax on savings is deferred until the savings are withdrawn to pay for consumption. The tax is similar to most value-added taxes¹⁷ since it provides a tax rebate on exports and taxes imports.^{18,19}

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15. The ability of the United States to ignore the consequences of the international implications of tax reform has been questioned. See, e.g., Lawrence H. Summers, *Taxation in a Small World*, in TAX POLICY IN THE TWENTY-FIRST CENTURY 64 (1988):

Until recently, international taxation has been an arcane subspecies among American tax lawyers, and international considerations have rarely influenced the thrust of tax reform.... Such a provincial approach to tax policy may have been appropriate in an earlier era, but the increasing economic integration of the world requires a more global approach to tax policy. The emphasis in recent American tax reform debates on competitiveness is only a precursor to a time in which international considerations will play a pervasive role in shaping tax policies.

Id.

16. See Kemp Commission, *supra* note 12, at 442 (noting that additional national sales tax proposals came from Representatives Bill Tauzin and Dan Schaefer).
17. A proposal that has received less attention involves replacing the income tax system with a Value-Added Tax ("VAT"). This approach, suggested by Representative Sam Gibbons, was to replace the corporate and personal income tax system with a VAT. See WILLIAM M. GENTRY & R. GLENN HUBBARD, DISTRIBUTIONAL IMPLICATIONS OF INTRODUCING A BROAD-BASED CONSUMPTION TAX 1 (CEPR Pub. No. 443, 1996). The United States is the last OECD country without a federal VAT.
18. A VAT differs from a national sales tax, as it taxes goods and services throughout the distribution chain instead of just at the retail level. Each time a good or service is sold to another business, the tax is paid for by the purchaser, who is then eligible for a rebate once the item is sold to the next purchaser. Under a VAT, businesses are taxed on the difference between gross revenue and input costs, including purchases of capital goods. VATs are often preferred over retail sales taxes, as there is less chance of tax evasion under the rebate system where both the vendor and the purchaser report the transaction. Ultimately, the tax is born by the consumer through higher prices. Since the consumer is ineligible for a rebate, she need not report the sale.
19. A tax system similar to the national sales tax or VAT proposals can adopt the "destination" approach (commodities are taxed on the basis of location of consumption, and therefore exports would leave the United States tax free, and imports would be subject to a compensatory tax) or the "origin" approach (commodities are taxed on the basis of their place of production or origin, therefore revenues from the tax would go to the United States).
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2. Consumed Income Tax.

Senators Sam Dunn and Pete Domenici propose a consumed income tax system called the "Unlimited Savings Allowance" ("USA") tax.²⁰ All income from labor or capital would be taxed only once on an individual's tax return. This tax would exempt savings from personal income tax in a similar manner as Registered Retirement Savings Plans in Canada or Individual Retirement Accounts in the United States.²¹ A taxpayer is allowed unlimited deductions from taxable income for all net savings. Returns resulting from the savings (e.g., interest or dividends) would only be taxed to the extent that they are not re-invested. The USA Tax would also permit deductions for mortgage interest, charitable contribution and some education costs. Progressive rates from eight percent to forty percent are applied on the remaining income.²²

There would be a separate value-added tax ("VAT") on businesses at a rate of eleven percent. Businesses and individuals would be permitted to claim tax credits to offset the employer and employee portion of federal payroll taxes. The business tax would exempt export sales and tax imports while income from foreign sources would remain untaxed.²³

3. Flat Tax.

Flat tax proposals have attracted the most attention in the United States and initially appeared to have the best chance of actually being implemented.²⁴ The most prominent flat tax proposal has been put forth by Representative Richard Armey and Senator Richard Shelby.²⁵ Under their proposal, a tax is applied at both the household and firm level. Businesses are permitted to write off immediately any new investments and are permitted deductions for labor costs, cost of inputs and pension contributions. The remainder of a business income is taxed at a flat rate at seventeen percent.²⁶

Individuals are then taxed at the same rate on their wages and pension distributions.²⁷ Under the proposal, individuals would not be able to deduct their savings but also would not be taxed on the earnings from the savings (other proposals would permit deduction

20. See Alliance USA, *USA Tax System*, 66 TAX NOTES 1482 (1995).

21. See, e.g., KLEIN & BANKMAN, *supra* note 8, at 399. Income earned by monies placed in an IRA account is not taxed as long as it accumulates. *Id.*

22. Alliance USA, *supra* note 19, at 1489.

23. *Id.* at 1496.

24. Highlights of the flat tax debate include Steve Forbes's, failed, but much publicized, attempt to win the Republican nominee position in 1996 while running on a platform for flat tax reform.

25. See RICHARD ARMEY, *THE FLAT TAX: A CITIZEN'S GUIDE* (1996). This tax is modeled on a proposal by economists Robert Hall and Alvin Rabushka. See ROBERT E. HALL & ALVIN RABUSHKA, *THE FLAT TAX* (2d ed. 1995).

26. See ARMEY, *supra* note 24, at 50. See also HALL & RABUSHKA, *supra* note 24, at 52 (indicating that a 19% rate will generate the same revenues as does the current system).

27. Although the flat tax is referred to as a single rate tax, this is technically inaccurate, as all flat tax proposals would exempt from tax household incomes up to a certain level (e.g., the Armey Shelby proposal would exempt from tax the first \$33,000 in income for a family of four). Accordingly, there are two rates: 0% for household incomes up to a certain level and another rate imposed beyond this point. The use of exemptions adds a certain amount of progressivity to the flat tax system, as the average taxes paid by a household will increase as their income levels go up.

for amounts of income placed in savings). The flat tax hence taxes income from capital investments only once at the business level.

There would not be any tax rebate for exports and imports would not be taxed as they entered the country. Further, the foreign-source income of U.S. corporations and individuals would not be taxed.

C. THE IMPACT OF CONSUMPTION-BASED TAXES ON INVESTMENT ACTIVITY.

This section discusses how the proposals will likely affect investment activity in the United States. A central feature of each proposal is a reduced tax burden on investment activity. Accordingly, most proposals seek to stimulate investment activity by reducing the tax cost of initiating and engaging in such activity.²⁸ The Kemp Commission indicated that an investment friendly tax system was necessary to promote the economic well-being of the United States.²⁹

Still, the consumption-based tax proposals would continue to tax capital in certain areas just like an income tax system. A study reviewing the tax reform proposals described previously sets out the difference in capital taxation under the proposals and the current tax system.³⁰ The analysis concludes that "the distinction between a broad-based income tax and a broad-based consumption tax is that the former taxes the portion of capital income representing opportunity cost, while the latter does not."³¹ When a saver invests in a project, he sacrifices consumption today by using his resources to invest in the project and this is the opportunity cost of capital.³²

