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POLITICS, THE DEFICIT AND TAX REFORM*

By David A. Wolfe**

Issues of tax policy evoke widely varying reactions from tax practitioners, economists and students of the policy process. What differentiates the approach of the policy analyst from those of the other two is a concern with the role of tax policy and tax reform within the broader array of public policies. The policy analyst can study taxes from a number of perspectives: as one of an array of policy instruments available to governments to achieve desired policy ends; or, as part of the revenue budgetary process, the means by which government raises the funds to be allocated through the expenditure budgetary process; or finally, as one of the means used by government to affect the over-all distribution of income in society. Each of these perspectives emphasizes the role played by taxation in linking the institutions of the state to the broader social and economic context within which it is embedded. The pattern of taxation through which state revenues are generated reveals fundamental truths about the prevailing pattern of relations between the state and society.

One of the hallmarks of the advanced industrial society of the post-war period has been the relative increase in the reliance on the income tax as the primary source of public revenues and the decline in importance of more traditional forms of taxation, such as commodity taxes. In this respect, the increased prominence of the income tax was linked to other changes associated with the rise of the Keynesian welfare state. Changes in the corporate income tax,

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in particular, assumed an increasingly prominent role among the policy instruments employed by the state to promote economic growth and development. The preference for the corporate income tax as an instrument of economic policy was closely tied to the diffusion of Keynesian ideas within government policy-making circles. The widespread acceptance of Keynesianism was itself a key aspect of the post-war political settlement between labour and capital in most of the industrial democracies. The terms of the post-war settlement involved a trade-off: control of the investment decision-making process was left in the hands of private enterprise in exchange for the use of macroeconomic policies to stabilize levels of employment and income, the generation of rising levels of mass consumption, and the expansion of the public sector to guarantee a minimum level of social welfare for all members of society. The political rationale provided by Keynesian economic theory legitimated the terms of the settlement:

> It was Keynesianism that provided the ideological and political foundations for the compromise of capitalist democracy. Keynesianism held out the prospect that the state could reconcile the private ownership of the means of production with democratic management of the economy.... Democratic control over the level of unemployment and the distribution of income became the terms of the compromise which made democratic capitalism possible.[1]

The success of the post-war settlement depended upon the ability of the state to maintain a steady rate of economic growth with stable levels of prices and employment. Given the underlying assumptions of the Keynesian compromise, the achievement of this result was, in turn, dependent upon the investment behaviour of private firms. In this context, corporate tax policy constituted an important part of the post-war settlement. The high level of public spending occasioned by the increased provision of welfare benefits required governments to tap a wide variety of revenue sources. For both political and economic reasons, the corporate income tax represented an essential component of this expanded revenue base. At the same time, governments had to ensure that the taxation of private profits through the corporate income tax did not undermine the prospect of sustained investment. This would have jeopardized

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[1] A. Przeworski & M. Wallerstein, "Democratic Capitalism at the Crossroads" (1982) 2 Democracy 52 at 54.

the over-all rates of growth in the economy, and ultimately, the terms of the political settlement itself. As a consequence, the selected application of corporate tax measures came to be used as a critical means for ensuring that the incentives to invest remained strong, while leaving the nominal rates of corporate taxation untouched. Thus, the politics of the corporate income tax played a central role in the way that the specific terms of the post-war settlement were elaborated in most of the industrial democracies.

The broad consensus which existed about both the use of Keynesian fiscal policies and the role of the income tax in revenue generation began to dissolve in the 1970s with the emergence of simultaneous inflation and unemployment. The inability of Keynesian policies to deal with these problems was compounded by their growing association with the burgeoning deficits that characterized the public finances of many industrial countries. The re-emergence of budgetary deficits as a major political issue in the 1970s, in turn, heightened the political debate surrounding the main components of the public finances – the revenue and expenditure budgets. Although both sides of the budgetary process have been subjected to increasing public scrutiny in the past decade, the exact relation between them and the emerging deficits has been poorly understood, at best. Similarly, the specific national contexts of budgetary deficits have been sparsely analyzed. Although many Western industrial nations have incurred higher budgetary deficits, there are wide variations in the extent and source of these deficits. Some of the variance is undoubtedly accounted for by the different patterns of economic growth experienced in these countries, but political factors have also played a critical role.

