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The Politics Of Canadian Tax Policy: 1978--1988 Tax Reform As Constitutional Change

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THE POLITICS OF CANADIAN TAX POLICY: 1978-88

-- TAX REFORM AS CONSTITUTIONAL CHANGE

by

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ABSTRACT

Large-scale tax reforms have such a pervasive impact on political and economic relationships within a society that they may be considered as a form of constitutional change.

This thesis examines the concept of the economic constitution as applied to the Canadian income and sales tax systems during the 1970s and 1980s. It analyzes the institutions, ideas and interests which shaped comprehensive tax reform proposals by Canadian Finance Ministers in 1981 and 1987-88, and compares it with piecemeal approaches to tax reform during this era. It concludes that large-scale tax reform initiatives are unlikely to be politically viable or durable unless the following four major conditions are met.

There must be a broad consensus among policy-makers, stakeholder groups and the general public on policy objectives and the feasibility of proposed reforms in meeting those objectives. Political leaders must be able to navigate proposed reforms through the bureaucracy, cabinet and Parliament, and must be able to overcome institutional constraints inside and outside government. Proposed tax reforms must deliver tangible benefits for the majority; and tax reform must be accompanied by measures designed to minimize the inevitable business and economic disruptions resulting from reform. This frequently involves some form of compensation to existing stakeholders to assist in the transition to the new policy structure.

KEYWORDS -- Taxation - Canada, Tax Reform - Canada, Budgets - Canada, Economic Constitution, Interest Groups.

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If taxation is the lifeblood of the body politic, research grants often fulfil a similar function for graduate students. The author acknowledges the financial support of the Social Sciences and Humanities Research Council in the research and writing of this study.

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CHAPTER 1 -- INTRODUCTION

The economic and fiscal structures which guide Canadian tax policies experienced major changes in the 1980s. These were as far-reaching, in their own way, as the changes which occurred in the political constitution. In fact, they have had as substantive an impact on the lives of ordinary Canadians as have changes to the political constitution. These changes reflect a substantial shift in the climate of ideas shaping fiscal and tax policies not only in Canada but also throughout much of the industrialized world. As such, they may be viewed as tantamount to changes in the "economic constitution" -- by which we mean the generalized rules and institutions which create a durable framework of order for the economic activities of individuals, groups and governments in a society.[1]

This thesis examines three distinct attempts to introduce major structural changes to the Canadian federal tax system, or tax reform[2], under successive Ministers of Finance between 1978 and 1988. These are Allan MacEachen's tax reform budgets of 1981-82; a series of piecemeal structural changes introduced by Marc Lalonde and Michael Wilson between 1982 and 1986 and Michael Wilson's White Paper and Income Tax Reforms of 1987-88.

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[1] James M. Buchanan, *The Economics and Ethics of Constitutional Order*, (Ann Arbor, MI, University of Michigan Press, 1991).

[2] Tax reform can be defined as major structural changes to the tax system or a major rebalancing of government revenue sources. It may involve system-wide attempts at restructuring the rules and principles of taxation or "piecemeal" approaches dealing with major segments of the tax structure. See Martin Feldstein, "On the Theory of Tax Reform", *Journal of Public Economics* 6, [1977], 77-102; F. St. Hilaire and J. Whalley, "Reforming Taxes: Some Problems of Implementation", from David Laidler (ed.), *Approaches to Economic Well-Being*, (Toronto, University of Toronto Press, 1985), 195-96; Alan Peacock, "Fiscal Theory and the Market for Tax Reform", from Karl W. Roskamp & Francesco Forte, eds. *Reforms of Tax Systems*, (Detroit, Wayne State Univ. Press, 1980), 11-21.

The Political Economy of Tax Reform

The study of tax policy is dominated by economists. However, any significant change in tax policy or in the overall level or distribution of taxation has major political implications. The Carter Commission report and the resulting White Paper on Tax Reform (1967-71) have been the subject of extensive political and economic analysis.[3] Less has been written on the partially aborted 1981 tax reform budget, although the Canadian Tax Foundation has published a series of works on technical aspects of tax policy during the 1980s. More recently, Allan Maslove has summarized the political process and the distributive effects of the federal tax reform initiative of 1987-88.[4]

International tax reform trends have been the subject of extensive discussion, especially by economists such as Richard Bird, Michael Boskin, Sijbren Cnossen, Kenneth Messere, Charles McLure, and Joseph Pechman.[5] The political economy of tax reform has undergone significant rethinking since the early 1970s, as part of a larger challenge to traditional models of public finance. Several theorists of public choice have challenged

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[3] For a discussion of the tax reform debates of the 1960s, see Richard M. Bird, "The Tax Kaleidoscope: Perspectives on Tax Reform in Canada", *Canadian Tax Journal* 18:5, [September-October 1970], 444-473; Meyer Bukovetsky and Richard M. Bird, "Tax Reform in Canada: A Progress Report", *National Tax Journal* 25, [March 1972], 15-41; Neil Brooks, *The Quest for Tax Reform:, the Royal Commission on Taxation Twenty Years Later*, (Toronto, Carswell, 1988); Leslie T. MacDonald, *Taxing Comprehensive Income: Power and Participation in Canadian Politics 1962-1972*, Ph.D. Dissertation, Carleton University, 1985.

[4] Allan Maslove, *The Politics of Tax Reform*, (Halifax, NS, Institute for Research in Public Policy, 1989).

[5] John G. Head and Richard M. Bird, "Tax Policy Options in the 1980s", in Sijbren Cnossen (ed.), *Comparative Tax Studies*, (Amsterdam, North Holland, 1983), 3-29; Bird, "The Tax Kaleidoscope...", 433-442; Richard M. Bird & Charles E. McLure, Jr., "The Personal Income Tax in an Interdependent World" in Sijbren Cnossen & Richard M. Bird, *The Personal Income Tax: Phoenix from the Ashes?*, (Amsterdam, North Holland, 1990), 235-255; Michael J. Boskin, *Reagan and the Economy*, (San Francisco, Institute for Contemporary Studies, 1987); Sijbren Cnossen, ed., *Comparative Tax Studies*, (Amsterdam, North Holland, 1983); Cnossen, "Overview", in Joseph M. Pechman, ed., *World Tax Reform -- A Progress Report*, (Washington, DC, The Brookings Institution, 1989), 261-268.

many of the traditional assumptions of public finance. These include James Buchanan's work on fiscal exchange theory and the "leviathan" model of taxation[6], Walter Hettich and Stanley Winer's proposals for a "Positive Theory of Taxation"[7], and Irwin Gillespie's adaptation of this theory to the structure and process of Canadian tax policy.[8]

The politics of tax policy can be analyzed in a number of different ways. Historically, the breakdown of the political consensus on economic policy-making in Western industrialized nations during the 1970s has many parallels to the political and economic crisis facing politicians and policy-makers during the 1930s and 1940s -- out of which eventually emerged a new Keynesian consensus. Drawing on the debate over Keynesian ideas in the 1940s, Peter Hall suggests a synthesis of three separate models for analyzing the management of major policy changes in industrial democracies: the idea-centered approach, the management or institution-centered approach and the coalition-building approach.[9] An understanding of these models can explain how pressures for structural

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[6] James M. Buchanan, "Taxation in Fiscal Exchange", *Journal of Public Economics* 6 (1976), 17-29; Buchanan, "The Limits of Taxation", in Walter Block and Michael Walker (eds.), *Taxation: An International Perspective*, (Vancouver, Fraser Institute, 1984); James M. Buchanan and Richard E. Wagner, *Democracy in Deficit: The Political Legacy of Lord Keynes*, (New York, Academic Press, 1977); Geoffrey Brennan and James M. Buchanan, *The Power to Tax: Analytical Foundations of a Fiscal Constitution*, (Cambridge, Cambridge Univ. Press, 1980).

[7] Walter Hettich and Stanley Winer, "A Positive Model of Tax Structure", *Journal of Public Economics* 24, [September 1984], 67-87; Hettich & Winer, "Blueprints and Pathways: The Shifting Foundations of Tax Reform", *National Tax Journal* XXXVIII(4), December 1985, 423-445; Hettich & Winer, "The Positive Political Economy of Income Taxation", in Cnossen & Bird (eds.), *The Personal Income Tax: Phoenix from the Ashes?*, 265-289.

[8] W. Irwin Gillespie, "The Department of Finance and PEMS: Increased Influence or Reduced Monopoly Power", in Allan M. Maslove (ed.), *How Ottawa Spends 1984*: The New Agenda, (Toronto, Methuen, 1984), 189-214; Gillespie, *Tax, Borrow and Spend: Financing Federal Spending in Canada, 1867-1990*, (Ottawa, Carleton University Press, 1991).

[9] Peter A. Hall, *The Political Power of Economic Ideas*, (Princeton, Princeton University Press, 1988). A similar approach is taken by Bruce Doern & Glen Toner in their study of the National Energy Program of 1980, *The Politics of Energy*, (Toronto, Methuen, 1985).

economic change are translated into major changes in tax policy through the political process. The following three sections address each of these three approaches.

1) The Idea-Centered Approach

The idea-centered model of policy change is based on the belief that the activities of the modern state require a set of unifying principles capable of generating answers to the major policy challenges facing public policy-makers and cloaking the detailed actions of the state with a semblance of popular consent. It is the contention of this thesis that the unifying principles of post-war Canadian economic policy were unable to address the political and economic challenges of governing Canada in the 1970s and early 1980s. The politics of economic policy, and with it tax policy, were centered on the search for a new national policy that would address the challenges facing the Canadian economy, balancing the demands of competing social and economic interests, and serving the interests of the federal state.[10] Thus, the search for tax reform was closely linked to the development of a new economic policy paradigm -- a restructuring of the quasi-constitutional arrangements governing public policies and the allocation of property rights and economic opportunities among Canadians.

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[10] See Chapter 7. The concept of a "new national policy" is outlined in Donald V. Smiley, "Canada and the Quest for a National Policy", *Canadian Journal of Political Science* VIII(1), [March 1975], 40-62. A competing concept for national economic development, an "international policy" of combining a neo-liberal approach of removing barriers to trade and investment while expanding the domestic welfare state, is outlined in Richard Simeon and Ian Robinson, *State, Society and the Development of Canadian Federalism*, (Toronto, University of Toronto Press, 1990). John McDougall and Smiley both cite Harold Innis' scepticism over the limitations of a centralized industrial strategy in addressing the often competing needs of Canada's diverse provincial and regional economies. See John N. McDougall, "North American Integration and Canadian Disunity", *Canadian Public Policy* XVII(4), [September 1991], 395-408; Smiley, "Canada and the Quest for a National Policy"; H.A. Innis, "Decentralization and Democracy", from *Essays in Canadian Economic History*, Mary Q. Innis, (ed.), 1956.

At its simplest level, the idea-centered model is based on two questions: "what are the objectives of tax policy?" and "how many different objectives can a tax system pursue until the competition among objectives makes the whole process self-defeating?" The search for a rational, internally coherent tax policy is at the heart of any debate on tax reform.

The politics of tax reform reflects a debate with both technical and philosophical elements over the most effective ways to balance the competing objectives of tax policy. Tax reform can be approached in several ways.

Comprehensive tax reform involves an attempt to rationalize and restructure in one legislative package a major component of the overall tax system, such as income taxation or sales taxation in pursuit of a limited number of political and theoretical objectives. These often reflect a high degree of abstraction, and the subordination of political considerations and trade-offs to the grand design of tax theorists.[11]

Piecemeal tax reform involves individual changes to a particular element of the tax system, such as the tax treatment of inflation, energy development, families or retirement savings, in isolation from the rest. Martin Feldstein and others argue for piecemeal,

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[11] Noted proposals for comprehensive tax reform are those of Carter Commission report of 1967, which inspired the Benson White Paper of 1969; the Meade Committee in Great Britain (J.D. Meade, Chmn., *The Structure and Reform of Basic Taxation*, (London, George Allen & Unwin, 1978), and the U.S. Treasury, Blueprints for Basic Tax Reform, (Washington, Government Printing Office, 1977). For an overview of competing normative concepts of tax reform, see Hettich and Winer, "Blueprints and Pathways"; John Bossons, "The Objectives of Taxation and the Carter Commission Proposals", *Canadian Public Administration* XII, [Summer 1969], 137-165; also St. Hilaire & Whalley, "Reforming Taxes: Some Problems of Implementation"; Feldstein, "On the Theory of Tax Reform".

systematic tax reform as a way of bringing about large-scale changes in an orderly, politically manageable way.[12] These ideas are addressed in greater detail in Chapter 3.

The philosophical debate is primarily over the character and principles on which government policy should be based, and is therefore inevitably value-laden and influenced by ideology. The dominant ideology of tax reform during the 1960s and early 1970s, reflected in the Carter Commission Report, was proudly rationalist in its assumptions. It asserted that governments had the ability and, indeed, the responsibility to redesign the tax system from first principles. It also contended that the benefits resulting from the comprehensive application of its theoretical model would far outweigh the social and economic costs of the transition.[13] This position, which largely ignores both the political dimension of tax reform and the extent to which existing tax laws have a pervasive impact on a nation's social and economic arrangements, is open to challenge both on empirical and philosophical grounds. For example, Gillespie argues that:

> the problem lies in the complete lack of relationship between the "good" tax system based on the norms of analysts and the tax system which is the outcome of a very political marketplace where groups of politicians compete against one another for the votes of the electorate which will bestow the prize of political power. ... To ignore this political process ... is to ignore the systematic, analytical examination of the causes of tax reform, the processes of tax reform and the possible limits of tax reform.[14]

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[12] Examples of major "piecemeal" changes to the tax system include inflation indexation in the 1973 federal budget and its partial withdrawal in the 1985 budget, the proposed changes to tax treatment of retirement savings in the 1984 budget, (eventually implemented in 1991), changes to the Corporate Income Tax system in 1986 and the restructuring of the Unemployment Insurance system in 1989-90.

[13] "Carter Report"; Bossons, "The Carter Commission ...".

[14] W. Irwin Gillespie, "Tax Reform: the Battlefield, the Strategies, the Spoils", *Canadian Public Administration* 26(2), [Summer 1983], 183; at an empirical level, see Roger S. Smith, "Rates of Personal Income Tax: The Carter Commission Revisited", *Canadian Tax Journal* 35(5), [September-October 1987], 1226-1248; on the philosophy of tax reform, see Feldstein, "On the Theory of Tax Reform", and Brennan and Buchanan, *The Power to Tax*; at a broader philosophical level, see Michael Oakeshott, "Rationalism in Politics", in *Rationalism and Politics and Other Essays*, rev. ed., (Indianapolis, Liberty Press, 1991).

Thus, it is not enough for ideas to offer the prospect of resolving pressing economic and social problems. Nor is it sufficient for them to be able to attract public support. First, they must be adopted by those responsible for the formal design, authorization and implementation of policy within the institutions of governments and their related policy communities.

2) The Institution-Centered Approach

The institutional framework for policy making plays a vital role in determining the nature and direction of policy innovation.[15] Institutions may be conceived in two ways: as formal legal structures -- constitutions, legal precedents, and formal government organizations -- or as political, legal and administrative conventions which govern the relationships of individuals, groups and organizations within the polity, economy and society.[16] Wildavsky, Weir, Good, Maslove, Hartle and Steinmo[17] all stress the importance of institutions and processes to the shaping of budgetary priorities and tax policies.

The management or institution-centered model is based on the internal requirements, processes and interests of the key policy-making bodies within the federal government,

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[15] Margaret Weir, "Ideas and Politics: The Acceptance of Keynesianism in Britain and the United States", from Hall, *The Political Power of Economic Ideas*, 53-86.

[16] Sven Steinmo, "Political Institutions and Tax Policy in the United States, Sweden and Britain", *World Politics* XLI(4), 502.

[17] Aaron Wildavsky, *Budgeting: A Comparative Theory of Budgetary Processes,* 2nd ed., (New Brunswick NJ, Transaction Books, 1986); Margaret Weir, "Ideas and Politics"; David A. Good, *The Politics of Anticipation*, (Ottawa, School of Public Administration, Carleton University, 1980); Maslove, *The Politics of Tax Reform*, and Douglas G. Hartle, *The Revenue Budget Process of the Government of Canada*, (Toronto, Canadian Tax Foundation, 1982); Hartle, *The Federal Deficit*, Discussion Paper 93-30, Government and Competitiveness Series, (Kingston, ON, School of Policy Studies, Queen's University, 1993); Sven Steinmo, "Political Institutions and Tax Policy in the United States, Sweden and Britain".

especially the Department of Finance, the Privy Council Office and the Cabinet. While the Minister and Department of Finance have a virtual monopoly over the technical aspects of tax policy, and are the single most important players in the determination of national economic policies, they must work within a number of important institutional constraints.

Tax and economic policies must be consistent with the broader political and economic strategies of the federal government. The Minister of Finance is heavily dependent upon the active support of the Prime Minister in order to exercise effective control over spending targets and fiscal policy. The Minister faces constant pressures from his cabinet colleagues to accommodate a wide range of policy objectives, along with the partisan political calculations of the government. The increasingly rigorous commitment of the Bank of Canada since the mid-1970s to restrictive monetary policies to contain and reduce inflation have also imposed periodic constraints on federal fiscal and tax policies.

Other constraints on Canadian Finance Ministers include those imposed by provincial governments, international capital markets and Canada's status as a small, relatively open, trade-dependent economy. These issues will be addressed in greater detail in Chapter 4.

The willingness of provincial governments to accommodate major changes can also be a major constraint on structural changes to federal tax policy, especially in areas of taxation in which federal and provincial taxation overlap, or which are vital to the economic development of larger provinces. As federal-provincial income tax collection agreements largely integrate the tax bases of the federal government and nine provinces,[18] federal tax reform effectively becomes provincial tax reform as well.[19]

The Department of Finance has sought consistently to maintain its independence from societal actors in defining the objectives and methods of tax policy. Between 1982 and 1988, it generally avoided head-on confrontations with other major political interests, preferring to harmonize differences through a process of informal bargaining, negotiation and consensus-building. The difference between the tax reform initiatives of 1981 and 1987-88 was that a key objective of the former was to redistribute political and economic power from the private to the public sector without prior notice or consultation, while that of the second was to rationalize tax preferences while actively developing processes to cultivate the support of societal actors -- both inside and outside the business community.

The Department of Finance responded to the increased pressure from competing interest groups in the 1980s by making significant changes to its organization, staff levels and consultation processes in order to maintain control over the budgetary process. Even so, during this period, it faced increased pressure from an increasingly active Commons' Finance Committee, which for a time became a major vehicle for the public communication and legitimization of changes to tax policy.

The thesis will build on studies of previous tax reform initiatives by analyzing the increasingly complex processes of consultation and alliance building necessary for Finance Ministers and their officials if they were to translate proposals for structural change into law during the 1980s. It will also review the impact of competing political

[18] Quebec maintains its own personal income tax system. Quebec, Ontario, and Alberta have separate corporate income tax structures from that of the federal government.

[19] For a discussion of the impact of tax reforms on provincial economies in the fields of income, sales, and excise taxes and tax-related transfers (equalization), see David W. Conklin and France St. Hilaire, *Provincial Tax Reforms: Options and Opportunities*, (Halifax, NS, Institute for Research on Public Policy, 1990).

demands from a growing range of societal interests for the legitimation of federal tax policies through increased openness and accountability both in the design and administration of tax laws.

3) The Coalition Building Approach

The coalition-building model is based on the idea that the pursuit of consistent economic policies requires sustained political support from a wide cross-section of interests for whom political ideas are a means of promoting or protecting their interests and status. The public choice literature on Canadian public finance, particularly Gillespie, Milne, Hartle and Savoie, argues for the necessity of a coalition-building strategy to design and implement an effective comprehensive tax reform program that is both politically and economically viable.[20] An effective strategy for the building of such a coalition depends as much or more on maintaining or enhancing the purchasing power of the individual citizens and groups whose support is desired as on the validity of the intellectual, technical or macro-economic arguments made for tax reform.[21]

This view of the tax policy process reflects a neo-pluralist conception of the tax policy community as involving competing interests within the federal government and among a

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[20] Gillespie, "Tax Reform: The Battlefield..."; David Milne, *Tug of War*, (Toronto, James Lorimer, 1986); Douglas G. Hartle, *The Expenditure Budget Process of the Government of Canada*, Canadian Tax Paper # 81, (Toronto, Canadian Tax Foundation, 1988); Savoie, *The Politics of Public Spending*, (Toronto, University of Toronto Press, 1990). Also highly influential is Olsen's theory of collective action and rent seeking by interest groups. Mancur Olsen, *The Rise and Decline of Nations*, (New Haven, Yale University Press, 1982).

[21] Bukovetsky & Bird, "Tax Reform in Canada"; Gillespie, "Tax Reform: The Battlefield ..."; W.T. Stanbury, *Business-Government Relations in Canada*, (Toronto, Methuen, 1986), 379-85; Ronald Robertson, "The House of Commons Committee and the Aftermath of the Royal Commission on Taxation" from Neil Brooks, ed., *The Quest for Tax Reform*, (Toronto, Carswell, 1988), 43-51.

variety of societal interests.[22] Unlike the general public, organized interests have developed significant expertise in specific areas of tax policy and the capacity to defend them within the policy process. Such groups can often exact concessions from the government on the technical details of tax policy in return for lending their support to legitimate those changes in the eyes of their constituents.

Summary

The basic elements of the tax system are so deeply embedded in the fabric of Canadian economic and social life as to be part of a quasi-constitutional structure of economic rights and entitlements. Tax reform, whether comprehensive or piecemeal, is thus the economic equivalent of constitutional change.

Under normal circumstances, the political success of tax reform depends on the ability of the Minister of Finance to build a consensus on the objectives and content of reform among three distinct groups: tax policy experts, major interest group stakeholders and the general public. However, active support from the latter is vital only when the first two groups, which form the broader tax policy community, are in serious conflict.

The history of Canadian tax policy during the 1970s and 1980s demonstrates that comprehensive tax reform usually leads to conflicts which cause serious political damage to the government of the day. The assault on entrenched economic rights usually associated with comprehensive tax reform makes it exceptionally difficult to obtain the degree of consensus necessary to achieve political success or lasting policy change on a large scale. As a general rule, piecemeal tax reforms are more likely to lend themselves to

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[22] A. Paul Pross, *Group Politics and Public Policy*, (Toronto, Oxford Univ. Press, 1986); William Coleman, *Business and Politics.*

the consensus-building process necessary if one is to conciliate entrenched economic interests while introducing significant and lasting changes to the tax structure.

As with constitutional reform, the process of introducing successful changes to structural policies, including tax reform, depends in part on the development and effective marketing of a new policy paradigm capable of overcoming major policy problems or crises more effectively than existing policies and structures. It also depends in part on the ability of political leaders to navigate proposed reforms through a series of formal and informal institutional processes both inside and outside government and to overcome a variety of institutional constraints. These include inter-departmental competition, cabinet and parliamentary opposition, the structures and conventions of federalism, legal requirements imposed by the constitution and the courts, and the influence of international agreements and capital markets. Major changes to tax laws in Canada's major trading partners, especially the United States, may also have a significant effect. Last but not least, successful tax reform requires politicians who are able to mobilize and sustain a coalition of interests that gain from the proposed reforms, while overcoming or buying off opposition from those groups whose interests or entrenched rights are most likely to be damaged by them.

Sources and Methodology

A comprehensive review of the politics of Canadian tax policy should utilize all three models in order to develop a coherent picture of the changes which have taken place during the 1980s. The ideas-centered model explains the rising and waning influence of policy paradigms on senior policy-makers. The institution-centered model explains the trade-offs among institutional actors inherent in the budgetary process and its role as the government's main agenda-setting device for economic policy.[23] The coalition-centered model identifies critical factors in maintaining a degree of consensus and political legitimacy in a highly fragmented political community of competing interests.

The political perception of tax policy varies dramatically depending on the perception of the onlooker -- politician, Finance Minister, Finance Department official, academic expert, interest group representative, journalist, investor, business-owner or manager, or taxpayer. A detailed study of the politics of Canadian tax policy must therefore draw on a number of sources. Part I develops the theoretical framework outlined above, reviewing the political and economic literature on tax policy, tax reform and related policy processes and making extensive use of original research. Parts II and III, the historical sections of the thesis, make extensive use of the public record: budget speeches, budget and policy papers published by the Minister and Department of Finance; other public statements of Finance Ministers from both published releases and unpublished files of the Department of Finance; coverage of budget and tax policy issues by the daily and business press; the Parliamentary record in Hansard; and the public hearings and reports of relevent Commons' and Senate Committees. Part II addresses the tax reform cycle of 1971-82, between the passage of Edgar Benson's tax reform legislation, Bill C-259, and the unravelling of Allan MacEachen's tax reform budget of 1981. Part III reviews the tax reform cycle of 1982-88, involving numerous efforts at piecemeal tax reform by Finance Ministers Marc Lalonde and Michael Wilson between 1982 and 1986, and the latter's more comprehensive efforts at income and sales tax reforms in 1986-88.

Both theoretical and historical sections will also draw on personal interviews with a number of major participants and observers of the Canadian tax policy process: two

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[23] Michael H. Prince, G. Bruce Doern and Allan M. Maslove, *The Politics of the Budgetary Process*, (Toronto, Univ. of Toronto Press, 1985), Vol. 41, Background Papers, Royal Commission on the Economic Union.

former Ministers of Finance, six Deputy Ministers of Finance, a number of current and former Finance Department officials responsible for the detailed development of tax policy, senior officials of the Prime Minister's and Privy Council Offices, senior private sector tax professionals, officers of the Canadian Tax Foundation, and representatives of national business and trade associations. Unless otherwise identified, interview sources are coded in order to respect the conditions of confidentiality under which much of this information was gathered.[24] The sections of the thesis dealing with public opinion draw mainly on polls commissioned by the Department of Finance. This polling data is used to determine the nature of public opinion on tax policy during the period and its relationship to the processes of making and "selling" changes in tax policy to the Canadian people.

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[24] Codes will identify status of participants in research (e.g. M = cabinet minister, D = deputy minister, ADM = assistant deputy minister, FO = Finance Department official, MP = Member of Parliament, PMO = senior official from Prime Minister's office, P = professional or academic expert, AE = association executive.) Ministers and senior officials are drawn mainly, though not exclusively from the Department of Finance.

PART I

THE ECONOMIC CONSTITUTION, TAX REFORM AND THE TAX POLICY COMMUNITY

CHAPTER

CHAPTER 2 -- TAX POLICY AND THE ECONOMIC CONSTITUTION

INTRODUCTION

Canadian tax policy is the central and most comprehensive expression of the relationship between the citizen's ordinary life and the role of the federal state. Indeed, in certain important respects, the tax structure is to economic life what the formal political constitution is to civic life: an elaborate framework of rights, rules and responsibilities and an arrangement which reflects the basic compromises of the Canadian economic and social order.[1] The Income Tax Act, in particular, involves a balancing of the long-term interests of major state and societal actors. Its pervasive impact on the economic relationships of individuals, groups, governments and nations means that its central objectives, principles and structures cannot be changed without significant social and economic disruption.

The politics of tax policy therefore necessarily revolves around the balancing of competing political and economic objectives. Major social and economic interests strive to obtain the recognition and entrenchment -- effectively, the constitutionalization -- of their interests within the tax structure. Officials of the Department of Finance struggle to preserve the integrity and coherence of the tax structure both as a source of revenue and as a set of policy instruments capable of promoting the national interest. Ministers and Deputy Ministers of Finance attempt to balance the demands of "good policy" and "good politics" in order to achieve their policy objectives, preserve their political legitimacy, and secure re-election for their governments.

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[1] John H. Head and Richard M. Bird, "Tax Policy Options in the 1980s", in Sijbren Cnossen (ed.), *Comparative Tax Studies*, (Amsterdam, North Holland, 1983), 4.

While Finance Ministers make dozens of marginal and technical tax amendments through the annual budget process, the Income Tax Act's major features and objectives have remained relatively stable since the creation of the present legislative framework in 1949.[2] Every fifteen to twenty years, however, the accumulation of annual amendments and technical changes make the tax system sufficiently unwieldy as a policy instrument that Ministers attempt to rationalize and streamline it through a process of comprehensive tax reform. However, this approach to tax reform has the potential to reopen debate on the underlying principles of the economic constitution. As such, it creates an opportunity for certain groups to obtain or enhance legal recognition of their central interests, values and policy goals. It also poses a potential threat to the positions of groups whose "constitutionalized" interests may come under renewed scrutiny -- and possible attack.

This chapter applies the concept of an economic constitution to the Canadian tax structure and suggests a series of tests for distinguishing between major structural or "constitutional" reforms to the tax system and the routine political and administrative changes which result from the normal policy-making and political brokerage activities of governments. From these tests, it identifies a number of steps that are necessary for a federal Minister of Finance to succeed in implementing and legitimizing major tax reform initiatives.

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[2] Vern Krishna, *Fundamentals of Canadian Tax Law*, 4th ed., (Toronto, Carswell, 1993), 1-3. Despite three rounds of comprehensive tax reform in 1967-71, 1981-82 and 1986-88, the overall income tax structure, while constantly evolving, is still largely based on the principles of the 1949 Act. See below, 40. Interviews, Wolfe D. Goodman; Robert Lindsay.

RECOGNIZING THE ECONOMIC CONSTITUTION

Two major purposes of political constitutions are to define the powers available to governments and to provide the means to limit the use of those powers.[3] Political constitutions may contain several elements. These may include one or more written documents which define and limit the powers of governments towards their citizens and, in a federal system, their relationships with one another. They may also include legal precedents and institutional arrangements established either by binding agreements among governments or judicial rulings. However, constitutions are also bodies of legal custom, tradition, convention[4] and precedent -- "the living constitution" -- which embody the fundamental social and political institutions and values of a society.[5]

Peter Russell notes the existence of two distinct Anglo-American constitutional traditions. The British parliamentary or Burkean tradition is the product of "organic development ... the collection of laws, institutions and political practices that have survived the test of time and are found to be useful by a people".[6] Constitutional change may be

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[3] Geoffrey Brennan and James M. Buchanan, *The Power to Tax, Analytical Foundations of a Fiscal Constitution*, (Cambridge, Cambridge Univ. Press, 1980), 4-5.

[4] Marshall and Moodie define constitutional conventions as: "binding rules of constitutional behaviour which are considered to be binding by and upon those who operate the Constitution, but which are not enforced by the law courts (although the courts may recognize their existence)". Geoffrey Marshall and Graeme Moodie, *Some Problems of the Constitution*, (London, Hutchinson, 1959). For more detailed discussion in a Canadian context, see Andrew Heard, *Canadian Constitutional Conventions: The Marriage of Law and Politics*, (Toronto, Oxford University Press, 1991).

[5] A.V. Dicey, *Introduction to the Study of the Law of the Constitution*, 8th ed., (London, Macmillan & Co., 1915), 21-29; Lon L. Fuller, "Human Interaction and the Law", *American Journal of Jurisprudence* 14, [1969], 1-38. In an age of growing moral scepticism over the substantive ends of law, the legitimacy of legal structures has come to rest increasingly on rules of justice or a procedural morality of law independent of the political objectives of competing state and societal interests. F.A. Hayek, *The Constitution of Liberty*, (Chicago, University of Chicago Press, 1960); Lon L. Fuller, *The Morality of Law*, (New Haven, Yale Univ. Press, 1964).

[6] Peter H. Russell, *Constitutional Odyssey*, 2nd ed, (Toronto, University of Toronto Press, 1993), 10.

implemented gradually and incrementally, through the accretion of judicial rulings and the widespread acceptance of political practices, or by a parliamentary consensus confirmed and accepted by subsequent governments.[7] "Lockean constitutionalism", a major element in American constitutional theory, is based on "the perception of the written constitution as a comprehensive statement of the basic principles of government and the rights of the people".[8] Amendment may take place either through a stringent process of securing an extraordinary majority for proposed changes or through a shift in the philosophy of judicial interpretation -- often driven by political competition to secure control of the courts.[9] Both Burkean and Lockean traditions are reflected in Canadian constitutional theory.

Reg Whitaker notes that before 1982 in Canada, written constitutions were intended primarily to define relationships between governments rather than citizen-state relationships.[10] The 1982 Constitution, particularly the Charter of Rights and Freedoms, reveals the growing influence of American constitutional ideas in Canada -- especially for the protection of traditional or prescriptive rights of individuals against the intrusions of increasingly remote and bureaucratized governments. It also reveals a trend towards the more widespread constitutionalization of interests -- the formal recognition of group

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[7] Individual constitutional changes, such as the Reform Bill of 1832 or the Parliament Act of 1911 may be bitterly contested in Parliament, and yet become the basis for an enduring national political consensus.

[8] Russell, ibid., 9.

[9] The U.S. constitutional tradition is divided among advocates of "strict constructionism", "judicial activism" and "judicial restraint". See David M. O'Brian, *Storm Center*, 3rd ed., (New York, W.W. Norton, 1991). For competing conservative and liberal interpretations of constitutionalism, see Edward Erler, *The American Polity*, (New York, Crane Russak, 1991); Mortimer Adler, *We Hold These Truths*, (New York, Collier Books, 1987).

[10] Reg Whitaker, "Democracy and the Constitution", in A. Keith Banting and Richard Simeon, *And No One Cheered: Federalism, Democracy and the Constitution Act*, (Toronto, Methuen, 1983), 240-60.

aspirations and entitlements as formal rights in the constitution in ways which may preempt the normal competition of interests through the political process.[11]

James M. Buchanan describes the basic economic institutions of a liberal democratic society as part of its economic constitution in the sense that:

> a constitution is conceived as a set of rules, or social institutions within which people operate and interact with one another ... rules (which) ... set boundaries on what activities are legitimate.[12]

These rules or institutions come to be seen as legitimate either through a process which leads to formal agreement among major political and economic stakeholders, through the gradual development of a normative or ethical consensus between these groups and their attentive publics, or through the generalized application of legal and administrative precedents over an extended period.[13] Major changes to these rules, affecting not only the details of policy but their conceptual and institutional framework, can usually be achieved only with the consent of the major stakeholders or by an overwhelming and enduring shift in the social and political consensus.