This opportunity cost of capital equals the before-tax return on a marginal investment. At the margin, a firm will continue to acquire and hold capital until the last unit of capital earns just enough income to cover the cost of holding it.³³ Taxes on marginal investments drive up the cost of capital and firms must earn more income in order to

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28. Consumption-based tax proponents claim that the current U.S. income tax system favors current spending and discourages investment and waiting for returns since both the income out of which savings are made and the return from those savings are taxed.
 29. Kemp Commission, *supra* note 12, at 434 ("Capital is the engine of a growing economy.") In order to support this position, an economic study was cited which states that almost half of historical economic growth in the United States was attributable to capital accumulation. *Id.*
 30. See GENTRY & HUBBARD, *supra* note 17, at 3. Realized capital income is divided into four components: (1) the opportunity cost of capital (the return to waiting); (2) the expected risk premium for investing (the return to risk-taking); (3) inframarginal returns to investing ("economic profit" to economists); and, (4) a remainder return which reflects realizations of capital income differing from expectations. Under the consumption-based tax proposals, most investments are taxed on the last three components. An income tax system taxes capital in all four areas. *Id.*
 31. *Id.* at 11.
 32. See A. Lans Bovenberg, et al. *Tax Incentives and International Capital Flows: The Case of the United States and Japan*, in TAXATION IN THE GLOBAL ECONOMY 283, 288 (Assaf Razin & Joel Slemrod eds., 1990).
 33. See, e.g., Kenneth McKenzie & Jack M. Mintz, *Tax Effects on the Cost of Capital*, in CANADA-U.S. TAX COMPARISONS 190 (John B. Shoven & John Whalley eds., 1992).
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break even, hence discouraging investment.³⁴ Removing the tax on marginal investments under the tax reform proposals will thus alter the incentive to invest in capital.³⁵

A study that examined the potential impact of the tax reform proposals on household and firm behavior in the United States concluded that the proposals would lower the investment tax wedge facing new investments.³⁶ Accordingly, under the proposals, there would be a rise in after tax returns on marginal investments and a fall in before-tax returns (which equals the cost of capital). The study concludes that a reduction in taxes on capital should be followed by an increase in investment in the United States.³⁷

As such, a switch to a consumption-based tax system will likely increase the after-tax return on equity financed investments in the United States as the current double taxation

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34. Marginal taxes are important because they help to explain the potential for tax to influence investment decision-making: these taxes give us the cumulative tax distortion applicable on the marginal decision to invest. See Robin Boadway, *The Theory and Measurement of Effective Tax Rates*, in *THE IMPACT OF TAXATION ON BUSINESS ACTIVITY* 61 (Jack M. Mintz & Douglas D. Purvis eds., 1985) (noting that average tax rates give the average taxes paid on all decisions, both marginal and inframarginal).
 35. The potential for tax to alter decision making on marginal investments requires further explanation concerning how tax creates a wedge between before tax returns and after tax returns. Take the example of an individual named Saver who has some extra funds to invest. Saver has the option to purchase a safe investment, such as a government bond, that might earn a real (i.e., inflation adjusted) return of 5% after taxes. Saver will therefore not invest unless he believes he can earn a return at least equal to this 5%. A company named Seeker which is seeking funds may wish to entice Saver to invest in the company. Seeker must pay Saver dividends of, say 7% in order for him to earn the 5% return; the difference equals the amount of personal tax that Saver would have to pay on the dividend income. In order to pay Saver dividends equal to the 7%, Seeker would have to earn a return of 10% on the project; the difference is paid in corporate taxes. Economists say that tax has driven a wedge between the pre-corporate income tax rate of return of 10% and the after-personal tax rate of return of 5%. This total wedge is used to calculate effective tax rates on marginal investments. Economists measure effective tax rates by inputting relevant provisions in the tax code that make up tax burdens, such as tax rates and depreciation deductions, as well as non-tax factors such as interest rates. Effective tax rates on marginal investments are used as policy tools to help in understanding the potential for tax to influence investment decision making. See OECD, *TAXING PROFITS IN A GLOBAL ECONOMY: DOMESTIC AND INTERNATIONAL ISSUES* 87 (1991).
 36. See ALAN J. AUERBACH, *TAX REFORM, CAPITAL ALLOCATION, EFFICIENCY AND GROWTH* (CEPR Pub. No. 444, 1995). To understand the impact of the proposals, the study initially reviewed current effective tax rates on marginal investments in the United States. This review suggested that tax distortions within assets, sectors, and industries no longer have a major influence on investment decision making. The main distortion that remains is the overall taxation of capital income associated with the corporate income tax. This latter tax drives an investment tax wedge between a firm's before-tax return and the pre-personal tax return. In the example above, the difference would be between the returns of 10% and 7%.
 37. *Id.* at 24. Savings levels will also be increased under the proposals, although the quantitative effects of each proposal on savings varies. It is noted, however, that the results of the analysis may also vary depending on the ease with which capital adjusts in the transition to the new consumption-based tax regime as well as the openness of the economy.
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of corporate income and dividends would be removed.³⁸ The question remains, however, whether interest rates or the cost of capital for debt financed marginal investments will be reduced.³⁹

D. SUMMARY.

Moving to a consumption-based tax system will likely encourage savings and investment by reducing current tax penalties on these activities.⁴⁰ As a result, economists generally assert that there will be an increased level of investment in the United States (although investment may be reduced in the transition period as taxpayers anticipate the implementation of investment friendly tax reform). Even critics of the tax reform proposals agree that investment will increase but argue that such increase would be lower than expected.⁴¹

Some of this increase in investment will likely come from foreign individuals and companies. In fact, the Kemp Commission indicated that a single rate consumption-based tax system "will probably attract foreign capital too by making the United States a particularly attractive place in which to invest."⁴² The question that remains is whether or not this increase in investment in the United States would come at the expense of the Canadian economy.

38. Corporate profits are taxed once at the corporate level and again when profits are distributed to shareholders at the individual level. I.R.C. §§ 11, 61(a)(7), 301 (1997).

39. See GENTRY & HUBBARD, *supra* note 17, at 25. High statutory corporate income tax rates tend to reduce the cost of capital on debt-financed marginal investments since the higher the tax rate, the more interest that can be deducted, and hence more tax savings are realized. Under most consumption-based tax proposals, permitting a corporation to immediately expense investments may offset the present value of foregone interest deductions. If the proposals encourage firms to issue more equity (since after-tax returns rise) and less debt, then interest rates should be reduced when demand for this type of financing is curtailed. The suppliers of capital that receive higher after-tax returns on equity will require higher returns on debt (and thus higher interest rates). The resulting impact of these two contrary positions on the level of interest rates has been called ambiguous. Cf. AUERBACH, *supra* note 35, at 24 ("It seems reasonable to conclude that the increased overall investment will be accompanied by a decline in the before-tax interest rate").