Recent years have witnessed a substantial increase in the comparative politics literature analyzing the relationship between economic and political variables, including a number of studies that have focused directly on the relationship between the emergence of budgetary deficits and a set of political and economic variables. The results of these studies indicate that the tendency for governments to incur deficits, and the way in which governments react to the incidence of deficits, is closely linked to the nature of partisan politics within the individual countries. The extent of control of government by leftist or rightist parties accounts for a substantial degree of the cross-national variations that are observed. This variable in turn is strongly affected by the underlying relationship between the organization of social interests and politics parties.

The findings of a study by Walter Korpi and Michael Shalev, concerning the political and social variables that affect the incidence of industrial unrest, contain useful insights for this question. The authors note a strong relationship between the extent of continuous control of government by leftist parties and the degree of harmony in industrial relations. The incidence of industrial strife is directly affected by the level and nature of government spending programmes, themselves the products of the partisan control of government. The presence of leftist parties in government is in turn closely tied to a number of social factors, including the degree of unionization of the labour force, the degree of working class mobilization, the predominance of industrial unions within the labour movement, the degree of unity within the labour movement, and the strength of the ties between the labour movement and leftist political parties.[2]

Building on these findings, David Cameron examined the experience of the industrial nations to consider the effects of partisan control of the government on the origins of the deficit in the last two decades. His findings indicate a very high correlation between partisan control of the government and the level and rate of increase of government expenditure. Control of the government by leftist parties has had a substantial effect on both the level and the composition of government spending. Those countries having the highest incidence and most extended duration of leftist governments experienced the greatest increase in spending on social programmes. To some extent, government attempts to compensate for declining rates of economic growth after the mid-1960s accounted for the growth of social spending. However, even after this variable was taken into account, the partisanship of governments still

[2] W. Korpi & M. Shalev, "Strikes, Power and Politics in the Western Nations, 1900-1976" in M. Zeitlin, ed., *Political Power and Social Theory* (New York: JAI Press, 1980) 301 at 316.

explained a substantial proportion of the difference in levels of social spending.[3]

On analyzing the relationship between these factors and the incidence of deficits among the industrial countries, Cameron found that most governments were in a deficit position for the period after 1965. Furthermore, the size of the deficit increased in the period up to the early 1980s. Contrary to most popular expectations, he found no necessary correlation between high levels of public expenditure and the size of the deficits incurred by various governments. The more significant variable in predicting the size of the deficit was the relative taxing capacity of the various governments. In fact, there are significant differences in the revenue-generating capacity of the major OECD[4] nations. Statistical analysis of the source of these variations indicated that they were produced by the partisan complexion of governments in the individual countries. Countries that experienced stable and enduring leftist government in the period after 1965 had higher levels of taxation than countries in which conservative governments prevailed. The variation in the average size of the budgetary deficits was closely related to the variations in taxing capacity; there was an inverse relationship between the level of taxation and the size of the deficit.[5] On the basis of these findings, Cameron concluded that

> [e]vidently, enduring control of government by leftist parties allows nations to enjoy the benefits of a large and expanding public economy – for example, relatively generous provision of social security benefits, social assistance, and unemployment compensation – while avoiding whatever macroeconomic costs are produced by large deficits. How? By imposing relatively high taxes – especially taxes on personal income and health. The nations in which nonleftist parties usually govern are more likely to experience a smaller, more miserly public economy (especially when conservatives dominate government *and* a chronic fiscal crisis reflected in relatively large deficits (especially when centrist and Christian Democratic parties dominate

[3]D.R. Cameron, "Taxes, Spending and Deficits: Does Government Cause Inflation?" in L. Lindberg & C. Maier, eds, *The Politics of Inflation and Recession*, (Washington, D.C.: Brookings Institution, 1985) 224 at 234-39.

[4]Organization for Economic Co-operation and Development.

[5]Cameron, *supra*, note 3 at 252-59.

> government), for they are more reluctant to levy high taxes, especially the taxes on income and wealth which fall most heavily on their upper-income supporters.[6]

Cameron's findings concerning the political determinants of the tax structure receive substantial confirmation from the results of another study, by Manfred Schmidt. Schmidt examined the factors that contributed to variations in the taxing capacity of the Western industrial democracies from 1950 to the mid-1970s, breaking the findings down into three different periods for the post-war era. In the first period, the 1950s, the growth of taxing capacity was influenced by three factors: the degree of external dependence of the economy (as individual economies became more integrated into the world economy in the early post-war years, a greater degree of state intervention was required to control the repercussions of that enhanced integration);[7] the over-all rate of economic growth, which provided a broader base from which to extract government revenues; and left-wing control of the major offices of the state.[8]

The second period, 1960 to 1975, witnessed the most considerable expansion of the taxing capacity of government in these nations. In this period, the political composition of governments and the relative openness of the economy continued to be significant factors, but they were supplemented by another set of intervening variables. Of major importance were the degree of cohesion among rightist political parties, and the relative strength of the organized labour movement. In countries in which there were organizational and ideological splits among the parties of the right, fewer political impediments obstructed the expansion of the tax system to finance a higher level of public expenditures on health, welfare and educational programmes.[9]

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[6] *Ibid.* at 260.