Such rules or institutions may be generalized to the whole of society, such as widespread rights of private property ownership, the predominance of market capitalism -- defined as the private ownership of the means of production within a system of more-or-less competitive markets -- the provision of a social safety net through the programs of the

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[11] Arguably, the Canadian constitution has always maintained an uneasy balance between parliamentary sovereignty and prescriptive individual and group rights. Evidence of the latter is found in early constitutional documents such as the Proclamation of 1763 (aboriginal peoples), the Quebec Act of 1774, and the guarantees of minority language and religious educational rights in the B.N.A. Act of 1867. The 1982 Charter includes guarantees of gender equality, the rights of minority language communities, aboriginal treaty rights, diverse ethnocultural communities, and interprovincial fiscal equalization.

[12] Brennan and Buchanan, *The Power to Tax*, 3.

[13] James M. Buchanan, "Interests and Theories in Constitutional Choice", in Buchanan, *The Economics and Ethics of Constitutional Order*, 51-64.

welfare state, or the expectation of almost universal taxpayer-funded medical services.[14] Others are central to the identities of major economic and social groups within the society -- the "family farm", "supply management" and, until recently, the "Crow Rate" for large segments of Canadian agriculture; collective bargaining and a variety of legal immunities for organized labour (at least in the private sector); and generalized provisions for small business in federal and provincial tax legislation.

The detailed rules of the economic constitution are defined in large measure by "framework legislation" which codifies, creates or radically changes the institutional structure governing the legal, economic or social status of large segments of society, and whose application is interpreted primarily by the courts or by an independent regulatory agency. Canadian examples include the Income Tax Act, the Canada Labour Code (and parallel provincial statutes), the Canada Business Corporations Act, the Competition Act (formerly the Combines Investigation Act), the Bank Act, the Bankruptcy Act, legislation creating systems of supply management for various agricultural sectors, the Unemployment Insurance Act and the Criminal Code. While the government may introduce marginal policy changes and technical amendments from time to time, the institutional structures created by such legislation tend to be extremely durable and resistant to large-scale change. While the Bank Act is subject, by its own terms, to Parliamentary review every ten years, most other framework economic legislation is

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[14] C.B. Macpherson identifies such "entitlements" as a form of private property. [C.B. Macpherson, "The Meaning of Property", in Macpherson, *Property: Mainstream and Critical Positions*, (Toronto, University of Toronto Press, 1978), 8.] Buchanan notes that the fundamental requirement for the retrenchment of welfare state institutions is the existence of an economic surplus sufficient to compensate those whose "property rights" have been infringed upon as a result of changes in their settled economic expectations. (Buchanan, *Liberty, Market and State*, 178-185.)

effectively subject to major structural change only with the consent of Parliament *and* major stakeholder groups.[15]

Buchanan, Mancur Olson and Douglas Hartle argue that the growth of government intervention in the economic and social life of most industrial nations since the Second World War has led to an increase in "rent seeking" by organized groups: i.e. the capture or preservation of economic advantages conferred by preferential state actions. The greater the extent of government intervention in economy and society, the greater the incentives for organized groups to engage in rent seeking or rent avoidance.[16] The success of certain groups in obtaining institutional recognition and protection of their distinctive identities and interests in framework economic or fiscal legislation creates precedents for other groups to follow in staking their claims to political and/or economic recognition.

Therefore, just as political constitutions evolve over time as the result of formal amendment, judicial interpretation and the rise of new constitutional conventions which reflect changes to the social and political balance of power, an economic constitution may evolve through changes in structures of taxation, forms of property ownership, or

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[15] The structures of Canada's Competition Act, Bankruptcy Act and post-1971 Unemployment Insurance system have repeatedly proven highly resistant to major changes opposed by major stakeholders in the existing policy communities.

[16] James M. Buchanan, "Rent Seeking and Profit Seeking", in James M. Buchanan, Robert Tollison and Gordon Tullock, eds., *Toward a Theory of a Rent-Seeking Society*, (College Station, TX, Texas A&M University Press, 1980), 3-15; Mancur Olson, *The Rise and Decline of Nations*, (New Haven, Yale University Press, 1984); Douglas G. Hartle, *The Expenditure Budget Process of the Government of Canada: A Public Choice-Rent Seeking Perspective*, Canadian Tax Paper # 81, (Toronto, Canadian Tax Foundation, 1988).

broadly-based income transfer and other entitlement programs which reflect the shifting balance of political and social forces.[17]

The generalized application of the tax system and its ability to influence the distribution of economic opportunities and rewards for an entire society lends itself not only to the log-rolling and rent-seeking activities of politicians and interest groups, but also to the "constitutionalization of interests" -- the transformation of the political discourse of interests competing for benefits within the political system to the constitutional language of rights and entitlements.[18] However, to understand the Canadian tax system as a constitutional instrument, we must first locate it in relation to the formal constitutional framework.

THE TAX SYSTEM AS ECONOMIC CONSTITUTION

Canada's political and economic constitutions reflect four major sets of relationships: between federal and provincial governments (federalism), between individuals and the state, between competing state and societal interests, and between Canada's senior governments and international political and economic interests.

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[17] Gillespie advances fourteen hypotheses of the factors influencing the balance of political forces and revenue sources in a "positive political economy of taxation". These include the number of taxpayers affected by a particular tax, tax innovation, formal constitutional restrictions, the state's credit standing, the number and extent of tax preferences, international and domestic tax competition, administrative and enforcement costs of taxation, and the elasticity and stability of the revenue base relative to national income. Gillespie, *Tax, Borrow and Spend*, Chapter 2.

[18] For a more general discussion of the "rights explosion" in political discourse, see Mary Ann Glendon, *Rights Talk*, (New York, The Free Press, 1991). For the application of this concept to group rights under the post-1982 Charter of Rights and Freedoms, see Alan C. Cairns, "The Minoritization of the Constitution", in David C. Leslie and Ronald Watts, *Canada: The State of the Federation, 1990*, (Kingston, Institute for Intergovernmental Relations, 1990).

1. The Constitutional Division of Powers

The *Constitution Act*, 1867, as interpreted by the courts, has resulted in shared jurisdiction between federal and provincial governments over more than 75 percent of federal revenue sources and almost two-thirds of provincial revenue sources during the 1980s and early 1990s, most notably personal and corporate income taxes and premiums to finance public pensions.[19]

Section 91(3) permits the federal government to raise "money by any Mode or System of Taxation". Ottawa has exclusive control over customs and excise duties[20], indirect taxation,[21] and Unemployment Insurance.[22] Federal tax legislation must originate in the House of Commons, and is not legally binding until passed by Parliament.[23]

Provincial governments control "direct taxation within the Province",[24] expressed primarily through provincial retail sales taxes. Their "primary jurisdiction over resource

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[19] Boadway, Robin W. and Frank Flatters, "Federal-Provincial Fiscal Relations Revisited: Some Consequences of Recent Constitutional and Policy Developments", in Melville McMillan, ed., *Provincial Public Finances: Plaudits, Problems and Prospects*, Vol. 2, (Toronto, Canadian Tax Foundation, 1991), 93.

[20] While customs duties have been a declining source of revenue for many years, excise taxes on gasoline, alcohol and tobacco have been a significant source of increased federal revenues in recent years.

[21] The Federal (Manufacturers') Sales Tax (FST) between 1924 and 1990, the Goods and Services Tax (GST) since 1990.

[22] Section 91(2A) of *Constitution Act, 1867*, as amended in 1940.

[23] *Constitution Act, 1867*, c.3, ss.53,54. Historically, legislation may be made effective on or after the date of a federal budget, as long as it ultimately receives Parliamentary approval. However, in recent years, the Parliamentary process has resulted in delays in passage of up to two years following the introduction of legislative changes.

[24] Section 92(2) of *Constitution Act, 1867*. Nine provinces, Alberta excepted, collect Retail Sales Taxes on varying tax bases of goods and services. Provincial succession duties were gradually abolished after 1972. The federal courts have ruled that this does not preclude the federal government from levying the Goods & Services Tax as a "direct tax".

taxation" was confirmed following a bitter conflict among federal and provincial governments and resource industries over energy revenues in the 1970s and early 1980s.[25]

TABLE 2-1
TAX REVENUE SHARES -- ALL CANADIAN GOVERNMENTS
1981-82, 1991-92

	1981-82			
	FEDERAL (%)	PROV.& LOCAL (%)	FEDERAL (%)	PROV. /LOCAL (%)
Personal Income Tax	60.7	39.3	62.8	37.2
Corporate Income Tax	68.8	31.2	65.0	35.0
General Sales Tax	46.7	53.3	47.9	52.1
Other consumption taxes	58.7	41.3	47.2	52.9
Natural Resources	54.1	45.9	1.1	98.9
Health and social insurance	49.4	50.6	62.6	37.4
Property and Related taxes	0.0	100.0	0.0	100.0
Customs Duties	100.0	0.0	100.0	0.0

N.B. Revenue figures calculated prior to inter-governmental transfers.

[Source: *The National Finances, 1994*, (Toronto, Canadian Tax Foundation, 1994), Table 4-3.]

Other relevant constitutional rules include Section 121 (1867), which provides for free trade among all provinces in goods produced in any province, Section 125, which exempts both federal and provincial Crown property from taxation[26], and Section 8 of the 1982 Charter of Rights which guarantees individuals the right "to move to and take up residency in any province" and "to pursue the gaining of a livelihood in any province".[27]

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[25] Section 92A, *Constitution Act, 1982*; Marsha A. Chandler, "Constitutional Change and Pubic Policy: The Impact of the Resource Amendment (Section 92A), *Canadian Journal of Political Science* XIX:1, [March 1986], 103-26.

[26] Krishna, *The Fundamentals of Canadian Tax Law*, 4th ed., 6-7.

[27] Anthony Sheppard, "Taxation Policy and the Canadian Economic Union", in Mark Krasnick, *Fiscal Federalism*, (Toronto, University of Toronto Press, 1986), Volume 65 of Background Studies, Royal Commission on the Economic Union and Development Prospects for Canada, 154-9.

The Constitution's assignment to the provinces of primary responsibilities for such major areas of public spending as education, health care, social services, and intra-provincial transportation contributed to a significant fiscal imbalance following the Great Depression of the 1930s.[28] This led to a half-century of federal-provincial revenue sharing agreements, culminating in the formal constitutionalization of equalization payments in 1982.[29] However, while the federal government's postwar fiscal advantage in administering the Personal Income Tax system in nine provinces[30] has given it significant political leverage over the tax policies and spending priorities of the provinces, the larger provincial governments -- especially Ontario -- can impose serious political constraints on federal actions.[31] For this reason, much of the "constitutional" structure governing Canadian tax policies is the product of federal-provincial executive agreements.

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[28] Peter M. Leslie, "The Fiscal Crisis of Canadian Federalism", in Peter M. Leslie, Kenneth Norrie and Irene K. Ip, *A Partnership in Trouble, Renegotiating Fiscal Federalism*, (Toronto, C.D. Howe Institute, 1993), 14-27.

[29] Section 36(2), *Constitution Act, 1982* commits the federal government "to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation". However, specific levels and formulae for equalization payments are not entrenched.

[30] Quebec is the lone exception. While all provincial governments impose Corporate Income Taxes, only Ontario, Quebec and Alberta administer their own CIT systems. Ottawa administers the CIT for the other provinces. Administering its own income tax and pension systems has made Quebec significantly more independent of federal government transfer payments in its budget planning than any other province.

[31] Fiscal constraints which have limited the growth of federal transfers to the provinces have reduced federal leverage over provincial fiscal policies. Provincial "own-source" revenues as a percentage of total provincial revenues have steadily increased from 74.0 percent in 1960-64 to 75.6 percent in 1970-74, 79.2 percent in 1980-84, and 81 percent in 1987-91. (Department of Finance, *Economic Reference Tables*, (Ottawa, the Department, 1992), 94.

2. Quasi-Constitutional Arrangements: Executive Agreements and International Treaties

The main components of the *national* tax system in Canada are income and excise taxes, the Canada/Quebec Pension Plans, Unemployment Insurance, and the federal-provincial tax collection agreements. Of these, the Income Tax Act, the Federal-Provincial Tax Collection Agreements, and agreements governing equalization are the most financially significant elements. Taxes on personal and corporate income accounted for 61.5 percent and 51.7 percent of federal and provincial tax revenues, respectively, in 1990.[32]

The national tax system became highly centralized during the 1940s, reflecting federal fiscal dominance during and after the Second World War. This centralization also reflects the adoption of Keynesian economic policies and the use of fiscal policy for national economic stabilization after 1945.[33] While federal dominance has declined and the tax system has become more decentralized since the 1960s, the tax collection and revenue sharing agreements remain critical vehicles for national economic integration. (See Table 2-2)

The Federal-Provincial Tax Collection Agreement[34], originally concluded in 1957, is a major pillar in Canada's economic union. It provides for:

* tax harmonization -- a common federal-provincial tax base, defined by the federal government, applying to nine provinces (excepting Quebec) for personal income taxes and seven provinces for corporate income taxes;

* federal administration and collection of income taxes for these provinces;

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32 David B. Perry, "The Tax Mix in Recession", *Canadian Tax Journal* 41(3), [1993], 583-94.

33 Perry, *A Fiscal History of Canada*, 151-65.

34 The current federal-provincial agreement is reflected in the *Federal-Provincial Fiscal Arrangements and Established Programs Financing Act, 1977*. For a summary of the evolution of federal-provincial revenue sharing, see Robin W. Boadway & Paul A.R. Hobson, *Intergovernmental Fiscal Relations in Canada*, Canadian Tax Paper # 96, (Toronto, Canadian Tax Foundation, 1993), 35-75.

* limited provincial discretion in setting PIT rates -- provinces levying taxes at a percentage of the federal rate, with limited provisions for individual provincial surtaxes and tax credits;[35]

* allocation rules to prevent double taxation of individual and business taxpayers with residence in more than one province; and

* a short-term federal revenue guarantee to offset revenue losses to the provinces resulting from changes in federal tax rates or changes in the tax base.[36]

While the federal government has made greater use of tax abatements and tax point transfers to the provinces since the mid-1970s in lieu of cash transfers for shared-cost programs, there is little coordination between federal and provincial tax rates and fiscal policies. Growing fiscal constraints and the

TABLE 2-2
FEDERAL REVENUE SHARING AS PERCENTAGE OF PROVINCIAL REVENUES -- 1981-82, 1990-91

	General Purpose Transfers		Total Federal Transfers	
	1981-82 (%)	1990-91 (%)	1981-82 (%)	1990-91 (%)
Newfoundland	30.1	29.6	47.1	44.4
P.E.I.	32.2	29.1	51.5	44.0
Nova Scotia	27.0	22.6	45.3	37.3
New Brunswick	25.1	25.0	44.7	39.4
Quebec	11.3	9.3	23.2	19.4
Ontario	0.3	0.4	16.8	12.1
Manitoba	15.3	15.1	31.2	27.9
Saskatchewan	8.8	11.7	23.1	27.4
Alberta	2.0	3.2	10.2	15.8
British Columbia	0.1	0.1	13.9	12.0

[Source: Based on Tables 3:10; 3:11, *Provincial and Municipal Finances, 1991*, (Toronto, Canadian Tax Foundation, 1992]

chronic deficits of the 1980s have led to increased fiscal competition and burden shifting between and among federal and provincial governments.[37]

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35 By contrast, provincial corporate income tax rates are levied on a company's taxable income, not federal taxes payable. Quebec, Ontario and British Columbia have established separate corporate income tax systems.

36 Boadway & Hobson, ibid., 51.

37 Leslie, Norrie and Ip, *A Partnership in Trouble*; Fair Tax Commission, *Fair Taxation in a Changing World*, 123)

Unilateral federal changes to the tax base can have significant effects on provincial revenues and economic activities. For this reason, changes to federal tax policy affecting major provincial industries can provoke serious political reactions from provincial governments.[38] While these do not effect the formal distribution of constitutional powers, they can impose serious political constraints on federal proposals for major structural change.

Canada's status as a relatively open economy largely dependent on international trade and capital flows also imposes a range of formal and structural constraints on the taxing powers of the federal government. Canada has entered into a network of bilateral tax treaties with most of its major trading partners which typically define who is subject to taxation; provide for reciprocal, non-discriminatory tax treatment of nationals and non-nationals; permit withholding of taxes on income earned by foreign residents; and allow credits for foreign income taxes paid to avoid double taxation of cross-border income and capital flows.[39] Parallel rules govern taxation of foreign source income by Canadian residents. Finally, Canada's relatively high dependence on foreign investment for economic development and public finance and the major investments of Canadian corporations in other countries have placed significant limits on the federal government's ability to impose or enforce taxes on capital income that are significantly higher than

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[38] Examples include mining or financial services in Ontario or oil and gas in Alberta, See M.W. Bukovetsky, "The Mining Industry and the Great Tax Reform Debate", in A. Paul Pross, *Pressure Group Behaviour in Canadian Politics*, (Toronto, McGraw Hill, 1975), 87-114; G. Bruce Doern & Glen Toner, *The Politics of Energy, The Development and Implementation of the National Energy Program*, (Toronto, Methuen, 1985).

[39] Richard M. Bird and Jack M. Mintz, "Introduction" to Bird & Mintz, eds., *Taxation to 2000 and Beyond*, Canadian Tax Paper # 93, (Toronto, Canadian Tax Foundation, 1993), 11.

those imposed by its major trading partners -- or which hinder international capital flows.[40]

3. Income and Excise Taxes: The Legislative Framework

Although the first Income Tax Act was passed as a temporary wartime measure in 1917, the present structure of Canada's Income Tax Act was introduced in 1949. Separate income tax rules apply to individuals (the personal income tax), corporations (the corporate income tax), different kinds of corporations, trusts, non-profit organizations, and foreign-source income. The Income Tax Act has a "progressive" rate structure, with marginal rates on individuals increasing with levels of taxable income.[41] Since 1949, there has been a trend towards expanding the definition of taxable income while lowering marginal tax rates. The top personal marginal rate was lowered from 84 percent in 1949 to 61.34 percent in 1973, and 51.0 percent in 1987, although the income levels at which these rates were applied have been reduced significantly.[42] While personal income tax is normally levied on the annual income of individuals, rather than households, the income tax system has come to recognize the increasing diversity of economic and social arrangements through a wide range of tax preferences and adjustments. Income tax policy and legislation are the responsibility of the Department of Finance. However, Revenue Canada (formerly the Department of National Revenue) administers and collects federal taxes.

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[40] Wayne Thirsk, *Fiscal Sovereignty and Tax Competition*, Government and Competitiveness, Discussion Paper # 93-8, (Ottawa, School of Policy Studies, Queen's University, 1993); Herbert Stein, ed., *Tax Policy in the Twenty First Century*, (Toronto, Wiley & Sons, 1988).

[41] Marginal tax rate: the rate applied to each additional dollar of annual income. Effective tax rates: the ratio of taxes paid to an individual's net income.

[42] *The National Finances, 1993*, (Toronto, Canadian Tax Foundation, 1993), 7:7.

The 1949 Act sharply limited ministerial discretion in the interpretation of the Income Tax Act, created an independent Tax Appeal Board, and established many of the current concepts and definitions of personal and corporate income, including those providing for the partial integration of personal and corporate income taxes and the declining balance method of Capital Cost Allowances.[43] Major changes were made to the Act in 1971, following the report of the Carter Royal Commission, a White Paper and major public debate. Tax rates were lowered, many tax preferences modified or abolished, and income taxes extended to capital gains for the first time.[44] A number of piecemeal changes to the tax structure during the 1970s and 1980s introduced new concepts including partial inflation indexing, refundable tax credits for lower and middle income taxpayers, and expanded recognition of multi-year income patterns for investment income and retirement savings. The 1987-88 tax reform legislation further broadened the tax base, lowered marginal rates, and converted a number of traditional deductions into tax credits.[45] Most of these changes, while important, have resulted in the gradual piecemeal evolution of an existing tax structure rather than large-scale structural change.

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[43] Perry, *Taxation in Canada*, 5th ed., Canadian Tax Paper # 89, (Toronto, Canadian Tax Foundation, 1990), 19. The dividend tax credit is meant to offset the double taxation of corporate dividends in the hands of shareholders, thus "integrating" personal and corporate taxes so that income taken as salaries or dividends will be subject to similar tax rates. Since 1971, shareholders in Canadian controlled private corporations (CCPCs) have enjoyed full integration -- that is, a complete credit for corporate taxes payable on dividends.

[44] For a detailed discussion, see Richard M. Bird, "The Tax Kaleidoscope: Perspectives on Tax Reform in Canada", *Canadian Tax Journal* 18:5,[September-October 1970], 444-473; Meyer Bukovetsky and Richard M. Bird, "Tax Reform in Canada: A Progress Report", *National Tax Journal* 25, March 1972, 15-42; Leslie T. Macdonald, *Taxing Comprehensive Income: Power and Participation in Canadian Politics 1962-1972*, Unpublished Ph.D. Dissertation, (Carleton University, 1985).

[45] A tax deduction reduces taxable income, providing the greatest proportional benefit to taxpayers with the highest marginal rates in a progressive tax system. A flat rate tax credit reduces tax payable, thus providing equal benefits for those with taxable income. A refundable tax credit provides taxpayers with a cash benefit, whether or not they have net taxable income after calculating other deductions and credits.

The Excise Tax Act historically provided for three forms of taxes: customs duties on imported goods, excise taxes on specific goods such as gasoline, alcohol and tobacco, and a general sales tax. The Federal (or Manufacturers') Sales Tax (FST) was levied on domestic or imported manufactured goods between 1924 and 1990, when it was replaced by a Goods and Services Tax (GST). The FST was the federal government's second largest source of revenue during the 1970s and 1980s. Federal efforts to replace it with a Wholesale Tax in 1975-77 and 1982-83 failed as a result of massive resistance from business groups.[46] After several false starts, the FST was replaced by the Goods and Services Tax -- a value-added tax on most goods or services sold in Canada imposed at each level in the production and distribution chain.

The tax structure reflects the policy and legislative framework designed by the Department of Finance and approved by Parliament. However, the actual interpretation of tax laws is the responsibility of Revenue Canada, subject to review by the federal courts.

4. Constitutional and Common Law Precedents

Historically, the role of the courts in the economic constitution has fallen into three main categories: jurisdictional boundary maintenance, individual tax litigation, and since 1982, the application of specific Charter rights to the administration and, more recently, the design of the tax system.

Traditionally, the federal courts have carried out "boundary maintenance" between federal and provincial tax jurisdictions. This has often led to a certain degree of legal arbitrage as

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[46] Douglas G. Hartle, *Political Economy of Tax Reform: Six Case Studies*, Discussion Paper # 290, (Ottawa, Economic Council of Canada, November 1985).

individual and corporate taxpayers attempt to use the federal-provincial division of powers to limit federal or provincial fiscal innovations hostile to their interests.[47]

The courts have also imposed strict procedural requirements on the revenue-raising activities of governments.

> "It has been well established since Magna Carta that there is no common law authority to levy taxes; income tax can only be levied under the authority of specific fiscal legislation.[48]

The constitutional doctrine of "no taxation apart from law" has resulted in strict legal limits on retroactive taxation.[49] It has also reinforced the constitutional role of the courts in applying common law rules of statutory interpretation.[50] The role of the courts is amplified by several factors. Rather than applying a single set of rules to all forms of income derived from all sources, Anglo-Canadian traditions of tax law provide for separate rules and principles of taxation for different "sources and types of income", such

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[47] John N. McDougall, "Natural Resources and National Policies", in G. Bruce Doern, *The Politics of Economic Policy*, (Toronto, Univ. of Toronto Press, 1985), 163-219; Hugh Thorburn, *Interest Groups in the Canadian Federal System*, (Toronto, Univ. of Toronto Press, 1985).

[48] Krishna, *The Fundamentals of Canadian Income Tax*, 39.

[49] It also limits retrospective laws which impose future penalties on past actions which were legal when taken. "A statutory provision is considered retrospective if it creates new obligations, imposes new duties or attaches new disabilities in respect of past events or transactions." Krishna, ibid., 53.

[50] Perry comments that "for our income tax we borrowed our original statute law substantially from the United States and our jurisprudence from England". J. Harvey Perry, *Taxation in Canada*, 5th Ed., 39.

as employment and investment income, capital gains, and several distinct kinds of business income recognized by Parliament.[51]

Historically, the courts have ruled that tax laws must be applied exactly as written by Parliament in order to minimize the level of bureaucratic discretion in seizing the property of individuals for use by the state.[52] The doctrine of "strict construction" provides for courts to interpret tax laws in accordance with the plain and established meanings of its language.[53] While this can work both for and against the interests of individual taxpayers, it has also contributed to a system of competitive tax avoidance in which many taxpayers and their professional advisors go to great lengths to minimize their taxes within the law. The basic principle of taxpayer rights in common law was summarized by Lord Tomlin in *I.R.C. v. Duke of Westminster* (1936):

> Every man is entitled, if he can, to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result ... he cannot be compelled to pay an increased tax.[54]

In response to such rulings legitimizing specific tax avoidance tactics, Finance Ministers introduce annual legislative changes to Parliament, including a number of specific anti-

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[51] Historically, the Income Tax Act has recognized that different businesses subject to very different operating conditions may be subject to different tax laws in order to achieve rough justice. Examples include the distinct but overlapping tax treatments of widely and closely-held corporations, financial institutions, foreign subsidiaries, trusts, and non-profit organizations. For a summary of differing the "English" and American concepts of income and their impact on the Canadian tax system, see Perry, *Taxation in Canada*, 5th ed., 33-39.

[52] Unlike the United States Congress, whose staff drafts actual tax legislation, Canadian tax legislation is drafted by the Justice Department lawyers seconded to the Department of Finance, in cooperation with the Tax Legislation Division, before its approval by Parliament. No other federal department has such an arrangement.

[53] Krishna, *Fundamentals of Canadian Income Tax*, 41-47.

[54] [1936] AC 1 at 19-20, 19 TC 490 at 520. (House of Lords). Krishna cites a number of legal authorities on the legal principles of tax avoidance and tax planning, along with legal doctrines which have evolved to limit abuses of these rights. Krishna, *Fundamentals of Canadian Income Tax*, Chapter 26, "Tax Avoidance".

avoidance rules. In recent years, the Courts have imposed stricter limits on tax avoidance by taking into account the purpose or intent of tax rules, not only their literal wording.[55] This "purposive approach" to interpreting tax laws has been reinforced since 1987 by Parliament's approval of General Anti-Avoidance Rules (GAAR) which have vastly expanded bureaucratic discretion in the administration and enforcement of tax laws.[56]

Since the Charter of Rights came into legal effect in 1985, the federal courts have primarily applied its provisions to tax policy in matters relating to enforcement and the rights of the accused.[57] While the Courts have been somewhat reluctant to apply the equality provisions of the Charter to substantive matters of tax policy, their recent willingness to entertain such cases on issues dealing with gender equality and family status suggests that a new set of constitutional issues may be introduced into the balancing of economic and social interests through the tax system.[58]

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[55] Krishna, Ibid., 47-52.

[56] Krishna, *Fundamentals of Canadian Income Tax*, 1113-1168. Robert F. Lindsay, "The General Anti-Avoidance Rule: Points to Consider", in *Report of Proceedings of Fortieth Tax Conference*, (Toronto, Canadian Tax Foundation, 1989); Robert D. Brown, et al, "The GAAR and Tax Practice: More Questions than Answers", in *Report of Proceedings of Forty-First Tax Conference*, (Toronto, Canadian Tax Foundation, 1990).

[57] Bruce Verchere and Jacques Bernier, "Rights and Freedoms in Tax Matters", in *Proceedings of the Thirty-Eighth Tax Conference*, (Toronto, Canadian Tax Foundation, 1987).

[58] The Federal Court of Appeal rejected a claim of child care costs as a business expenses under the Charter's gender equality provisions in *Symes* ... (1993). However, in *Thibodeau* ... (1994), it overturned a longstanding provision governing the inclusion of child support payments in income on the grounds of equality of family status. This decision was overturned on appeal by the Supreme Court of Canada.

MAJOR FUNCTIONS AND PRINCIPLES OF TAXATION

Like the political constitution, the tax structure as economic constitution is both functional and normative in character. It serves a number of overlapping and often competing functions, while attempting to balance competing principles which reflect a wide range of political, economic and ideological assumptions and objectives. Just as a political constitution often embodies a range of checks and balances to provide for effective representation of divergent interests and deterrants to the abuse of political power, an economic constitution must balance competing principles and interests to secure widespread and enduring popular support. "Balance" is widely seen as an essential element of a "good" tax system -- between the principle of "ability to pay" and "benefit related taxation",[59] between the taxation of income, consumption and capital,[60] and between the demands of social egalitarianism and the pursuit of economic growth.[61]

Taxation is widely seen among economic conservatives as a limited exception to the right of private property, subject to the control and limitation of Parliament.[62] This principle is expressed in the common law doctrine that individuals have the right to organize their affairs within the law so as to minimize their tax liabilities. Competing with this view is

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59 Bossons, "The Objectives of Taxation"; Buchanan, "Taxation in Fiscal Exchange"; Feldstein, "On the Theory of Tax Reform".

60 Wolfe D. Goodman, "The Importance of Balance in the Tax System", in Brooks, *The Quest for Tax Reform*, 139-142.

61 Head and Bird, "Tax Policy Options in the 1980s', 5.

62 "In a free country, governments exist to protect the individual and his inherent right to life, liberty and property. ... Taxation, in any form, like property expropriation, is a negation of private property rights. ... If one agrees that the state exists to protect the rights, ... governments must exercise great restraint and justice in the manner in which they levy taxes. Otherwise, taxation becomes the tyranny of the majority, who in uncontrolled (and somewhat natural) zeal to shift the burden of taxation away from themselves on to others, substitute a fair tax system with a discriminatory system of fiscal confiscation." I.H. Asper, *The Carter Commission Report on Taxation -- An Objective View*, (Equitable Income Tax Foundation, 1967), 2.

the doctrine of taxation as a positive good -- a means of financing collective action to secure the common good. This principle is often used, particularly by liberals and social democrats, to justify the generalization and expansion of taxation.

Michael J. Boskin cites four major functions of fiscal policy and taxation in the modern economy: the financing of government expenditures, the attempted redistribution of income, the encouragement or discouragement of certain activities, and the stabilization of the overall economy.[63] Tax policies are simultaneously a form of economic regulation, a source of incentives and disincentives for economic efficiency and growth, and a tool for the macro-management of the economy. The more objectives that the tax system pursues at the same time, the greater the difficulty of harmonizing them or of avoiding the unintended consequences of conflicting policies.[64] This balance is usually the product of competing interests in the political marketplace, rather than of the abstract theories or scientific designs of economists.[65]

The Income Tax Act, as the single largest source of both federal and provincial government revenues, is a core element of the economic constitution. At the risk of oversimplification, the durable core of the Act's mandate to raise revenues contains three main principles: horizontal equity, economic neutrality (or efficiency) and vertical equity.[66] *Horizontal equity* requires that individuals in similar circumstances should pay similar levels of (or have similar exemptions from) taxation Individuals or companies in

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63 Michael J. Boskin, *Federal Tax Reform: Myths and Realities*, (San Francisco, Institute for Contemporary Studies, 1978), 2.

64 France St. Hilaire and John Whalley, "Reforming Taxes: Some Problems of Implementation", 195-224.

65 W. Irwin Gillespie, "Tax Reform: the Battlefield, the Strategies, the Spoils", *Canadian Public Administration* 26(2), [Summer 1983], 182-202; Gillespie, *Tax, Borrow and Spend: Financing Federal Spending in Canada, 1867-1990*, (Ottawa, Carleton University Press, 1991).

66 Louis Eisenstein, *The Ideologies of Taxation*, (New York, Ronald Press, 1961).

different circumstances may also persuade the Department of Finance to allow them to calculate income in different ways in order to be subject to the same *effective* rate of taxation.

Horizontal equity is often linked to the values of "neutrality" or "efficiency" -- the idea that the tax system should not bias individual economic decisions in the marketplace[67] or restrict the ability of businesses and investors to adjust to changing technologies, distribution systems and forms of business organization. However, governments have often ignored this principle in practice when it suits their political or economic interests to do so in order to encourage economic growth or build political alliances with key producer interests.

Since its inception in Canada in 1917, income taxes have also been based, in large measure, on the principle of *vertical equity* or ability-to-pay -- the idea that the necessary expenses of government related to provision for the Common Good should be distributed among individuals so that effective tax rates increase with the level of income.[68] Lars Osberg summarizes the principle of vertical equity as follows.

> The rich should pay more tax than the poor, because they can afford to. By this criterion, one of the objectives of the tax system should be to progressively increase tax rates as ability to pay increases so that the distribution of after-tax income will become more equal.[69]

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67 This principle is largely based on the underlying economic assumption of the superior efficiency of self-regulating markets in the absence of government intervention. The real world applications of this principle may vary depending on the existence of structural barriers to market adjustment, the flexibility of the tax system in measuring income, imposing tax liabilities, and recognizing the functional equivalence of different forms of income (e.g. real or nominal valuation of income from capital).

68 John Bossons, "The Objectives of Taxation and the Carter Commission Proposal", *Canadian Public Administration* XII(2), [Summer 1969], 137-165; L.T. Macdonald, *Taxing Comprehensive Income.*

69 Lars Osberg, "The Problem of Equity in Taxation", in Allan M. Maslove, ed., *Fairness in Taxation: Exploring the Principles*, (Toronto, University of Toronto Press, 1993), 75.

In practice, the redistributive goals of taxation have often been modified to limit the impact of high marginal tax rates on private investment and economic growth. The higher the marginal rates of taxation, the greater become the incentives to avoid taxes by shifting economic activity to activities or jurisdictions with lower tax rates -- or by evading taxes altogether. Hettich and Winer note that

> oppositio . to the use of a tax depends on effective (rather than nominal) tax prices. ... The more revenue that is raised per dollar of potential tax base with a particular tax, the more political opposition ... there will be to that tax.[70]

Consequently, a progressive tax rate structure increases the political incentives to limit or reduce the size of the tax base by providing various tax preferences or exemptions.