40. See Heidi Glenn, *Consumption Taxes Good for Economy*, 76 TAX NOTES 893 (1997). An analysis by the Congressional Budget Office concludes that consumption-based tax reform would improve the economy slightly by reducing the influence of taxes on the timing of spending decisions. *Id.* Intercorporate dividends are fully deductible only if the recipient company owns 80% or more of the distributor's shares. See I.R.C. § 243 (1997).

41. See, e.g., Fred Stokeld, *Brookings Panel Drills Holes in Kemp Commission's Tax Plan*, 70 TAX NOTES 487, 489 (1996) (indication from one analyst that the Kemp Commission's plan to double the rate of real income growth is "quite a stretch" and that an increase of 0.3 percent in economic growth in a year is more realistic.)

42. See Kemp Commission, *supra* note 12, at 450.

III. The Impact of U.S. Tax Reform on Canada.

A. THE EFFECT OF PREVIOUS UNITED STATES TAX REFORM ON CANADA.

Would United States tax reform have a spill-over effect on the Canada economy? Previous economic studies have examined how Canada's economy reacted to the significant tax reform undertaken in the United States in 1986 ("TRA86"). These studies indicate that TRA86 caused stocks across industries in Canada to react in an inverse manner compared to stock price behavior in the United States.⁴³ These studies also state that TRA86, as well as tax reform in Canada, altered the manner in which United States corporations operating in Canada funded their investments.⁴⁴

The impact of TRA86 on Canada, however, was no doubt lessened by the fact that Canada implemented its own tax reform in 1987 and this reform was similar in nature to TRA86 as income tax rates were lowered, marginal rate brackets reduced, deductions curtailed, and the tax base broadened.⁴⁵ After both legislative reforms took place, a similar overall tax burden on capital existed in both countries.⁴⁶

In fact, government discussion of this type of tax reform took place earlier in Canada and was largely a reaction to developments in tax policy in England. TRA86 hastened the implementation of Canadian reform as the government attempted to ensure that its tax system better reflected United States developments.⁴⁷ It appears that TRA86 did not have a major impact on the Canadian economy. This could perhaps be attributed to the swiftness of the Canadian response to TRA86 which ensured that capital received a similar tax treatment.

43. See Joel Slemrod, *The Impact of U.S. Tax Reform on Canadian Stock Prices*, in CANADA U.S. TAX COMPARISONS 237, 238 (John B. Shoven & John Whalley eds., 1992). Canadian stock price behavior in Canada can be explained by the theory that whatever hurts U.S. companies helps their Canadian competitors; however, no evidence demonstrated that the negative correlation was stronger for industries with a high degree of competition between the two countries. *Id.*

44. Roy D. Hogg & Jack M. Mintz, *Impacts of Canadian and U.S. Tax Reform on the Financing of Canadian Subsidiaries of U.S. Parents*, in STUDIES IN INTERNATIONAL TAXATION 47, 49 (Alberto Giovannini, et al. eds., 1993). TRA86 altered the tax treatment of U.S. multinationals operating in Canada, which may have caused, along with non-tax factors, the Canadian companies to increase dividend payouts to their U.S. parents, since the tax incentive to reinvest earnings in Canada was reduced, as well as favoring the use of more local debt financing. *Id.*

45. See, e.g., John Bossons, *The Impact of the 1986 Tax Reform Act on Tax Reform in Canada*, 40 NAT'L TAX J. 331, 333 (1987). TRA86 put pressure on Canadian policy-makers to reduce nominal corporate tax rates mainly as a result of changes to U.S. foreign credit rules. *Id.*

46. See, e.g., McKenzie & Mintz, *supra* note 32, at 207.

47. See John Whalley, *Foreign Responses to U.S. Tax Reform*, in DO TAXES MATTER? 286, 307 (Joel Slemrod ed., 1990). Although initially influenced by tax reform in England, Canada modified its corporate tax reform in 1987 through deeper cuts in rates in light of U.S. actions, even though both countries had been moving in the same general direction from 1985 onward. *Id.*

B. IMPACT OF TAX REFORM ON CANADIAN CAPITAL FLOWS.

There are a number of factors that increase the likelihood of a spill-over effect concerning capital flows between the United States and Canada if the tax reform proposals are initiated. The fact that the Canadian and American capital markets are highly integrated⁴⁸ ensures that capital flows are sensitive to fiscal change. Further, the United States consists of almost one third of the international capital markets⁴⁹ whereas Canada is a relatively small player in the global capital markets. Accordingly, the United States has sufficient market power to influence factors such as global interest rates or global asset prices that will impact the manner in which investments are undertaken and funded in Canada.

The discussion concerning the likely impact of the tax reform proposals on Canadian capital flows is general in nature. This results from the fact that many of the details of the tax reform proposals remain to be worked out as well as the fact that each proposal may result in a different tax treatment of capital.⁵⁰ The impact of the reform on international flows will also vary depending on the tax treatment that international investments receives under the new approach.⁵¹ For example, if an origin-based tax system (i.e., a system that does not provide tax rebates for exports and imports will enter the country without taxes like the flat tax proposal) is implemented, Canadian holders of American assets would be

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48. See, e.g., John Shoven & Michael Topper, *The Cost of Capital in Canada, the United States and Japan*, in CANADA-U.S. TAX COMPARISONS, at 217, 229. A review of the cost of capital and risk/return ratios of the individual capital markets of Canada and the United States leads to the conclusion that the two capital markets have a high degree of integration. *Id.* See also Alan Rugman, Canada: Globalization and Competitiveness in a Regional Market 37 (1995) (unpublished manuscript) which discusses a study that indicates that Canadian interest rates have been determined by the U.S. Federal Reserve System for the last thirty years and that the value of the Canadian dollar has followed lock step with changes in the U.S. dollar against non-American currencies during this period. *Id.*
 49. See ROBERT E. HALL, THE INTERNATIONAL CONSEQUENCES OF THE LEADING CONSUMPTION TAX PROPOSALS, 18 (CEPR Pub. No. 447, 1995) (indicating that the size of the capital market flows may assist in altering U.S. interest rates under consumption-based tax reform).
 50. The manner in which these rules are phased in will also affect the impact of the change in tax rules on Canada.
 51. The proposals noted above, as well as the Kemp Commission report, recommend that the United States should consider switching to a territorial approach to taxing foreign investments (i.e., foreign source income would be tax exempt). This would clearly alter the tax incentive of U.S. firms to engage in international investment, since these investments would generally take on the host country's tax burden (unlike the current situation under the worldwide system where in many situations the tax burden on foreign investments is equivalent for U.S. domestic investments). See Kemp Commission, *supra* note 12, at 449. Recommendations to change to a territorial approach have received much criticism from commentators mainly due to concerns about tax avoidance. See, e.g., Michael McIntyre, *International Aspects of Kemp Commission Report*, 70 TAX NOTES 607 (1996).
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worse off than United States investors. This would occur since the Canadian investors would bear the burden of the transition to the consumption-based tax.⁵²