[7] This finding is congruent with the major finding of an earlier study. Compare D.R. Cameron, "The Expansion of the Public Economy" (1978) 72 Am. Pol. Sci. Rev. 1243.

[8] M.G. Schmidt, "The Role of the Parties in Shaping Macroeconomic Policy" in F.G. Castles, ed., *The Impact of Parties: Parties and Policies in Democratic Capitalist States* (London and Beverly Hills: Sage, 1982) 97 at 118.

[9] *Ibid.* at 120.

In the most recent period of his study, covering the economic recession from the mid-1970s onward, the findings were clouded by the impact of lower rates of economic growth on government revenues. When this cyclical effect was controlled, the findings were very similar to those for the two earlier periods. The growth of the tax state continued to be much higher under social democratic governments, or in situations in which there was an even distribution of power between the leftist and rightist parties. In countries dominated by political parties of the right, increases in tax revenues were distinctly lower than would be expected on the basis of rates of economic growth.[10]

In sharp contrast to the ideological stance of most right-wing parties, the countries that have run the largest deficits are those in which centrist or right-wing parties have predominated for most of the post-war period. Because of the political constraints imposed upon them by their own electoral constituencies, these governments have proven less able than left-wing ones to implement the tax policies necessary to finance existing levels of public expenditure. This general finding is quite consistent with the statistical evidence available on the source of budgetary deficits in Canada from the mid-1970s onwards.[11] Although a large part of the Canadian deficit was caused by cyclical economic factors, most of the remainder resulted from the failure of governments to balance their revenue raising capacity with the growth of public expenditures. Canada certainly fits the case suggested by Cameron, in that the federal government has been dominated by a centrist government for most of the post-war period. A closer examination of the politics of taxation in the post-war Keynesian era suggests that the experience of the federal government in Canada closely parallels those of other centrist and right-wing governments.

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[10] *Ibid.* at 123.

[11] I have analyzed the statistical evidence on the source of budgetary deficits in Canada in greater detail in "The Politics of the Deficit" in G.B. Doern, ed., *The Politics of Economic Policy*, vol. 40 (Toronto: University of Toronto Press, 1985) 111 at 112 [Background studies prepared for the Royal Commission on the Economic Union and Development Prospects for Canada].

In Canada, it was the Liberal government of Prime Minister Mackenzie King that engineered the terms of the post-war political settlement and introduced Keynesian policy ideas into government use. The key to the success of the Liberal party in the post-war period was its ability to balance the competing claims of the broad political constituencies from which it drew support. A wide array of legislation passed in 1944 and 1945 as part of its reconstruction programme was essential to the early post-war success of the Liberal government.[12] Part of this programme was the introduction in the corporate income tax of a measure to allow for the double depreciation on up to 80 percent of the cost of investments in productive plant or equipment for the reconversion, modernization or expansion of facilities following the end of the war. Other measures introduced by the government allowed companies to write off current expenditures for research and development, to average their profit basis over several years for taxation purposes and to write off portions of the Excess Profits Tax for use in capital expansion.[13] These measures were intended to facilitate the reconversion of the economy from a wartime basis to peacetime production, as well as to overcome business fears about the possibility of a post-war recession.

In addition, the government viewed the corporate tax measures as important because of the perceived need for a trade-off with the extensive new social welfare measures also introduced as part of its reconstructive programme. Both were integral components of the post-war settlement between capital and labour. The key to the success of the settlement (and the electoral fortunes of the Liberal party) was the perception by both sides that this new form of state intervention would ultimately work to their advantage.

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[12] D.A. Wolfe, "The Rise and Demise of the Keynesian Era in Canada: Economic Policy, 1930-1982" in M.S. Cross & G.S. Kealey, eds, *Readings in Canadian Social History*, vol. 5: *Modern Canada, 1930-1980s* (Toronto: McClelland & Stewart, 1984) 46 at 49.

[13] Canada, Department of Reconstruction and Supply, *Encouragement to Industrial Expansion in Canada: Operation of Special Depreciation Provisions, November 10, 1944 – March 31, 1949* (Ottawa: King's Printer, 1948) at 17, 22.