As a result, the greater the state's demands for revenue relative to the size of an economy, the more likely it is to levy a wide range of taxes capable of diffusing political opposition.[71] Otherwise, high marginal and/or effective tax rates lead to pressures on goven ients for the removal of tax-related barriers to various activities which may be identified by various groups with the social or economic well-being of society.[72] While this may be accomplished through incidental or transitory changes to tax legislation, the larger the organized group in question -- or the greater its ability to link its particular interests with the general interests of society -- the more its demands are likely to lead to their "constitutionalization" within the broader tax structure.

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70 Walter Hettich and Stanley Winer, "A Positive Model of Tax Structure", *Journal of Public Economics* 24, (1984), 71-72. This is a repeated theme of interviews with federal senior tax policy officials. (FO1)

71 Bird, "The Tax Kaleidoscope", 463-69.

72 Eisenstein describes this as the "removal of barriers" ideology, which demands that compensatory actions taken through tax system to obtain equality of opportunity for individuals or companies in unequal circumstances. Eisenstein, *The Ideologies of Taxation*. See also Mancur Olsen, *The Rise and Decline of Nations*, (New Haven, Yale University Press, 1984); John Kay, "Routes to Fiscal Neutrality", in Philip Chappell, John Kay, Bill Robinson, *Which Road to Fiscal Neutrality?*, (London, Institute of Economic Affairs, 1990), 9-20.

ECONOMIC RIGHTS, CONVENTIONS AND THE CONSTITUTIONALIZATION OF INTERESTS

A major challenge in defining the theory of an economic constitution is to distinguish "constitutional" structures and processes from the ordinary competition of interests and the policy processes which characterize the day-to-day practice of politics. "Constitutional" measures transcend ordinary changes in policy in two basic ways. One is procedural: there is a requirement for a higher degree of consensus on "constitutional" matters. The other is substantive: proposed changes face a widespread public perception that they are conferring or withdrawing rights or entitlements of citizenship.

The major difference between statutory and constitutional law is that the former may be changed at the discretion of the government of the day, subject to the approval of Parliament or legislature; changes to the latter require a substantial and ongoing shift in the consensus of major social and political actors over the distribution of power and the ideas which justify its use.

The longer a particular principle, feature or *convention* of tax law remains in effect, the greater the number of taxpayers that benefit from such provisions; the greater their relative importance to the economic well-being of a cohesive economic group, the more likely this principle or convention is to become an acquired property right which secures the ability of individuals or corporations to produce revenues as a direct result of government policy and legislation.[73] Consequently, the right cannot be withdrawn without some form of compensation, usually in the form of lower tax rates and/or transition rules to ease taxpayers' collective burden of adjustment to the new system.

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[73] C.B. Macpherson, "The Meaning of Property", in Macpherson, *Property: Mainstream and Critical Positions*, (Toronto, University of Toronto Press, 1978), 8.

The following tests suggest themselves in distinguishing the economic constitution from normal, everyday legislative measures.

1) Generalized Application to Large Numbers of Taxpayers

The institution or legal structure should be general in application, so that it has a pervasive influence on the economic decisions and status of a broad cross-section of individual or business taxpayers. Major changes to such provisions would cause significant economic dislocation sufficient to disrupt the political balance of power and threaten the political survival of the offending Minister or government.[74] Finance Minister Michael Wilson acknowledged this principle during the mid-1980s when he made only relatively minor changes to general tax preferences benefiting large numbers of taxpayers while curtailing a large number of narrowly-targeted tax preferences benefiting specific groups.

Examples of such generalized features of the tax system include the taxation of individual rather than family (or household) income,[75] the small business deduction for small Canadian-controlled private corporations, the capital gains exemption for owner-occupied homes, and the taxation of most capital gains upon realization rather than on an accrual basis.[76]

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[74] Finance Minister Edgar Benson lost his parliamentary seat at the election following his 1971 tax reform bill. Allan MacEachen's political career was blighted by the political backlash against the National Energy Program and the 1981 tax reform budget. Both men were succeeded by colleagues who reversed many of their policies.

[75] A fairly recent exception to this principle involves the taxation of family-related tax preferences and transfers on the basis of household income.

[76] Capital gains taxes on most assets are levied upon their sale or as payment is received over a limited number of years. Taxes on accrued gains would apply on the annual increase in the value of the asset, whether or not the owner was able to realize the value in cash.

Finance Ministers may succeed in removing or curtailing general tax preferences providing significant benefits to large numbers of taxpayers. However, this may require implementation in smaller, incremental steps over a number of years -- or require compensation in the form of tax reductions in other areas.[77]

2) Broad Perception of an Economic Right among Beneficiaries

The institution or legal structure should have acquired the normative status of an "economic right" through the passage of time or long-standing legitimization through the political process.[78]

Such economic rights may be linked to the fulfilment of societal norms and responsibilities: for example, tax deductions and credits which recognize the personal responsibility, within limits, to care for one's family, save towards one's retirement, or contribute to the well-being of one's community through contributions to charitable organizations. Such norms may convey either a presumed right to state assistance or to non-interference in the fulfilment of such obligations. Other "rights" are linked to principles of natural justice: the avoidance of double taxation, protection against retroactive taxation or the right to deduct the costs of earning income. The proliferation of such rights, whether established as formal matters of law or convention, may create serious problems in balancing competing rights and conflicting concepts of rights.

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77 For example, the elimination of the general deduction to parents for dependent children took place in several steps between 1987 and 1993. The deduction was first converted to a credit in 1988, emphasizing a shift in benefits to lower-income families and an increase in the means-tested child tax credit. Over time, benefits were gradually phased out for parents earning more than $ 40,000 - $ 50,000, depending on the number of children.

78 Macpherson, "The Meaning of Property".

While critics of "tax expenditures" have argued that tax-assisted activities could often be accomplished more efficiently by direct government spending programs, this might well involve a transfer of economic discretion from individuals and corporations to state actors which would provoke bitter resistance from those whose economic rights would thus be restricted.

3) Comparable Social and Economic Status

Economic demands and interests of major social groups become institutionalized as rights within the tax system as organized interests and individuals succeed in demonstrating the validity of comparisons between related forms of economic or social activity, some of which already benefit from tax preferences. These changes may be the result of legal action or the political process.

Major examples include income tax amendments providing for equal tax treatment of married and common-law couples, for the equivalent tax treatment for employment pensions and RRSPs introduced in the 1984 budget, and comparable treatment extended to farms and small businesses for many years. The principle of horizontal equity is often used by the courts to extend tax preferences beyond the limits originally set by Parliament. However, the principle of "horizontal equity" may also be used to increase tax liabilities if the Minister of Finance can persuade Parliament and other interest groups that a particular group's tax privileges give it an unfair economic advantage not available to others.

A quick review of personal and corporate income tax preferences reveals the extent to which various interests have secured entitlements to income tax exemptions, deferrals, deductions or credits. These include special provisions for "culture and recreation, education, farming and fishing sectors, general business and investment, small business, resource sector", families and child care, private health insurance, lower-income groups, retirement savings and pensioners, Indians, homeowners, and the recognition of the multi-year character of business and investment income and expenses.[79]

4) Relative Economic Impact

Elements of the tax system may be considered "constitutionalized" when they provide a disproportionate benefit to a major organized element of Canadian society of sufficient economic and political importance to block major changes to these provisions or to force the payment of compensation in the event of their removal or substantial reduction. Compensation normally takes the form of offsetting tax reductions in other areas, generous transitional provisions, or both.

Thus, a diverse and relatively unorganized group of taxpayers may face the gradual erosion or loss of a generalized tax preference which provides only marginal benefits -- for example, the deductibility of employment expenses in 1988 -- while smaller, more cohesive economic groups succeed in protecting tax preferences of vital interest to their sectors. For example, cohesive sectoral interests such as charities, the insurance industry and the oil and gas industry frequently succeed in watering down or eliminating major changes to their tax structures. Such groups are most likely to succeed when they can demonstrate a disproportionate economic burden or major competitive disadvantage from proposed changes resulting in business failures, politically significant increases in unemployment, or a large-scale shift of investment and economic activity to neighbouring jurisdictions. For example, the political backlash against the introduction of a capital gains tax in 1971 from farmers, small business owners, and investment dealers was

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[79] Canada. Department of Finance, *Personal and Corporate Income Tax Expenditures*, (Ottawa, the Department, December 1993), Table 1.

sufficient to force Finance Minister Benson to introduce generous transition provisions and to eliminate federal wealth and inheritance taxes as partial compensation for the new tax.

Maslove has suggested that for a *comprehensive* tax reform program to become politically successful, the government must demonstrate to significant majorities of most major socio-economic groups that they will be better off as a result of tax reform.[80]

5) Disproportionate Importance to Major Provincial Economies

Any major change which threatens to disrupt the economies or tax bases of provinces or regions is subject to implicit provincial consent. Federal-provincial revenue sharing agreements have explicit provisions for a one-year revenue guarantee to cushion provincial revenues against the effects of unilateral federal changes. Provincial governments have often lobbied effectively against federal tax changes which threaten to have a disproportionate impact on major provincial industries or on major income transfer programs.

Federal efforts to change the structure of energy taxes were regularly hamstrung by provincial opposition during the 1970s. The unilateral imposition of the National Energy Program in 1980, while offset to a degree by subsequent federal-provincial negotiations, prompted a long-term political backlash which led to the policy's reversal after the 1984 election. As noted earlier, regionally concentrated industries are often able to limit

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[80] Maslove, *Tax Reform in Canada*; Maslove and Eicher, "Reforming Taxes ...". Senior Finance Department officials have confirmed that one of their major preoccupations in designing the 1987-88 White Paper on Tax Reform was to quantify and communicate the net economic effects of their proposals for all income levels and major socio-economic interests. (Interviews, D1, F02).

federal efforts to raise their taxes by persuading provincial governments to lobby on their behalf.

6) Mobility of Capital or Economic Activity

The mobility of goods, services and capital gives consumers, businesses and investors who have the capacity to transfer significant levels of economic activity to neighbouring jurisdictions with lower nominal or effective tax rates the power to impose serious constraints on government policy, thus constitutionalizing their interests within the tax system. Individual and business taxpayers who can readily avoid taxes by transferring or converting politically-valued investment and other economic activities to less heavily-taxed jurisdictions or activities are more likely to obtain recognition of their interests through the tax system than those with limited mobility.[81]

The political significance of threatened capital flight or job losses depends on the relative affluence (and economic diversification) of the regions most directly affected, the capacity of governments and other societal actors to replace the revenues or economic activity from other sources, and the willingness of provincial governments and/or major societal actors to challenge the federal policies in question.

Canadian businesses and investors often attempt to use the threat of capital flight to fend off proposed tax increases or to obtain reductions in their tax burdens relative to Canada's major competitors. However, the impact of foreign precedents can cut both ways. Major changes to British and American tax laws in the mid-1980s, while resulting in a general lowering of income tax rates, also resulted in significant increases in the overall tax burden on many kinds of investment income. Canada's adoption of the Goods and Services Tax between 1985 and 1990 reflects a conscious effort to remove barriers to

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[81] Wayne Thirsk, Fiscal Sovereignty and Tax Competition, op. cit.

international trade and investment while retaining the freedom to finance variations in the level of public services between Canada and its major trading partners.[82]

Consumers may also take advantage of significant differences in consumption tax levels in different provinces or between Canada and the United States in ways which constrain the ability of governments to raise tax rates. In recent years, many Canadians have shown a willingness to challenge high prices and taxes on consumer goods, as demonstrated by the growth of cross-border shopping and the underground economy.[83] Large-scale smuggling of cigarettes to evade the substantial difference between Canadian and American excise taxes prompted the federal and Quebec governments to make major reductions in their cigarette taxes in 1994, prompting several other provinces to follow suit.[84]

CONCLUSION

The constitutional traditions of parliamentary sovereignty and responsible government place few formal limits on governments' ability to legislate within their own jurisdictions on major issues of economic policy. However, major structural changes to framework economic legislation such as the Income or Excise Tax Acts, the Competition Act, the Bank Act or the Bankruptcy Act affect such a wide range of public and private economic

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82 Hon. Michael H. Wilson, *Tax Reform 1987: Sales Tax Reform*, (Ottawa, Department of Finance, June 18, 1987), 11-18; interview, Stanley H. Hartt. See Chapter 12.

83 "Canadians flood U.S. in record numbers", *Vancouver Sun*, Jan. 18, 1992, A1; "Cross border shoipping helps push travel deficit to record $ 7.1 b.", *The Gazette*, (Montreal, Feb. 28, 1992), F3; "What makes Canadian prices high", *The Globe and Mail*, (Toronto, May 15, 1992), B6.

84 "High taxes feed defiance of law", *The Globe and Mail*, Jan. 26, 1994; "Cigarette taxes cut", *Toronto Star*, Feb. 9, 1994, A10,11.

transactions that they virtually compel adherence to certain quasi-constitutional conventions.

The study of federal tax politics and policies during the past thirty years suggests that there is a process closely akin to an "amendment procedure" which Finance Ministers must observe in order to be successful in implementing major tax reforms. The most important requirement is that formal and informal consultations should be used to test the economic, political and administrative viability of proposed changes with tax experts and affected interests. These usually involve the publication of proposed changes in a White Paper and formal Parliamentary hearings involving experts and major interest groups. Maslove and Eicher suggest several other necessary components of the process: a commitment to revenue neutrality[85] from tax reform, the need to ensure that a majority of all major socio-economic groups are economic "winners", and some form of compensation for groups which may pay significantly higher taxes as a result of structural changes to the tax system.[86] Other traditional conditions include the avoidance of retroactive changes and the provision of adequate transitional measures to facilitate economic adjustment. Failure to comply with these procedural requirements can fatally undermine Parliamentary and public support for tax reform -- or result in its reversal by subsequent governments or Ministers of Finance.

The choice of an incremental, piecemeal approach to tax reform permits the gradual introduction of new ideas, policy objectives and procedural changes through the normal budgetary process which can create both internal and external constituencies for further

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[85] Revenue Neutrality -- the idea that the federal government will not use tax reform to disguise an overall tax increase. In practice, this often means a reduction in overall tax revenues, to err on the side of political caution.

[86] Allan M. Maslove & Heidi Eicher, "Reforming Taxes: where to go and how to get there", in Michael Prince, ed., *How Ottawa Spends: 1987*, (Toronto, Methuen, 1987), 176-210.

change. This allows potentially controversial structural changes to evolve gradually through the normal processes of policy development, brokerage politics and administrative trial and error. Such incremental changes, for example, the gradual replacement of universal family benefits and tax deductions with a system of targeted tax credits between 1978 and 1993, are far less challenging to existing structures, processes and interests than would have been a large scale constitutional change such as the introduction of a guaranteed annual income through the tax system.

The introduction of major structural changes to the tax system are the functional equivalent of amendments to the political constitution. They reflect a balancing of interests, a response to pressing political and economic problems which cannot be resolved by ordinary political means, and a search for unifying ideas that can serve as a catalyst for structural change.

CHAPTER 3 - TAX REFORM AND THE POLITICS OF IDEAS

> Good ideas do not always win. ... To become policy, ideas must link up with politics -- the mobilization of consent for policy. Politics involves power. Even a good idea cannot become policy if it meets certain kinds of opposition, and a bad idea can become policy if it is able to obtain support.
>
> Peter Gourevitch[1]

> Our taxes reflect a continuing struggle among contending interests for the privilege of paying the least. ... Equity is the privilege of paying as little tax as somebody else.
>
> Louis Eisenstein[2]

Tax reform does not occur in a vacuum. Its sweeping impact on economic structures and relationships, comparable to that of major changes to the political constitution, is such that only a real or threatened breakdown of the existing system is likely to prompt political leaders or major societal actors to take the risk of reopening fundamental questions of the citizen's economic relationship with the state and one another through the process of tax reform.

According to Peter Hall, structural changes to economic policy are the product of the interplay of ideas, institutions and interests.[3] This chapter discusses tax reform as the product of the search for a set of unifying principles ("the idea-centered approach") consistent with the government's overall political and economic objectives. It examines the instrumental use of ideas to advance or combat different concepts and agendas for tax reform at three levels: the political, bureaucratic and academic. It discusses the dominant public finance paradigm for tax reform during the past generation, the Haig-Simons

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[1] Peter Gourevitch, "Keynesian Politics: The Political Sources of Economic Policy Choices", in Peter A. Hall, ed., *The Political Power of Economic Ideas: Keynesianism Across Nations*, (Princeton, Princeton University Press, 1989), 87-88.

[2] Louis Eisenstein, *The Ideologies of Taxation*, (New York, Ronald Press, 1961), 3-4, 176.

[3] Hall, *The Political Power of Economic Ideas.*

concept of comprehensive income taxation embodied in the report of the Carter Royal Commission on Taxation[4] and its influence on proposals for tax reform. It assesses the economic, political and administrative viability of Carter's ideas as proposals for radical change in the economic constitution, and their gradual adaptation to existing institutional structures. Finally, it addresses the conflict between Carter's concept of comprehensive tax reform as a root and branch restructuring of taxation from first principles and the extensive web of societal obligations and interests which have evolved from the use of tax policy as an active instrument to further the objectives of Canadian governments and major societal groups. It suggests that while specific policy problems may be successfully resolved by piecemeal structural changes to the tax system consistent with theoretical or academic concepts of tax reform, too many Canadians identify their economic and social interests with the existing tax structure for a comprehensive tax reform program based on radical changes in the basic principles of taxation to be politically viable -- except in the event of a national emergency.

THE ROLE OF IDEAS IN SHAPING STRUCTURAL POLICY CHANGE

Most changes to public policy are made at the margin. The economic system can only absorb a certain amount of change at any one time without triggering collective political and economic indigestion. The tax system is so deeply interwoven with existing social and economic relationships that politicians must be able to provide taxpayers -- expecially those who are significant stakeholders in the existing system -- with compelling

[4] Comprehensive income taxation: inclusion of all forms of income, defined as the growth of "comprehensive net worth", in the tax base with a minimal number of exemptions or deductions. This differs from comprehensive tax reform, which is a complete overhaul of one or more major elements of the tax system, but which may involve the rationalization rather than the wholesale elimination of tax preferences. Henry C. Simons, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy*, (Chicago, University of Chicago Press, 1938); Royal Commission on Taxation, *Report*, ("The Carter Report") 5 vols., (Ottawa, Queen's Printer, 1967).

justification if they are to win their support for changes which may well lead to the disruption of accustomed business practices and economic expectations.

The dominant values which have shaped Canadian tax policy since the 1940s are those of fairness -- both vertical and horizontal equity -- and the general commitment of governments to promote economic opportunity and growth for individuals, businesses and the nation as a whole. However, while a rich literature has emerged on these concepts, their practical application is partly a function of the dominant political values shaping Canadian economic and social policies and partly a reflection of the major policy challenges facing Finance Ministers at any one time.

Peter Hall and Peter Gourevitch have suggested that economic ideas can provide an effective rationale for major changes to political and economic structures, subject to four major conditions. The first condition is the promise of economic viability: the new ideas should offer the prospect of resolving a society's major economic problems in a way that currently dominant policy ideas and paradigms fail to do. Second, a new system of ideas should receive authoritative sponsorship within the political system by leading politicians, senior bureaucrats, and/or an authoritative body of experts established to study the issue. Third, these governmental actors should have the institutional capacity to implement their proposals. This includes legal or constitutional authority and administrative viability: i.e., the capacity of bureaucratic structures and economic processes to adapt to required changes. Finally, the new ideas should be politically viable: they should offer sufficient benefits to a cross-section of societal interests to sustain a government and its policies through successive elections.[5]

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[5] Hall, *The Political Power of Economic Ideas.*

France St. Hilaire and John Whalley have noted that political discourse on tax reform and the tax structure tends to take place on three distinct levels: the political, the bureaucratic and the academic.[6]

The political approach, constrained by cluttered political agendas and the short time horizons of the electoral cycle, tends to focus on the resolution of major structural or policy problems by means of piecemeal responses, often of high political visibility. It is often a reaction to external events or societal pressure. As such, it tends to be heavily weighted by calculations of coalition-building and brokerage politics which take into account the need to balance the potential impact of proposed policies on different interest groups and marginal voters for whose electoral support the government and opposition are competing. Examples of Finance Ministers following this approach include John Turner's partial indexing of personal income taxes in 1973 to offset inflation (followed by their partial deindexation in 1985), Jean Chretien's introduction of the refundable child tax credit in 1978, Marc Lalonde's National Energy Program (NEP) of 1980 and pension reform proposals of 1983-84 and Michael Wilson's introduction of the capital gains exemption and the minimum income tax in 1985, followed by the dismantling of the NEP in 1986.

The political approach may lend itself to clientele politics, in which Finance Ministers offer economic benefits to specific groups in the hope of gaining disproportionate political and/or economic benefits, to majoritarian politics -- in which both costs and benefits are widely dispersed among a broad cross-section of taxpayers -- or to the redistribution of income from upper to lower income taxpayers. (See Table 3-1.)

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[6] France St. Hilaire & John Whalley, "Reforming Taxes, Some Problems of Implementation", in David Laidler (ed.), *Approaches to Economic Well-Being*, (Toronto, University of Toronto Press, 1985), 196-202.

TABLE 3-1
PIECEMEAL TAX REFORMS: THE "POLITICAL" APPROACH

YEAR	INITIATIVE	DISTRIBUTIVE IMPACT	POLITICAL RESULT
1973	PIT Indexation	Majoritarian (distributive)	Tax reduction -- strong support
1978	Child Tax Credit	Mildly redistributive (targeted)	Consensus support » basis for long-term changes to family transfers
1980	National Energy Program	Redistributive (regional) / Clientele (inter-corporate)	Implemented with marginal changes; gradual erosion in response to polit. reaction. Scrapped 1984-86.
1984	Pension Reform	Majoritarian/ distributive	Consensus support » gradual implementation.
1985	Lifetime capital gains exemption	Clientele	Sharply disputed; offset by higher inclusion rates 1987-89; gradual erosion: 1987-94.
1985	Minimum personal income tax	Redistributive (symbolic)	Reduced to mainly symbolic measure
1985	Corporate Income Tax Reforms	Mildly Redistributive	Net tax increase/ offset by other gov't policies.
1987	Income Tax Reform	Majoritarian/ distributive	Consensus support benefits for most groups.

Clientele -- benefits targeted to specific group, financed through higher taxes/deficits paid by majority.
Redistributive -- significant transfer of resources from minority of higher income groups or regions to those with lower incomes.
Majoritarian/distributive -- broad distributive of benefits to majority of population, businesses. Usually involves broadly based tax reductions or preferences.

The bureaucratic approach tends to be a more-or-less pragmatic synthesis of policy objectives and the institutional interests of state actors. It both initiates and "filters ideas from the other levels, rejecting some but making others concrete and implementable".[7] These proposals are usually intended to work within existing political and institutional structures, unless these have become unworkable. The bureaucratic approach to tax reform usually occurs in areas of relatively high economic importance but low political visibility and relatively high technical complexity. Examples include Finance Department proposals for the comprehensive inflation indexation of investment income in 1982-83, corporate tax reforms in 1985-86. However, as demonstrated by repeated efforts to introduce sales tax reform, departmental efforts to introduce major structural changes without significant societal support have generally failed.

The bureaucratic and political approaches usually lend themselves to a process of incremental rather than radical change -- individual acts of (usually) uncoordinated government intervention arising from the search for collective solutions to individual social and economic problems. Aaron Wildavsky explains this process as largely a function of the political culture -- a blend of popular and elite attitudes towards the role of governments and the "good society". These are reflected in the competition of groups and interests for power, the uses of power and the arguments advanced to justify their actions.[8] Both the tax and the expenditure sides of the budgetary base "reflect and justify the social order," as do the rules and processes used to arrive at them.[9] Joseph Schumpeter explains this process by his theory of competitive political elites bidding for votes, while noting the need for an independent and highly professionalized bureaucracy to balance the

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[7] Ibid., 207.

[8] Aaron Wildavsky, *Budgeting - A Comparative Theory of Budgetary Processes*, 2nd ed., (New Brunswick NJ, Transaction Books, 1986), 9-16, Chapters 11, 12. See also Jonathan R.T. Hughes, *The Governmental Habit Redux: Economic Controls from Colonial Times to the Present*, 2nd ed., (Princeton, Princeton University Press, 1991); Carolyn Webber and Aaron Wildavsky, *A History of Taxation and Expenditure in the Western World*, (New York, Simon & Schuster, 1986), Chaps. 1,9,10.

[9] Wildavsky, *Budgeting: A Comparative Theory*, 336-340.

policy effects of political competition within a rational framework of economic policy.[10] S.J.R. Noel emphasizes the Canadian tradition of elite accommodation[11] which has lent itself to the development of a series of partnerships between governments and economic interests in a manner comparable to what Theodore Lowi has described as "interest-group liberalism".[12] Like the growth of government spending described by Wildavsky, Savoie and others, the gradual development of the income tax system into its present multi-dimensional complexity was the cumulative product of decades of judicial rulings and budgetary decisions dealing with a wide range of specific problems in law and policy.[13] Eric Nordlinger and other theorists of state autonomy emphasize the role of state actors pursuing their interests and policy objectives sometimes independently of societal actors, sometimes through their manipulation, sometimes by building coalitions with them to achieve common interests.[14]

The sheer volume of incremental changes to tax laws in recent years has lent itself to periodic efforts at consolidation -- a major cause of both comprehensive and piecemeal

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[10] Joseph A. Schumpeter, *Capitalism, Socialism and Democracy*, (New York, Harper Torchbooks, 1975), 269-296.

[11] S.J.R. Noel, "Consociational Politics and Canadian Democracy", *Canadian Journal of Political Science*, 4:1, January 1971, 15-18; Noel, "Political Parties and Elite Accommodation: Interpretations of Canadian Federalism", in J. Peter Meekison (ed.), *Canadian Federalism: Myth or Reality*, 3rd ed., (Toronto, Methuen, 1977).

[12] Theodore J. Lowi, *The End of Liberalism*, 2nd ed., (New York, W.W. Norton, 1985). For a discussion of this process in a Canadian context, see M.M. Atkinson and W.D. Coleman, *The State, Business and Industrial Change*, (Toronto, Univ. of Toronto Press, 1989); and Coleman, *Business and Politics: A Study of Collective Action*, (Toronto, Univ. of Toronto Press, 1988).

[13] The effects of incrementalism can be seen in the complexity of the Income Tax system and the distinct but interdependent character of its component parts. For a comprehensive single volume treatment, see Vern Krishna, *Fundamentals of Canadian Income Tax Law*, 4th ed., (Toronto, Carswell, 1993).

[14] Eric A. Nordlinger, *On the Autonomy of the Democratic State*, (Cambridge, MA, Harvard University Press, 1981); David Held, "Central Perspectives on the Modern State", in Held, *Essays on State, Power and Democracy*, (Cambridge, Polity Press, 1989), 11-55.

tax reforms. Allan Maslove suggests the existence of a tax reform cycle in which a consensus is reached on the area of an appropriate tax base. This is subsequently eroded by the extension of tax preferences to various groups in response to changing economic, political and technical conditions. It then gives way to the restructuring of the entire tax system in response to a new synthesis of political and economic priorities.[15]

The academic approach tends to reject piecemeal or generic approaches to tax reform in favour of a comprehensive restructuring of the tax system based on certain normative principles in order to make it conform more closely to an ideal tax base.[16] For this reason, the academic approach to tax reform, often expressed in theoretical or "optimal" models of taxation redesigned from first principles, poses the most direct challenge to the economic constitution. It is analogous to what Peter Russell has described as "mega-constitutional reform" in the political sphere: a reopening of basic questions of national identity, citizenship and "fundamental principles of the body politic".[17] The Carter-Benson reforms of 1967-71 and Allan MacEachen's tax reform budget of 1981 are the clearest examples of this approach to tax reform.

While piecemeal approaches to tax reform have a mixed record of political success -- as measured either by public acceptance, successful integration into the tax system for the medium or long term, or the achievement of their declared policy goals -- proposals for comprehensive tax reform have usually provoked far more controversy. As a general rule, the political success and durability of proposed tax reforms since the 1960s have

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15 Allen M. Maslove, *Tax Reform in Canada: Its Process and Impact*, (Halifax, Institute for Research in Public Policy, 1989), 16-20.

16 Royal Commission on Taxation, *Report*, ("The Carter Report") 5 vol., (Ottawa, Queen's Printer, 1967); Stanley B. Surrey, *Pathways to Tax Reform*, (Cambridge, Harvard Univ. Press, 1973); St. Hilaire and Whalley, "Reforming Taxes", 195-6.

17 Peter H. Russell, *Constitutional Odyssey*, 2nd ed., (Toronto, University of Toronto Press, 1993), 75-6.

been in inverse proportion to the degree to which they were challenged (or perceived to challenge) existing structures and principles of taxation.[18] Table 3-2 assesses a number of formal proposals for large-scale tax reform since the 1960s based on the degree to which each would have changed existing concepts and methods of taxation.

Two major theories of comprehensive tax reform have challenged existing tax structures in Canada and other major industrial countries since the 1960s. The first, as noted earlier, is the Haig-Simons model of the comprehensive income tax, which became the basis for the report of the Carter Royal Commission on Taxation in 1967. It provided the intellectual impetus for the 1969 Benson White Paper, the 1981-82 tax reform budgets of Allan MacEachen, and the tax policy agenda for much of the Canadian Left since the 1960s.[19]

The second model was that of an expenditure-based income tax system[20] in which current consumption rather than income would be taxed. This became the subject of widespread academic debate following the 1977 report of the Meade Commission in Great Britain.[21] During the 1980s, this idea was reinforced by proposals for a flat-rate

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[18] The most notable exception, the Goods and Services Tax, was implemented despite bitter public and partisan opposition. Its survival may be attributed less to growing public tolerance than to the lack of consensus over a feasible alternative and to the fiscal and economic dislocation that would result from its elimination.

[19] David Lewis, *Louder Voices: The Corporate Welfare Bums*, (Toronto, James Lorimer, 1972); National Council of Welfare, *The Hidden Welfare System*, (Ottawa, November 1976); Linda McCuaig, *Behind Closed Doors: how the rich won control of Canada's tax system and ended up richer*, (Toronto, Viking/Penguin, 1987).

[20] Robin Boadway and Neil Bruce, "Theoretical Perspectives in Tax Reform", in David Laidler, ed., *Approaches to Economic Well-Being*.

[21] J.D. Meade, Chmn., *The Structure and Reform of Basic Taxation*, (London, George Allen & Unwin, 1978)

TABLE 3-2

CONCEPTUALIZING COMPREHENSIVE TAX REFORM
"MAXIMALIST" AND "MINIMALIST" APPROACHES

10	--- Carter Commission (1967)
9	--- Goods and Services Tax (1989-90)
	--- Forget Report on U.I. Reform (1986)
8	--- Benson White Paper (1969)
7	--- MacEachen Budget (1981)
6	--- Benson Income Tax Reforms (1971)
5	
	--- White Paper on Wholesale Tax (1982-83)
4	--- Wilson Income Tax Reforms (1987-88)
3	
2	--- Wilson Corporate Tax Reforms (1985-86)
1	

"10" -- Comprehensive restructuring of concepts and objectives of taxation from first principles;
"1" -- rationalization of existing tax preferences without any significant changes to existing concepts or objectives of taxation.

income tax.[22] While these ideas of consumption-based or flat-rate income taxes proved to be too radical a departure from existing orthodoxies to be politically or administratively viable in Canada, they effectively challenged the theoretical supremacy of the Haig-Simons model.[23]

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[22] Robert E. Hall and Alvin Rabushka, *The Flat Tax*, (Stanford, CA, Hoover Institution Press, 1985); David A. Dodge, "Canada", in Joseph Pechman (ed.), *World Tax Reform - A Progress Report*, (Washington, The Brookings Institution, 1988); Dodge, "The Economic Objectives of Tax Reform", in J. Mintz and J. Whalley, *The Economic Aspects of Tax Reform*, (Toronto, Canadian Tax Foundation, 1989), 41.

[23] Laidler, *Approaches to Economic Well-Being*; Henry J. Aaron, Harvey Galper, Joseph A. Pechman, *Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax*, (Washington, D.C., The Brookings Institution, 1988); Sijbren Cnossen & Richard M. Bird, *The Personal Income Tax, Phoenix from the Ashes*, (Amsterdam, North Holland, 1990).

During the mid-1980s, the federal government opted for a pragmatic rather than an ideological approach to tax reform. This involved a rationalization and restructuring of tax preferences aimed at facilitating lower tax rates, rather than a radical departure from the existing tax structure. The pragmatic approach was the result of almost twenty years of ideological warfare sparked by Carter's grand strategy for comprehensive tax reform.

THE CARTER REPORT AND THE REFORM AGENDA

The political impetus for the 1960s' round of tax reform had been the fear of many tax professionals that the federal courts were gradually moving in the direction of a redefinition of income which could subject many upper income taxpayers to huge retroactive tax liabilities at high marginal rates of income tax.[24]

However, Carter's recommendations exceeded their worst fears, arguably doing more to create a political crisis for the government than to resolve one. Rather than merely tidying up the anomalies and inconsistencies of the existing tax system, the Commission's massive report, released in 1967, proposed a root-and-branch restructuring of the Income Tax system involving major philosophical and structural departures from the existing system and tax increases averaging 40 percent for many upper income taxpayers.[25] While these proposals were generally welcomed at the time by orthodox Keynesian economists

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[24] Douglas G. Hartle, "Some Analytical, Political and Normative Lessons from Carter", from Neil Brooks (ed), *The Quest for Tax Reform*, (Toronto, Carswell, 1988), 401; Les McDonald, "Why the Carter Commission Had To Be Stopped", from Brooks, ibid., pp. 352-354; McDonald, *Taxing Comprehensive Income*, (Ph.D. Dissertation, Carleton University, 1985), Chapter 2. Perry notes that the risks of unfavourable tax rulings on disputed taxes were magnified by marginal income tax rates of up to 80%, compared with about 50% in the post-1971 tax system. Perry, *A Fiscal History of Canada*, (Toronto, Canadian Tax Foundation, 1989), 279-83.