The analysis below is divided into two categories: (1) foreign direct investment flows ("FDI"); and, (2) foreign portfolio investment flows. FDI can be viewed as entrepreneurial investment that typically involves control of the foreign business entity and may involve the placement of physical assets. Foreign portfolio investment is generally non-entrepreneurial investment that is sensitive to interest rate fluctuations and can move from one country to the next with the push of a computer button. FDI is less mobile across borders than foreign portfolio investment.⁵³ It should be noted that economists continue to debate the extent to which cross border capital movement is influenced by taxation.⁵⁴

1. *The Impact on Canadian Direct Investment Flows.*

Contrary to conventional wisdom in Canada,⁵⁵ it appears that the overall current income tax burden on marginal investments in Canada is generally comparable to tax burdens in the United States. Although a certain amount of distortion likely still exists among different assets and industries, currently taxes should not exert significant influence on overall investment decisions regarding investment location between the two countries.⁵⁶

The consumption-based tax proposals, however, would bring about a significant difference in the tax burdens placed on marginal investments in the United States.⁵⁷ Reduced

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52. Under the destination approach contemplated for the National Sales Tax and the USA Tax, a Canadian investor planning to consume abroad escapes the transition burden on the consumption tax. The U.S. owners of Canadian debt and equity assets would bear the transition costs as long as they plan to consume in the United States. Under the origin principle, the positions would be reversed, and Canadian asset holders would bear the transition burden while U.S. holders of foreign assets would escape this burden. An origin-based tax would therefore impose, all else being equal, a greater transition burden to the Canadian investor relative to U.S. investors. See GENTRY & HUBBARD, *supra* note 17, at 16. See also HALL, *supra* note 48, at 8 (concluding that domestic equity holders should suffer capital losses as a result of consumption tax reform: an origin VAT will impose the same loss on foreign equity holders as on domestic ones).
 53. See, e.g., A. Lans Bovenberg, et al., *supra* note 32 (portfolio investment is more sensitive to after-tax rates of return than direct investment since the latter investments are undertaken for reasons other than temporary higher rates of return).
 54. See Cockfield, *supra* note 3 (reviewing several studies which indicate that the impact of taxes on capital flows continues to be unclear).
 55. Concern is often expressed in Canada that higher tax burdens on capital investments encourages firms to relocate to the United States. See e.g., Peter Cook, *Yes, But Can We Compete on Taxes*, GLOBE & MAIL, Dec. 30, 1994, at B2.
 56. Marginal effective tax rate studies have been conducted that try to measure the total tax burdens on marginal investments in Canada and the United States. See DUANJIÉ CHEN & KENNETH J. MCKENZIE, *THE IMPACT OF TAXATION ON CAPITAL MARKETS: AN INTERNATIONAL COMPARISON OF EFFECTIVE TAX RATES ON CAPITAL 15* (1997) (study indicates that, for investments in capital employed in manufacturing services, the marginal effective tax rates for Canada and the United States are comparable). See also McKenzie & Mintz, *supra* note 32, at 209 (overall industry aggregate marginal effective tax rates for 1990 have moved closer in the recent past); Shoven & Topper, *supra* note 47, at 232 (studies conclude that cost of capital results are very similar in Canada and the United States and investment location decisions will be driven by non-tax considerations).
 57. See *supra*, text accompanying notes 35 to 36.
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costs of capital in the United States will make it easier for firms to fund capital investments. Since the marginal tax burdens in Canada would become relatively larger than the American tax burden, all else being equal, the interaction of the tax systems provides incentives for investments to take place in the United States rather than Canada.

Further, the tax reform proposals will likely increase the after-tax profitability of equity investments in the United States relative to Canadian equity investments. Accordingly, the tax reform could spill over into Canadian investment flows in a number of ways.⁵⁸ It will offer an incentive to Canadians to invest in United States industry instead of investing domestically. It will encourage existing businesses in Canada to relocate from Canada to the United States. Further, United States multinational firms would be discouraged from acquiring new Canadian investments due to the differences in tax burdens imposed on marginal investments.⁵⁹

Consumption-based tax reform might also reduce new investment to Canada from non-American international firms as the United States becomes a more attractive investment site. International firms seeking access to the North American market would have to locate in one of the NAFTA countries in order to take advantage of the origin of goods requirement necessary for tariff-free circulation.⁶⁰ An international firm seeking a skilled workforce and infrastructure to support capital intensive projects will likely choose between Canada and the United States as potential investment locations. As both countries are generally similar with respect to other potential investment criteria, the firm may decide to locate the new investment in the United States if the tax burdens are sufficiently less attractive in Canada.⁶¹

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58. See generally Reuven S. Avi-Yonah, *The International Implications of Tax Reform*, 67 TAX NOTES 913, 914-18 (1995) (under the tax reform proposals, foreigners would increase FDI in the United States possibly by buying U.S. companies and then shifting profits to them).
59. As set out in the proposals, U.S. multinationals would be exempt from paying tax for income earned by their foreign subsidiaries. These firms, however, would not be able to receive credit for income taxes paid in Canada, which would provide a powerful incentive to relocate to the United States or some other low-tax jurisdiction. See ANDREW B. LYON, INTERNATIONAL IMPLICATIONS OF U.S. BUSINESS TAX REFORM 19 (Technical Comm. on Bus. Taxation Working Paper No. 96-6, 1996).
60. Under NAFTA's rules of origin for trade, foreigners are encouraged to produce goods in North America that will qualify as originating goods, which can then move among the Member States without tariffs. See Frederick M. Abbott, *Integration Without Institutions: The NAFTA Mutation of the EC Model and the Future of the GATT Regime*, 40 AM. J. COMP. L. 917, 920 (1992) (discussing how the structure of NAFTA may create a more trade diverting regime than the European Union as a result of the origin of goods rule).
61. A business may decide to invest or increase existing investments in another country for a number of reasons. The World Competitiveness Report published by the World Economic Forum lists a number of factors for assessing investment climate of a country, including overall economic strength, government policies, infrastructure, human resources, and scientific and technological capacity. See INVESTMENT CAN. RESEARCH AND POLICY STAFF, WORKING PAPER NO. 9, INTERNATIONAL INVESTMENT AND COMPETITIVENESS 49 (1992) [hereinafter INVESTMENT CAN.]. Canada and the United States are similar in most of these factors and therefore tax differences may provide a crucial incentive. For a comparison of macro-economic variables of the NAFTA countries, see Cockfield, *supra* note 3, app. A.
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In 1995, there was a FDI flow of approximately \$14 billion (Canadian)⁶² into Canada and the total stock of FDI in Canada stood at \$168 billion (Canadian).⁶³ Roughly two-thirds of these flows have historically come from the United States⁶⁴ which emphasizes the sensitivity of the Canadian economy to adverse tax changes from its neighbor. In fact, the world stock of foreign direct investment in Canada tripled between 1980 and 1990,⁶⁵ and a Canadian government report states that foreign investment is now "essential for the competitiveness of the economy."⁶⁶ The previous analysis suggests that these funds invested in Canada by foreign residents would be diluted to a certain extent as a result of American consumption-based tax reform.