The dramatic rise in popularity of the CCF[14] and the increased militancy of organized labour during the war had made Mackenzie King and the Liberals keenly aware of the need for reform to counter the political challenge from the left. However, the party's political history made them acutely conscious of the dangers of alienating the major business interests in Canadian society. The recollection of the "free trade" follies of the late nineteenth and early twentieth centuries made Mackenzie King determined not to repeat the mistakes of the past. The Liberal government's able prosecution of the war effort had gained them substantial support among Canada's business leaders. This support went a long way towards overcoming any opposition that might have been voiced to the reform measures. The corporate tax incentives provided the additional bond to secure the terms of the settlement. As Reg Whitaker has argued, the key to the Liberals' post-war electoral hegemony was the ability to balance this competing set of business and reform concerns:

> The Liberal party was operating in an environment in which two sometimes contradictory forces were at work in shaping the party's role. On the one hand, the party had to finance its operations as a party as well as manage a capitalist economy as a government, both of which left it vulnerable to the demands of the corporate capitalist world. On the other hand, the party had to get votes, which left it vulnerable to the demands of public opinion.... The Liberal party demonstrated superior skill at calling in one of these forces to redress the balance when the other became too dominating.[15]

The limits of this strategy seemed to have been reached, however, with the disastrous defeats of the party at the hands of John Diefenbaker's Progressive Conservatives in the federal elections of 1957 and 1958. The defeats set in motion a critical process of reappraisal within the Liberal party, particularly among a younger generation of party activists. Their feeling was that the party had lost track of the appropriate balance and its policy orientation had shifted too far to the right during the last years of the St. Laurent government. A recovery of the reforming spirit that had guided the

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[14] Co-operative Commonwealth Federation, 1932-33 to 1958; democratic socialist movement and political party; forerunner of New Democratic Party.

[15] R. Whitaker, *The Government Party: Organizing and Financing the Liberal Party of Canada, 1930-1958* (Toronto: University of Toronto Press, 1977) at 401-402.

Liberals through the early post-war years was required to improve the party's electoral prospects. The call for a renewed spirit of reform was captured best in several of the papers presented to the study conference sponsored by the National Liberal Federation at Queen's University, Kingston in September, 1960 – particularly those by Tom Kent and Maurice Lamontagne.

The paper by Tom Kent outlined the social reforms needed to recapture the spirit that had guided the Liberal policy in the reconstruction era. They included the introduction of medical insurance to complement the programme of hospital insurance created in 1957; an improved unemployment benefits scheme, which would be sensitive to national variations in the rate of unemployment; improved retraining programmes for the unemployed; the introduction of measures to simulate the relocation of capital to the depressed regions of the country; urban renewal programmes; better support for the educational system; improved programmes to deal with hard-core welfare cases; and improved levels of foreign aid.[16] Owing to Kent's role as senior policy advisor to Lester Pearson, and with strong support from the progressive wing of the Liberal party, Kent's proposals virtually became the policy agenda of the Liberal governments of the 1960s. This marked shift to the left in party policy under Pearson angered Liberal supporters in the business community who felt that the traditional liberalism of King and St. Laurent was being abandoned.[17]

The emphasis on redistributive policies seemed to be even more accentuated during the early years of the Trudeau government, to the continued dismay of business interests. This growing dissatisfaction with the Liberals crystallized in opposition to the effort at comprehensive tax reform, which followed closely after a decade of major social reforms. Irony lay in the fact that the tax reform process had been initiated by the Diefenbaker government when, in response to business' concerns over problems with the tax system, it established the Royal (Carter) Commission in September

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[16] T. Kent, *Social Policy for Canada: Towards a Philosophy of Social Security* (Ottawa: Policy Press, 1962) at 39-50.

[17] C. McCall-Newman, *Grits: An Intimate Portrait of the Liberal Party* (Toronto: Macmillan, 1982) at 268.