[25] McDonald., "Why the Carter Commission...", 360-1; John Bossons, "The Objectives of Taxation and the Carter Commission Proposals", *Canadian Public Administration* XII(2), Summer 1969, 137-165; Richard M. Bird, "The Tax Kaleidoscope: Perspectives on Tax Reform in Canada", *Canadian Tax Journal* 18:5, September-October 1970, 444-473.

on normative and technical grounds, they posed a serious enough threat to existing economic relationships to promote massive political resistance from large elements of the tax and business communities, even after substantial revisions by Department of Finance officials.[26]

The Haig-Simons model on which the Carter Report is based, redefines income as any increase in taxpayer's net wealth, hence net buying power, during a fixed period, usually a calendar year. Unlike the traditional Anglo-Canadian definition of income, it does not distinguish between various forms of cash income, accrued income[27], imputed (notional) income[28], or growth in the value of assets not readily subject to conversion into cash and personal gifts. Rather, it seeks to eliminate all "artificial" distinctions in income which have resulted from the accumulation of legislative and judicial decisions and trade-offs over the years, and to replace them with a comprehensive benchmark tax structure. Departures from its ideal tax base (tax preferences) were characterized as "tax expenditures", on the grounds that failure to collect taxes is the perceived equivalent of

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[26] Ibid., 452; I.H. Asper, *The Carter Commission Report on Taxation -- An Objective View*, (--, Equitable Income Tax Foundation, 1967), 1-8; L.T. Macdonald, Taxing Comprehensive Income; Hon. Edgar Benson, *White Paper on Tax Reform*, (Ottawa, Department of Finance, 1969).

[27] Taxation of accrued income: taxes applied to income or revenue earned but not necessarily received received in cash by taxpayer. Historically, business income and taxation have been calculated on an accrual basis; individual and farm income have been calculated on a cash basis. Traditionally, accrued capital gains (growth in nominal asset values) have not been subject to taxation -- although this has changed for certain categories of investments such as mutual funds in recent years.

[28] Imputed income: income calculated on the basis of a formula imposed by law, rather than actual market values, cash or accrued income; income "which would have been received" if certain circumstances had occurred. Haig-Simons suggested its application to "imputed" rental value of family homes and other assets which are used for personal consumption rather than generating income.

direct government transfers to the taxpayers in question.[29] This distinction was captured in the slogan "a buck is a buck" used to promote the Benson White Paper.

The Benson White Paper of 1969 and the MacEachen tax reform budget of 1981 both attempted to introduce modified versions of the Carter proposals as part of a comprehensive restructuring of the Income Tax Act.[30]

Carter's ideas appealed to three very different groups within the broader tax policy community. Libertarians and neo-classical economists (a distinct minority in the 1960s) supported the wholesale removal of tax preferences as state-imposed distortions on private economic activity. Taxing accrued and imputed income would force taxpayers to shift investments to those areas which would yield the highest returns, rather than sitting on unproductive capital to avoid taxes.[31]

Many public finance economists and professionals applauded Carter's proposals for returning the tax system to what they believed should be its main purpose, the collection of tax revenues, while using other policy instruments to achieve other economic and social policy objectives. In this view, shared by many officials of the Department of

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[29] Stanley Surrey and Paul R. McDaniel, *Tax Expenditures*, (Cambridge, MA, Harvard Univ. Press, 1985); for extended discussions see Neil Brooks, (ed.), "Tax Expenditure Analysis", *Canadian Taxation* 1(2), [Summer 1979], Roger S. Smith, *Tax Expenditures*, Canadian Tax Paper # 61, (Toronto, Canadian Tax Foundation, 1979) and Neil Bruce, ed., *Tax Expenditures and Government Policy*, Kingston, ON, John Deutch Centre for the Study of Economic Policy, Queens University, 1988).

[30] MacEachen, *Budget Speech*, November 12, 1981; Department of Finance, *Analysis of Federal Tax Expenditures for Individuals*, (Ottawa, The Department, November 1981).

[31] A 1994 study suggested that adoption of the Haig-Simons model of income would have increased the tax base by $ 132 billion in 1988: including $ 51.3 billion ($ 4,900/family) for accrued capital gains on owner-occupied homes; $ 26.3 billion ($ 2,517/family) on accrued pension and RRSP income; $ 17.8 billion ($ 1,700 / family) on imputed rent; and $ 3.4 billion (325/family) on employer-provided benefits -- increasing the taxable income of families earning $ 40,000 to $ 100,000 by an average of 28.4 percent. Frank Vermaeten, W. Irwin Gillespie, and Arndt Vermaeten, "Tax Incidence in Canada", *Canadian Tax Journal* 42(2), 348-416, Tables A3,A4,A5.

Finance,[32] substituting public grants, loans, subsidies and regulations for tax preferences would enable governments to improve the targeting of public assistance, and impose greater control and accountability over public spending.[33]

Social democrats applauded Carter's egalitarian goal of subjecting all forms of income to progressive tax rates, thus radically increasing the scope for the redistribution of income and wealth and the expansion of other activities by the state.[34]

However, these responses generally occurred in the rarified world of economists and specialists in public finance rather than in the broader political arena. In reality, Carter's proposals for a radical restructuring of the tax system owed more to 1960s' optimism over governments' capacity to apply rational management techniques to the economy than to any widespread public sense of crisis over the shortcomings or inadequacies of the tax system.

Edgar Benson's White Paper on Taxation, released in early 1969, rejected the Carter Report's most radical recommendations, but sought to implement enough of them -- including the taxation of capital gains in addition to the existing Estate Tax, the elimination of the low tax rate for small business, the integration of personal and corporate income for tax purposes, and increased taxes on resource industries and on

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[32] Interviews, senior Department of Finance officials. (ADM-1; ADM-2; FO3, FO4)

[33] Neil Bruce, ed, *Tax Expenditures and Government Policy*.

[34] Neil Brooks, *The Search for Tax Reform*, (Toronto, Carswell, 1988); L.T. Macdonald, *Taxing Comprehensive Income*.

intergenerational gifts and transfers -- to promote a significant political backlash.[35]

Benson later commented that

> the White Paper ... was released, I am told, on the anniversary of the Russian revolution and was received in much the same way by many members of our affluent society.[36]

As a result of the public outcry, Benson committed the federal government to a policy of ongoing revenue neutrality by linking the phase-in of White Paper measures to the phased reduction in Corporate Income Tax (CIT) rates. Benson eliminated the federal Estate Tax to avoid double taxation of capital gains and made extensive revisions to the White Paper which brought the design of Canada's tax system much closer to that of the United States than to that of the Carter blueprint.[37]

Allan MacEachen's tax reform budget of 1981 was an effort to eliminate many of the tax preferences which had been added to the tax system during the previous decade and to extend accrual taxation to a number of areas of business and investment income. The political impetus for the 1981 tax reform budget was a looming fiscal and economic crisis. The U.S. Federal Reserve Board had responded to high and increasing inflation with monetary shock treatment which drove Canadian interest rates over 22 percent -- more than 10 percent in real terms. Conventional Keynesian economics called for a more

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[35] Former Deputy Finance Minister Robert Bryce believes that these four measures were the key political weaknesses which made the Carter Report and the White Paper politically unacceptable. (R.B. Bryce, "Implementing the Report: Processes and Issues", from Brooks, *The Quest for Tax Reform*, 39-42.) For detailed comparison of the Carter and White Paper proposals, see Meyer Bukovetsky and Richard M. Bird, "Tax Reform in Canada: A Progress Report", *National Tax Journal* 25, [March 1972], 15-20; Perry, *A Fiscal History of Canada*, 292-297. See also Douglas G. Hartle, *Political Economy of Tax Reform*, Discussion Paper # 290, (Ottawa, Economic Council of Canada, 1985).

[36] Hon. Edgar J. Benson, "Attempts to Further the Goals of the Carter Report: The White Paper on Tax Reform", in Brooks, *The Quest for Tax Reform*, 53.

[37] E.J. Benson, "Letter to Chairmen of House and Senate Finance Committees", House of Commons, *Debates*, June 11, 1970, 8023, quoted in *Canadian Tax Journal* 18(4), July-Aug. 1970, 328-329; Bukovetsky and Bird, "Tax Reform in Canada", 39.

restrictive fiscal policy to combat inflation and to permit an easing in interest rates. The Trudeau cabinet, elected on a social democratic platform of activist government, was committed to sharp increases in public spending. Finance Minister Allan MacEachen chose to impose the resulting tax increases through a systematic attack on tax preferences rather than a general increase in tax rates.[38]

MacEachen explicitly justified his proposals by appealing to the concept of "tax expenditures" as arbitrary and unfair departures from Carter's economic ideal.[39] This decision suited the policy preferences of many tax policy officials within the Department of Finance who shared a deep intellectual commitment to Carter's model of tax reform, and who deeply resented the accretion of so many elements to the tax system which they regarded as politically-inspired distortions of a "good tax system" during the 1970s.[40]

While Finance Department officials have disclaimed any intent for the 1981 tax reform budget to be part of a broader economic strategy[41], MacEachen's rhetoric -- and that of his political opponents -- ensured that the resulting political battle would be fought in the shadow of the earlier Carter-Benson proposals for reform.

Both Benson and MacEachen were forced to make major changes in their initial tax reform proposals in order to make them politically and economically viable. The issues

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38 Hon. Allan J. MacEachen, *Budget Speech*, (Ottawa, Department of Finance, November 12, 1981); Interview, former Deputy Minister of Finance. [D3] See Chapters 8-9.

39 MacEachen, *Budget Speech*, November 12, 1981; Hon. Allan J. MacEachen, *Analysis of Federal Tax Expenditures for Individuals*, (Ottawa, Department of Finance, November 1981). See Chapter 8.

40 Interviews, former Liberal MP (MP3), Assistant Deputy Ministers (ADM-2; ADM-3), current and former officials of Tax Policy - Legislation Branch (F01, FO3, FO4). The political and bureaucratic processes which led to the 1981 tax reform budget are discussed in detail in Chapter 8.

41 Interviews, former Deputy Minister (D3); former Assistant Deputy Ministers (ADM2, ADM4); current and former officials of Tax Policy - Legislation Branch. (FO1, FO4).

of economic and political viability struck directly at the heart of the claims made for Carter's vision of tax reform -- particularly with the increasing integration of Canada's economy into continental and global markets for goods and capital.

Economic Viability

The strongest economic arguments for comprehensive income taxation[42] were rooted in neo-classical economic theory. Economists of this school argued that the existing patchwork quilt of tax exemptions and preferences created incentives for taxpayers to convert taxable income into forms of income taxed at lower rates or not at all -- most notably the conversion of business and investment income into capital gains. The Carter-Benson tax reforms would remove many of these economic distortions and inequities, and increase the incentives for taxpayers to maximize their economic opportunities in the marketplace rather than through the zero- or negative-sum games of rent-seeking and tax avoidance. Moreover, exposing investment income to accrual taxation would prevent the growth of large concentrations of wealth and economic power -- an argument which clearly appealed to the egalitarian spirit of the 1960s. The general prosperity of the 1960s made distributive issues seem a higher economic and political priority than capital formation or micro-economic measures to encourage economic growth.

However, critics of the Carter-Benson proposals and the 1981 tax reform budget charged that these benefits were contingent on several major factors. First, the economic incentives of tax reform would only be realized if tax increases from base broadening measures were offset by substantial reductions in tax rates so that all major groups in society would be better off. Economic research during the early 1980s suggested that

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[42] See fn. 4, p. 51.

high marginal and effective tax rates created a social cost of 30 to 50 percent in excess of the taxes collected -- placing a premium on the incentive effects of reducing tax rates.[43] Second, the distributive benefits of tax reform would depend on the accessibility and efficiency of direct government spending programs adopted as substitutes for tax preferences. This was unlikely with many broadly-based tax measures, especially those targeted at the middle class and small businesses.[44] Third, the success of tax reform was contingent on the federal government's ability to manage international capital flows and thus reduce the effects of transfer pricing, international tax competition and arbitrage on investment, corporate incomes and opportunities for tax avoidance. Canada's increasing openness to international trade and investment made such control increasingly difficult, if not counterproductive. Fourth, the economic effects of comprehensive income taxation were closely linked to price stability and the level of inflation. The government's single year accounting framework took little or no account of the impact of inflation on medium and long term investments -- a major drawback in the inflationary economy of the 1970s and early 1980s, especially on business and investment income.[45] Fifth, the administrative viability of the proposals was dependent on adequate transition and

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43 St. Hilaire and Whalley, "Reforming Taxes", 203; Roger S. Smith, "Rates of Personal Income Tax: The Carter Commission Revisited", *Canadian Tax Journal* 35(5), [September-October 1987], 1230-37.

44 Haig-Simons challenged a wide range of middle-class tax preferences which sheltered the accrued value of pensions, retirement savings, family homes and businesses -- along with non-cash employer-paid benefits. In the absence of equivalent direct state transfer programs which would be costly and administratively difficult to implement, the result would be a shift from long-term savings and investment to short-term consumption -- and probably an increase in the concentration of wealth in the hands of the state and large private corporations. Jonathan R. Kesselman, "Direct Expenditures vs. Tax Expenditures for Economic and Social Policy", in Bruce, *Tax Expenditures & Government Policy*, 289-300, 318.

45 John F. Helliwell, "Inflation and Tax Reform", *Canadian Tax Journal* XVIII(2), [March-April 1970]; Glenn P. Jenkins, *Inflation: Its Financial Impact on Business in Canada*, (Ottawa, Economic Council of Canada, 1977); John Bossons, "The Effect of Inflation-Induced Hidden Wealth Taxes", *Report of Proceedings from Thirty-Second Tax Conference*, (Toronto, Canadian Tax Foundation, 1980), 16-41.

grandfathering provisions to minimize the economic disruption of tax reform and its potential for retrospective application.

> If normative implications of the accretion concept of income are taken seriously, much more vigorous efforts are needed to fully tax in-kind fringe benefits, to tax retirement claims on imputed (non-cash) income, to fully tax realized capital gains, to move towards an accrual tax on other capital gains, and to fully integrate the corporate with the personal income tax. *Doing so, however, invites enormous and possibly insuperable valuation, imputation and inflation adjustment problems.*[46]

Business criticisms of both the Carter Report, the Benson White Paper and the 1981 budget emphasized their potential for disrupting existing patterns of economic activity. The Benson White Paper was modified extensively following Parliamentary hearings and business lobbying. The 1981 MacEachen Budget, which sought to introduce major changes to the tax structure without benefit of prior consultation with the private sector or general public, was notable for its initial lack of transitional measures -- a factor which seriously damaged its economic and political credibility.[47]

With the economic benefits of comprehensive income taxation sharply contested, tax reform had to survive on its political merits. These were debated in both ideological and pragmatic terms.

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[46] Cnossen, "Comment" in Pechman, *World Tax Reform*, 266-7. (GEH emphasis added).

[47] Allan M. Maslove and Heidi Eicher, Refc[illegible] Taxes: where to go and how to get there", in Michael Prince, ed., *How Ottawa Sp[illegible] 1987*, (Toronto, Methuen, 1987); MacEachen introduced a number of transitional measures six weeks after the budget, but by then, its political credibility had been wrecked by the systematic criticism of opposition parties, assorted interest groups and the news media. Hon. Allan MacEachen, *House of Commons Debates*, December 18, 1981; *The Financial Post, The Globe and Mail, The Toronto Star, The Vancouver Sun, The Citizen* - November-December 1981. Its economic credibility was further damaged by the onset of the recession of 1981-82.

Political Viability

The raucous public debate over both major proposals for comprehensive tax reform -- the Carter-Benson tax reform proposals of 1967-1971 and the MacEachen Budget of 1981 -- politicized tax policy in Canada to an unprecedented degree. The tax reform debates masked a broader debate over the role of government within the economy and society. Would the design of the federal tax system limit or expand the fiscal powers of governments to manage the Canadian economy and pursue a wide range of social policy objectives through direct federal expenditures? Opposition to the Carter-Benson-MacEachen message of tax equity was largely expressed in the language of resistance to higher taxes and limits to the expansion of governmental power.

The political viability of the Haig-Simons model of tax reform hinged on the capacity of would-be reformers to convince a majority of Canadians to accept two propositions. The first was normative: that the ability of upper-income Canadians to exploit a wide range of tax preferences not often used by lower and middle-income taxpayers imposed a serious injustice on the latter and reduced revenues otherwise available for redistribution by governments. The second was pragmatic: that a majority of taxpayers and the Canadian economy as a whole would be better-off under the lower tax rates possible with a restructured tax system. This appeal to the neo-classical ideas of market economics was sharply at odds with the rhetoric of successive federal governments which proclaimed the need for comprehensive state intervention to correct market failures, promote equality of economic opportunity and social justice.

The political critique of the Haig-Simons model of tax reform was based on three main objections. The first was ideological: that comprehensive income taxation carries with it an implicit assumption that the state had first claim on a society's income and wealth.[48] This was reinforced, particularly in 1981-82, by the reformers' aggressive use of the tax expenditure concept -- the idea that any deviation from the benchmark tax base is an implicit subsidy by the state to taxpayers whose incomes, as redefined by Carter, are not subject to the fullest possible degree of taxation.[49] This was a radically different concept of income which would have forced large numbers of middle class taxpayers to face major reductions in their disposable incomes -- a small factor to academic economists, but a major consideration to politicians seeking re-election.[50] These factors shifted the grounds of debate from theoretical discussions of "ability to pay" to the very practical question of whether the individual taxpayer would receive significantly increased value in return for higher taxes.

> Practically any family...today that makes less than $ 30,000 a year ($ 75,000 in 1990) finds that its needs are always pressing against its after-tax income. And this, in turn, means that the argument from "ability to pay" no longer has the moral or persuasive power it used to, and that even the liberal middle class feels that taxation has gone quite far enough.[51]

The second major objection was that comprehensive income taxation was seen to have the effect of shifting economic discretion and power from individual and business taxpayers to the state. This is ironic, as it was the precise opposite of Simons' intent, which was to facilitate market forces and break up large concentrations of economic power.[52]

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48 Asper, *The Carter Commission Report...*; Hughes, *The Governmental Habit*, 220; Irving Kristol, "On Taxes, Poverty and Equality", *The Public Interest* 37, [Fall 1974], 14-15.

49 Supra, fn. 35, p. 64; Neil Brooks, "Making Rich People Richer", Saturday Night, [July 1981], 30-35; Canadian Taxation, 1(1), Spring 1979.

50 Supra, fn. 36, p. 64.

51 Irving Kristol, "On Taxes, Poverty and Equality", *The Public Interest* 37 [Fall 1974], 21; see also Boskin, *Federal Tax Reform*, 1-25; Buchanan, "Taxation in Fiscal Exchange".

52 Simons, *Personal Income Taxation*; Michael Oakeshott, "The Political Economy of Freedom", in Oakeshott, *Rationalism in Politics and Other Essays*, 2nd ed., (Indianapolis, IN, Liberty Press, 1991).

However, to the degree that advocates of tax reform saw it as an opportunity to replace tax preferences, whose use was largely at the discretion of individual taxpayers, with government programs in which benefits were to be targeted and distributed at the discretion of government officials, they reinforced the view of business interests that tax reform was intended as a vehicle for the expansion of state control of the economy.[53]

Ronald Robertson, former Director of the Canadian Tax Foundation and senior advisor to the Commons Finance Committee during the 1969 White Paper debate, suggests that

> the hearings indicated that the individual taxpayer saw the battle as being between himself and the government and rejected the Royal Commission and White Paper perspective that equity between taxpayers should be the goal. Tax theorists and advisors should never forget this.[54]

However, perhaps the greatest political handicap facing the Haig-Simons approach to tax reform was that large segments of the Canadian public had come to accept the idea of tax policy as an active instrument of economic and social policy -- largely because they had become the beneficiaries of such tax preferences. The federal government failed to create a political constituency with a clear interest in tax reform. At the same time, interests threatened with sharply higher taxes as a result of tax reform -- most notably small businesses, the investment and resource industries and large numbers of private sector tax professionals -- organized massive political resistance.[55] These groups succeeded in persuading the parliamentary opposition, several provincial governments, large segments of the mass media and the general public that proposed reforms threatened their economic well-being. As a result, the broad outline of comprehensive tax reform became obscured

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[53] Kenneth Woodside, "The Political Economy of Policy Instruments: Tax Expenditures and Subsidies in Canada", in M.A. Chandler & M.M. Atkinson (eds.), *The Politics of Canadian Economic Policy*, (Toronto, Univ. of Toronto Press, 1982).

[54] Ronald Robertson, "The House of Commons Committee and the Aftermath of the Royal Commission on Taxation", from W. Neil Brooks, *The Quest for Tax Reform*, 47.

[55] Maslove, *Tax Reform in Canada*; Maslove & Eicher, "Reforming Taxes". For detailed discussion of 1981 tax reform, see Chapters 9.

by the proce. .ı political brokerage.

THE PRAGMATIC APPROACH TO TAX POLICY

The major alternative to academic ideas for comprehensive tax reform is a pragmatic approach which accepts the tax system as one policy instrument among many which governments may use to respond to societal preferences[56] for the accommodation or encouragement of certain activities and the discouragement of others. It recognizes that the cumulative effect of using tax policies in this way is that tax considerations become deeply embedded in the social and economic fabric -- and that major changes to the tax system, particularly those leading to higher taxes, may be extremely disruptive for individual citizens and businesses unless carefully designed and accompanied with appropriate transitional measures or selective exemptions.

The choice of tax preferences (or tax penalties) rather than other policy instruments such as subsidies, regulations or direct state ownership may reflect the pressures of external economic forces, especially tax rules and rates in neighbouring countries. They may also seek to accommodate entrenched patterns of economic activity or norms of social behaviour which precede the citizen's responsibility to the state -- for example, the support of dependent family members or of religious and charitable activities. Alternately, they may be the result of deliberate political decisions to provide new incentives for economic development or socially desirable behaviour through generalized or targeted tax reductions (or increases).

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[56] "Societal preferences" may reflect a consensus of public opinion or the success of interest groups in translating their preferences into public policies in the absence of serious public opposition.

This outlook reflects the predominant ideology of business liberalism which has dominated Canadian economic policy for most of the period since the Second World War. It is also consistent with public choice analyses of the policy process such as those of Hartle and Savoie which emphasize the institutional interests of policy-makers and their desire to preserve and exercise the power of the groups or institutions they represent.[57]

Advocates of the pragmatic approach to tax policy and tax reform may explicitly reject the normative assumptions of comprehensive income taxation as the dominant principles of tax policy. Alternately, they may perceive that whatever their conceptual virtues, Carter-inspired concepts of equity and comprehensive taxation can only be implemented piecemeal as part of a balance among the competing policy goals. Such a balance is seen as necessary to legitimate fiscal and tax policies through interest accommodation and conciliation. In either case, this approach, which David Good labels *The Politics of Accommodation,*[58] lends itself to a process of brokerage politics and incremental policy change.

Maslove has noted that the pragmatic approach to tax policy carries with it a periodic need for tax reform -- if only to rationalize the large number of policy changes since the previous restructuring.[59] Piecemeal changes to the tax structure are preferred to large-scale or comprehensive change because they are easier to implement without creating serious economic disruption or political controversy. Piecemeal changes such as the indexing of personal income taxes in 1973 -- or their partial deindexing in 1982 and 1985

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[57] Hartle, *Political Economy of Tax Reform*; *The Revenue Budget Process of the Government of Canada*, (Toronto, Canadian Tax Foundation, 1982); *The Expenditure Budget Process of the Government of Canada: A Public Choice-Rent Seeking Approach*, Canadian Tax Paper # 81, (Toronto, Canadian Tax Foundation, 1988); Donald Savoie, *The Politics of Public Spending in Canada*, (Toronto, University of Toronto Press, 1990).

[58] David A. Good, *The Politics of Accommodation*, (Ottawa, School of Public Administration, Carleton University, 1980).

[59] Maslove, *Tax Reform in Canada*; Maslove & Eicher, "Reforming Taxes".

-- may be implemented unilaterally through the budgetary process. However, in recent years, they have usually been the product of a consensus-building process including formal and informal consultations between the federal Minister and Department of Finance and a range of governmental and societal interests.

Perhaps the most important reason for the persistence of the pragmatic approach to tax policy as an alternative to comprehensive tax reform is the flexibility it offers to politicians, major economic interests, and ordinary taxpayers in promoting their perceived interests through the political process.

Ministers of Finance value the use of tax preferences to balance the political and economic claims of competing interests within society. This enables them to respond to a wide range of economic concerns without having to create new bureaucratic instruments for the delivery of public services or direct subsidies for the promotion of economic development.

However, critics of the pragmatic approach argue that to the extent that tax preferences become entrenched as fiscal entitlements rather than discretionary expenditures, tax preferences become demand-driven and thus power is lost to the Minister of Finance as well.

The pragmatic approach to tax policy lends itself to piecemeal responses to policy problems and challenges, i.e. the use of tax policy to encourage or discourage certain social activities, or to mitigate the effects of external economic forces which threaten the security of individual citizens or major societal groups.

The pragmatic approach to tax policy also has a bias towards accommodating business practices which gives private businesses and investors considerable discretion in pursuing their economic interests without the detailed bureaucratic supervision typical of many regulatory structures or of direct government subsidies. To the extent that investments in particular sectors or regions offer higher levels of risk or require longer periods before reaping a competitive rate of return, tax preferences offer both politicians and business interests a convenient way to diffuse risk, harness private capital to promote economic development, and create a mutually beneficial political environment. To the extent that potential tax revenues are reduced by such policies, business interests can point to higher levels of job-creating, revenue-generating economic activity -- and a reduced potential for (or dependence on) direct state control. At the same time, the widespread availability of tax preferences lends itself to competitive rent seeking by business and other societal interests.

These features, while attractive to politicians, bureaucrats and interest groups whose outlook on the role of the state is shaped by the ideology of business liberalism, are usually anathema to those with a social democratic, Marxist or statist outlook. These tend to view tax preferences as tax expenditures involving the alienation of discretionary economic power from the state to private interests. This tends to make the state more dependent on the cooperation and goodwill of bourgeois interests thus reducing its power to implement structural economic and social change over the long term.[60] Attempts to link comprehensive tax reform with radical structural economic change has not escaped the attention either of liberal reformers attempting to cushion taxpayers against the forces of economic uncertainty or neo-conservatives who seek to legitimate market forces and reduce the role of an activist state as the primary instruments for economic well-being and constructive societal change.

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60 Woodside, "The Political Economy of Policy Instruments"; McQuaig, *Behind Closed Doors*; Leo Panitch, "Beyond the Crisis of the Tax State: From Fair Taxation to Structural Reform", in Maslove, *Fairness in Taxation*, 135-59.

Shifting Trends in Tax Policy

Canadian tax policy during the 1970s and mid-1980s was largely defined by the efforts of successive Ministers of Finance to respond to three major challenges: 1) growing public tax fatigue;[61] 2) the collapse of the post-war consensus on the role of government in the economy; 3) conflicting policy pressures to stimulate the economy, promote job creation, restrain inflation, and protect both taxpayers' standards of living and existing levels of public services. The seeming virtue of Carter-style comprehensive tax reform -- its attempt to minimize the tax structure as an instrument of policy activism or political reward -- was a major handicap under these circumstances.

The tax reform processes of 1967-71 and 1981-82 fostered a large political constituency for politicians who blamed many of the nation's economic ills on excessive taxation or inappropriate tax policies -- the politics of tax resistance.[62] The ink on Bill C-259, the Liberal government's comprehensive tax reform bill which had been ten years in the making, was barely dry when most of its basic premises were called into question both from inside and outside the government.

> In many ways, the true legacy of Carter was not the reformed Income Tax Act of 1971, but the myriad of tax expenditure items introduced in the personal income tax during the decade that followed.[63]

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[61] Liberals, Conservatives and New Democrats competed through the 1970s to offer tax relief in various forms to Canadians. See Gillespie, *Tax, Borrow and Spend,* (Ottawa, Carleton Univ. Press, 1991), 189-94. Public resentment over growing levels of direct taxation was reinforced by partisan attacks on wasteful tax concessions and subsidies to business by the New Democrats, and attacks on government waste and abuses of social programs by the Conservatives. David Lewis, *Louder Voices: The Corporate Welfare Bums*, (Toronto, James Lorimer, 1972); National Council on Welfare, *The Hidden Welfare System*, (Ottawa, 1976); Jeffrey Simpson, *The Discipline of Power*, (Toronto, Personal Library, 1981).

[62] John Turner epitomized this tendency within the Liberal Party after 1972, Jim Gillies, Sinclair Stevens and their fellow "supply-siders" within the Conservative Party during the late 1970s with their calls for tax cuts and "stimulative deficits".

[63] David A. Wolfe, "Politics, the Deficit and Tax Reform", *Osgoode Hall Law Journal* 26(2), [1988], 366.

Domestic political competition and the proliferation of interest groups seeking to preserve their relative tax positions combined to make tax limitation and the equitable distribution of tax exemptions a central issue for federal politicians.[64] Political competition and economic insecurity reinforced a trend towards client politics[65] in the allocation of tax preferences. Policy makers offered selected tax reductions to specific groups in the hope of combatting stagflation, increasing economic growth, cushioning adjustments to structural economic change and promoting a growing range of policy priorities.[66] However, pressures for tax limitation also led to the growth of several broadly-based tax preferences, most notably the partial indexation of personal income taxes, which amounted to a de-facto restructuring of the tax system.[67]

These policies limited the growth of taxation relative to that of the economy between 1975 and 1985. They also created a widespread public sense of entitlements to tax exemptions and preferences as cushions against economic disruption. This prompted competition among political parties to appease voters' fears of declining living standards

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[64] The two most prominent interest groups emerging from the White Paper debate of 1969-71 were the National Citizens' Coalition and the Canadian Federation of Independent Business. For a discussion of the growth of business-related interest groups, see Coleman, *Business and Politics: A Study in Collective Action.*

[65] James Q. Wilson, *The Politics of Regulation*, (New York Basic Books, 1980), 369-71. Mucciaroni notes the development of a similar process in the United States during the 1970s. Gary Mucciarioni, "Public Choice and the Politics of Comprehensive Tax Reform", *Governance* 3(1), January 1990, 2-8.

[66] Examples include sustained pressure for expanded tax benefits for the broad small business sector, for regional development, for specific industries (e.g. agriculture, Canadian films), for lower- and middle-income families, for job creation to absorb the huge influx of baby boomers into the labour market and a wide range of other groups. However, the relatively centralized nature of Canadian tax policy-making limited the growth of company-specific tax preferences which became a feature of the U.S. tax system under pressure from powerful Congressional Committees. For examples of ad hoc tax policy at its finest, see Louis Eisenstein, *The Ideologies of Taxation*, 156ff.

[67] This decision implicitly placed the preservation of Canadians' real incomes ahead of the raising of government revenues as a central principle of Canadian tax policy. See Hartle, *The Political Economy of Tax Reform*; Gillespie, *Tax, Borrow and Spend*, 189-94.

by promising ever more tax reductions.[68] As both direct federal spending and federal-provincial transfers continued to grow despite revenue constraints, the result was steady increases in federal budget deficits as the current costs of public services and federal income transfers came to be separated in the public mind from the taxes necessary to pay for them.[69]

When Allan MacEachen sought to rescind a wide range of tax preferences in his 1981 tax reform budget in order to reduce the deficit and combat inflation, the resulting political backlash resulted in a series of policy reversals. MacEachen's ghost enforced a policy of pragmatism throughout the first term of the Mulroney Government (1984-88), which was seeking to rationalize tax preferences through gradual consolidation rather than their elimination.

Finance Minister Michael Wilson epitomized the pragmatic tradition of tax policy in his incremental, consensus-seeking approach to tax reform between 1985 and 1988. The main impetus for tax reform in 1986-88 was the passage of a tax reform package by the U.S. Congress which broadened the tax base significantly and made major cuts to personal and corporate income tax rates.[70] The Mulroney Government, committed to the

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68 Most notably the 1978-79 Conservative election platform promising to make mortgage interest, property taxes, and a wide range of other items tax deductible and the Liberal campaign of 1980, based on rejection of the Clark government's proposed 18 cent per gallon gasoline tax. Simpson, *The Discipline of Power*.

69 This phenomenon was not limited to Canada. The reliance of the liberal welfare state on chronic deficit financing became the subject of numerous studies in several industrial nations during the 1970s. For Marxist, neo-conservative and liberal perspectives, see James O'Connor, *The Fiscal Crisis of the State*, (New York, St. Martin's Press, 1973); Buchanan and Wagner, *Democracy in Deficit*; Michel Crozier et al, *The Crisis of Democracy*, (New York, New York University Press, 1975); Daniel Tarchys, "The Scissors Crisis of Public Finance", *Policy Sciences* 15 [1983], 205-24.

70 Robert D. Brown, "Canadian Tax Reform: Can We Do Better the Second Time Around", in *Report of Proceedings, Thirty Eighth Tax Conference, 1986*, (Toronto, Canadian Tax Foundation, 1987); interviews, former Deputy and Assistant Deputy Ministers of Finance (D1, D2); former PMO officials (PMO-1).

negotiation of a free trade agreement with the United States, recognized the need to avoid major differences between effective tax rates in Canada and the United States to promote the competitiveness of Canadian businesses. Tax reform became a vital part of this economic strategy. However, unlike Benson and MacEachen's initial efforts at tax reform in 1969 and 1981, the 1986-88 tax reform program broadly copied the tax reform strategies of the United States and other major trading partners[71] rather than introducing major intellectual or policy innovations.