2. Portfolio Investment in Canada.

International portfolio investment represents in the aggregate a greater portion of capital flows to the Canadian economy than FDI (Canadian portfolio investment held by foreigners totaled \$441 billion (Canadian) in 1995).⁶⁷ In 1995, there was an increase in the amount of Canadian bonds and stocks held by foreigners in the amount of Cdn.\$26 billion.⁶⁸ It has been suggested that since the proposals do not tax foreign consumption, the world's mobile capital can be invested tax free in the United States and then consumed outside its borders.⁶⁹ This would provide incentives for foreigners to funnel their portfolio investments to the United States⁷⁰ and not Canada.

As previously discussed, the result of the tax reform on interest rates in the United States is less clear.⁷¹ If the contemplated increase in investment activity in the United States is offset by a rise in the domestic savings rate then upward pressure on domestic pre-tax interest rates may not take place and additional portfolio investment will not be attracted from countries such as Canada. It is therefore not clear what the impact of U.S. consumption-based tax reform would be on the amounts of portfolio investments held by foreigners.

62. STATISTICS CAN. BALANCE OF INTERNATIONAL PAYMENTS, CANSIM MATRIX 2333 (1996). [hereinafter STATISTICS CAN.].

63. STATISTICS CAN., CANADA'S INTERNATIONAL INVESTMENT POSITION AT YEAR END, CANSIM MATRIX 4180 (1996). [hereinafter STATISTICS CAN.].

64. See INDUSTRY CAN. MICRO-ECON. POLICY ANALYSIS STAFF, WORKING PAPER NO. 9, INTERNATIONAL INVESTMENT AND COMPETITIVENESS 7, 15 (1992) [hereinafter INDUSTRY CAN.] (noting a growing trend of countries other than the United States placing their FDI in Canada).

65. Two-thirds of the capital stock of FDI is provided by the United States. *Id.* at 7 (the increase of FDI went from US\$51 billion in 1980 to US\$164 billion in 1990).

66. See INVESTMENT CAN., *supra* note 61, at 2.

67. STATISTICS CAN., *supra* note 63.

68. STATISTICS CAN., *supra* note 62.

69. See Avi-Yonah, *supra* note 57, at 915.

70. This would impose significant costs on the ability of Canada and other countries to tax their residents. *Id.*

71. See *supra* note 38.

B. IMPACT ON FINANCIAL STRATEGIES.

United States consumption-based tax reform will influence the manner in which companies with operations in Canada and the United States conduct their financial affairs.⁷² The cost of capital of a Canadian investment by a U.S. parent is affected by the manner in which it is funded. The Canadian subsidiary can finance ventures by borrowing locally, issuing shares or using retained earnings. The U.S. parent could fund the venture in Canada by transferring debt or equity capital to the subsidiary that could in turn use one of the three methods to finance the project. These different avenues will result in different amounts of tax paid on the Canadian project as a result of the different tax treatment that each avenue receives at the company and investor level.⁷³

Higher Canadian corporate tax rates after the reform is initiated calls for local borrowing by the Canadian subsidiary. Interest deductibility under the Canadian tax system will tend to drive down the cost of capital as rates increase since a larger amount of interest is expensed. Canadian parents may also want to increase debt financing and then transfer these amounts to United States subsidiaries in order to take advantage of the tax rate differentials. The Canadian parent should then inject equity into the subsidiary since interest payments received from abroad will be taxed at the Canadian rate. These types of activities could pose serious problems to Canadian tax authorities as tax revenues would be eroded under greater levels of debt financing in Canada.

United States parents may also want to take advantage of lower costs of capital on equity financing in the United States and then loan the funds to the Canadian subsidiary. This approach would be particularly important since interest payments on debt would not be deductible under the consumption tax proposals.⁷⁴ These types of strategies are subject to Canada's thin capitalization rules that attempt to prevent a Canadian subsidiary from reducing its taxable Canadian profits by maximizing its interest expense to related non-resident creditors.⁷⁵

The consumption-based proposals would impose low statutory tax rates on business profits.⁷⁶ As indicated, these rates are significantly lower than the Canadian corporate

72. Although the impact of taxes on investment decision making is unclear, multinationals often structure their financial transactions to take advantage of tax differences among nations. See, e.g., COMMISSION OF THE EUROPEAN COMMUNITIES, REPORT OF THE COMMITTEE OF INDEPENDENT TAX EXPERTS ON COMPANY TAXATION, 92 TNI 36-15, Sept. 2, 1992, available in LEXIS, Fedtax Library, TNI File (indicating that roughly two-thirds of respondents claimed that taxation is always or usually a major factor in financial decisions).

73. See generally David Harris et al., *Income Shifting*, in U.S. MULTINATIONAL CORPORATIONS 277 (Alberto Giovannini et al. eds., 1993).

74. See, e.g., LYON, *supra* note 59, at 20.

75. Sections 18(9.2)-(9.8) of the Income Tax Act, S.C. 1970-72 (Can.) [hereinafter Canadian Tax Act] indicate that a resident subsidiary will be denied a deduction of interest on that portion of its debt owed to non-arm's length non-resident shareholders (or other related persons) that exceeds three times the total shareholder's equity of those persons in the subsidiary. The debt owing to relevant non-residents is defined as the greatest amount outstanding at any time in the year.

76. The USA Tax imposes a business tax rate of 11%, while the flat tax imposes a 17% business tax.

income tax rate of thirty eight percent.⁷⁷ Multinationals could take advantage of the difference in tax burdens between the countries through transfer pricing.⁷⁸ This would be a particularly sensitive area as a result of the enormous amount of related party transactions between the two countries.⁷⁹

Through the use of transfer pricing, United States firms might increase cross-border charges to their Canadian affiliates in order to reduce taxes in Canada (and hence reduce revenues to the Canadian fisc). Alternatively, Canadian multinationals may try to shift profits to the United States. This type of strategy is subject to the Canadian and United States tax rules regarding the valuation of transfers between related parties (which generally provide that the prices should conform to prices charged in comparable arm's length transactions).⁸⁰

This section has touched on several financial strategies that might be used by multinational firms with operations in Canada: all of which would have the effect of eroding Canadian tax revenues.