1962 to study the matter and make recommendations. The final report of the Royal Commission, released in 1967, was far from what had been expected. It adopted a position which stressed the need for the integration of personal and corporate taxation and placed primary emphasis on the personal income tax as the best means to achieve this goal. The Commission recommended that horizontal equity was to be achieved through broadening the base of the personal income tax to include virtually all accretions to wealth; personal and corporate income taxes were to be fully integrated; the corporate income tax would continue to be collected at a uniform rate for all corporate profits, but would be only a withholding tax to be credited against the personal tax due on income; the preferential tax treatment afforded to earnings from mineral extraction was to be substantially reduced; and finally, insurance companies and banks were to be taxed in a manner more nearly conforming with other companies. The recommendations of the Royal Commission were met by an extremely hostile reaction from the business community, despite the impeccable, blue-ribbon credentials of its members. As one student of the subject expressed it, "The release of the Carter *Report* unleashed one of the most massive campaigns of corporate pressure upon the state in modern Canadian political history."[18]

In an effort to mollify the outraged business community, some of the Carter recommendations were substantially watered down in the *White Paper on Tax Reform* introduced by the Trudeau government in 1969. With respect to the corporate income tax, the *White Paper* proposed that corporations be classified into two types, widely-held and closely-held, to be determined by the method of trading of the corporation's shares. The tax treatment of the closely-held corporations was to follow the full-integration model recommended by the Carter Commission, while the widely-held corporations were only to be subject to half integration. The *White Paper* also recommended that realized capital gains be brought into income and taxed at ordinary rates. The corporation income tax was to be levied at a uniform rate of 50 percent on all corporate income, effectively eliminating the preferred tax treatment of small

[18] R. Gardner, "Tax Reform and Class Interests: The Fate of Progressive Reform, 1967-72," (1981) 3 Can. Tax. 245 at 247.

businesses. The mining and oil industries were to continue to receive preferential treatment but to a slightly lesser extent than they had previously.

The *White Paper* proposals were referred to standing committees of the House of Commons and the Senate for detailed study and public comment. The standing committees, particularly the Senate committee, which was largely composed of corporate tax lawyers, provided a convenient platform for the numerous business opponents of the proposed reforms to air their positions. Opposition to the *White Paper* was expressed through organized, mass letter-writing campaigns, through intensive lobbying efforts organized by the major business interests, and through strategic announcements of delays in major investment projects. The proposal to eliminate the lower tax rate for small businesses stimulated a strong reaction. Opposition from small business rallied behind the hastily formed Canadian Council for Fair Taxation in an extensive lobbying and public relations effort. The mining companies, led by Alfred Powis of Noranda Mines, were especially skilled at lobbying the provincial governments to make representations on their behalf to the federal government. The public debate over the tax reform proposals occurred in the middle of 1970, when many businesses in Canada were already beginning to suffer the adverse effects of the recession induced by the government's restraint policies. The newly elected Liberal Premier of Quebec, Robert Bourassa, who had promised to create 100,000 new jobs in the province, was especially vulnerable to the threatened capital strike. Inevitably, the Liberal government caved in under this sustained pressure from the business community. The reports of both Parliamentary committees recommended substantial modifications to the proposals of the *White Paper* and even before the reports were tabled in late 1970, the government had committed itself to some key changes.[19]

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[19] *Ibid.* at 251-53; the stages of tax reform are also described in M. Bucovetsky & R.M. Bird, "Tax Reform in Canada: A Progress Report" (1972) 25 Nat'l Tax J. 15; first-hand accounts of the policy process are provided by E. Kierans, "Problems of Tax Reform" (Winter 1979) 1 Can. Tax 22; M. Saltsman, "Reflections on Tax Reform in Canada" (Winter 1979) 1 Can. Tax. 25 at 25-26. The specific role played by the mining industry is analyzed in M. Bucovetsky, "The Mining Industry and the Great Tax Reform Debate" in A.P. Pross, ed., *Pressure Group Behaviour in Canadian Politics* (Toronto: McGraw-Hill Ryerson, 1975) 89. The influential role of the Senate Committee on Banking and Finance is discussed in C.

The amendments to the *Income Tax Act* that were finally introduced in 1971 contained an even more diluted version of the proposals originally recommended by the Carter Commission. In the area of capital gains, only half of the realized gains were to be reported as personal income and taxed at the applicable rate; in the place of the integration of personal and corporate income tax, there was to be a partial gross-up and credit for dividends received from taxable Canadian corporations; the corporate tax rate was set at a lower level than had originally been proposed and the lower tax rate on the profits of small businesses was retained; and finally, the provisions relating to the taxation of income from mining and oil and gas production followed the broad outlines of the *White Paper*, but incorporated several further liberalizations with respect to the assets of new mines and the calculations of earned depletion allowances.[20]

In effect the final result of the nearly nine-year-long tax reform process was a far cry from the scope and breadth of the original set of Carter proposals. By any objective criterion, the outcome of the political process would have to be seen as a great victory for the various business groups that had lobbied long and hard to protect their vested interests. The political costs of their acceptance of even a limited broadening of the tax base was the inclusion of a number of principal concessions: the one-half taxation of capital gains; the introduction of the dividend tax credit; the retention of the small-business tax rate; and the allowance of deductions for interest on money borrowed to acquire the shares of another corporation (which was included at the last minute in the tax reform bill). Reflecting on the outcome from the perspective of a decade later, J. Harvey Perry, a former member of the Carter Commission, wrote:

> It is an understatement to say that the final results fell far short of [the] goals. The grand designs crumbled under concerted taxpayer pressure.... The federal tax system

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Campbell, *The Canadian Senate: A Lobby From Within* (Toronto: Macmillan of Canada, 1978) at 15-17.