A number of studies have noted the similarities in tax reform programs initiated in most OECD countries during the 1980s. These included a lowering of marginal tax rates, particularly for upper-income earners, a reduction in the number of personal income tax brackets, a broadening of the tax base to reduce narrowly-targeted tax preferences and reduce the overall differences in effective tax rates between business sectors, and a modest shift in the tax burden from lower to middle and upper income individuals and corporations.[72]

While the prevalence of conservative political parties of different stripes in Canada, the United States and Great Britain offers a superficial ideological explanation for these trends in tax reform, it does not explain why nominally social democratic governments -- including those of Sweden, Italy, Australia and New Zealand -- followed broadly similar patterns. Guy Peters suggests that the increasing integration of national economies into regional and international markets led not only to the spread of ideas for tax reform but also to the creation of competitive pressures that led many business groups and their

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[71] Joseph A. Pechman, *World Tax Reform - A Progress Report*, (Washington, DC, The Brookings Institution, 1988); S. Cnossen and Richard M. Bird, eds., *The Personal Income Tax: Phoenix from the Ashes*; B. Guy Peters, *The Politics of Taxation*, (Cambridge, MA, Blackwell, 1991).

[72] Peters, *The Politics of Taxation*, 276-282.

political supporters to champion such measures.[73] In Canada, the shift of conservative political parties from protectionist and paternalistic approaches to economic policy[74] to more populist, market-oriented approaches during the 1980s received strong support from the entrepreneurial elites of Quebec and Western Canada which became the core of Brian Mulroney's governing Conservative coalition.

The federal government's need to legitimate its pro-business economic policies with a broader population impatient with higher taxes and the growing spending constraints imposed by chronic budget deficits also led it to adopt a number of Carter's recommendations to increase the progressivity of the tax base and achieve specific policy objectives.

These included:

- the recognition of families as single tax units, at least for purposes of the taxation of family benefits and child care allowances;
- the replacement of personal exemptions and dependants' allowances by tax credits -- a major feature of tax reform in 1987-88;
- reduced tax preferences for resource industries; and
- replacement of the existing manufacturers' sales tax with a national retail sales tax -- ultimately reflected in the Goods and Services Tax of 1991.

Despite a large number of piecemeal structural and policy changes during the 1980s, the tax reforms of the late 1980s fell firmly within the pragmatic tradition of incremental change rather than seeking comprehensive reforms which might confront established interests with radical changes to the tax base. The one major exception -- the Goods and Services Tax -- contained significant exemptions and was carefully tailored (albeit with

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[73] Peters, *The Politics of Taxation*, 286-7.

[74] Richard Johnston, "The Electoral Basis of Canadian Political Party Systems", in K.C. Carty, ed., *Canadian Political Party Systems*, (Peterborough, ON, Broadview Press, 1992), 597-609.

very limited political success) to respond to the technical and political objections of consumer and business groups and provincial governments. Even so, it became the focus of bitter political resistance from taxpayers resentful of what appeared to be a major new consumption tax.

CONCLUSION

Major changes to tax policy do not occur in an intellectual vacuum. Rather, they reflect the spread of ideas which offer economically credible responses to significant policy problems which cannot be resolved by existing policy structures or concepts. However, by themselves, ideas for major policy change have a limited influence. They must enjoy the sponsorship of authoritative political figures. They must be capable of implementation within existing political institutions -- and adaptable both to a country's dominant political culture and the interests of the governing party and its supporters.

Edgar Benson's proposals for tax reform were not excessively radical in the context of the late 1960s. However, like Allan MacEachen's proposed tax reforms in 1981-82, they succeeded in alienating much of the governing Liberals' support among business groups and professionals by confronting them with the prospect of significantly higher taxes without corresponding benefits.

Michael Wilson was successful in promoting tax reform as long as he could point to the precedents of relatively successful tax reform programs in the United States and Great Britain -- and offer significant benefits (or minimal costs) to the majority of the government's business and middle class supporters. But Wilson's idea of a joint federal-provincial sales tax, while probably the technically soundest, most politically marketable idea for sales tax reform advanced during the 1980s, fell by the wayside in the absence of provincial support.

Ideas may contribute to the legitimization of proposed policy changes -- for example, by linking them credibly to larger societal objectives which already enjoy broad popular acceptance or support. Alternately, they may be discredited by association with failed or divisive policy experiments of other eras or in other countries. However, the Canadian public has shown a limited tolerance for abstract ideas as a justification for policy change when these appear to threaten their individual or group interests -- or when they become associated in the public mind with failed policy initiatives in other areas or countries.

Efforts to build a consensus on tax reform in a society as diverse as Canada's are likely to involve a balancing of competing economic, social and political objectives, and a blurring or diffusion of theoretical precision and ideological rigour. Consensus is more easily achieved through the processes of piecemeal tax reform, in which specific problems can be addressed with the cooperation of a narrower range of interests.

The problem with any comprehensive theoretical framework for tax reform in a decentralized political and economic system such as Canada's is that it reopens all the established economic and political relationships of society -- not just the dysfunctional ones. While this may be intrinsically attractive to the ideologically-minded, it also guarantees tremendous political and economic disruption as established social and economic relationships are subordinated to the service of an abstraction. The potential for disruption guarantees political resistance which is unlikely to be overcome unless the majority of organized interests and politically attentive citizens can be convinced that tax reform can be a positive sum game -- positive, that is, both for society and their own interests.

In this view, the ideal of a fully rational, neutral tax system is utopian. The income tax, reflecting the basic compromises of Keynesian political economy, reconciles within itself the policies accommodating the creation of new wealth and economic activity by private businesses and investors and the redistributive functions of the modern state.[75] The coordination or reconcilation of these objectives takes place within a series of institutional and political constraints which are central to the political calculus of tax reform.

[75] Bird, "The Tax Kaleidoscope", 445ff; Bird, "Tax Reform in Canada", 439, Feldstein, "Compensation in Tax Reform", *National Tax Journal* 29(2), [June 1976], 123-130; Aaron, Galper, Pechman, *Uneasy Compromise*, 1-3.

CHAPTER 4 -- INSTITUTIONS, INTERESTS AND PROCESSES: THE TAX POLICY COMMUNITY

The tax policy process may be divided into two very different processes -- internal and external. The design and implementation of tax policy and tax reform in Canada are mainly the responsibilities of the tax policy community within the Department of Finance. While they are influenced by attentive actors in the broader policy community, the federal cabinet, Parliament, and major interest groups, the Department has a virtual monopoly on federal tax policy through the budget process.

While ideas are an important component of policy change, the conversion of ideas into tax legislation requires that they be championed by Ministers of Finance and their senior officials, and navigated through the often complex political and administrative institutions of the federal government. A focus on the policy-making processes within these institutions, particularly within the federal Department of Finance, ("the institution-centered approach") is important because internal processes powerfully influence the timing, direction and extent of tax reform proposals.

This chapter analyzes the institutional framework for tax policy within the federal government and the internal, largely bureaucratic process of tax policy formation within the Department of Finance: the tax policy community, its major actors, and the different roles of those actors in the tax policy process. It also examines the institutional constraints on the Minister of Finance in making major changes to tax policy, and the ways in which these may affect the policy process.

Chapter 5 will examine the process of legitimating the Department's proposals for structural and policy change as they are translated into law and political support.

TAX POLICY: THE INSTITUTIONAL FRAMEWORK

Institutional analyses of tax reform and other major shifts in economic policy stress the importance of state actors as an independent policy force in the introduction of major policy change and of state institutions as "the organizational channels through which political actions must pass".[1] Institutions may be conceived in a number of ways: as formal legal structures -- constitutions, legal precedents, and formal government organizations -- or as political, legal, social and administrative conventions: systems of rules which govern the relationships of individuals, groups and organizations within a polity, economy and society.[2] While the Department of Finance has dominated the formation of federal economic policies and has enjoyed a virtual monopoly over matters of tax policy during the period of this study,[3] these policies also reflect a political and economic context which is shaped by the interaction and competition of a number of state actors, not just organizations, seeking to influence and control policy priorities and choices. This process is subject to change rather more frequently than the formal structures of government, leading Hall to define institutions as

> the formal rules, compliance procedures, and standard operating practices that structure the relationship between individuals in various units of the polity and economy. As such, they have a more formal status than cultural

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[1] Sven Steinmo, "Political Institutions and Tax Policy in the United States, Sweden and Britain", *World Politics* XLI(4), [July 1989], 501; Eric A. Nordlinger, *On the Autonomy of the Democratic State*, (Cambridge, MA, Harvard University Press, 1981); Peter A. Hall, ed., *The Political Power of Economic Ideas*, (Princeton, NJ, Princeton Univ. Press, 1989); B. Guy Peters, *The Politics of Taxation*, A Comparative Approach, (Cambridge, MA, Blackwell, 1991).

[2] Steinmo, "Political Institutions and Tax Policy", 502.

[3] G. Bruce Doern, *The Politics of Canadian Economic Policy*, (Toronto, University of Toronto Press, 1985), 1-109, W. Irwin Gillespie, *Tax, Borrow and Spend*, (Ottawa, Carleton University Press, 1991).

> norms, but one that does not necessarily derive from legal, as opposed to conventional, standing.[4]

The institutions influencing tax policy and reform are partly economic in character -- for example, the predominance of capitalism as the organizing principle of the Canadian economy and Canada's integration into international capital markets -- partly a function of Canada's constitutional blend of federalism and Westminster-style parliamentary institutions, especially cabinet government, and partly a system of rules and conventions devised by central agencies to coordinate the budgetary processes of the federal government and ensure their accountability to cabinet and Parliament through the Minister and Department of Finance.

The Tax Policy Community within the Department of Finance

The formation and evaluation of Canadian tax policy is the direct concern of the Minister of Finance and his officials. David A. Good identifies the tax policy community within Finance as the Minister, Deputy Minister, the Assistant Deputy Minister - Tax Policy and Legislation, and a number of senior and middle managers in the Tax Policy and Federal-Provincial Relations Branches -- about 25 people in the late 1970s.[5] (See Table 4-1) Since then, the institutionalization of budget and tax reform consultations has resulted in the creation of a Consultations and Communications Branch headed by an Assistant Deputy Minister, the expansion of the tax policy branch, and the enhancement of its position within the Finance hierarchy. Staff levels in the Tax Policy Branch grew by more than 60

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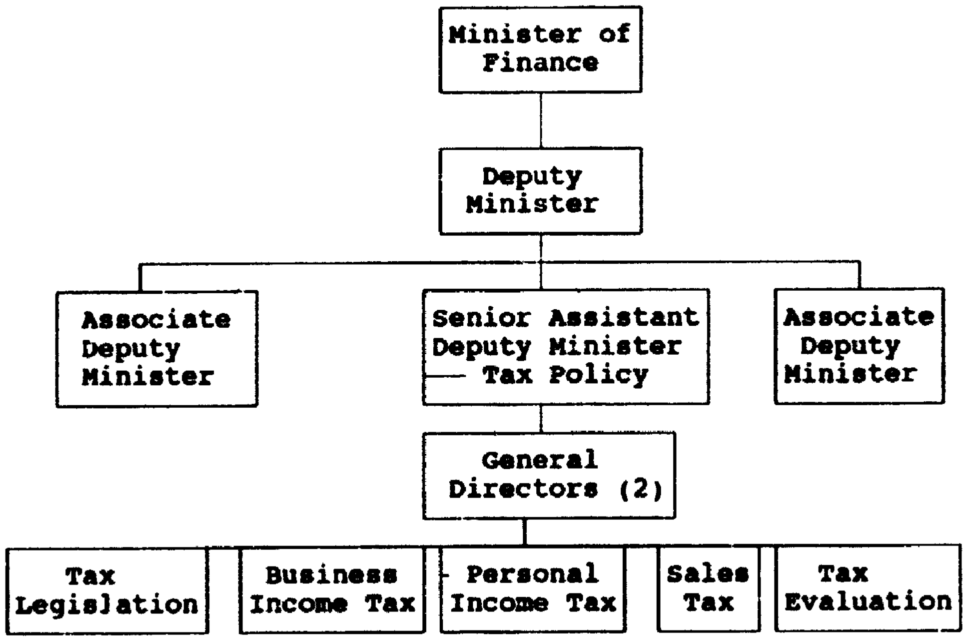
[4] Peter Hall, *Governing the Economy: The Politics of State Intervention in Britain and France*, (Cambridge, Polity Press, 1986), 23, quoted in Steinmo, "Political Institutions and Tax Policy", 502.

[5] David A. Good, *The Politics of Anticipation*, (Ottawa, School of Public Administration, Carleton University, 1980), 45-78.

percent between the late 1970s and the mid-1980s and have averaged 121 since 1987-88. (See Table 4-2.)

TABLE 4-1
THE TAX POLICY COMMUNITY IN THE DEPARTMENT OF FINANCE



[SOURCE: Finance Canada, *Structure and Role*, (Ottawa, The Department, 1990]

Good distinguishes between the tax community as a group of insiders within the Department of Finance which closely guards its monopoly control over the tax policy process, and what he calls "the attentive actors" -- members of the federal cabinet, the Revenue Canada officials called upon to enforce tax laws, officials of other affected federal departments and Members of Parliament.

> In Canada tax policy is made in one place, the tax community. Other agents in the process, standing outside the community, influence tax policy in subtle and indirect ways. ... Outsiders are taken into account before tax proposals are put forward and decisions announced. The tax community anticipates the reactions of attentive actors. Tax policy is made not through the centre bargaining with the periphery but rather by accommodating some of the outsiders' concerns within the tax decisions that it makes.[6]

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[6] Good, *The Politics of Anticipation*, 79.

TABLE 4-2

TAX POLICY AND LEGISLATION BRANCH STAFF LEVELS[7]

Fiscal Year	Number of staff	Fiscal Year	Number of staff
1983-84	95	1989-90	127
1984-85	107	1990-91	117
1985-86	113	1991-92	122
1986-87	102	1992-93	120
1987-88	111	1993-94	122
1988-89	130	1994-95	118e

[SOURCE: Dept. of Finance, *Estimates*, *Part III*, (Ottawa, 1983-84 - 1994-95)]

Interviews with Department of Finance officials at all levels suggest that Good's description of the Finance Department monopoly is as true of issues within federal jurisdiction in the 1990s -- especially income tax legislation -- as it was during the 1970s. As one former senior official puts it, "Finance always had control of the agenda" [8]

The "attentive actors" of the broader tax policy community also include taxation interest groups, heavily weighted towards the business community, selected academic specialists and tax professionals, particularly the Joint Tax Committee of the Canadian Bar Association and the Canadian Institute of Chartered Accountants (CBA/CICA).[9] During the 1980s, the federal cabinet played an active role in considering strategic issues of

[7] As these figures include support staff, they are not directly comparable to Good's measurement of the tax community. The Finance Department directory for 1994-95 lists 32 persons in management positions and 83 in professional positions within the Tax Policy Branch. See also Richard W. Phidd, "The Reorganization of Finance Ministries and their Role in Policy Formulation: A Case History of Finance Canada, 1963-88", paper prepared for Canadian Political Science Association, [June 1988].

[8] Interview, former senior tax policy official. (F03)

[9] Good, Ibid., 79-97.

policy change.[10] Parliamentary reform since 1985 has also led to an active, if subordinate role, for the Commons' Finance Committee in the policy process.

While the policy process described by Good became more transparent and consultative during the 1980s, an understanding of the tax policy community still begins with key actors within the Department of Finance.

The Role of the Tax Policy Branch

The Tax Policy Branch (formerly Tax Policy and Legislation) of the Department of Finance is the professional heart of the tax policy community. Since the late 1970s, the Branch has been divided into staff and line functions, with increasing degrees of specialization since the mid-1980s. Separate divisions for Personal Income Tax, Business Income Tax and Sales Tax (formerly Commodity Tax) are responsible for assessing the economic impact of existing policies and proposed changes to tax laws through the budget process. The Tax Legislation Division is responsible for the specific wording of legislative changes, adapting and responding to changes in the legal environment, and adapting policy decisions into the precise legal language of statute law, in cooperation with Tax Counsel Division and the Department of Justice.

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[10] Interviews, former cabinet ministers, Deputy Ministers, and PMO/PCO officials. While the details of income tax reform in 1981-82 and 1987-88 were primarily the responsibility of the Minister of Finance and his officials, a Special Cabinet Committee on the Goods and Services Tax was struck to provide direct political oversight of this highly charged issue.(D4)

The Assistant Deputy Minister and the two General Directors periodically set up task forces or project groups to examine specific policy areas.[11] Each division is sub-divided into a number of specialized sections dealing with individual elements of the tax structure.

During the 1980s, the Tax Policy Branch was managed by two General Directors, one responsible for the legislative, the other the tax policy aspects of budgetary changes -- although the two functions inevitably overlapped. These position have traditionally been filled by career Finance Department officials. The senior General Director, R. Alan Short[12], had been with the Branch since the mid-1960s. Of the others, Nick LePan (1983-87) and David Holland (1991-93) were a[illegible]ng-serving officials in the tax policy branch. The General Directors and Directors of individual branches are responsible for identifying major technical and policy problems within the tax system, filtering proposals for change into budgetary and technical streams,[13] screening out proposals which may be technically flawed or economically ill-advised, and advising the Assistant Deputy Minister (and often, the Minister) on the structuring of budgetary proposals.

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[11] The Goods and Services Tax Task Force carried much of the responsibility for the design and implementation of sales tax reform in 1987-90. Smaller task forces have been set up during the 1990s on Indian and Federal-Provincial Taxation.

[12] Chairman of the Branch's Legislative Committee since 1993.

[13] Budgetary changes are proposals with significant policy or economic implications; technical changes are amendments to the Act meant to clarify the law, correct unintended applications or limit abuses of particular tax rules. Budgetary changes are approved by the Minister, announced in the budget and subject to parliamentary consideration; technical changes are included in draft legislation, but usually given minimal attention within the political process. For discussion, see Albert B.C. Drache, "Introduction to Tax Policy Formulation: Canada 1972-76", *Osgoode Hall Law Journal* 16(1), [June 1978].

The Tax Policy Branch is part of a self-conscious professional elite within the Department and the profession, cultivating an ethic of public service and "guardianship" over the tax base and the integrity of the tax system.[14]

> It's a bit like the U.S. and the rest of the world. ... We've got the power and they (other departments) have to deal with that.[15]

It maintains close relations with senior members of the legal, accounting and economics professions, and encouraged closer ties through executive interchanges during much of the 1980s[16] -- although relatively few outsiders develop relations of close mutual trust and professional respect with the career professionals who dominate the management ranks of the Branch.[17]

Attitudes towards Tax Policy

> One of the most important norms that tax policy officers learn is that their job is to defend the tax system against forces that would erode its legitimacy and its revenue base.[18]

The tax policy community was sharply divided during most of the 1980s over the extent to which the tax system could or should be used as an effective instrument of economic

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[14] Interviews, current and former Department officials. (ADM-1, F01, F03, F04, F05). Good, *The Politics of Anticipation*, 50. Donald Savoie has developed the concepts of "guardians" and "spenders" at length in *The Politics of Public Spending* in Canada, (Toronto, Univ. of Toronto Press, 1991).

[15] Alan Freeman, "The department that counts", *The Globe and Mail*, (Toronto, June 1, 1992), A1,5.

[16] Interviews, (D2, D5, ADM-2, F01, F05, F06). Glenn Jenkins comments that following the 1981 budget, he hired as many economists to the tax policy branch as tax practitioners in order to enhance its capacity to assess the likely impact of proposed tax changes. (Interview, Glenn P. Jenkins).

[17] Interviews, (F01, F05, P6)

[18] Good, *The Politics of Anticipation*, 50.

and social policy. Interviews with current and former officials of the Department suggest ongoing debate and conflict between "purists" committed to the classical public finance view of the tax system and ideologically committed to the reduction of tax prefe.ences and tax expenditures, and "pragmatists" whose view of tax policy sought to reconcile the political priorities of the government with the constraints of economic and administrative viability.

> There were two kinds of people working in the tax policy area ... people with a fixed view of what the tax system ought to be (and) others who see the tax system as just another instrument of policy.[19]

A third group within the Department, the "technicians" focused primarily on issues of policy implementation, rather than ideological debate.

A former Deputy Minister labels the first group the "golden truthers".[20] Initially dominated by economists schooled in the traditions of the Carter Commission, most were intellectually committed to a systematic application of the tax expenditure concept, to resisting the addition of new tax preferences to the tax structure, and to removing as many existing preferences as possible as illegitimate intrusions on the public domain.

Some sought to use their influence and expertise to promote large-scale economic and social change through fundamental changes to the tax structure, regardless of the potential for short-term economic disruption in the transition to a fairer tax system. Others were incrementalists -- attempting to apply Carter's principles of equity to individual segments of the tax structure as circumstances permitted.

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[19] Interview, former Deputy Minister (D5). A senior private sector tax professional comments that since the late 1980s, "there is much less divergence within the group (the broader tax policy community) than within the Canadian people as a whole." (P6)

[20] Interview, former Deputy Minister. (D5) Another senior official concurred with the comment that some of these officials "had an almost moral-religious view of the good tax system". (ADM-3)

The "pragmatists'" approach to tax policy is more consistent with the traditional policy-administration paradigm of the public service. In this view, Ministers and governments are elected to govern and to set the priorities and objectives for public policies.

> "Our role as officials was to devise and execute what the government of the day wanted to do."[21]

In this view, it is the function of civil servants to advise Ministers of the likely consequences of proposed policies, to devise the means of balancing competing objectives, and once decisions are made, to attempt to maximize the benefits and minimize the disruptions resulting from policy decisions made by Ministers and the Department's Senior Management.[22]

The "pragmatists" tend to assess tax preferences on their relative efficiency in achieving a range of policy goals, the likelihood of potential abuse, revenue losses, or economic disruption. Proposals for tax reform tend to be judged more in terms of their administrative and economic viability, and the difficulties involved in achieving a transition to the new system, than by reference to an abstract ideal.

Good comments that "the tax officer is the victim of conflicting norms and must play conflicting roles" -- protecting the integrity of the tax system on the one hand and serving the Minister's broader policy and political needs on the other.[23] In effect, an ongoing tension exists and is necessary between the political and technical requirements of tax policy -- between theoretical concepts of "good tax policy" and "what is practical" in terms of its political and economic impact.[24]

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[21] Interview, former Deputy Minister. (D5)

[22] Interviews, (D5, ADM-3, F07)

[23] Good, *The Politics of Anticipation*, 55.

[24] Interview, former Assistant Deputy Minister. (ADM-3)

Ultimately, the role of the Department's senior management is to referee these debates, to strike a balance among the competing views of tax policy and to reconcile the demands of sound tax and economic policies with the government's broader political objectives.

The Role of the Assistant Deputy Minister

The Assistant Deputy Minister (ADM) -- Tax Policy provides overall direction for the development of tax policy within the tax policy community. He is responsible for coordinating and shaping budgetary proposals for consideration by the Department's senior management and the Minister, setting priorities for the Branch, and for managing major problems which have arisen within the tax system.[25] He may champion ideas for piecemeal structural change, and promote them through the policy process. While the political decision to introduce piecemeal or comprehensive tax reform is the Minister's prerogative, the ADM - Tax Policy is responsible for developing and implementing the reform proposals and for providing the detailed economic and technical justification necessary to support the Minister's proposals before Parliament.[26]

Unlike most other managers in the Branch, who tend to be career Finance Department professionals, the ADM is often a tax policy expert drawn from outside the Department. Marshall ("Mickey") Cohen (ADM: 1972-77; Deputy Minister 1982-85) was a senior tax lawyer before his recruitment to the Department by Jim Brown (ADM: 1964-71) in 1970. Glenn Jenkins (ADM 1981-84) was a leading academic tax economist at Harvard. David

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[25] For a more detailed discussion of the ADM - Tax Policy's role, see Good, *The Politics of Anticipation*, 62-65.

[26] Parliamentary oversight of the details of tax legislation and tax reform proposals usually involve hearings of the Senate Banking Committee (before 1983) and Commons' Finance Committee (especially since 1985). As Ministers rarely appear before these Committees, the burden of explaining and justifying policy proposals in detail usually falls on the ADM - Tax Policy and his General Directors.

Weyman (ADM: 1984-86) and Kevin Dancey (ADM: 1993-95) were senior partners with leading national accounting firms. The exceptions, Ed Neufeld (ADM: 1978-80) and David Dodge (ADM: 1986-92; Deputy Minister since 1992), were economists and career public servants with substantial experience in the Department of Finance.

The Assistant Deputy Minister may be a policy entrepreneur, aggressively promoting his own policy ideas to the Deputy Minister and the Minister, or a manager, developing and transmitting the consensus of his officials The ADM's background and outlook can be vital in shaping the "tax policy culture": the ideas, values and objectives that will be promoted or downgraded in budgetary suggestions to the Minister.[27] Cohen promoted an activist approach to tax policy as a tool of economic and social policy both as ADM - Tax Policy and later, as Deputy Minister.[28] Neufeld and Jenkins leaned strongly in the other direction -- towards the protection of the tax base and a more rigorous approach to "neutrality" in taxation. This was epitomized in their promotion of the tax expenditure concept to quantify and publicize the costs of current and proposed tax preferences, thus making it serve as an instrument of budgetary discipline.[29]

The Role of the Deputy Minister

The Deputy Minister is the Chief Operating Officer of the Department. He is responsible for coordinating the wide range of fiscal and economic policy issues facing the government and advising the Minister on how to balance the competing political and policy demands of his position. In addition to the formulation of tax policy, the

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[27] Good, *The Politics of Anticipation*, 62-63; supported by comments of present and former tax policy officials interviewed. (ADM-3, F03, F04)

[28] Interviews, Marshall A. Cohen; former tax policy officials (ADM-1, ADM-3, F03, F04); McQuaig, *Behind Closed Doors*.

[29] Interviews, E.P. Neufeld, Glenn P. Jenkins.

Department of Finance's responsibilities include the coordination of fiscal and budgetary policy; negotiations with other federal Departments on policy issues with major tax or spending implications, monetary, exchange rate and other international economic policies (in cooperation with the Bank of Canada); federal-provincial fiscal relations, and the regulation of banking and financial institutions. Hartle comments that "the very character of the Department as a whole may depend on the Deputy Minister".[30]

The Deputy's role in tax policy is "to balance the demands of good tax policy with the political necessities of the day".[31] The Deputy's participation in the details of tax policy depend on his personal background, inclination and the salience of tax issues to the government's political standing.

The Deputy Minister's appointment is a political statement. Deputy Ministers are chosen by the Prime Minister and accountable not only to their own Ministers but also to him through the Clerk of the Privy Council.[32] In selecting Deputy Ministers of Finance in recent years, Prime Ministers have tended to draw upon experienced Deputy Ministers from other departments or senior officials in central agencies. Two major exceptions, Grant Reuber in 1979 and Stanley Hartt in 1985, were recruited from outside the federal

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[30] Douglas G. Hartle, *The Revenue Budget Process of the Government of Canada*, Canadian Tax Paper # 62, (Toronto, Canadian Tax Foundation, 1982), 37.

[31] Interview, former Deputy Minister (D5).

[32] Gordon F. Osbaldeston, *Keeping Deputy Ministers Accountable*, (London, ON, National Centre for Management Research and Development, 1988)

government to promote a closer coordination between the policies of a newly elected government and the Department of Finance.[33]

The degree of a Deputy Minister's influence over tax policy also depends on his management style, personal interests and intellectual or ideological outlook. Good and Hartle describe two contrasting management styles employed by Deputy Ministers during the 1970s: "the conciliator ... who tended to promote wide discussion and debate on issues within the Department" and "the zealot" who tended to promote his personal outlook on tax issues in dealings with subordinates.[34]

Marshall Cohen, with his extensive experience in tax policy issues, tended to be a "hands-on" executive, taking a major interest in tax issues, promoting high-profile changes to "restore incentives" to the tax system, and taking charge of inter-departmental negotiations on pension reform -- an issue with major tax and spending implications.[35] Hartt, a newcomer to the Department, was more collegial in his approach, chairing long meetings with both senior managers and more junior officials in attendance to discuss a wide range of policy options.[36] Coming from a background in corporate law, Hartt, like Cohen, sought to promote executive interchanges between the public and private sectors to enhance mutual awareness and understanding.[37] Stewart and Gorbet were more

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[33] Interviews, former PMO officials. (PMO-1, PMO-2). One senior Clark advisor comments that "we wanted the Department of Finance to regain its historically strong leadership role in the development of policy; ... it was imperative to have very strong new leadership for the Department. It was for this reason that we recruited Grant Reuber rather than because of any particular harmony between Reuber's views and those of the new government, although I believe such harmony did exist." (PMO-2, correspondance with author.)

[34] Hartle, The Revenue Budget Process, 37.

[35] Interviews, former Finance Department officials. (D5, D8, ADM-3, F02, FO5)

[36] Interviews, former Finance Department officials (D1, D2, D4, F02)

[37] Interview, Stanley H. Hartt.

inclined to delegate tax issues to their subordinates unless particular problems required specific attention.[38] However, Stewart set in motion a comprehensive review of tax preferences in 1980 and signalled the willingness of senior management to entertain

TABLE 4-3
BACKGROUNDS OF DEPUTY MINISTERS OF FINANCE: 1970-95

Prime Minister	Deputy Minister	Tenure as Deputy	Previous Experience in Finance	Other Dept. (D.M.)	PCO	O/S Gov't
Trudeau	S. Reisman	1970-75	Yes	Yes	No	No
	T. Shoyama	1975-78	Yes	Yes	Yes	No
	W. Hood	1978-79	Yes	No	No	No
Clark	G. Reuber	1979-80	Economist/Banker			Yes
Trudeau	I. Stewart	1980-82	No	Yes	Yes	No
	M. Cohen	1982-85	Yes*	Yes	No	No+
Mulroney	S. Hartt	1985-88	Lawyer		No	Yes
	F. Gorbet	1988-92	Yes	No	Yes	No
	D. Dodge	1992-	Yes*	No	No	No
Chretien						

* FORMER ADM-TAX POLICY, DEPARTMENT OF FINANCE
\+ TAX LAWYER IN PRIVATE PRACTICE BEFORE 1970.

significant tax increases for corporations and upper-income taxpayers as part of the government's anti-inflation program -- decisions which led directly to the largely abortive

38 Interviews, Ian Stewart, Fred Gorbet.

tax reform budget of 1981.[39]

The Role of the Minister

The Minister of Finance differs from other members of the tax policy community in that he is a senior member of the federal cabinet and, thus, a political figure for whom tax policy considerations must be reconciled with the overall economic policy objectives of the government and with the political interests of the governing party.[40] The institutional interest of the Department of Finance is to constrain federal spending within the limits dictated by a prudent fiscal policy.[41] The institutional interest of a government in power is to get re-elected. When policy objectives and political interests collide, the government's political interests are usually paramount.[42]

Through his responsibility for preparing, presenting and promoting the federal budget, the Minister of Finance largely directs the federal government's economic agenda. Though influenced by the representations of cabinet colleagues, interest groups and, on occasion,

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[39] Ian A. Stewart, Testimony, *Minutes and Proceedings*, Standing Committee on National Finance, The Senate, May 27, 1980; Stewart, "Global Transformation and Economic Policy", from Thomas A. Axworthy & Pierre E. Trudeau, eds., *Towards a Just Society: The Trudeau Years*, (Markham, ON, Penguin Books Canada, 1990), 107-125.

[40] Of the last nine Finance Ministers, four - John Turner, Allan MacEachen, Michael Wilson and Paul Martin, were former candidates for their party's leadership; three - MacEachen, John Crosbie, and Marc Lalonde, were senior regional ministers in cabinet (and active defenders of Atlantic and Quebec interests, respectively); two - MacEachen and Don Mazankowski, were Deputy Prime Ministers. Most (Jean Chretien and MacEachen being the most notable exceptions) were the government's strongest political links to the business communities of Ontario and/or Quebec.

[41] Savoie, *The Politics of Public Spending*; Good, *The Politics of Anticipation*; Douglas G. Hartle, *The Expenditure Budget Process of the Government of Canada*, Canadian Tax Paper # 81, (Toronto, Canadian Tax Foundation, 1988).

[42] Savoie, *The Politics of Public Spending*; Hartle, *The Expenditure Budget Process*. A significant exception may be made for the federal government's policies of fiscal restraint in 1989-91. [Interviews, D2, D4, MP1]

the Parliamentary opposition, the Minister controls virtually all tax policy decisions included in the budget and subsequent tax legislation.[43]

The degree of a Finance Minister's influence and independence depends largely on his relationship with the Prime Minister and his ability to maintain the latter's support against the competing claims of cabinet colleagues. As a former ministerial aide from the Mulroney era put it:

> the Finance Minister has 38 natural enemies in cabinet. The prime directive of the Minister of Finance is to maintain a close relationship to the Prime Minister. ... Every minister has a natural relationship with the Prime Minister and will use it to protect his own turf.[44]

It also depends on the Prime Minister's interest in economic policy issues, and his leadership style -- particularly in managing competition among cabinet colleagues. Prime Minister Trudeau's direct involvement with economic issues was intermittent; he usually left their management to trusted senior ministers -- particularly MacEachen (until the 1981 budget backlash) and Lalonde.[45] Brian Mulroney was much more involved in the brokerage of policy decisions, especially between 1984 and 1986. Herman Bakvis has

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43 There are three exceptions to this rule. First, the Prime Minister may preempt his Finance Minister, publicly as with Prime Minister's Trudeau's August 1978 surprise announcement of tax and spending changes and Prime Minister Mulroney's public endorsation of the minimum personal income tax in 1984, or privately, as with Mulroney's prior insistence on revisions to the 1985 budget. [Jean Chretien, *Straight from the Heart*, 2nd ed., (Toronto, Key Porter, 1994), 117-18; Interview, senior PMO official.(PMO-1)] Second, cabinet may veto or impose strict limits on a proposed policy change -- as with Wilson's proposals for a Business Transfer Tax in 1986. Third, political responsibility for a major policy change with tax and budgetary implications may be given to a senior cabinet colleague, even though the measure is announced in the budget, notably the National Energy Program of 1980.