C. OTHER IMPLICATIONS.

1. *Effect of Canadian International Tax Policy.*

The impact of United States tax reform on Canada may be magnified as a result of the integrated economies of the two countries. This would only occur if Canadians are given the same incentive as domestic American investors.⁸¹ Whether or not investors receive the same incentives is determined by the interaction of the tax systems of the two coun-

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77. This is the rate for sizeable corporations in Canada, ignoring surtaxes. See Canadian Tax Act, *supra* note 75, § 123(1). There is a credit for the first 10% of provincial corporate income taxes. Certain investments carry lower tax rates. For example, the rate for manufacturing and processing corporations is 21% after the provincial tax abatement. See Canadian Tax Act, *supra* note 75, § 123(2).
78. International transfer pricing rules are used to calculate the cost of goods and services among related business entities that have operations in different countries.
79. The amount of U.S.-Canada related party transactions reached Cdn.\$166 billion in 1993. See ROBERT TURNER, STUDY ON TRANSFER PRICING (Technical Comm. on Bus. Taxation Working Paper No. 96-10, 1996). The adoption of new international transfer pricing rules by the IRS, see Treas. Reg. § 1.482-1 (1994), has caused concern among Canadian tax practitioners as to the fairness of these rules. The Canadian tax authorities issued a statement indicating that they would not necessarily abide by U.S. decisions under the new rules. Robert Brown & Michael Alexander, *Sovereignty in the Modern Age*, 20 CAN.-U.S. L.J. 273, 286 (1994).
80. Still, transfer pricing incentives may encourage firms to expand their real U.S. production activities at the expense of Canadian operations. It is presumably easier to conceal profit shifting from other locations when a larger portion of the activities is situated in the United States. See LYON, *supra* note 59, at 20. The United States has moved away from the comparable arm's length rules in recent years and has implemented rules that indicate a company must choose the "best method" to calculate related party transactions, including profit-based methods. See Treas. Reg. § 1.482-1 (1994).
81. See, e.g., AUERBACH, *supra* note 36, at 24 (foreigners may receive the same incentives as Americans depending on whether the foreign countries will extend foreign tax credits for the new U.S. taxes).
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tries. There are two general categories that a nation's international tax policy may fall under. If the foreign investor is taxed in her home country under the world-wide category (i.e., the home country taxes resident company earnings at home and abroad), then the foreigner's incentive to invest in the United States will not change.⁸² If, on the other hand, a territorial system is in place (i.e., the home country does not tax foreign earnings by resident companies), then the foreign investor would receive the same incentive that American investors receive as the tax burden in this situation is roughly the same for domestic and international investors.

Canada generally does not tax active business income that is repatriated to Canadian parent companies from companies located in tax treaty partner countries like the United States.⁸³ Canada, through its tax policy and tax treaty with the United States, therefore effectively permits Canadian investors to receive roughly the same investment incentives as Americans receive.

Under the proposals, foreign source income would be exempt from United States tax. Marginal investments in Canada by United States firms would take on the higher tax burden that domestic Canadian investments receive. Hence an American investor considering investing in Canada would receive relatively unfavorable capital income tax treatment if the contemplated tax reform takes place while the Canadian investor is given tax incentives to place investments in the United States. If consumption-based reform were initiated, the interaction of the tax policies would tend to encourage Canadians to invest in the United States and discourage United States investment in Canada after consumption-based tax reform was initiated.⁸⁴

2. Trade.

It appears that the United States tax reform proposals would not distort trade flows between the two countries. Both NAFTA⁸⁵ and the tax treaty between Canada and the United States⁸⁶ have provisions to ensure that cross-border goods and services receive non-discriminatory tax treatment. The consumption tax proposals would not, however, discriminate against imported goods and services from Canada since they would place the

82. This would occur as long as the foreign investor can obtain credit for U.S. taxes paid. It should be noted that most "world-wide" tax systems, like the one used in the United States, permit the investor to defer taxation until profits are repatriated to the home country. This makes the system resemble a "territorial system".

83. Canadian Tax Act, *supra* note 74, § 113(1)(a). The active business income must be earned by a foreign affiliate (i.e., the Canadian company owns at least 10% of a class of issued shares) in order to be exempt from taxation. Canada also has a series of tax rules to tax the income of foreign branch offices on an accrued basis as well as passive income in certain cases, which means Canada also uses the "world-wide" approach.

84. Canadian tax policy may have to change to the world-wide approach. See *infra* note 97.

85. See NAFTA, *supra* note 1, art. 3(a).

86. This non-discrimination provision covers all taxes imposed at the federal level. See U.S. Canada Treaty, *supra* note 2, art. XXIV(10).

same tax burden on domestic and foreign goods and services.⁸⁷ Further, consumption taxes do not generally distort trade flows.⁸⁸

More worrisome from Canada's perspective, the reform measures are said to provide incentives to increase exports from the United States since domestic production is favored over foreign production.⁸⁹ This may result in a reduction in imports from Canada and upset the current trade balance between the countries. Canada's economic success depends, in large part, on exports to the United States market.⁹⁰

3. U.S.-Canada Tax Treaty.

A United States switch to a consumption-based tax would also have implications concerning the manner in which the bilateral tax treaty coordinates the different treatment of taxes between Canada and the United States. A consumption tax would not fall within the definition of income tax in the Canada-United States tax treaty. Currently, the tax treaty indicates that only federal income taxes and capital taxes are covered.⁹¹ The non-discrimination clause alone in the tax treaty extends coverage to all taxes imposed at the national level (e.g., the GST).⁹²

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87. The USA Tax and national sales tax proposal grant a tax rebate on exports and tax imports, while the flat tax imposes a tax on exports, but imports enter the country tax-free.
88. Economists assert that exchange rates adjust to offset the impact of consumption taxes on cross-border goods and services. See, e.g., HALL, *supra* note 49, at 7. For an explanation of this process, see Jane G. Gravelle, *International Tax Competition: Does It Make a Difference for Tax Policy?*, 39 NAT'L TAX J. 375 (1986). Nonuniform consumption taxes (i.e., different tax rates on different commodities), however, will distort the pattern of production and trade. These "[d]istortions will arise under either the destination [(e.g., the USA and national sales tax)] or origin-based system [(e.g., the flat tax)]...., but only under the origin-based taxes will the locational pattern of production be disturbed". See Joel Slemrod, *Tax Cacophony and the Benefits of Free Trade*, in FAIR TRADE AND HARMONIZATION: PREREQUISITES FOR FREE TRADE? 283, 283 (Jagdish Bhagwati & Robert E. Hudec eds., 1996).
89. See LYON, *supra* note 59, at 21. Since consumption taxes are neutral in their effects on whether to produce for domestic or foreign consumption, export incentives under the current income tax system are actually reduced. This would be outweighed, however, by the fact that the new measures would encourage domestic production since the income tax system favors foreign production when taxes on these earnings can be deferred in low tax jurisdictions. *Id.*
90. Canada and the United States are each others' largest trade partner with approximately U.S. \$100 billion in exports to Canada and U.S.\$111 billion in imports from Canada in 1993. See FREDERICK M. ABBOTT, LAW AND POLICY OF REGIONAL INTEGRATION: THE NAFTA AND WESTERN HEMISPHERIC INTEGRATION IN THE WORLD TRADE ORGANIZATION SYSTEM 121 n.7 (1995).
91. U.S.-Canada Treaty, *supra* note 2, art. II. Note that Article I(3)(a) indicates that the convention will apply to "identical or substantially similar" taxes to income taxes. *Id.*
92. *Id.* art. XXV (this provision was modified by Article 13 of Third Protocol to the U.S.-Canada Treaty signed on Mar. 17, 1995, which extended coverage to all federal taxes).
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Pursuant to the tax treaty, Canada and the United States agree to relieve double taxation by granting a credit against income tax paid in the other country.⁹³ Accordingly, a Canadian corporation or other foreign multi-nationals operating in the United States would not be required to grant relief for the payment of consumption-based taxes. Presumably, the tax treaty would have to be renegotiated (along with other U.S. tax treaties) to take into consideration the changes of the tax reform.⁹⁴