[20]Gardner, *supra*, note 18 at 253-55; Bucovetsky & Bird, *supra*, note 19 at 15-41.

> is now so riddled with special features that one would almost conclude that the reverse of the commission's plea for neutrality had been followed....[21]

In spite of the clear victory that they had won, the entire reform process left a bitter taste in the mouths of the business community, and a legacy of bad feeling between it and the Liberal government of Pierre Trudeau.

The moderate degree of uniformity and progressivity achieved as a result of tax reform was further eroded in the budgets of the subsequent years. The erosion began with the first budget of the new Finance Minister, John Turner, in May 1972. Turner's elevation to the Finance portfolio was seen as a direct attempt by the Prime Minister to appease the hostile business reaction aroused by his government's recent policy initiatives. If this was indeed his role, Turner wasted little time in setting about the task. The immediate pretext was the introduction by the United States government of a co-ordinated series of policies in August 1971 designed to promote greater investment by U.S. multinationals and to encourage them to relocate some of their manufacturing activity within the boundaries of the domestic economy. The measures that constituted this part of President Nixon's new economic policy included a special investment credit for firms undertaking new investment in the U.S., the proposals for an accelerated depreciation range that would enable firms to derive greater tax benefits from new investment in the U.S. and the Domestic International Sales Corporation (DISC) proposal that was designed to provide for the deferral of corporate income taxes on profits earned by American corporations from exports. The DISC proposal gave rise to the greatest concern among Canadian policy-makers. In the view of an interdepartmental committee set up to analyze corporate tax incentives, "The D.I.S.C. legislation posed three potential threats to the Canadian economy – increased competition from U.S. exporters in Canadian markets, increased competition in third country markets and increased incentives for new capital investment and the accompanying new

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[21] J.H. Perry, *Background of Current Fiscal Problems*, Canadian Tax Paper No. 68 (Toronto: Canadian Tax Foundation, 1982) at 86; the origins of the corporate interest deduction are discussed in G. Bale, "The Interest Deduction to Acquire Shares in Other Corporations: An Unfortunate Corporate Welfare Tax Subsidy" (1981) 3 Can. Tax. 189 at 191.

employment opportunities to be located in the United States rather than in Canada."[22]

The Turner budget made it clear that the Canadian government was not prepared to lose a bidding war with the U.S. government for the loyalty of American multinationals. The budget introduced a new two-year write-off of the cost of all machinery and equipment purchased after 8 May 1972 for use in the manufacturing and processing of goods in Canada. It also announced a reduction in the top rate of corporate income tax applicable to manufacturing and processing profits after 1 January 1973 from 49 to 40 percent. An independent econometric study of the relative effects of the Canadian and American tax measures concluded that the degree of tax relief provided by the Canadian measures was much greater than that provided by the American ones.[23] This substantial difference can only be explained as an attempt by the Liberal government to mend some of its fences with the business community and to restore the terms of the post-war political settlement.

The size of the corporate tax cuts was sufficiently large to arouse the New Democratic Party to focus on them as a major issue in the federal election campaign that year. The NDP leader, David Lewis, travelled across the country denouncing the Liberal government for its hand-outs to the "corporate welfare bums." Lewis condemned the Liberals in the following terms:

> In the last eight years, the federal government gave away $3.5 billion to industry in the form of grants and other subsidies, and approximately twice as much in income-tax concessions – a total of $10 billion to the corporations, most of them large and wealthy. Despite all this corporate welfare, hundreds of thousands of Canadians are jobless, and millions are living in poverty. Messrs. Trudeau and Stanfield talk about the importance of "business confidence". With profits rising every year, I don't believe we have to cater any longer to this bromide.[24]

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[22] Canada, Tax Measures Review Committee, *Corporate Tax Measures Review* (Ottawa: Information Canada, 1975) at 12.