44 Interview, Dept. of Finance. (F02)

45 Interview, senior PMO official. (PMO-3) For discussion of Trudeau's approach to tax reform and economic policy, see John N. McDougall, *The Politics and Economics of Eric Kierans: A Man for all Canadas*, (Montreal-Kingston, McGill-Queen's University Press, 1993), 106-16; Christina McCall-Newman, *Grits*, (Toronto, Macmillan of Canada, 1980); Christina McCall and Stephen Clarkson, *Trudeau and Our Times, Vol. 2, The Heroic Delusion*, (Toronto, McClelland and Stewart, 1994) and Donald Johnston, *Up the Hill*, (Montreal, Optimum, 1986).

described Mulroney's early leadership style as "transactional", lending itself to policy deals with individual ministers, often with little regard for the cabinet hierarchy or the fiscal framework. Mulroney's management style led to a much closer liaison between the Minister of Finance and the Prime Minister on budgetary and tax issues to limit the political conflicts which surfaced during the government's first six months in office.[46]

After 1986, much of the management of cabinet business was delegated to Don Mazankowski as Deputy Prime Minister and chair of its Operations Committee. The result was more centralized political control of the budgetary process -- particularly on issues where "Maz"'s and Finance Minister Wilson's views coincided.[47]

Finance Ministers' approaches to tax policy vary widely, depending on the political priorities of the government, the Minister's background and ideological outlook, his political experience, management style and relations with departmental officials. As the political head of the Department, the Minister is experted to set strategic directions for policy. Some Ministers, most notably Michael Wilson, have taken a hands-on approach, becoming directly involved in the discussion and development of policy. Others, like Marc Lalonde, have set clear political objectives for policy and left the details to Department management and staff. Still others, most notably Allan MacEachen, have been relatively remote (or even hands-off).[48]

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[46] Interviews, former PMO, PCO, Finance officials. (PMO-1, D7, F02) A senior PCO official comments that "the P. .ne Minister took greater care (in reviewing) the 1985 budget" than had been the case with previous budgets. "Once burned, twice shy." [Interview, [D7]

[47] Herman Bakvis, *Regional Ministers*, (Toronto, Univ. of Toronto Press, 1991), 262-4; Interviews, Hon. Michael Wilson; former PMO officials. (PMO-1)

[48] Interviews, former Ministers of Finance, Finance Department officials. (M3, ADM-3, F01, FO2, F03).

However, the Minister's role is not limited to setting policy priorities or to balancing the political and economic trade-offs inherent in the budgetary process. It also involves the legitimization of the budget and its proposed changes to tax policy. Ministers must exercise political judgment to determine the range and scope of pre-budget consultation and the degree to which public advocacy, consultation and coalition-building are necessary to build public support for the government's fiscal and tax policies. The increased fiscal pressures of the 1980s and the political backlash against MacEachen's 1981 budget have led to significant changes to the budgetary process as Ministers of Finance seek to legitimize policy change through an expanded consultation process.

TAX REFORM - PROCESSES AND CONSTRAINTS

Finance Ministers seeking to restructure the tax system have the options of introducing proposed changes within the framework of a single budget, or of signalling proposed changes to the public and interest groups through the publication of a White Paper, followed by extended public and/or private consultations, and ultimately, legislation.

Maslove, Prince and Doern note that federal budgets are major goal-setting and tactical occasions for the federal government, allowing them to showcase their fiscal and economic priorities and their skill in dealing with economic issues.[49] Major crises or departures from the fiscal plan may occasion supplementary statements by the Minister of Finance or even the Prime Minister to confirm that the government is "in charge" of the situation. Since the 1981 tax reform budget, it has often served as a springboard for consultations on proposed policy changes. The adversarial character of Parliamentary debate also ensures that the budget provides opposition parties and interest groups with

[49] Allan M. Maslove, Michael J. Prince and G. Bruce Doern, *Federal and Provincial Budgeting*, (Toronto, University of Toronto Press, 1986), Chapter 2.

high profile opportunities to attack (or more rarely, to applaud) the government's priorities and actions.

The budgetary approach to tax reform allows the government to take advantage of the tradition of budget secrecy to seize the political initiative before interest groups can mobilize to defend their interests. Budgetary approaches may be most appropriate in introducing piecemeal changes in tax reform. These can be politically popular measures, such as the limited indexation of income taxes introduced in 1973, or more controversial measures involving a limited range of societal actors, such as the National Energy Program of 1980. However, using the budget process to introduce changes to entrenched fiscal privileges, whether of provincial governments or specific societal interests, is an invitation to political polarization and a test of the government's ability to "sell" public opinion on its concept of the national interest.

The consultative approach offers the opportunity to test market ideas in greater detail, discard those which are found to be politically or administratively unworkable, and provide stakeholders in the tax system with the chance to buy into a consensus on proposed policy changes.[50] It lends itself to coalition-building and the coopting of major interests into the policy process. However, it also exposes the government to the risk of losing control of the policy process. The political assault mounted by the business community and the provinces upon the Benson White Paper in 1971 and the generally antagonistic relationship between the Trudeau Government and these groups in 1981 argued strongly for Finance Minister MacEachen to introduce tax reform through the budget process.[51]

[50] W. Irwin Gillespie, "Tax Reform: the Battlefield, the Strategies, the Spoils", *Canadian Public Administration* 26(2), [Summer 1983], 182-202.

[51] Gillespie, Ibid., Meyer Bukovetsky and Richard M. Bird, "Tax Reform in Canada: A Progress Report", *National Tax Journal* 25, [March 1972], 15-41; David Milne, *Tug of War*, (Toronto, James Lorimer, 1986), 36ff.

Both the budget and consultative processes take place within a broader framework of institutional constraints which lend themselves to incremental changes in the tax structure rather than a comprehensive restructuring of the tax system

Institutional and Political Constraints

A purposeful piecemeal approach to incremental tax reform over a number of years is likely to be more effective and durable than a comprehensive effort at system-wide reform involving the full range of personal, corporate, capital, excise, estate and social security taxes. Richard Bird suggests a number of practical constraints on the government's capacity to introduce large-scale policy changes. These include limits on the staff resources needed to maximize the technical benefits of change on a wide range of issues simultaneously and the need to avoid "collective political indigestion" among interest groups and taxpayers with too many changes to absorb in a short time.[52]

> The political system can absorb only so much policy change at any one time, particularly with respect to tax reform in which the nature of things engenders few supporters and many opponents.[53]

Irwin Gillespie has suggested that the introduction of piecemeal reforms to the tax system, such as the partial indexing of the personal income tax system, can be introduced within the framework of a single budget, while comprehensive tax reform requires a commitment to widespread public consultations by government, the development of transitional measures and trade-offs to compensate "losers" in the reform process and ease the political and economic pain of adjustment.[54]

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[52] Bird, "The Tax Kaleidoscope, Perspectives on Tax Reform in Canada", *Canadian Tax Journal* 18:5,[September-October 1970], 455.

[53] Bird, "The Tax Kaleidoscope", 454.

[54] Gillespie, "Tax Reform: The Battlefield...", 193-197.

Three other systemic constraints help to define the "limits of the possible" for tax reform in Canada: the political requirement for revenue neutrality, the exigencies of international competitiveness, particularly in comparison to the United States, and respect for provincial sovereignty.

The principle of revenue neutrality in tax reform implicitly recognizes that the state is engaged in an adversarial relationship with taxpayers. From the perspective of the taxpayer whose income, assets or status relative to other societal actors are potentially threatened by the prospect of new or higher taxes, "all taxes are bad taxes".[55]

The principle of international competitiveness in tax policy is enforced by Canada's position as an open economy, highly dependent on international trade and investment for its prosperity. Wayne Thirsk has suggested that specific issues of tax competitiveness are largely issues of the relative mobility of capital (for business taxation), of consumers (for commodity taxes), and of labour (for income and social insurance taxes).[56] However, the political implications of competitiveness may vary considerably depending on the relative importance of individual firms or industry sectors on the economic development and employment prospects of different communities and regions of the country.

The central role of multinational corporations in Canadian manufacturing and resource industries and the competitive pressure of marginal and effective U.S. tax rates on the Canadian tax system has made it difficult for the federal government to introduce

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[55] Hartle, *The Expenditure Budget System...*, 35-45; Robert D. Brown, "Canadian Tax Reform: Can We Do Better the Second Time Around", from *Report of Proceedings of the Thirty-Eighth Tax Conference, 24-26 November 1986,* (Toronto, Canadian Tax Foundation, 1987), 3:25; Ronald Robertson, "The House of Commons Committee and the Aftermath of the Royal Commission on Taxation", in Neil Brooks, *The Quest for Tax Reform*, (Toronto, Carswell, 1988), 49.

[56] Wayne Thirsk, *Fiscal Sovereignty and Tax Competition, Government and Competitiveness,* Discussion Paper # 93-8, (Ottawa, School of Policy Studies, Queen's University, 1993).

principles of taxation which differ radically from those of Canada's major trading partners.[57] This reality has surfaced in several ways over the years: the gutting of the Benson White Paper's resource tax proposals, the precipitous retreat from estate and gift taxes in the late 1960s,[58] massive resistance to the introduction of a comprehensive income tax base for personal and business income in 1969-71 and 1981-82, the increased use of higher indirect and payroll taxes throughout the 1980s as alternative sources of revenue to the Income Tax,[59] and the catalytic effect of American tax reform on the Canadian decision to introduce comprehensive tax reform in 1986.

The rapid growth of cross-border shopping, large-scale smuggling and underground economic activity following major excise tax increases in the late 1980s and the introduction of the Goods and Services Tax in 1990 are further evidence of this constraint at the level of consumption taxes and consumer spending.[60]

Provincial governments, especially those of Ontario and Quebec, have strongly resisted any federal intrusion into provincial jurisdiction and revenue shares in direct taxation and

[57] David A. Dodge, "Economic Objectives of Tax Reform", in J. Mintz and J. Whalley, *The Economic Aspects of Tax Reform*, (Toronto, Canadian Tax Foundation, 1989), 37; John Bossons, "Comment" from Joseph A. Pechman, ed., *World Tax Reforms: A Progress Report*, (Washington, The Brookings Institution, 1988), 69-77; Brown, "Tax Reform...the Second Time Around", 3:13. The internationalization of tax policy, particularly for the taxation of business and investment income, has become a world-wide issue in recent years with the integration of international capital markets and the relative decline of the United States as a hegemonic economic power. See Lawrence Summers, "Taxation in a Small World", in Herbert Stein, *Tax Policy in the Twenty-First Century*, (New York, John Wiley & Sons, 1988), 64-75; Bird, "Tax Reform in Canada...", 1989.

[58] Bukovetsky & Bird, "Tax Reform in Canada", 40.

[59] Dodge, "Economic Objectives of Tax Reform", 39; the share of social security payroll taxes increased from 4.8% of federal revenues in 1975 to 5.8 percent in 1985 and 10.5 percent in 1990.

[60] Ontario. Ministry of Industry, Trade & Technology, *The State of Small Business, 1990*, 21-3; "Canadians flood U.S. in record numbers", *Vancouver Sun*, April 18, 1992, A1; "What makes Canadian prices high", *The Globe and Mail*, Toronto, May 15, 1992, B6; "High taxes feed defiance of law", *The Globe and Mail*, Jan. 26, 1994; "Cigarette taxes cut", *Toronto Star*, Feb. 9, 1994, A10-11.

resource revenues. They have also led political counter-attacks against tax measures that may threaten the economic well-being of important provincial industries, especially in the fields of mining and energy development.[61]

The role of provincial governments has become increasingly important in recent years as the federal government has sought to harmonize federal and provincial sales tax systems in conjunction with the introduction of the Goods and Services Tax. Increasing fiscal competition between the senior levels of government, intensifying fiscal constraints and a reduction in the rate of growth of federal transfers to the provinces has also led to increased pressure on the federal government to permit greater diversity in provincial income tax bases and rate structures.[62]

The MacEachen budget of 1981 directly challenged these constraints by attempting a systematic overhaul of tax preferences which raised overall tax levels at the same time as Ottawa was challenging the provinces for control over oil and gas revenues. Wilson's twin strategies of coalition-building with provincial governments and key societal actors and separating tax increases from the tax reform process played a vital role in diffusing potential opposition to tax reform in 1985-88 and allowing tax reform to be dealt with on its technical merits.[63]

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61 Bukovetsky & Bird, "Tax Reform in Canada", 40; A.R.A. Scace, "Ontario Proposals for Tax Reform", *Canadian Tax Journal* 18(4), [July-August 1970], 310-318; Peter Foster, *The Sorcerers' Apprentices*, (Toronto, Totem Books, 1982); Allan M. Maslove and Heidi I. Eicher, "Reforming Taxes: where to go and how to get there", in Michael Prince, ed., *How Ottawa Spends: 1987*, (Toronto, Methuen, 1987), 195-96.

62 Canada. Department of Finance, *Personal Income Tax Coordination: The Federal-Provincial Tax Collection Agreements*, (Ottawa, The Department, July 1991); Ontario. Fair Tax Commission, Fair Taxation in a Changing Economy, (Toronto, University of Toronto Press, 1993), 245-55.

63 However, it also allowed the benefits of federal tax reform to be dissipated as a result of higher provincial tax rates on the broader base resulting from tax reform.

The cumulative impact of these constraints is to increase the potential political costs of major changes to federal tax policies. While federal Ministers of Finance have considerable power in pursuing their policy objectives, particularly during periods of majority government, their ongoing political effectiveness depends on their ability to mobilize widespread political support for their policies from the attentive actors of the broader policy community and in the court of public opinion.

CONCLUSION

In a narrow sense, the tax policy process is controlled by the Minister and Department of Finance. However, their autonomy in making radical changes to tax policies or the tax structure is limited by a series of contraints imposed by both the political and economic constitutions: Prime Ministerial and cabinet government, the Parliamentary system, fiscal federalism and (since 1982) the legal guarantees of the Charter, domestic entitlements and the international economic system.

Thus, the process of managing structural policy change involves not only the formal institutional powers of Ministers and governments, but also the mobilization of support and consent among attentive actors among the tax professions and members of the advocacy groups who make up the broader policy community, and the general public -- the "external" tax policy process.

CHAPTER 5 - COALITION-BUILDING, INTEREST GROUPS AND THE POLITICS OF TAXATION

> The structure of taxes is created by the process of a very political marketplace, where groups of politicians compete against each other for the votes of the electorate which will bestow the prize of political power.
>
> Irwin Gillespie[1]

Effective coalition-building between the federal government and major interest groups is an essential step in the legitimization of tax reform. It was certainly a major difference between the politically-damaging tax reform initiatives of 1969, 1981 'or 1990) and Michael Wilson's successful tax reform program of 1987-88.[2]

The power of the Minister and Department of Finance depends in part on the latter's role as the central agency responsible for coordinating fiscal and economic policy within the federal government. However, their power is constrained by their ability to legitimate those policies in the eyes of the Canadian public -- particularly when introducing major structural changes to the tax system.

While interest group pressures may contribute to a government's decision to begin the study of large-scale tax reform, as in 1962, the importance of interest-group politics to governments seeking to introduce major changes to economic framework legislation or other elements of the economic constitution lies chiefly in the ability of interest group coalitions to challenge the government's claim to legislate in the public interest --

[1] W. Irwin Gillespie, *Tax, Borrow & Spend*, (Ottawa, Carleton University Press, 1991), 16.

[2] David Milne, *Tug of War*, (Toronto, James Lorimer, 1986); W.T. Stanbury, *Business-Government Relations*, (Toronto, Methuen, 1986); and Allan M. Maslove and Heidi I. Eicher, "Reforming Taxes: where to go and how to get there", in Michael Prince, ed., *How Ottawa Spends: 1987*, (Toronto, Methuen, 1987), 176-210. The defection of large segments of the business community from Michael Wilson's pro-GST "coalition", together with the residual political bitterness of the 1988 election campaign, can be largely credited for the political backlash surrounding the introduction of the Goods and Services Tax -- even before the relative severity of the 1991-92 recession.

especially as this is reflected in the economic well-being, or perception of well-being, of large elements of society.

The political success of tax reform in Canada has been conditional on the ability of the Minister and Department of Finance to market it as a "positive-sum game" yielding economic benefits or minimal costs for most major economic or social groups. While this may contribute to a small-scale redistribution of income, it effectively precludes the use of tax reform as an instrument for raising taxes, reducing deficits or redistributing income and/or wealth on a large scale. Public acceptance of, or acquiescence to, tax reform also depends on the government's ability to mobilize sustained political support from a cross-section of organized interests which reflect, or can influence, large segments of public opinion. The study of the interaction of governments and interest groups ("the interest-centered approach") is important because that interaction vitally affects the ultimate political success or failure of tax reform initiatives.

This chapter examines the nature of the *public* tax policy process, defined as the process of reconciling government policy objectives with the political and economic expectations of various societal interests, as an exercise in political legitimation and coalition-building. As part of this process, it explains the relationship between the Department of Finance and the various groups which make up the broader tax policy community, most notably interest groups and interested Members of Parliament. It also assesses the role of the general public and public opinion on Ministers, their decisions and "non-decisions".

Tax Reform and Coalition-Building

Proposals for major structural changes to the tax system must win support in a competitive political marketplace in which governments attempt to maximize the political benefits of government spending (and of selective tax concessions as a form of spending) and minimize the political costs of taxation for groups of voters whose support is necessary for them to win and retain political power.[3] Governments whose Finance Ministers have ignored these constraints in introducing major tax reforms have usually lost the subsequent election, despite such expedients as changing ministers or attempting to mitigate the effects of tax reform on selected groups.

Prior to the 1981 tax reform budget, efforts at coalition-building by the Minister and Department of Finance were usually of an ad-hoc nature, modifying tax laws through the annual budget cycle in an effort to deal with pressing political problems and to correct inequities which had arisen as a result of previous tax changes.[4] This process was usually reactive. It often resulted in the unravelling of previous tax reform initiatives and the systematic erosion of the tax base as Finance Ministers, particularly John Turner in 1972-75 and Marc Lalonde in 1982-84, scrambled to recover the political support lost by their predecessors' reform efforts.[5]

Since 1981, the Department of Finance has recognized the need to cultivate a broader degree of consensus when introducing major tax reforms.[6] The process of consensus-building involves three major elements. First, it addresses the substance of tax policy: the effort to refine or reform policies based on broadly shared values and policy objectives.

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[3] Gillespie, *Tax, Borrow and Spend*, Chapter 2.

[4] The 1969-71 White Paper on Tax Reform involved widespread public consultations prior to the introduction of legislation. However, the government rapidly lost control of the political agenda and was forced to react to a series of political attacks from both from enraged societal interests and alarmed members of its own Parliamentary caucus. L.T. Macdonald, *Taxing Comprehensive Income*, (Ph.D. Dissertation, Carleton University, 1985).

[5] Finance Minister Don Mazankowski made minimal adjustments to tax reform measures introduced by his predecessor, Michael Wilson, between 1985 and 1990. While tax reform wa a secondary issue in the 1993 election which resulted in the virtual obliteration of the Conservative Party, the other major parties were at least nominally pledged to make major changes to the tax system.

[6] Interviews, current and former Finance Department officials.

Second, it involves the process of policy change: the manner in which changes are introduced and refined in response to public consultation and debate. Finally, it takes careful account of economic and symbolic outcomes: who wins or loses economically and politically as a result of tax reform.

Several Canadian observers have attempted to develop political theories of tax reform rooted in public choice theories of political competition. Walter Hettich and Stanley Winer have advanced a "positive theory of taxation" based on political cost-benefit analyses for the level and distribution of various kinds of taxes.[7] Irwin Gillespie has expanded the Hettich-Winer model by taking into account the influence of governmental institutions and public choice theories of collective action.[8] Allan Maslove has argued that the Canadian government's ability to introduce tax reform is directly linked to its ability to build distributive coalitions of economic winners, and to mollify potential losers through a combination of financial compensation for lost tax breaks and transitional measures to ease the difficulties of adjustment to a new tax structure.[9] Douglas Hartle broadens this analysis by taking into account issues of institutional inertia and the importance of normative concepts such as power and status in defining voters' perceptions of their economic and social well-being.[10] Hartle also demonstrates how well-organized interests can force major changes to government tax reform proposals on issues of

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[7] Walter Hettich & Stanley L. Winer, "A Positive Model of Tax Structure", *Journal of Public Economics* 24(4), 1984, 67-87; "Economic and Political Foundations of Tax Structure", *The American Economic Review* 78(4), 701-12.

[8] Gillespie, *Tax, Borrow and Spend*, especially Chapter 2.

[9] Allan M. Maslove and Heidi I. Eicher, "Reforming Taxes ..."; Allan M. Maslove, *The Politics of Tax Reform: Its Process and Impact*, (Halifax, Institute for Research in Public Policy, 1989).

[10] Douglas G. Hartle, *The Expenditure Budget Process of the Government of Canada: A Public Choice-Rent Seeking Approach*, Canadian Tax Paper # 81, (Toronto, Canadian Tax Foundation, 1988); Hartle, *The Federal Deficit*, Discussion Paper # 93-30, Government and Competitiveness Series, (Kingston, ON, School of Policy Studies, Queen's University, 1993).

relatively little salience to the broad majority of voters, particularly by shifting public debate to the potential effects of tax reform in disrupting economic activity.[11] All of these studies emphasize the contested character of most tax reform initiatives in a competitive political marketplace, and the need for governments to engage actively in coalition and consensus-building in order to legitimize their proposals with interest groups *and* the broader electorate.

The Public Tax Policy Process

Prior to 1981, the budget speech was the focal point of political debate over federal tax policy in Canada. The steady stream of technical and budgetary changes to tax policy during the 1970s often led to bitter disputes among interest groups, tax practitioners and Finance Department officials over the objectives and impact of proposed changes. These disputes were aggravated by the principles of budget secrecy and the absence of an effective process to assess the potential impact of tax measures in the budget.[12] This resulted in a steady stream of proposals for change to the budgetary process -- most with a view to loosening the conventions of budget secrecy and improving the effectiveness of budget consultations. Among others, the Canadian Tax Foundation made two formal proposals for changes to the budgetary process in 1977 and 1982.[13] The efforts of

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[11] Douglas G. Hartle, Political Economy of Tax Reform: Six Case Studies, Discussion Paper # 290, (Ottawa, Economic Council of Canada, November 1985).

[12] Marshall A. Cohen, "The Budget Process and Income Tax Changes", in *Report of Proceedings of the Twenty-Ninth Tax Conference, 1977*, (Toronto, Canadian Tax Foundation, 1978), 10.

[13] Canadian Tax Foundation, Tax Legislative Process Ctee., "The Tax Legislative Process", *Canadian Tax Journal* XXVI(2), [March-April 1978], 157-82; Committee on the Budget Process, "On Opening Up the Budget Process", *Canadian Tax Journal* 30(2), [March-April 1982], 161-78. The Department of Finance released discussion papers on consultation and the budgetary process in 1982 and 1985 which were a partial response to the Tax Foundation's recommendations.

successive Finance Ministers to build greater public support for the increasingly difficult trade-offs involved in budgetary policy has led to the progressive broadening of the public consultation process since 1982.

Marshall Cohen notes that the building of consensus involves three distinct aspects: "the general direction of tax policy, specific tax initiatives and the nuts and bolts of particular tax changes".[14] Each aspect of consultation takes place at a different level.

The general direction of tax policy is a political matter, reflecting "the political and economic environment for particular policies, the volume of demands on government, and the real or perceived urgency of these problems".[15] These demands and the options for balancing and responding to them are weighed by the Minister and Deputy Minister and involve formal and informal consultations with the Prime Minister, cabinet colleagues, central agencies and other Deputy Ministers, and sometimes, with major horizontal interest groups.

Coleman identifies the traditional process of tax policy formation as part of a pressure pluralist network in which autonomous state agencies make policy at arm's length from, but responsive to, the competing political pressures of a wide range of interest groups.[16]

[14] Cohen, "The Budget Process ...", 11.

[15] Ibid.

[16] William D. Coleman, *Business and Politics: A Study in Collective Action*, (Toronto, University of Toronto Press, 1988), 47-50. Wolfe and Savoie offer contrary views in which Finance's extensive use of tax preferences during the 1970s is seen as part of a power struggle within the federal government for control over the economic policy process. David A. Wolfe, "The Politics of the Deficit", in G. Bruce Doern (coord.), *The Politics of Economic Policy*, (Toronto, University of Toronto Press, 1985), 149; Donald A. Savoie, *The Politics of Public Spending*, (Toronto, University of Toronto Press, 1990) 75, 93 Phidd suggests an alternate interpretation: that Deputy Ministers of Finance after 1975 shifted from an "authoritative" to "consultative" management style in setting limits on the spending aspirations of their colleagues in other departments. R.W. Phidd, "The Reorganization of Finance Ministries and their Role in Policy Formulation: A Case History of Finance Canada, 1963-88", paper prepared for Canadian Political Science Association, June 1988, 23.

While the general public is not directly involved in policy discussions over the general direction of tax policy, policy debates at this level must take public opinion into account, whether as an enabling or limiting factor in policy change.[17]

Specific tax policy proposals are Departmental initiatives, filtered through a political process which has come to involve an increasing degree of formal consultation between Ministers and a wide range of interest groups. At the peak of this process during the late 1980s, Ministers and Ministers of State for Finance met with 60 to 70 interest groups during the annual budget cycle.[18] Citing time constraints and the difficulty of reconciling competing pressures and priorities within the traditional one-on-one consultation format with interest groups, Don Mazankowski shifted towards a series of round-table consultation meetings with different groups after 1991.[19] In the 1993-94 budget cycle, Paul Martin imposed a more arms-length format on consultations by setting up a series of regional conferences on budget and tax policy priorities involving interest groups, tax practitioners and selected citizens. It remains to be seen, however, whether the broadening of the public consultation process will indeed lead to a dilution of business influence over the tax policy process, as forecast by Robert Young,[20] or whether it will result in a shift in the methods used by business groups to lobby the Department of Finance.

The practical details of policy development and translation of technical policy proposals into legislative language is the product of consultations between different parts of the tax

[17] Prime Minister Mulroney's 1984 campaign promise to introduce a Minimum Income Tax of some form to offset the pyramiding of tax incentives to avoid income taxes is an example of this kind of approach.

[18] Beverley Brooks, Director, Consultations Division, Dept. of Finance, July 1995.

[19] Interview, senior Finance Department official. (ADM-6)

[20] Robert A. Young, "Business and Budgeting: Recent Proposals for Reforming the Revenue Budgetary Process", *Canadian Public Policy* IX(3), [Autumn 1983], 347-61.

policy branch and individual businesses, technical experts and tax professionals. Since the Scientific Research Tax Credit fiasco of 1983-85,[21] this has involved an increasing number of contacts between relatively junior officials of the Department and individual businesses to test the practical impact of proposed changes on actual business operations.[22]

Deputy Ministers and Tax Policy ADMs since the early 1980s have also emphasized the importance of building bridges between the very different cultures of career Finance Department officials and private sector tax professionals and economists in order to promote a greater degree of mutual understanding and cooperation. As part of this process, they hired a number of private sector professionals on executive interchange during the 1980s.[23] Among others, David Weyman (ADM: 1984-86) and the current (1995) ADM, Kevin Dancey, were both recruited from major national accounting firms as Assistant Deputy Ministers responsible for tax policy. Senior tax professionals have been hired regularly since the early 1980s as consultants, particularly on technical issues of legislative drafting.

"Political" consultations are usually kept separate from technical consultations, on which Finance officials seek out individuals or groups with specialized policy knowledge.[24] The consultative process within the broader tax policy community provides an opportunity for Finance to "sell" its general policy objectives to representatives of key societal interests. However, the Department's objective is to maintain control so that the Minister is able to

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[21] See Chapter 10, case history 10-2.

[22] Interview, senior tax policy officials. (F07, F08)

[23] Interviews, Dept. of Finance (D2, D5, ADM-2, ADM-7, F01. F05).

[24] Tax policy branch officials tend to dismiss the policy proposals of interest groups as ritual displays of political posturing with little insight into the actual workings of the tax system or the requirements of "good tax policy". Interview, Finance Department officials. (F01, F07)

lead the policy process rather than being guided primarily by the reactions of interest groups or the general public. In discrete policy areas, such as retirement savings, small business taxation, energy taxation or corporate taxation, Finance has succeeded in maintaining the initiative over policy by focusing its dealings with selected representatives of each segment, and using them as sounding boards for possible changes in the system.

Private sector representations on tax policy tend to be rather segmented, with few, if any, organizations paying close attention to the broad range of tax policy and tax administration issues. Those which are most prominent or most vocal include major "horizontal" business groups such as the Business Council on National Issues and the Canadian Federation of Independent Business, and sectoral business organizations including the Canadian Manufacturers' Association, the Canadian Construction Association, the Investment Dealers' Association of Canada, the Canadian Petroleum Association and the Mining Association of Canada, all of which are regular participants in the consultative process. These groups were less influential in affecting the details of budgetary proposals, although certain elements of their wish lists might surface on budget nights, than in influencing the broader direction of tax policy. They did this mainly by linking the concepts of tax relief, tax restraint and tax competitiveness with the United States with that of business competitiveness in the minds of politicians and public opinion. However, the more public a group's lobbying activities, especially in its own interests, the less likely it is to exert direct influence over bureaucratic decisions.[25]

The Joint Tax Committee of the CBA/CICA plays an altogether different role, usually avoiding involvement with political issues of tax policy, but taking an active role in

[25] Interview, senior Finance Department official.(F01) A senior tax professional responds that outside interests may influence the technical application of tax laws where they seriously interfere with business decision-making, but that they have rather less influence over the basic policy decisions. (P6)

advising the Tax Policy Branch on a wide range of technical issues, including teh effective impact of tax laws on individual businesses and taxpayers. The Joint Tax Committee's technical expertise, low political profile and non-partisanship have helped it to obtain a relatively privileged status in dealings with Departmental officials.[26]

However, in several highly complex and specialized areas of tax policy, the advocacy role may evolve into virtual participation in the initial stages of policy formation. Some areas of tax law, such as those governing financial institutions and international transactions, are so specialized and complex that only a handful of professionals inside or outside the Department play an active role in the field. However, even in such cases, outsiders usually only react to Departmental proposals for legislative change. Expertise, mutual respect and absolute discretion are the major criteria for continuing involvement in these specialized policy communities.[27]

However, while Finance Ministers and officials may attempt to anticipate and limit political conflict by broadening the consultation process, the process of tax reform also involves the ability to gain and hold the political initiative in Parliament, the news media and public opinion.

Agenda Setting, Interest Group Competition and the Public Budgetary Process

The annual budget speech is the focal point of the federal government's efforts to define and mobilize public support for its fiscal and economic agendas. As such, it is an opportunity for the government to define its priorities, to exercise leadership, and to

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[26] Interview, senior tax policy official. (F01)

[27] Interview, current and former Finance Department officials and consultants. (F01, F05, F06, P3, P6) One highly connected accountant comments in this context that "they won't consult people who won't keep their mouths shut." (P6)

legitimate its policies both through the formal processes of Parliament and direct appeals for public support. The process of legitimation is complicated by the need to create a community of shared values on two levels -- between the Department of Finance and attentive actors in the tax policy community on the one hand, and between the Minister of Finance and the politically attentive electorate on the other.

Finance Ministers actively seek to shape public opinion through the budgetary process -- both to increase political support and to diffuse potential opposition to their policies. The last four Ministers of Finance (Lalonde, Wilson, Mazankowski and Martin) have sought to build public support for their policies by carrying out speaking tours of major regional centres before and immediately after each budget.

The budget's "agenda-setting" function is reinforced by weeks of media speculation, often encouraged by "trial balloons" circulated by Finance Ministers and "informed sources". The budget's political salience is reinforced by public expectations, common since the Keynesian revolution of the 1940s, that the government exercise "economic leadership" in promoting economic growth, stimulating job creation, controlling inflation, reducing regional disparities and social inequities, or simply exercising fiscal discipline over its own operations. It becomes the major topic of media coverage and parliamentary debate for several weeks each year. In the event of major structural changes, this debate can easily continue for months, or even years.

However, while Finance Ministers take public opinion into account in setting the general direction of tax policy, the public debate over specific tax measures has been dominated by a relatively small number of interest groups, most of which focus their advocacy efforts on relatively narrow areas of tax policy. Many of these interest groups have been successful in recent years in projecting their expectations and demands through the media and sustained pressure on Members of Parliament. Interest group reactions to the budget were often given media attention comparable to that given the Minister and opposition critics. This has empowered selected interest groups to serve as a filter for public perceptions of the budget, and forced Finance Ministers to anticipate interest group reactions in designing their policies.

The most influential interest groups attempting to influence the budgetary process during most of the 1970s and 1980s represented major segments of the business community -- large corporations and small businesses, manufacturers and resource industries. Though business groups may have the highest profile and the largest representation in the broader tax policy community, a number of social policy groups such as the National Council on Welfare and the National Anti-Poverty Organization (NAPO) have also emerged to lobby for the use of the tax system as an instrument of income redistribution, especially to lower-income families. While social policy groups were rarely able to win in direct confrontations over general policy objectives with business groups during the 1970s and 1980s,[28] they were able to convince the Department of Finance to introduce refundable tax credits for lower-income families and convert many personal income tax deductions to credits mainly targetted at lower and middle-income earners in the income tax reforms of 1987-88. Interviews with senior government officials suggest that this success could be seen as part of a deliberate government strategy to broaden support for major tax reform legislation by appealing to as broad a cross-section of interests as possible in the year before a general election.[29]

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[28] Social policy groups attempted in the late 1970s to make "tax expenditure analysis" a major tool for income & wealth redistribution. While this was a major theme of the 1981 MacEachen budget, it prompted a large enough backlash among business groups and tax professionals to discredit the concept as an ideological weapon. Other direct confrontations between social policy and business groups over the expansion of the public pension system and the creation of a Minimum Tax suggested that the former's influence was limited to those objectives which could be accomplished through piecemeal change to the tax system.