D. CONCLUSION.

The effects of the tax reform on capital flows between the two countries will ultimately depend on what sort of international tax policy position the United States adopts and the Canadian response to that policy. Until these positions are known, only general observations concerning the impact of the proposed tax initiatives can be made. Still, it appears that, all else being equal, investment activity will flow from Canada to the United States. Further, the contemplated tax reform will likely change the method whereby Canadian and United States firms fund investments and will thus have an adverse impact on Canadian tax revenues. Canada's ability to sustain long term economic growth would therefore be placed in jeopardy by radical consumption-based tax reform in the United States.

IV. How Could Canada React?

The foregoing analysis has suggested that United States consumption-based tax reform would have an adverse impact on capital flows into Canada. This section of the article will touch on the options available to the Canadian government if consumption-based tax reform was initiated in the United States.

A. DO NOTHING.

A do nothing strategy is clearly not a realistic option if the United States tax reform will have a long term negative impact on the Canadian economy. In a world of economic and financial market integration, the ability of Canada to go its own way is greatly diminished.⁹⁵ Cross-border capital mobility undermines the sovereign control of Canada over its domestic tax policy by placing constraints on the freedom to choose among different tax alternatives. No reaction from the Canadian government would simply permit capital outflows to continue and tax revenues to be depleted.

93. *Id.* art. XXIV.

94. This would not be an easy task. The Third Protocol amendment to the U.S.-Canada Treaty took over four years to negotiate. See, e.g., Juliann A. Martin, *Tax Reform Could Destroy Treaty Network*, 76 TAX NOTES 891 (1997) (noting that U.S. treaty partners would likely terminate their treaties with the United States since they would no longer have any incentives to provide income tax concessions).

95. See Cockfield, *supra* note 3 (discussing the pressures on Canadian policy makers to ensure that tax policy between Canada and the United States remains similar in matters that affect cross-border capital flows).

B. ALTER ITS TAX SYSTEM.

Canada could try to match the effect of the United States reform by creating similar tax burdens on capital. This could be achieved by reducing statutory corporate income tax rates and/or permitting more business deductions. The Canadian government could also reintroduce a general investment tax credit or some other mechanism to offset the relatively unfavorable tax treatment of new investments.

This type of strategy, however, would undo much of the progress towards a simpler tax system that began in Canada in 1987.⁹⁶ Further, such mechanisms may not be as transparent to tax planners at multinational corporations as, say, a one-rate flat tax. Fiddling with the current income tax system may not ultimately redress the imbalance in tax burdens on marginal investments if U.S. consumption tax reform is enacted. Canada could also increase its tax expenditures (i.e., tax subsidies) to boost certain businesses or industries, but this would also likely meet with limited success.⁹⁷

Alternatively, Canada could pass legislative changes to stop capital outflows by directly countering the United States reform and/or by unilaterally abrogating its tax treaty.⁹⁸ Tax rules could be created to try and tax U.S. source income of Canadian resident multinationals or to create strict anti-deferral rules for U.S. source income.⁹⁹ It has been suggested that these types of strategies may be ineffective, however, since they will only make it harder to attract capital from the United States and elsewhere.¹⁰⁰ Further, Canadian resident companies may simply relocate their legal place of business to the United States or sell off shareholdings to American companies.¹⁰¹

96. See RICHARD M. BIRD, ET AL., *TAX REFORM IN CANADA: A DECADE OF CHANGE AND FUTURE PROSPECTS 20-21* (International Ctr. for Tax Studies, Faculty of Management, Univ. of Toronto Paper No. 1, 1994) (describing the reduction of special investment incentives during the 1980s).

97. It does not appear that NAFTA prohibits this type of tax subsidization. See Paul R. McDaniel, *Formulary Taxation in the North American Free Trade Zone*, 49 *TAX L. REV.* 691, 715, 719 (1994).

98. See Avi-Yonah, *supra* note 58, at 923 (foreseeing a possible collapse of the international income tax treaty system and unrestrained tax competition to reduce taxes or, in counter-measures, to capture foregone revenue base).

99. For example, Canada could try to extend its Foreign Accrual Property Income (FAPI) rules to capture U.S. taxable profits since the United States might be regarded as a tax haven if the reform is passed. FAPI earned by a controlled foreign affiliate of a Canadian company is included as taxable income regardless of the time of repatriation. See Canadian Tax Act, *supra* note 75, § 91(1). FAPI only includes, however, passive income, certain capital gains and certain non-arms length business income. See also Reuven S. Avi-Yonah, *Comment on Grubert and Newlon, 'The International Implications of Consumption Tax Proposals*, 49 *NAT'L TAX J.* 259 (1996) (suggesting that countries may deny deferral on unrepatriated profits of U.S. subsidiaries of their multinationals, increase withholding taxes, and try to expand their tax jurisdiction).

100. See Harry Grubert & T. Scott Newlon, *Reply to Avi-Yonah*, 49 *NAT'L TAX J.* 267, 269 (1996). It is not likely that countries will enact counter-measures, since this would only exacerbate the problem of attracting U.S. capital. If the tax treaty with the United States is canceled, the former treaty partner would be subject to high statutory withholding rates. *Id.*

101. This last strategy would have the odd effect of actually increasing FDI into Canada, since foreign companies would be holding Canadian assets after the sale.

Should Canada engage in an all-out tax war with the United States if the Americans enact radical consumption-based tax reform? Realistically, the answer must be no. The relatively small size of the Canadian economy in comparison to the United States economy means that Canada would have little or no chance of winning such a war.