[23] J. Helliwell & J. Lester, "Reviewing the Latest DISC: Simulations of its Aggregate Impact on Canada" (1972) 20 Can. Tax. J. 291 at 297.

[24] D. Lewis, *Louder Voices: The Corporate Welfare Bums* (Toronto: James, Lewis and Samuel, 1972) at 111.

The attack on the "corporate welfare bums" garnered the NDP a great deal of attention in the federal election, and the party wound up holding the balance of power in the next Parliament. The corporate tax measures had not passed through Parliament before the election was called, so they had to be reintroduced in the new session. The NDP eventually agreed to support the passage of the measures on the condition that their duration would be limited and that the government adopt an expansionary fiscal stance in the 1973 budget. However, with the return of the Liberals as a majority government after the federal election of 1974, the corporate tax incentives were enshrined as permanent features of the tax system. The corporate tax measures of 1972 were merely the most visible of a host of changes introduced in the tax system in the years immediately following tax reform. In each of the five years following the passage of the tax reform bill, the number of amendments to the *Act* ranged between 75 and 175. According to the Minister of Finance who presided over most of these changes, the extensive amendments "reflected a decision to roll back on unworkable sections of "tax reform." It was a deliberate decision."[25] The verdict of what constituted "unworkable" was clearly as much a political judgment on the effects of tax reform, as it was a technical or administrative judgment.

The indefinite extension of the corporate tax write-offs in the fall of 1974 was partially justified as a counter-cyclical stabilization measure to counter the effects of the global recession brought on that year by the OPEC[26] energy price increases. As the recession intensified throughout 1975 and as growing labour militancy squeezed corporate profits, the government resisted the pressure to implement mandatory wage and price controls. Instead, it resorted to the adoption of a 5 percent investment tax credit in the budget of June 1975 for investment in new buildings, machinery and equipment for the manufacturing and processing industries undertaken between 24

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[25] D.G. Hartle, *The Revenue Budget Process of the Government of Canada: Description, Appraisal, and Proposals*, Canadian Tax Paper No. 67 (Toronto: Canadian Tax Foundation, 1982) at 22.

[26] Organization of Petroleum Exporting Countries.

June 1975 and 30 June 1977. The tax credit measure was a novel departure from the previous pattern of corporate tax policy, in that it resulted in a permanent tax saving rather than the deferred tax liability which resulted from the accelerated depreciation measures. The investment tax credit was intended as a direct and permanent form of relief to the beleaguered business interests suffering from the increased wage pressure of a militant labour movement.[27]

The business goodwill so assiduously cultivated by John Turner in his brief tenure in the Finance portfolio was quickly dissipated by the introduction of a policy of comprehensive wage and price controls in the fall of 1975, coupled with Pierre Trudeau's famous musings on the future of the free enterprise system in a year-end television interview. Although the business community had aggressively pressed the government to intervene in restraint of union wage demands, they were aghast at the kind of complicated regulations that the newly established Anti-Inflation Board imposed upon them.

The recession of the mid-1970s, coupled with business's alienation from the Trudeau government, did little to restore the Canadian economy to economic growth or lower the historically high rates of unemployment. The virtual abandonment of Keynesianism in 1975, with the imposition of wage and price controls and the swing to monetarism, discredited the post-war settlement from labour's perspective as well. In an attempt to promote some semblance of recovery, the government turned again to the tried and true techniques of the corporate tax incentives. In the budget of March 1977 the investment tax credit, which had been scheduled to expire, was extended until 1 July 1980 and its coverage was expanded to include current and capital expenditures on scientific research and development. In addition, the credit was increased to 7½ percent for areas designated under the *Regional Development Incentives Act* (RDIA), except for the Gaspé and the Atlantic provinces, where it was raised to 10 percent. These measures were extended further in the budget of April 1978. For the next ten years corporations would be allowed to deduct from their taxable

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[27] F.J. Harmon & J.A. Johnson, "An Examination of Government Tax Incentives for Business Investment in Canada" (1978) 26 Can. Tax J. 691 at 694.

income 50 percent of additional current and capital expenditures on research and development to the extent that those expenditures exceeded the average amount spent over the previous three years.[28]

The second budget of that year, brought down in November, provided a further extension of the corporate tax incentives. Acting on the recommendations of the Twenty-three Sector Industry Task Forces, which had been established as a consultative process with business and labour to chart a course for industrial strategy, the Minister of Finance announced the indefinite extension of the investment tax credit and the raising of the basic rate to 7 percent from 5 percent. The rate for investments in areas designated under the RDIA was raised to 10 percent from 7½ percent and for those in the Atlantic provinces and the Gaspé region of Quebec, it was doubled from 10 to 20 percent. Furthermore, investments in equipment for rail, air, water and long-haul road transportation were also made eligible for the 7 percent basic tax credit.[29]