[29] Interviews, Don Blenkarn, MP, senior Finance Department officials. (D1)

The relationship between the Department of Finance and the major interest groups which are part of the broader tax policy community has evolved significantly during the 1980s. Most business groups and senior tax professionals viewed the dirigiste economic policies of the Trudeau Government elected in 1980 with ill-disguised hostility. This attitude came to be reciprocated by many Finance Department officials who saw themselves as merely trying to recover a series of ill-advised or overly generous tax breaks given away by profligate Ministers during the 1970s.[30] After the political fiasco of the 1981 budget, both Ministers and senior officials came to see such overt conflict as detrimental to the country's political and economic stability.[31] This resulted in significant changes both to the public policy process and to the Finance Department's attitude towards the consultative process.

The consultation process has become vital in legitimizing changes to budgetary and tax policies in several ways. It allows Ministers of Finance to mobilize public consent for policy changes by explaining policy problems requiring changes to the tax system or the allocation of public funds before introducing legislation -- rather than being seen to dictate changes that may adversely affect the livelihoods of many individuals or important economic sectors. It often contributes to more effective, credible policies (and reduces the unintended consequences of poorly researched policies) by allowing Department officials to test their economic assumptions through formal and informal discussions with the interests most likely to be affected before they are firmly committed to a specific policy. As such, it also provides a face-saving way around the partisanship and institutional rigidities of the Parliamentary process by allowing Ministers, their officials and Members of Parliament the opportunity to examine the objectives of proposed

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[30] Interviews, current and former tax policy branch officials. (F01, F03, F04)

[31] Interviews, Hon. Marc Lalonde; senior Finance Department officials (D5, F01)

policies, their underlying logic and possible alternatives before their formal introduction as legislation or a White Paper in Parliament.

The institutionalization of the consultation process can be seen in the frequent use of Discussion Papers to introduce new tax policy (and other) initiatives during the mid and late-1980s, both in conjunction with the budget process and independently from it. Table 5-1 outlines the extent to which consultative processes have become institutionalized in the process of tax policy change. After 1985, Finance Ministers also routinely introduced proposed technical changes to Income and Excise Tax Acts, along with their explanatory notes, independently of the budget in Parliament in order to facilitate technical comment by tax experts, and revision if necessary.

These changes to the public tax policy process have also addressed the substance of policy conflicts. For example, Finance Ministers Lalonde and Wilson sought to rebuild cooperative relationships with business groups by rolling back some of the more unpopular elements of the National Energy Program and the 1981 budget. Wilson, in particular, actively sought the cooperation of business groups in designing his income and sales tax reforms of the late 1980s through an extensive process of consultations both before and after introducing his White Papers.

Wilson's active advocacy of policies of deficit reduction, free trade and less direct government intervention in the economy coincided with shifts in the positions of major business groups from protectionism and subsidy-hunting to less interventionist, more market-oriented policies. At the same time, Conservatives and Liberals sought to make a virtue of necessity by emphasizing the increased targeting of social benefits through the tax system -- a major goal of social policy advocates -- as a means of reconciling fairness in social policy with the constraints of deficit reduction and the promotion of economic growth. While these policy changes have not been without opposition, most notably the bitter conflict over the introduction of the Goods and Services Tax, the consultative process has helped to expand public awareness of fiscal and tax policy options enough that there has been little public pressure for major changes to either the income or sales tax systems in the mid-1990s.[32]

A major factor in Finance Ministers' ability to legitimize proposed policy changes has been the increased use of Parliamentary Committees in recent years as vehicles for "pre-study" of proposed legislation and the ventilation of interest group and public opinion.

Consensus Building and Parliamentary Politics

The intensely partisan climate of parliamentary politics generally promotes conflict and policy instability rather than consensus and continuity.[33] The single member plurality electoral system allows a political party to form a majority government without a majority of the popular vote and to wield largely unrestricted power as long as it remains within the jurisdictional boundaries set by the constitution, the conventions of federalism, and the courts. Steinmo comments that this results in a relatively unstable and incoherent tax structure in which partisanship and electoral calculations play a more important role in defining policy options than rational calculations of social or economic objectives.[34]

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[32] While public opinion remained hostile to the Goods and Services Tax after the 1993 election, neither parliamentary hearings nor public opinion surveys suggested broad public support for any major redesign of income or sales tax systems beyond the harmonization of federal and provincial sales taxes. This represents a major change in public attitudes from the debates of the early 1980s. Standing Committee on Finance, "Replacing the GST: Options for Canada", *Ninth Report*, (Ottawa, House of Commons, June 1994); Earnscliffe Strategy Group, "Attitudes Towards the GST: Results of a Nationwide Survey", (mimeo - Ottawa, ESG Research and Communications, July 1994).

[33] Sven Steinmo, "Political Institutions and Tax Policy in the United States, Sweden and Britain", *World Politics* XLI(4), [July 1989], 527-32.

[34] Ibid, 523-30.

> The hot competition of party politics has fostered the desire to introduce party differences and has afforded little incentive to analyze basic objectives, to assess possibilities and costs in the form of sacrificed alternatives.[35]

During the 1970s, the Senate Committee on Banking, Trade and Commerce exercised the major legislative oversight of tax policy issues. Its Chairman, Senator Salter Hayden, was probably the most influential figure on tax policy issues outside the Department of Finance during this period. Hayden initiated "pre-study" of tax bills by the Committee, as soon as they were introduced in the House of Commons. The Committee was served by experienced tax advisors who were given considerable latitude in briefing Senators, preparing questions and cross-examining witnesses.[36] Hayden's influence stemmed from his long experience,[37] his adroit use of expert consultants, and a preference for private negotiation with Finance Ministers and officials over public confrontation.[38] Unlike Commons' Finance Committees of the 1970s and early 1980s, which were comparatively inexpert and under tight political control, the Banking Committee regularly demanded amendments to budgetary tax bills,[39] receiving written commitments from the Minister of Finance that the required changes would be made in his next budget.[40] The Senate Committee's influence declined after Hayden's retirement in 1983.

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[35] T. Wilson "The Economic Costs of the Adversary System", in Sam Finer, ed., *Adversary Politics and Electoral Reform*, (London, Anthony Wigram, 1982), cited in Steinmo, "Political Institutions and Tax Policy...", 528.

[36] Senate Committee Counsel Thomas Gillespie had served the Committee since 1975. He worked closely with Senator Hayden and officials of the Tax Policy Branch, whose respect he had won for professional competence, discretion and political realism.

[37] A senior partner in a major Toronto law firm, Hayden was appointed to the Senate by Prime Minister Mackenzie King in 1940. He chaired the Senate Banking Committee between 1951 and 1983.

[38] Interviews, Thomas S. Gillespie, senior Finance Department official (F01).

[39] See especially Banking Committee Reports on Bill C-37 (1978), Bill C-17 (1979) and Bill C-48 (1981).

[40] Interview, Thomas S. Gillespie.

A major innovation in the 1986-88 tax reform process involved the role of the Commons Finance Committee. The government's partial implementation of some of the recommendations of the McGrath Report on Parliamentary Reform[41] provided an opportunity for Members of Parliament to play a more active role in the legislative process. The Committee's effective role in the policy process depended on several inter-related factors: the ability of the Committee's chairman to build a relatively non-partisan working relationship in which all members had an opportunity to exert an influence on the development of policy, even at the margin; the willingness of the Minister to involve the Committee fairly early in the policy-making process, both through extensive discussions with government officials and consideration of possible amendments; the ability of the Committee to obtain and make effective use of expert staff;[42] time for Committee members to develop sufficient mutual trust and technical expertise to play a constructive role in the policy process; and a decision by both Minister and Opposition to dispense with the rigidly adversarial culture of the traditional Parliamentary process.[43] In this way, the role of Members of Parliament came to resemble the role of interest groups which became a part of the bureaucratic policy-making process. Technical priorities could take precedence over ideological agendas. Public policies could be developed within a framework of negotiation and interest accommodation rather than the "moral-practical" conflict of a highly politicized public debate.[44]

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[41] Hon. James G. McGrath, Chmn., *Report of the Special Committee on the Reform of the House of Commons*, (Ottawa, House of Commons, June 1985).

[42] Cohen, "The Budget Process ...", 15.

[43] Interview, Don Blenkarn, MP.

[44] Claude Galipeau, "Political Parties, Interest Groups, and New Social Movements: Towards New Representations?", in Alain G. Gagnon and A. Brian Tanguay, *Canadian Parties in Transition*, (Toronto, Nelson, 1989), 414-417.

The Commons Finance Committee played an important role in reducing partisan conflict and building a broad consensus on tax reform issues during much of the period between 1985 and 1988. This is visible in the relatively low level of partisanship on the committee betweeen 1986 and 1988[45] -- in sharp contrast with the partisan rancour of the debate over the Goods and Services Tax after 1988 and the resulting decline of its influence on tax policy issues.

The third group with periodic involvement on tax policy issues is the government's parliamentary caucus. Under the Trudeau Liberals, the role of caucus was mainly reactive, serving as a lightning rod for public and interest group reactions on issues such as the 1978 reforms to Unemployment Insurance and the 1981 tax reform budget.[46] Prime Minister Mulroney used his caucus as a political "reality check"[47] on major policy initiatives during his first term. Cabinet and caucus resistance to proposed sales tax reforms delayed the introduction of the BTT/GST by more than two years, and forced Finance Minister Wilson to cultivate caucus as part of his consultation process.[48]

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[45] Robert J. O'Brien, "The Finance Committee Carves Out a Role ... and bloodies some three-piece suits in the process", *Parliamentary Government* 8(1), [1989], 3-10; interview, Don Blenkarn, MP.

[46] Interviews, former Liberal MPs; (M4, MP3) Paul Thomas, "Role of National Party Caucuses" in Peter Aucoin, ed., *Party Government and Regional Representation*, (Toronto, University of Toronto Press, 1985).

[47] Interviews, senior PMO and Finance Department officials (PMO-1, D4) Wilson comments that "I used caucus for the same reason. Policy development is relatively easy in a vacuum. Combining policy and understanding and managing the politics is a more complex issue ... particularly as it relates to taxation. Having the views of the broad range of interests available in caucus was extremely important to me in caucus." (Hon. Michael Wilson, correspondance with author.)

[48] Ibid. Wilson denies that caucus imposed serious constraints on his priorities as Minister of Finance. However, it appears that Wilson made serious efforts to cultivate caucus support and diffuse potential opposition as part of his strategy to build political support for income tax reform and the GST. (Interview, Hon. Michael Wilson, former Ministerial aide. (F02) This was a far cry from virtually ignoring caucus except during political emergencies, as most of his predecessors had done.

Tax Reform and Public Opinion

A large measure of a Finance Minister's success in winning the cooperation, however grudging, of interest groups, MPs and Senators, is his ability to win the support of public opinion. While the views of the average taxpayer have traditionally held minimal weight on detailed tax policy issues, public opinion becomes the court of appeal when political and economic elites are divided over the feasibility or desirability of major tax policy changes.

The role of public opinion is strongest in influencing the general direction and trends of tax policy -- particular on issues with a high public profile or symbolic importance. Public opinion may be assessed (and often manipulated) through mass media coverage of tax issues, the number and intensity of interest group members and ordinary voters contacting their Members of Parliament, or through polls and focus groups commissioned by central agencies, political parties and interest groups.

The Department of Finance conducts periodic public opinion research to test for public perceptions of the tax system and possible responses to policy options. However, these appear to have been less influential on detailed policies than on the themes and priorities stressed in the Minister's public statements.[49] These studies point to three overriding priorities in public views of tax policy and tax reform.

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[49] Decima Research Ltd., *Report to the Department of Finance on Qualitative and Quantitative Research*, "Decima (1985)", (March-April 1985); Decima Research Ltd., *Nation-wide Survey*, Department of Finance "Decima (1987)", (March 1987); Angus Reid Associates, *Canadians' View of Selected Public Policy Issues: The Results of a National Public Opinion Survey*, "Reid (1988)", (September 1988). Research reports obtained under Access to Information and Protection of Privacy Act. Hon. Michael H. Wilson, Budget Speeches, February 1987, February 1988; Tax Reform: The White Paper, June 18, 1987.

Not surprisingly, public opinion on tax policy appears to be closely tied to financial self-interest -- particularly with the maintenance of after-tax living standards. Public dissatisfaction with the tax system tends to increase when the average standard of living is seen to be eroded by inflation, taxes or both. Finance Department surveys suggest that the average citizen appears to be less interested in tax reform than in tax limitation.

The public's view of tax reform in the mid-1980s appears to have been one of overwhelming scepticism. Available polling data suggests that members of the general public had limited awareness of the tax system, except as it affects them as individuals.[50] Tax reform is perceived as a contest of "us" (average taxpayers, small businesses and farmers, who are often seen as neighbours, sources of local economic opportunities and fellow-victims of the tax system) and "them" (the government, large corporations and a few wealthy taxpayers who have access to a wide range of benefits not available to the average citizen).[51] Taxes are seen as "too high", typically having increased faster than the benefits received from government.[52] The federal deficit is seen as something "created unnecessarily by government waste and inefficiency".[53] During the 1980s, most Canadians preferred that it be reduced through lower spending, preferably on services used by others.[54] A March 1987 Angus Reid poll, published by Southam News,

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[50] Decima (1987), 52-56; Reid (1988), 64-65.

[51] Decima (1985):17; Decima (1987):11-12, 15-16, 50-52; Reid (1988), 63-69.

[52] Decima (1985):5-7; for an analysis of the impact of tax increases between 1984 and 1988 on the effective tax rates and disposable income of Canadians by income group, see Maslove, Tax Reform: Its Process and Impact, 35-42. Statistics Canada reports that real after-tax family income declined between 1980 and 1983, increased between 1984 and 1989, and dropped sharply between 1989 and 1993. However, income taxes paid by the average family rose significantly faster than transfer payments received between 1984 and 1990. *The Daily*, (Ottawa, Statistics Canada Cat. No. 11-001E, June 14, 1995), 3.

[53] Decima (1985): 23-24.

[54] Decima (1985):23-26; 63-64; Decima (1987):20-25.

> found that 68 percent of those surveyed believe that ordinary Canadians pay too much tax ... 43 percent feel that small businesses are overtaxed ... 70 percent think large corporations aren't paying their fair share and 76 percent that the rich are undertaxed.[55]

During this period, tax reform was widely perceived as a vehicle to increase taxes for the average person, with little prospect of improvement in the overall fairness of the tax system, whatever the government's proclaimed objectives.[56]

Secondly, Canadians' views of the tax system and their support for tax reform have been largely contingent on perceptions of equity and fairness: that those less well-off than themselves should pay lower taxes, that their own taxes should only increase a little or not-at-all, and that those better off than themselves, especially large corporations, should pay more.[57] Public support for NDP proposals for a minimum tax prompted Prime Minister Mulroney to adopt this proposal in 1984, despite significant reserva. ns among tax professionals and the Department of Finance.[58] The practical impact of public opinion can also be seen in the creation of a Large Corporations Tax in 1989 as a form of corporate minimum tax and in the growth of personal income surtaxes on upper-income earners by provincial governments since the 1987-88 tax reforms.

These themes, reinforced by the Mulroney Government's low ratings in the polls during the first half of 1987, seem to have played an important part in the decision to separate

[55] Claire Hoy, *Friends in High Places*, (Toronto, Key Porter, 1987), 128.

[56] Public perceptions of tax reform, even after its passage by Parliament in 1988, were coloured more by the government's historical performance of 1985-88 than by its actual effort to raise corporate income taxes. Reid (1988):64. In this climate, any serious effort at redistributing the tax burden may have had severe political consequences for the government. Gallup Canada, "72% believe tax system is less fair", *Toronto Star*, (December 10, 1990), A15.

[57] Decima (1987):15-17,31

[58] House of Commons, *Debates*, 33rd Parliament, 1st Session, Nov. 22, 1984, 490-1; Claire Hoy, *Friends in High Places*, 111,115; Donald R. Huggett, "The Minimum Income Tax", in *Report of Proceedings of the Thirty-Seventy Tax Conference, 1985*, (Toronto, Canadian Tax Foundation, 1986); interviews, Tax Policy Branch, Department of Finance.

income and sales tax reforms into separate stages to be implemented before and after the 1988 election, while seeking cover for the latter by attempting to build a consensus with provincial governments and a broad cross-section of the business community.[59]

The Canadian public's third persistent concern is that tax and economic policies promote, or at least not impede, economic growth. Tax policy changes which can be sold to the general public as facilitating economic growth and job creation are likely to win popular support, whether or not they are rooted in rational economic policies. Conversely, tax policy changes which are seen to limit growth or reduce employment may create serious political difficulties for a government, regardless of the level of support among tax experts. Public support for more redistributive tax and spending measures appears to grow during periods of relative prosperity and decline during periods of economic stagnation.

CONCLUSION

As a general rule, the political pressure for tax reform does not come from societal actors such as the interest groups which make up much of the broader tax policy community, since most of these prefer to work within the existing system.[60] Nor does it come from

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[59] Interviews, former Deputy Ministers (D1,D4). The March 1987 Southam News/Angus Reid poll found that 63 percent of respondants were opposed to the introduction of a Value-Added Tax to replace the Federal Sales Tax, with only about one in four supporting the proposal. Hoy, *Friends in High Places*, 128.

[60] Macdonald stresses that the appointment of the Carter Royal Commission on Taxation in 1962 was largely the result of pressures from representatives of tax professionsals such as the Canadian Bar Association, the Canadian Institute of Chartered Accountants and the Canadian Tax Foundation as a result of growing uncertainties over the direction of judicial rulings on capital taxation. [L.T. Macdonald, *Taxing Comprehensive Income*, Chapter 2.] The Commission's attempt to redesign the tax system from first principles so provoked the fury of tax professionals and their corporate clientele that they never again made the mistake of asking Ottawa to reopen the basic principles of taxation for public debate.

the taxpaying public, which suspects that governments are likely to use tax reform as a pretext to raise taxes.[61] Rather, the political impetus for tax reform generally comes from government officials and tax policy specialists within the academic community who seek to adapt to international competitive pressures or to stem the erosion of the tax base through the spread of tax preferences or competitive tax avoidance practices, and who perceive fundamental structural changes rather than piecemeal tinkering as the only viable response to these problems.

The political decision to take the risk of embarking on major structural changes to the tax system is often a matter of timing and political circumstances. These include the exhaustion of less radical options for the changes necessary for the government to achieve its political objectives. Economic growth must be sufficient to make tax reform a "positive sum game" by lowering taxes for most voters. Individual and business taxpayers must have adequate time to adapt to a new tax system and its inevitable disruptions before the government has to call an election. The government must also be able to market tax reform to the general public in a way consistent with popular conceptions of "fairness". These questions have little to do with the normative theory of tax reform, and everything to do with the political marketplace in which tax reform must be "bought" and "sold".

Both Finance Ministers MacEachen and Wilson sought to purge the tax structure of a wide range of benefits cherished by various special interests in the pursuit of a more economically efficient tax system capable of generating the revenues necessary to

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[61] A possible exception may be the widespread public sentiment for major revisions to or the elimination of the Goods and Services Tax before and after the 1993 election. However, as with the persistent campaign of the business community to eliminate the capital gains tax during the 1970s and early 1980s, it can be seen that widespread antipathy to a particular tax rarely lends itself to consensus on the taxes which should be imposed to replace potentially foregone revenues.

enhance their government's solvency and support their general economic policies.[62] MacEachen's political failure in 1981-82 and Wilson's relative success in 1987-88 argue strongly for the importance of the coalition-building approach in achieving effective tax reform.

[62] Hon. Allan J. MacEachen, *Budget Speech*, (Ottawa, Department of Finance, November 12, 1981); Hon. Michael H. Wilson, "Meeting the Challenge of Tax Reform", (Ottawa, Department of Finance, June 18, 1987).

TABLE 5-1
TAX REFORM PROCESSES IN THE 1980s

YEAR	ISSUE	PROCESS CHOSEN	EXTENT OF REFORMS	OUTCOME
1980	Nat'l Energy Program	Budget	Major sectoral/ challenge to prov. revenues/ jurisdiction, ind.structure	Highly polarized; implemented short-term; reversed in 1985-86.
1981	Income Tax Reform	Budget	Comprehensive	Highly polarized; short-term changes, reversed in 1984-85.
1982	Sales Tax Reform	Consultative -White Paper	Piecemeal	No consensus reached -- abandoned.
1982	Indexation of Personal Invest.Income	Consultative -Discussion Paper	Piecemeal	Passed with consensus changes:1983
1982	Pension Reform	Consultative -Green Paper	Piecemeal	Reintroduced with major changes 1984
1984	Pension Reform	Mixed Budget /Consultative	Piecemeal	Consensus changes in 1986 budget
1985	Partial PIT Deindexation	Budget	Piecemeal	Polarization Tax changes passed.
1985	Capital Gains Exemption	Budget	Piecemeal	Passed 1985; gradually curtailed, reversed 1987-1994.
1985	CIT Reform	Consultative -Discussion Paper	Piecemeal	Consensus changes in 1986 budget.
1985	Minimum Tax	Consultative -Discussion Paper	Piecemeal	Reduced to symbolic measure.
1987	PIT Reform	Consultative -White Paper	Semi-Comprehensive	Broad consensus; implemented 1988 budget.
1989	Sales Tax Reform	Consultative -White Paper	Comprehensive	Polarization Implemented w.widespread protest:1990

PART II

THE TAX REFORM CYCLE: 1971-82

CHAPTER

CHAPTER 6 -- TAX POLICY IN THE 1970s

> The public finances are one of the best starting points for an investigation of society, especially ... of its political life. The full fruitfulness of this approach is seen particularly at those turning points ... during which existing forms begin to die off and to change into something new and which always involve a crisis of the old fiscal methods.
>
> Joseph Schumpeter[1]

The basic premises of Canadian fiscal and tax policies during the 1970s were called into question by a series of economic shocks which undermined the post-war consensus supporting Keynesian economic policies. As a result, the Carter Commission's call for comprehensive taxation of all income -- which had been hesitantly acknowledged in the base-broadening measures of the Benson White Paper and the Tax Reform Bill of 1971 -- was largely ignored during the remainder of the decade. Indeed, successive Ministers of Finance led a stampede away from its recommendations. The four Ministers of Finance who followed Benson -- Liberals John Turner (1972-75), Donald MacDonald (1975-77), Jean Chretien (1977-79) and Conservative John Crosbie (1979-80) -- introduced more than 500 changes to the Income Tax Act in efforts to adapt to the political, economic and social pressures of the era, not to mention tax practitioners' frequent criticisms of the unintended consequences of previous changes.[2] In the process, the tax system became an active object of partisan political competition as all three national political parties sought to use it to reward (or punish) selected social and economic constituencies in the search for votes. This competition reflected both traditional patterns of brokerage and client politics in Canadian economic policy.

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[1] Joseph Schumpeter, "The Crisis of the Tax State", in Schumpeter, *The Economics and Sociology of Capitalism*, Richard A. Swedberg, ed., (Princeton, Princeton Univ. Press, 1991), 101.

[2] France St.Hilaire and John Whalley, "Reforming Taxes: Some Problems of Implementation", in David Laidler (ed.), *Approaches to Economic Well-Being*, (Toronto, University of Toronto Press, 1985), 211.

However, it also reflected the desires of federal politicians to legitimize their economic policies in the eyes of voters and major interest groups by stimulating growth and cushioning large numbers of voters against the effects of economic instability.[3]

These policies sought to defuse a growing ideological conflict over the basic relationships between state and society. This conflict was reflected in debates over specific questions of government policy such as the widespread use of tax preferences and government subsidies to encourage capital formation and regional economic development, the feasibility and desirability of a state-funded guaranteed annual income, and the appropriate balance between taxation and government spending in meeting a growing range of societal expectations and demands.

Should governments serve primarily as a referee or broker among competing social interests, or take an increasingly autonomous role in directing economic and social change? How should governments respond to the growing impact of inflation and taxes on citizens both in their private capacities and as consumers of public services? How should governments adapt to competing forces of global economic integration and domestic economic nationalism? These conflicts were reflected in the efforts of successive Finance Ministers to satisfy the contending forces through repeated changes to tax policy.

These efforts triggered a decade-long search for appropriate policy responses to stagflation -- the coincidence of rising rates of inflation and unemployment. Stagflation magnified the political pressures and conflicts inherent in the activist state, particularly over whether governments should adapt to or resist the pressures for structural economic

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[3] Gary Mucciaroni, "Public Choice and the Politics of Comprehensive Tax Reform", *Governance* 3(1), January 1990, 1-32.

change affecting all advanced industrial democracies.[4] The pressures on government to increase spending on a wide range of services conflicted with interest group demands for tax limitation to offset growing inflationary and competitive pressures. The result was a breakdown of traditional budgetary disciplines and a growing political bias towards deficit financing.[5]

The federal government made repeated attempts to address the resulting domestic political tensions through the incremental use of a wide range of tax policy instruments. Beyond the demands of partisan competition and client politics, the growth of tax preferences also reflected the federal Department of Finance's efforts to maintain its control over the economic and fiscal policy process in the face of growing competition both from within the federal government and from provincial governments increasingly assertive of regional interests.[6] By the end of the 1970s, these factors had contributed to routine deficit financing and an emerging willingness of the Department of Finance to consider major structural changes to the tax system that would help it to regain control over federal finances.[7]

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[4] Michel Crozier, Samuel P. Huntingdon, Joji Watanuki, *The Crisis of Democracy: Report on the Governability of Democracies to the Trilateral Commission,* (New York, New York University Press, 1975).

[5] In Canada, these competing pressures were reflected in business pressures to reduce taxes on corporations and capital income to preserve the competitiveness of Canadian industry against the United States, while spending ministers lobbied for higher direct public spending on social services and regional development. Donald A. Savoie, *The Politics of Public Spending*, (Toronto, University of Toronto Press, 1990); David A. Wolfe, "The Politics of the Deficit" in G. Bruce Doern, ed., *The Politics of Economic Policy*, (Toronto, University of Toronto Press, 1985). For an international perspective, see James M. Buchanan and Richard E. Wagner, *Democracy in Deficit: The Political Legacy of Lord Keynes,* (New York, Academic Press, 1977); Daniel Tarchys, "The Scissors Crisis in Public Finance", *Policy Sciences* 15 [1983], 205-24.

[6] J. Harvey Perry, *Background to Current Fiscal Problems*, Canadian Tax Paper # 68, (Toronto, Canadian Tax Foundation, 1982), Ch. 2; Savoie, *The Politics of Public Spending*, 75-86.

[7] Many of these proposals found their way into the National Energy Program of 1980 and the tax reform budget of 1981. See Chapters 7-8.

This chapter will summarize the factors contributing to the breakdown of the post-war Keynesian consensus on government management of the economy and their implications for Canadian tax policies. It examines efforts of successive Finance Ministers to use the tax system to adapt to growing inflation and unemployment, and the relationship between political competition and tax policy during the period from the passage of the tax reform bill of 1971 to the defeat of the Clark Government in the federal election of 1980.

THE GROWTH OF GOVERNMENT, THE FISCAL CRISIS AND THE TAX SYSTEM

Canadian economic policy between the end of the Second World War and the mid-1970s largely reflected Keynesian ideas of economic management.[8] The old consensus had been based on three major pillars suggested by Schumpeter as necessary for effective economic management in a democracy.[9] Economic policy had been relatively centralized under the control of the federal Ministry of Finance, which controlled or directly influenced the major levers of fiscal and monetary policy. Federal fiscal policy had been relatively disciplined, with Ministers of Finance able to enforce budgetary constraints on cabinet colleagues and interest groups, althcugh economic growth had left substantial room for greatly expanded program spending during these years. This system had been legitimized by relatively high levels of employment and economic growth -- and hence insulated from serious political or intellectual challenges.

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[8] J. Harvey Perry, *A Fiscal History of Canada*, (Toronto, Canadian Tax Foundation, 1989); W. Irwin Gillespie, *Tax, Borrow and Spend*, (Ottawa, Carleton Univ. Press, 1991). For a dissenting view, see Robert Malcolm Campbell, *Grand Illusions*, (Peterborough, ON, Broadview Press, 1987).

[9] Joseph A. Schumpeter, *Capitalism, Socialism and Democracy*, (New York, Harper Torchbooks, 1975) 289-96.

By the mid-1970s, however, five major economic and political challenges had begun to disrupt the post-war consensus on economic policy which had united most liberals, conservatives and social democrats in support of Keynesian macro-economic stabilization policies.

First, stagflation challenged the basic premises of Keynesian economic orthodoxy by demonstrating that inflation and unemployment rates could grow simultaneously. Second, a series of international economic shocks, such as the sudden rise in world oil prices in 1973, following the Arab-Israeli War, underlined the growing reality of globalization: that the major industrial and resource-based economies had become increasingly interdependent, thus limiting the policy-making discretion of individual governments. Third, fiscal measures taken during the 1970s to stimulate growth and help taxpayers adjust to inflation contributed to what has been alternately described as the "scissors' crisis"[10] of chronic budget deficits and the "fiscal crisis of the state".[11] Fourth, the growing impact of government spending and regulation on economic and social life contributed to a growing "crisis of democracy"[12] characterized by intensified political competition among both state and societal interests to protect or enhance their relative political, economic and social positions -- a competition reflected in frequent changes to the tax system. Fifth, the election of a separatist government in Quebec and the absence of effective representation of Western regional interests within the federal government between the mid-1970s and mid-1980s created an environment of federal-provincial

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[10] Daniel Tarchys, "The Scissors Crisis in Public Finance".

[11] James O'Connor, *The Fiscal Crisis of the State*, (New York, St. Martin's Press, 1973); Buchanan and Wagner, *Democracy in Deficit*. O'Connor's model is applied to the Canadian context by David Wolfe in "The Politics of the Deficit".

[12] Crozier et al, *The Crisis of Democracy*; Mancur Olsen, *The Rise and Decline of Nations*, (New Haven, Yale University Press, 1982)

confrontation which threatened to erode the legitimacy of federal economic leadership [13] These factors combined to force a reassessment of the political and intellectual basis for the Canadian state's role in the management of economic policy.

Fiscal Crisis Theory and the Role of the State

The political consensus which dominated public life in Canada and the United States during the 1950s and 1960s involved government efforts to minimize social conflict by expanding public investments and income transfer programs while limiting the degree of direct state involvement in the market economy. Government intervention, while frequent, was usually meant to promote economic growth and business development, thereby generating the private sector surpluses necessary to finance a growing state sector.

This mix of interest group liberalism and Keynesian pragmatism, however, was eventually challenged by a growing number of economists from both public choice and neo-Marxist perspectives. Building on the writings of Downs, Buchanan, Tullock, and Olson, public choice theory emphasized that political competition for votes led to the systematic pursuit of political power and influence by organized groups for the "realization of self-interest through the capture and use of government regulatory muscle."[14]

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[13] Canada, Task Force on Canadian Unity, *A Future Together: Observations and Recommendations*, (Ottawa, Supply & Services Canada, 1979).

[14] Jonathan Hughes, *The Governmental Habit Redux: Economic Controls from Colonial Times to the Present*, 2nd ed., (Princeton, Princeton University Press, 1991), 218; Anthony Downs, *An Economic Theory of Democracy*, (New York, Harper and Row, 1957); James M. Buchanan and Gordon Tullock, *The Calculus of Consent: Logical Foundations of Constitutional Democracy*, (Ann Arbor, MI, Michigan Univ. Press, 1962); Mancur Olsen, *The Logic of Collective Action*, (Cambridge, Harvard Univ. Press, 1965); Olsen, *The Rise and Decline of Nations*; Buchanan and Wagner, *Democracy in Deficit*; Brennan and Buchanan, *The Power to Tax*; James M. Buchanan. *Liberty, Market and State*, (New York, New York University Press, 1985).

Buchanan described the competition among individuals and groups "to maximize returns on their own capacities and opportunities ... through direct political allocation" as "rent seeking".[15] Politicians and officials of government departments and agencies were also seen to be engaged in "rent-seeking" by attempting to identify their own interests with the increasingly elusive concept of the public interest.[16] In a similar vein, Arthur Seldon wrote that

> governments are no longer to be seen as the impartial referee who sets the by-laws by which the economic 'game' in the market is played, but a powerful participant in the game, much more powerful than the individuals or firms and other 'players', and liable to ignore or bend the by-laws to its advantage, always claiming that it did so in the general interest of the other players.[17]

Despite fundamental differences in policy prescriptions, there were parallels between the public choice perception of the political process and that of a number of neo-Marxist theorists.[18] In both views, pervasive government intervention in the market economy and in society at large had blurred the distinctions between political and civil society. The increasing power of the political system to confer benefits or impose penalties on private economic and social activities had encouraged increased political activity by interest groups, together with the tendency of these groups to compete with one another and state

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[15] James M. Buchanan, "Rent Seeking and Profit Seeking", in James M. Buchanan, Robert D. Tollison and Gordon Tullock, eds., *Toward a Theory of a Rent-Seeking Society*, (College Station, TX, Texas A&M University Press, 1980), 4.

[16] Douglas G. Hartle, *The Expenditure Budget Process of the Government of Canada*, (Toronto, Canadian Tax Foundation, 1988); Gillespie, *Tax, Borrow and Spend*.

[17] Arthur Seldon, "Introduction", to James M. Buchanan, *Constitutional Economics*, (Oxford, Basil Blackwell, 1991), x.

[18] Claus Offe, "'Ungovernability': the renaissance in conservative theories of crisis", in Offe, *Contradictions of the Welfare State*, John Keane (ed.), (London, Basil Blackwell, 1984), 65-66.

actors to preserve or improve their economic power and social status.[19] This had been accompanied by what Offe describes as "the marketization of politics."

> The logic of capitalist democracy is one of mutual contamination: authority is infused into the economy by global demand management, transfers and regulations so that it loses more and more of its spontaneous and self-regulatory character; and market contingency is introduced into the state, thus compromising any notion of absolute authority or the absolute good.[20]

Ironically, the public perception of government intervention as "a moral imperative" in "an inherently unstable economy" made governments the prisoners of their own policy assumptions.[21] Writing in 1977, O'Connor attributed the "fiscal crisis" to the increasing inability of post-war Keynesian economic policies to satisfy the growing public expectation that the state would facilitate both "accumulation", the process of private capital formation necessary for wealth creation in a capitalist society, and "legitimation", the provision of public needs and private wants through an expanding system of public services and tax-financed income transfers.