C. ADOPT SIMILAR MEASURES.

Finally, Canada could consider adopting a similar consumption tax approach as the one eventually implemented by the United States.¹⁰² This would necessitate the same radical overhaul of the Canadian income tax system that is being considered in the United States.¹⁰³ This is probably the best method of achieving a similar tax treatment of capital and would avoid revenue depleting financial strategies.¹⁰⁴ By matching the tax changes in the United States, Canada should be able to avoid most of the problems created by the reform measures.¹⁰⁵

There would no doubt be considerable political pressure to avoid such a fate, however, as Canadians hate to give in to Americans.¹⁰⁶ Further, the current administration in Canada has already come out against the flat tax.¹⁰⁷ Implementing consumption tax reform in Canada would create serious political concerns surrounding provincial tax pow-

102. This process has been called "regulatory emulation" which has been defined as "the process whereby regulators change their policies as a result of observing the regulatory policies pursued by other countries". See STEPHEN WOOLCOCK, *THE SINGLE EUROPEAN MARKET: CENTRALIZATION OR COMPETITION AMONG NATIONAL RULES* 8 (1994).

103. Whether or not one believes Canada should follow the American lead is a normative decision largely determined by views concerning the desirability of a certain taxation method. If one thinks that consumption-based taxes are a good thing, it is easier to propose the adoption of this tax in Canada. If one opposes such a tax on some grounds, changing over to this system is much more difficult to swallow.

104. See Peggy B. Musgrave, *Substituting Consumption-Based Direct Taxation for Income Taxes as the International Norm: A Comment*, 45 NAT'L TAX J. 179, 183 (1992) ("Other countries would be forced to follow the U.S. lead to protect their economies from capital loss").

105. As indicated previously, a swift response from Canada to significant U.S. tax reform in 1986 probably reduced any adverse impact of this reform.

106. See Cockfield, *supra* note 3 (reviewing the desire of Canadians to preserve sovereignty through distinct government policies).

107. The governing Liberal Party is concerned with the regressive element of consumption based tax reform. See, e.g., *The Gospel According to Martin: No Flat Tax*, MACLEAN'S MAGAZINE, Feb. 12, 1996, at 70 (Finance Minister Paul Martin indicates that "We've run the numbers 14 different ways to Sunday, and we keep coming to the same conclusion...[it would only] benefit the wealthy at the expense of the poor."). But see Andrew Coyne, *A More Level Playing Field for Taxpayers*, GLOBE & MAIL, Aug. 16, 1995 (discussing the political support for the flat tax in Canada by the Reform Party). The 1991 Reform Party Blue Book of principles and policies states: "The Reform Party will work toward a simple and visible system of taxation, including the possibility of a flat tax." *Id.*

ers.¹⁰⁸ It is conceivable that Canadian government services may have to be curtailed in order to match tax burdens imposed in the United States.¹⁰⁹

In order to appease certain constituencies and maintain the appearance of sovereign control over domestic tax policy, the Canadian government may be able to maintain some of the more progressive elements of its individual personal income tax system by granting greater household exemptions or tax rebates to low income earners. There is less pressure to harmonize income taxes on individuals because labor cannot yet easily relocate across borders.¹¹⁰

V. Conclusion.

Consumption-based tax reform proposals that are being contemplated in the United States would result in a lower tax burden on new investments. All else being equal, the relatively higher tax costs on marginal investments in Canada after United States tax reform is initiated would encourage capital to relocate to the United States. These investment outflows would ultimately cause a reduction in economic growth and tax revenues in Canada. Further, United States consumption-based tax reform may have an adverse impact on foreign portfolio flows to Canada as well as the way financial strategies are structured by multinationals. Accordingly, the Canadian government would have to take action to redress the imbalance in tax rates and tax burdens, perhaps by implementing its own consumption-based tax reform.

108. The Goods and Services Tax, implemented in 1991, is perhaps the most unpopular tax ever to have been legislated in Canada. There would likely be little support for further consumption taxes. Presumably, the GST would be absorbed by the more comprehensive tax (the GST accounts for roughly 13% of federal tax revenues: *see infra* Appendix A). Further, an overhaul of the income tax system would have an impact on provincial government revenues, which are closely tied to the federal income tax system. Most provinces have a tax collection agreement with the federal government for corporate and personal taxes and have generally foregone the right to choose their own income tax base and apportionment formula. The provinces would likely scream bloody murder unless they were guaranteed equivalent revenues under the reform. This would be a very sensitive issue in a country where federal tax revenues are used, in part, as transfer payments to less wealthy provinces. For a discussion contrasting Canadian and U.S. sub-national tax systems, *see* Francois Vaillancourt, *Subnational Tax Harmonization, Canada and the United States: Intent, Results, and Consequences*, in CANADA-U.S. TAX COMPARISONS 323 (John Shoven & John Whalley eds., 1992).

109. Canada would have to figure out a way to ensure that its greater tax needs, *see supra* note 6, were preserved if consumption-based tax reform was initiated. This may be problematic if Canada tries to place the same tax burden on capital activity that would exist in the United States. It is possible that a large portion of the government services economy would have to be restructured with resulting economic (and political) upheaval.

110. Still, the Canadian government would have to ensure that its highest marginal personal tax rates do not greatly exceed U.S. rates; otherwise a so-called "brain drain" may result. NAFTA grants greater cross-border mobility for designated business people, investors, and white collar professionals. *See* NAFTA, *supra* note 1, ch. 17.

This potential necessity to enact radical tax changes in Canada highlights the tax policy implications of the interdependent economic relationship that exists between Canada and the United States. Relatively small countries (in economic and not territorial terms!) like Canada and Mexico must constantly be on alert for significant fiscal policy changes by large trade partners when these countries co-exist in a regionally integrated trade area. As the economies of the Member States become more entwined under NAFTA, the economic impact of fiscal reform by the United States (and possibly Canada or Mexico) on the other NAFTA partners will only increase. Multilateral efforts would reduce the potential for adverse economic impacts if the Member States agreed to adopt similar tax rules and tax burdens at the supranational level. The political reality in North America, however, suggests that this is wishful thinking indeed and will not likely take place for many years to come.

Appendix A.

CANADA-UNITED STATES SOURCES OF FEDERAL TAX REVENUES
AS A PERCENTAGE OF TOTAL FEDERAL REVENUES (1995)

	Canada (%)	U.S. (%)
Personal income tax	46	44
Corporate income tax	11	12
Social security/unemployment insurance contributions	14	36
Excise taxes and duties	8	4
Goods and services tax (VAT)	13	N/A
Other revenues	8	4

Source for Canadian statistics: Karin Treff & David B. Perry, *Finances of the Nation 2:4* (1996) (reviews Department of Finance preliminary figures for fiscal year 1995-96).

Source for U.S. statistics: Department of the Treasury, *United States Government Annual Report 11* (1995).