The ever greater reliance placed by the government on the corporate tax system as a policy instrument during the 1970s was the product of a number of factors. In part it reflected the government's continuing belief that tax incentives represented an effective tool to stimulate business investment, despite mounting academic evidence which cast doubt on this assumption. More significantly, however, the reliance on corporate tax incentives to promote economic growth served as a political device to repair the damage caused by other policy initiatives. In the early 1970s, the corporate tax incentives were part of a broader effort at fence-mending to counteract the legacy of the first Trudeau administration. In the latter part of the decade, the tax incentives clearly constituted an attempt to placate some of the business community's outrage over what it saw as the Trudeau government's growing commitment to state intervention in the economy. The ultimate success of this attempt to buy business' affections with tax dollars is highly dubious,

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[28] R.M. Bird, *Tax Incentives for Investment: The State of the Art*, Canadian Tax Paper No. 64 (Toronto: Canadian Tax Foundation, 1980) at 6.

[29] *Ibid.*; the Twenty-three Sector Industry Task Forces are described in greater detail in R.D. French, *How Ottawa Decides: Planning and Industrial Policy-Making 1968-1980* (Toronto: James Lorimer, 1980) at 120-23.

given the overwhelming level of support displayed by the business community for the Progressive Conservative party in the federal elections of 1979 and 1980.[30]

The greater reliance on the use of corporate tax incentives over the course of the decade represented merely the tip of the tax "iceberg". Reductions in the sales tax, the personal income tax and tariff rates were added on, along with further improvements in the terms of Registered Retirement Savings Plans and the introduction of the Registered Home Ownership Savings Plan. During the second half of the decade, spending through the tax system is estimated to have grown at a rate of 42 percent, compared with a 30 percent rate of growth of direct expenditures.[31] The federal budget paper on the deficit, issued in April 1983, estimated that the net effect of the major discretionary tax changes introduced since 1972 (excluding the indexation of the personal income tax) was to reduce federal budgetary revenues by $9.825 billion less than they would otherwise have been in the fiscal year 1982-83.[32] The increased use of tax expenditures as a tool of economic policy over the course of the decade was a primary cause of the widening federal budgetary deficit.

The legacy of tax policy in Canada during the 1970s bears a striking resemblance to the experience of other industrialized democracies governed by centrist and right-wing parties. The business and upper-income constituencies of the Liberal party proved strongly resistant to any attempted imposition of the levels of taxation necessary to fund the increased social spending of the 1960s. The Liberal party alienated a substantial portion of its business and upper-income constituencies during the 1960s with what were perceived as overly generous transfer programmes, culminating in a disastrous attempt at comprehensive tax reform. In this context, the

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[30] S. Duncan, "What Ottawa Did to Energy It May Do to Other Industries," *The Financial Post* (29 November 1980).

[31] E. Tamagno, "Comparing Direct Spending and Tax Spending" (Winter 1979) 1 Can. Tax. 44.

[32] Canada, Department of Finance, *The Federal Deficit in Perspective* (Ottawa: Queen's Printer, 1983) at 50-53; D.A. Wolfe, "The Politics of the Deficit" in *The Politics of Economic Policy*, *supra*, note 11 at 120-21.

tax reform process initiated with the release of the *Carter Commission Report* in 1967 stands out as a crucial turning point in the history of the post-war settlement and the Keynesian welfare state in Canada. Tax policy had initially constituted an important policy instrument in the mesh of compromises that bound together the post-war settlement; as a result of the effort to establish a rationalized tax system to finance the expanding costs of the welfare state, it came to symbolize the exact opposite. The price of repairing the political damage was a steady stream of tax concessions intended to reassure private enterprises and upper-income individuals that the cost of the welfare state in Canada would not fall on their shoulders. The persistent efforts to buy the affections of both large corporations and upper income earners with tax dollars created gaping holes in the tax structure and the fiscal position of the federal government. In many respects, the true legacy of the Carter Commission was not the reformed *Income Tax Act* of 1971, but rather the myriad of tax expenditure items introduced in the corporate and personal income tax during the decade that followed. Ultimately, this legacy of tax expenditures, and the burgeoning deficit they produced, weakened the efficacy of Keynesian fiscal policies and signalled the demise of the post-war settlement in Canada.