> The capitalist state must try to fulfill two basic and often mutually contradictory functions -- *accumulation and legitimation*. This means that the state must try to maintain or create the conditions in which profitable capital accumulation is possible. However, the state must also try to maintain or create the conditions for class harmony. A capitalist class that openly uses its coercive forces to help one class accumulate capital at the expense of other classes loses its legitimacy and hence undermines the basis for its loyalty and support. But a state that ignores the necessity of assisting the process of capital accumulation risks drying up the source of

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19 For a cross-section of non-Marxist treatments of this issue, see Alan C. Cairns, "The Embedded State", in Keith Banting (coord.), *State and Society: Canada in Comparative Perspective*, (Toronto, University of Toronto Press, 1986); Hartle, *The Expenditure Budget System*, 35-68; Olsen, *The Rise and Decline of Nations*; Kenneth S. Templeton, Jr.,(ed.), *The Politicization of Society*, (Indianapolis, Liberty Press, 1979).

20 Claus Offe, "Competitive Party Democracy and the Keynesian Welfare State: Factors of Stability and Disorganization", *Policy Sciences* 15 (1983), 228. See also Wildavsky, *Budgeting: A Comparative Theory of Budgetary Processes*: "The paradox is that in its effort to extend its control over the private sector, government has surrendered a good deal of its control over the public sector." (2nd ed., (New Brunswick NJ, Transaction Books, 1986), 349-50

21 Buchanan and Wagner, *Democracy in Deficit*, 95.

> its own power, the economy's surplus production capacity and the taxes drawn from this surplus (and other forms of capital).[22]

In the process, the growth of state intervention led to a blurring of the distinction between public and private spheres, between public needs and private wants.[23] Chronic deficit spending came to separate the perceived benefits of public spending from the visible costs of the taxes needed to pay for them.[24]

Canada: Fiscal Crisis in Slow Motion

In Canada, this dilemma was reflected in trends towards higher overall government spending, both real and nominal, in growing public resistance to parallel increases in taxation and a rapid increase in federal deficits between 1975 and 1985. (See Table 6-1). The unprecedented expansion of government spending, taxation, regulation and other forms of intervention during the 1960s and 1970s resulted in the increased penetration of the Canadian state into the workings of the national economy and the lives of individual Canadians. The combined spending of Canadian governments at all levels increased from 28.9 percent of GDP in 1965 to 40.0 percent in 1975 and 46.8 percent in 1985.[25] Table 6-1 compares the growth of federal and total government taxes, spending and deficits between 1965 and 1990.

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[22] James O'Connor, *The Fiscal Crisis of the State*, (New York, St. Martin's Press, 1973), 6.

[23] Daniel Bell, "The Public Household -- On 'fiscal sociology' and the liberal society", *The Public Interest* 37, [Fall 1974], 38.

[24] Buchanan and Wagner, *Democracy in Deficit.*

[25] Consolidated government revenues grew from 29.3 percent to 37.5 percent to 40.0 percent during the same period. Annual real per capita spending increased by 3.9 percent from 1965-66 to 1975-76, about 1 percent per year in the following decade. David B. Perry, "Historical Public Finance Data", *Canadian Tax Journal* 40(3), [1992], Tables 4,5, 809-10; Canada. Department of Finance, *Economic and Fiscal Reference Tables*, (Ottawa, September 1994), Tables 52-55.

Steady economic growth and modest rates of inflation during the 1960s provided both federal and provincial governments with annual revenue windfalls to finance new programs and spending without the need for formal increases in tax rates. Federal spending increased at a nominal rate of 16.3 percent per year during the five years of the tax reform debate (1966-67 through 1971-72) -- 12.1 percent after inflation. During the same period, federal personal income tax (PIT) revenues increased 23.2 percent per year after inflation. The steeply progressive tax system was a major beneficiary of even the "limited" inflation of the 1960s.[26]

TABLE 6-1
TAXES AND SPENDING AS PERCENT OF GROSS DOMESTIC PRODUCT

FEDERAL GOVERNMENT	1965	1970	1975	1980	1985	1990
REVENUES	15.9%	17.6%	18.6%	16.4%	17.4%	19.0%
SPENDING	15.0%	17.3%	20.8%	19.8%	24.0%	22.9%
DEBT SERVICE	1.8%	2.1%	2.2%	3.2%	5.2%	6.2%
SURPLUS /(DEFICIT)	0.9%	0.3%	(2.2%)	(3.4%)	(6.6%)	(3.9%)
TOTAL GOVERNMENT						
REVENUES	28.9%	35.2%	37.5%	37.5%	40.0%	43.3%
SPENDING	28.9%	35.2%	40.0%	40.3%	46.8%	47.4%
DEBT SERVICE	2.9%	3.7%	3.8%	5.4%	8.4%	9.5%
SURPLUS / (DEFICIT)	0.3%	0.8%	(2.5%)	(2.8%)	(6.8%)	(4.1%)

[SOURCE: *Fiscal and Economic Reference Tables*, (Ottawa, Department of Finance, September 1994)

The effects of rising inflation rates made taxes and popular perceptions of wasteful government spending major issues in the 1972 election, which left the Trudeau Liberals with the narrowest of margins in the House of Commons. Both opposition parties exploited taxpayer resentment of eroding standards of living and higher levels of unemployment. David Lewis and the New Democrats challenged the growth of corporate

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[26] *1990 Budget*, (Ottawa, Department of Finance, Feb. 1990), 140, 143; Statistics Canada, "Consumer Prices and Prices Indexes", [Cat. 62-010, 1989], 22.

tax breaks and government hand-outs to business,[27] while the Conservatives under Robert Stanfield made major gains by attacking abuses of the recently-expanded unemployment insurance program, and by promising to index both public pensions and personal income tax brackets.[28]

Benson's successor as Finance Minister, John Turner, sought to appease taxpayer resentment and rebuild Liberal ties with the business community[29] by presenting a series of budgets dominated by the political needs to accommodate individual, regional and sectoral interests at the expense of the short-term fiscal requirements of the public sector. In effect, federal tax revenues were allowed to lag behind the rapid growth of expenditures. This led to the steady growth of deficit spending, and with it, an impending crisis in fiscal policy. These decisions reflected the pressures of brokerage politics and conflicts within the federal government over the control and direction of economic policy.

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27 David Lewis, *Louder Voices: The Corporate Welfare Bums*, (Toronto, James Lorimer, 1972); "Corporate welfare, unemployment topics as Lewis surprises Trudeau ...", *The Globe and Mail*, Sept. 23, 1972, 1; V. Carriere, "Lewis dines ... denounces 'prince of bums', *Globe and Mail*, Oct. 2, 1972, 10; L. Watkins, "NDP's Corporate Ripoff Campaign ...", *The Globe and Mail*, Oct. 7, 1972, 10.

28 Hartle, *The Expenditure Budget System*, 78-81; Gillespie, *Tax Borrow and Spend*, 192-3; J. Slinger, "Tories would link pensions, living costs", *Globe and Mail*, Sept. 19, 1972, 8; N. Louttit, "Backlash in the Country", *Globe and Mail*, Oct. 6, 1972, 8.

29 Wolfe comments that "in spite of the clear victory they had won, the entire (tax) reform process had left a bitter taste in the mouths of the business community and a legacy of bad feeling between it and the [Trudeau] government. ... [Turner's] reliance on corporate tax incentives to promote economic growth served as a political device to repair the damage caused by other policy initiatives." Wolfe, "Politics, the Deficit and Tax Reform", *Osgoode Hall Law Journal* 26(2), [1988], 360,364.

TAX POLICY AND BUREAUCRATIC POLITICS IN THE 1970s

We have already discussed the responsibility of the Minister and Department of Finance to coordinate macro and micro-economic policy for the entire country.[30] This creates an institutional bias towards more generalized forms of intervention, (rarely non-intervention as suggested by the Department's critics)[31] and to resist the demands of other departments for new programs and higher spending.

However, the Trudeau Government's efforts to rationalize the decision-making structure of the federal-government during the early 1970s called into question the traditional preeminence of the Department of Finance in setting spending limits for the federal government. The Department also came under increasing pressure to share its monopoly over fiscal and economic policy with interests both inside and outside the federal government. This reflected both a series of institutional changes within the federal government and a shift in the balance of power between the Prime Minister and senior cabinet ministers.[32]

The increasing power of the Prime Minister relative to his senior cabinet ministers during an era of leader-centered politics increased the dependance of the Minister of Finance on Trudeau's personal and political support for his ability to define coherent fiscal policies.[33] The coordination of major policy initiatives through a system of cabinet committees, most

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[30] See Chapter 4.

[31] Savoie, *The Politics of Public Spending*, 78-86. Finance's responsibility for setting limits and enforcing priorities is often caricatured as a "systematic interventionist bias" (Doern and Phidd, *The Politics of Canadian Economic Policy*,) and a "reflex anti-spending position", (Richard French, *How Ottawa Spends..., 1982).*

[32] Savoie, *The Politics of Public Spending*, 75; Cahill, *John Turner, the Long Run*; Hartle, *The Revenue Budget Process of the Government of Canada*, (Toronto, Canadian Tax Foundation, 1982), 33-37, 66-68; Christina McCall-Newman, *Grits*, (Toronto, Macmillan of Canada, 1980).

[33] Hartle, ibid., 67; Christina McCall-Newman, *Grits.*

notably Priorities and Planning, "created an organizational precondition for departmental resistance" to Finance's ability to "pre-empt" policy decisions.[34] The salience of regional development and energy issues during the 1970s also increased pressure on Finance to incorporate a wider range of regional and sectoral considerations into its fiscal and economic policy decisions.

While these factors aggravated the potential for conflict between the Minister of Finance and his cabinet colleagues, the federal government's ability to pursue coherent economic policies appears to have been severely impaired by the running conflict between Finance Minister Turner and Prime Minister Trudeau during the early 1970s over fiscal and spending priorities which reflected very different views of the federal government's role in the economy.[35] Turner and his officials, most notably Deputy Minister Simon Reisman, considered it their responsibility to restrain federal spending to control growing inflation while selectively easing tax burdens on business so that the private sector could create employment for a rapidly growing labour force and maintain its competitive position in world markets. Turner's decision to introduce partial inflation indexing was strongly influenced by his belief that he could only constrain his colleagues' spending ambitions by slowing the growth of federal revenues.[36] However, the cabinet had committed the government to a wide range of social policy initiatives both before and during the minority government of 1972-74, during which the Liberals were dependent on

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[34] Hartle, *The Revenue Budget Process...*, note opposite p. 33.

[35] Savoie, ibid., 75; Hartle, ibid., pp. 33.

[36] This outlook was reinforced by Turner's belief that economic growth, job creation and the future of the Liberal Party could be achieved most effectively through cooperation between business and government. Cahill, John Turner: *The Long Run*, 154-55, 168-69, 178-79.

NDP support.[37] Although Turner resigned from cabinet in September 1975, the tax policies of his successor, Donald Macdonald, followed much the same course of interest accommodation: attempting to stimulate individual economic activity and regional development through a wide variety of tax preferences -- but within a fiscal framework within which taxation and spending policies were coordinated only in the sense of "giving with both hands".[38]

Between 1973 and 1979, Ministers of Finance introduced a wide range of piecemeal changes to the Income Tax Act, reflecting their multiple mandate to promote competitiveness and growth, limit the impact of tax-based inflation, and minimize inequities within the tax system. Some of these changes were primarily technical in nature, responding to the criticisms and suggestions of private sector tax professionals through formal and informal consultations such as the Annual Conferences of the Canadian Tax Foundation or the interaction between Department officials and senior members of the tax law and accounting professions.[39] Others reflected a degree of policy entrepreneurship among senior officials of the Department either as a means of using tax measures as a creative substitute for direct government spending or as an effort to

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[37] Christina McCall-Newman, *Grits*, 219-225; Cahill, *John Turner: The Long Run*, 178-81; Trudeau's economic thinking during this period was heavily influenced by the ideas of John Kenneth Galbraith on the dominance of large institutions in society and the need for systematic government regulation to balance the power of private institutions and reshape the expectations of society. See "Transcript of the Prime Minister's Interview ... A Conversation with the Prime Minister", (Ottawa, Prime Minister's Office, December 28, 1975).

[38] The Nielsen Task Force of 1985-86 used this phrase to describe the stacking of direct subsidies and tax incentives without any serious effort at coordination, cost-benefit analysis, or policy integration. (Hartle, *The Expenditure Budget Process*, 223-25; Savoie, *The Politics of Public Spending in Canada*, 134)

[39] Hartle, *The Revenue Budget Process*, 18, 22.

generate political credit for the government among business and professional groups increasingly critical of the government.[40]

This trend was reinforced by increased competition between federal and provincial governments for political credit for spending measures and by federal efforts to restrain direct spending during the Anti-Inflation Board period of 1975-78.[41] Viewed from this perspective, the use of tax preferences as an instrument of industrial strategy, regional development or job creation could be seen as a systematic effort by the Department of Finance to reassert its political and economic authority within a federal government seriously divided over its approach to economic management and political strategy.

If this was one of the aims of the Department, however, it ultimately proved self-defeating. The paradox of the "embedded state"[42] is that the ability of governments to make independent decisions based on the common good is undermined in proportion to the level of their direct intervention in the lives of citizens.[43] The greater the number of social and economic objectives to be achieved through the manipulation of the tax system, the greater is the likelihood that policies will conflict with one another, creating new anomalies and inequities whose victims would seek compensation or redress from the government. The greater the responsiveness of Finance Ministers to these pressures, the greater would be the potential revenue losses. These, in turn, would create pressure for a rationalization of tax pressures through comprehensive tax reform.

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40 Interviews, former Finance Department officials. (F03)

41 Wolfe, "The Politics of the Deficit", 149-50; Savoie, *The Politics of Canadian Public Spending*, 93,162; Perry, *A Fiscal History of Canada*, 200-201; Neil Brooks, "The Royal Commission on Taxation Twenty Years Later", in Brooks, ed., *The Quest for Tax Reform: the Royal Commission on Taxation Twenty Years Later*, (Toronto, Carswell, 1988), 6, fn.7.

42 Alan C. Cairns, "The Embedded State", in Keith Banting, ed., *State and Society*, (Toronto, University of Toronto Press, 1986), 54.

43 Interviews, Finance Department officials. (F01)

TAX POLICY AND INTEREST ACCOMMODATION: 1972-78

> We have created a tax jungle in which it is easy to get lost and very little light penetrates.
>
> Donald Johnston on the 1971 Tax Reform Act[44]

The political strategy of successive Liberal Ministers of Finance after 197? was to maintain the party's traditional coalition of business groups and lower and middle income Canadians. Business looked to government to provide an environment conducive to secure investments and economic growth. Lower and middle-income Canadians looked to government to protect them against the vagaries of the marketplace and adverse economic conditions. Both factors were conducive to the growth of what James Q. Wilson has labelled "client politics", in which competing interests pursue benefits from the state, the costs of which can be diffused over a wide range of taxpayers.[45]

However, the growth of tax preferences or "tax expenditures" during this period cannot simply be attributed to the vagaries of interest group politics, as sometimes suggested in the public finance literature. It also reflects efforts by politicians to strike a political balance between tax concessions to business and the expansion of broadly-based tax preferences available to the average taxpayer. The main objective of the latter was to mitigate the impact of inflation and progressive tax rates on the living standards and

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44 Donald Johnston, *Up the Hill*, (Montreal, Optimum Publishing, 1986), 196; Johnston, author of *Fiscalamity: How to survive Canada's tax chaos*, (Montreal, 1973) was later President of the Treasury Board and Minister of Economic and Regional Development under Trudeau.

45 James Q. Wilson, "The Politics of Regulation", in Wilson (ed.), *The Politics of Regulation*, (New York, Basic Books, 1980), 369. For specific application to the tax system, see Eisenstein, *The Ideologies of Taxation*, (New York, Ronald Press, 1961), Chapters 4,5,7,8.

savings capacities of the middle class.[46] This was, in effect, a majoritarian[47] response by politicians to public tax resistance.

The most notable of these structural changes was the indexation of the personal income tax system in 1973-74.

Tax Resistance, Indexation, and Majoritarian Politics

The Carter-Benson tax reform process had largely dismissed the issues of inflation and its impact on effective tax rates, tax equity and economic development.[48] However, in the inflationary environment of the early 1970s, the politically dominant view was that the appropriate tax base was that of "real consumption" -- the level at which the real disposable income of individuals and the real purchasing power of capital would not be eroded by the combined effects of taxes and inflation.[49] In plain language, this meant that governments should not profit from inflation at the expense of their citizens.

The political backlash against the Carter-Benson tax reform program was the first major sign of widespread public weariness with growing tax levels. But as inflation grew from

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[46] James Q. Wilson, "The Riddle of the Middle Class", *The Public Interest* 39, [1975], 125-9, and Irving Kristol, "On Taxes, Poverty and Equality", *The Public Interest* 37 [Fall 1974], 24-28.

[47] In Wilson's model, "majoritarian politics" produces gains for all or most of society with costs broadly diffused throughout society. (Wilson, ibid.).

[48] John F. Helliwell, "Inflation and Tax Reform", *Canadian Tax Journal* 18(2), March-April 1970, pp. 124-130.

[49] "Recent anti-inflationary policy has been characterized by three major themes: the rejection of deflationary measures aimed at counteracting in Canada price developments which were substantially external in origin; the stimulation and domestic supply; and the necessity of offsetting the effects of inflation upon individual Canadians, especially those least able to protect themselves from the erosion of real incomes." J.R. Allan, D.A. Dodge and S.N. Poddar, "Indexing the Personal Income Tax: A Federal Perspective", *Canadian Tax Journal* XXII(4), [July-August 1974], 355.

the 1 to 2 percent levels typical of the 1950s and early 1960s to 4 to 5 percent annual rates after 1967, middle income taxpayers recognized the impact of "bracket creep" on their disposable incomes. Conservative opposition leader Robert Stanfield made inflation indexing a major issue in early 1972.[50] Stanfield's promise to index tax brackets to inflation in the 1972 election campaign appealed to a growing public sentiment that governments should not profit from inflation at the expense of their citizens.[51]

While initially dismissed as political opportunism, Stanfield's proposal was adopted by Finance Minister Turner in his 1973 budget.[52] The minority Liberal Government of 1972-74 was caught between two fires -- that of "welfare" Liberals and the NDP opposition which held the balance of power in Parliament, calling for higher corporate taxes and social spending, and that of "business" Liberals and the Conservative opposition who hoped to achieve lower taxes and government spending restraint.[53]

Turner, thwarted in his role as "guardian of the public purse" by high-spending colleagues and Privy Council Office officials unwilling to concede Finance's primacy in determining economic policy, could not use the "windfall" tax revenues generated by inflation to reduce the deficit. Instead, Turner decided to "return" the inflation windfall to taxpayers through automatic indexing of tax brackets to the Consumer Price Index in the hope that his cabinet colleagues would not spend what they could not collect in taxes.[54] PIT

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[50] Stanfield, House of Commons, *Debates*, May May 15, 1972, 2267, quoted in in Gillespie, *Tax, Borrow and Spend*, 189.

[51] Stanfield, House of Commons, *Debates*, May 15, 1972, op. cit.; Hartle, *The Expenditure Budget System*, 78-81; Gillespie, *Tax Borrow and Spend*, 192-3.

[52] J.R. Allan, D.A. Dodge, and S.N. Poddar, "Indexing the Personal Income Tax: A Federal Perspective", 355-369; Douglas G. Hartle, *Political Economy of Tax Reform*, 151-178.

[53] Hon. John N. Turner, *Budget Speech*, February 19, 1973.

[54] Ibid.; Jack Cahill, *John Turner - The Long Run*, 168-69; 178-79.

indexation was accompanied by a series of popular tax concessions and reductions for individuals which removed 750,000 lower-income Canadians from the tax rolls altogether and proposed corporate tax cuts of 20% for manufacturers and small businesses in a measure held over from the 1972 budget.[55] As a result of these and other measures, the number of non-taxable individual PIT returns increased from 16.8 percent in 1970 to 35.5 percent in 1979.[56] (See Table 6-2)

TABLE 6-2
NON-TAXABLE PERSONAL TAX RETURNS AS PERCENT OF TOTAL

1970 - 16.8%	1974 - 23.0%	1978 - 38.5%
1971 - 22.7%	1975 - 29.2%	1979 - 35.5%
1972 - 22.2%	1976 - 28.6%	
1973 - 22.8%	1977 - 30.4%	

The dramatic growth of non-taxable returns after 1975 is attributable to two major factors: the growing number of lower-middle income taxpayers (50th to 80th income percentiles) whose tax deductions equalled or exceeded their incomes, and the broadened provisions for write-offs of self-employed business losses against other years' income after 1977.[57]

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55 Turner, *Budget Speech*, February 19, 1973; Cahill, ibid., 164-68; Perry, *A Fiscal History of Canada*, 71-72. "Should indexation occasion a long-run growth in personal income tax revenues below that necessary to finance a desired increase in real government expenditures, discretionary income tax increases could of course be imposed to provide the required revenues. Clearly, this process of explicitly legislated tax increases is superior from the point of view of accountability to taxpayers than is the alternative of relying upon a hidden 'inflation tax'." J.R. Allan, D.A. Dodge and S.N. Poddar, "Indexing the Personal Income Tax: A Federal Perspective", 369.

56 Author's analysis of taxation statistics: 1967-89.

57 Ibid.

Partial indexing was an extremely popular step at the time -- except perhaps with Finance Department officials who regretted its growing impact on the deficit.[58] The burdens of progressive income tax rates were offset by the rapid growth of tax preferences for middle and upper income Canadians. During the 1970s, while the federal tax base grew at an unprecedented rate, the total volume of tax preferences grew in direct proportion to the tax base. Total personal exemptions and deductions claimed from taxable income were 31.8 percent of assessed income in 1970, and remained virtually constant around 34 percent of assessed income between 1975 and 1984.[59]

Indexation was only one of a number of broadly-based tax measures introduced or expanded during the 1970s to facilitate private savings and capital formation. Successive Ministers of Finance took steps to expand the availability and contribution ceilings of pension and retirement savings plans[60] and, for corporate income, the expansion of the small business deduction for the vast majority of Canadian-owned businesses.

However, by its very nature, partial indexation also created a major precedent for the indexation or periodic inflation adjustment of a wide range of tax measures to compensate for inflation. This, in turn, led to growing political demands for equivalent treatment -- whether in the payment of taxes or the protection from taxes -- of all income groups and most kinds of economic activity so that tax policies would reflect more closely the

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58 An indication of indexing's political popularity is an assertion by Jim Brown, co-author of the Benson White Paper, that indexing was "the greatest reform of all in the taxation of the individual" and an "outstanding contribution to taxpayer rights". (James R. Brown, "Tax Reform - Six Years Later", from *Proceedings of Twenty-Ninth Tax Conference, 1977*, (Toronto, Canadian Tax Foundation, 1978), 47.) See also, Perry, *Background of Canadian Fiscal Problems*, for a different perspective.

59 *Taxation Statistics*, (Ottawa, Revenue Canada, annual).

60 Pension plan and RRSP contribution ceilings were increased by $ 1,000 and $ 1,500 respectively, effective the 1977 tax year. Perry, *A Fiscal History of Canada*, 298.

complexity and diversity of Canada's economy and society.

Client Politics and Tax Policy: 1972-78

The drift of the federal government away from a Keynesian framework for fiscal policy during the early 1970s was accompanied by a growing array of federal efforts to micro-manage the economy. Public expectations of an activist government meant, in effect, that non-intervention was not a serious political option during this period. As a result, governments responded by using a number of specific policy instruments at their disposal. These included tax incentives, direct and indirect subsidies to business to pursue various economic objectives, and government ownership through the creation or expansion of crown corporations. Often, a combination of these measures was used. For example, in the energy sector, the federal government established Petro-Canada as a crown corporation, expanded tax incentives for private oil and gas exploration and development, and introduced a variety of direct grant and subsidy programs with specific aims, such as to support conservation, stabilize prices and expand pipeline facilities.

The trend towards increased use of tax incentives or preferences as a preferred policy instrument can be explained on economic, technical and political grounds. Tax preferences were seen as a more economically neutral form of government intervention which did not make large areas of business activity conditional on prior bureaucratic approval. While this approach had important political benefits, including the support of a business community intensely suspicious of increased government scrutiny, it also increased the complexity of the tax system and the range of potential inequities in its treatment of different kinds of economic activity.

Tax professionals continued to comb through the Income Tax Act in search of inequities, anomalies, and inconsistencies after 1971. Their representations to Finance resulted in a series of technical amendments: 175 amendments in both 1972 and 1973, 146 in 1974, 75 in 1976 and 95 in 1977.[61] However, they also resulted in the progressive unraveling of the Benson tax reform act as taxpayers and their professional advisors sought to personalize the idea of tax equity -- arranging their affairs within the law "to pay as little tax as anyone else".[62] According to Turner, they

> "reflect(ed) a decision to roll back on unworkable sections of 'tax reform'. It was a deliberate decision."[63]

Business concerns over international competitiveness also spurred the growth of tax preferences, particularly for investments in resource and other capital intensive industries. Other groups argued for equivalent benefits in the name of equitable taxation to maintain their competitiveness and offset the impact of inflation on their tax burdens.

The politics of tax preferences benefited all Canadians in some way.[64] Based on a model of theoretical tax "purity", the volume of personal income "tax expenditures" rose from

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[61] St. Hilaire & Whalley, "Reforming Taxes: Some Problems of Implementation" in David Laidler, ed, *Approaches to Economic Well-Being*, (Toronto, University of Toronto Press, 1985), 211.

[62] Wolfe D. Goodman, "The Small Business Credit: A Critique of the Proposed Changes", *Canadian Taxation* 1(2), Summer 1979, 38-39; Marc Lortie, "The Double Taxation Controversy", *Canadian Taxation* 3(4), [Winter 1981], 228-229.

[63] Douglas G. Hartle, *The Revenue Budget Process...*, 22. See also Wolfe, "The Politics of the Deficit", 147.

[64] A summary of post-reform tax measures is found in J.A. Allan, S.N. Poddar and N R. LePan, "The Effects of Tax Reform and Post Reform Changes in the Federal Personal Income Tax, 1972-75", *Canadian Tax Journal* 26(1), Jan.-Feb. 1978, 1-30. The cumulative impact of the personal income tax measures of 1972-1975 was to reduce the relative tax burden on lower and middle-income Canadians. However, these were necessary if the 1971 broadening of the tax base were not to have resulted in major tax increases for virtually all middle and upper income taxpayers. (Ibid. pp. 9-17).

13.6 percent of total budget revenues in 1972 to 20.5 percent in 1977, compared with 11.6 percent and 13.3 percent respectively for corporate tax preferences.[65] (see Table 6-3)

The introduction of inflation indexing signalled a further shift from comprehensive income taxation towards the "real consumption" approach -- and opened the door to a series of tax preferences whose principal beneficiaries were savers and investors, the manufacturing and resource sectors, small business and regional development.[66]

TABLE 6-3
PERSONAL AND CORPORATE TAX EXPENDITURES: 1972-78[67]

	PIT Expenditures		CIT Expenditures	
	% growth vs. prev. year	% of total revenues	% growth vs. prev. yr.	% of total revenues
1972	--	13.6	--	13.6
1973	25.3	13.3	71.2	15.4
1974	47.5	15.1	39.1	16.6
1975	28.8	17.5	6.3	15.9
1976	15.4	18.6	-14.6	12.5
1977	13.0	20.5	9.3	13.3
1978	35.0	26.3	--	--

Even before the 1972 election, the newly appointed Finance Minister, John Turner, declared that his main political objective was to "restore the working relationship between business and government" by increasing incentives for job creation through private sector

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65 Maslove, Prince and Doern, *Federal and Provincial Budgeting*, (Toronto, University of Toronto Press, 1986), 87. The theoretical basis for the "tax expenditure account" is discussed in Chapter 8.

66 For a comprehensive accounting, see *Tax Expenditure Account*, (Ottawa, Department of Finance, December 1979). Finance's methodology is subject to a number of criticisms -- notably, its assumptions that the federal government would have reaped the full windfall benefit of inflation during the 1970s, and that certain measures were "tax expenditures" rather than structural adjustments to achieve "tax equity" between different groups of taxpayers. (See Roger S. Smith, "Tax Expenditure Analysis: Some Definitional Problems", *Canadian Taxation* 1(2), 19-22).

67 Maslove, Prince and Doern, *Federal and Provincial Budgeting*, 87. These calculations are based on a comprehensive tax base. Unlike those cited on p. 25, they include such items as inflation indexing, accrued capital gains and imputed income from owner-occupied homes in their list of tax expenditures.

investment rather than "government make-work programs".[68] Support for manufacturing and small business became the foundation of Liberal tax policies towards the business community.

The 1972 budget proposed, but did not implement, reductions in the corporate income tax (CIT) rate for manufacturers and processors from 49 percent to 40 percent and for small businesses from 25 percent to 20 percent. This was supplemented by accelerated depreciation allowances for manufacturing and processing equipment (the two year write-off), followed in subsequent years by the investment tax credit and the 3 percent inventory allowance designed to offset the impact of inflation on profits.[69] These provisions, taken together, proved an effective response to the American Domestic Import Substitution Corporation (DISC) program and other incentives and made Canadian investment opportunities in manufacturing during this period much more competitive with those in the United States.[70]

The growth of small business tax preferences answered a wide range of political and economic needs. Politically, lower taxes for small businesses, which are overwhelmingly Canadian and locally-owned, offset the potential political damage of being seen to favour a corporate sector dominated by large, foreign-owned firms. Small business owners bridled at the thought that large, capital-intensive corporations could accumulate tax preferences often not available to them, thereby paying lower effective tax rates. Newly organized under the leadership of groups such as the Canadian Federation of Independent Business, they pressed for equivalent recognition in the tax system. As a result, the

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[68] Cahill, *John Turner: The Long Run*, 154-55.

[69] Ibid., 157, 168-9; Perry, *A Fiscal History of Canada*, 70-72. Hon. John N. Turner, *Budget Speeches*, February 19, 1973, May 6, 1974, Nov. 18, 1974, (Ottawa, Department of Finance.)

[70] Cahill, *John Turner...*, 170-71; Perry, *A Fiscal History of Canada*, 70,1044

eligibility ceiling for the lower small business tax rate rose from $ 50,000 in 1971 to $ 100,000 in 1974, $ 150,000 in 1977 and $ 200,000 in 1981, along with a wide range of other changes beneficial to Canada's more than 800,000 small firms. The result, along with a sizable increase in the incorporation of small companies and the spread of aggressive tax avoidance schemes, was a high rate of employment growth among small firms, which accounted for more than 70 percent of net new employment during the 1970s.[71]

The slower growth rates and higher unemployment levels in Atlantic Canada and other resource development areas of Canada were a high priority for special government attention during the 1970s. Reforms to the Unemployment Insurance system designed to provide a de facto guaranteed annual income to areas of traditionally high unemployment ironically contributed to increased regional disparities by undermining work incentives and reversing market driven patterns of labour mobility. In addition to pumping hundreds of millions of dollars in regional subsidies into Eastern Quebec, Atlantic Canada and other depressed areas through the Department of Regional Economic Expansion and other programs, the Department of Finance provided exceptionally rich tax incentives for companies investing in areas of high unemployment. Jean Chretien, who was Minister of Finance between 1977 and 1979, summarized the government's thinking as follows:

> There are two particular areas where the Canadian government must provide incentives. The first is regional development. Without incentives, everything will tend to become concentrated in the industrial heartland of Central Canada. ... The second area ... is in helping Canadian companies to export their products.[72]

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[71] *The State of Small Business*, (Ontario Ministry of Industry, Trade and Technology, 1987), 67-80; Bernard Shinder, "The Taxation of Small Business: An Historical and Technical Overview", in *Symposium on the Simplification of the Small Business Provisions of the Income Tax Act*, (Toronto, Canadian Tax Foundation, July 11, 1983).

[72] Jean Chretien, *Straight from the Heart*, (Toronto, Key Porter, 1985), 95-96.

The delivery of economic benefits through the tax system had several benefits for both politicians and the business community as a whole. Business groups, in particular, preferred tax measures to direct subsidies because they provided a greater level of discretion in the timing and purpose of investments, and because they minimized the need for contact with a federal bureaucracy whose alien ways they neither understood nor appreciated. However, each of these political constituencies came to see its tax preferences both as a form of political and economic recognition within the tax system and as an acquired property right, reflecting Macpherson's observation on the evolution of property rights.

> The rise of the corporation as the dominant form of business enterprise has meant that the dominant form of property is the expectation of revenue. ... Its value as a property is its ability to produce a revenue. The property its shareholders have is the right to a revenue from that ability. ... A sharply increasing proportion of the individual's and the corporation's rights to any revenue at all depends on their relationship to the government.[73]

As the number and cost of tax preferences grew, supporters of expanded government services began to challenge what they saw as a double standard between persistent restraints in direct federal spending and rapid growth of "tax expenditures".[74]

While Finance Department officials increasingly shared these concerns and sought to curb the expansion of tax preferences,[75] the economy's sluggish growth, a volatile electorate and the imminence of a federal election in 1978 and early 1979 made it difficult to

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73 C.B. Macpherson, "The Meaning of Property", in Macpherson, *Property: Mainstream and Critical Positions*, (Toronto, University of Toronto Press, 1978) 8.

74 National Council of Welfare, *The Hidden Welfare System*, (Ottawa, November 1976), *The Hidden Welfare System Revisited*, (Ottawa, March 1979); Kenneth Woodside, "The Political Economy of Policy Instruments: Tax Expenditures and Subsidies in Canada", from M.M. Atkinson & M.A. Chandler, *The Politics of Canadian Public Policy*, (Toronto, University of Toronto Press, 1983), 173-197. See Chapter 8.

75 Hartle, *The Revenue Budget System*, 15; interview, senior Finance Department official. (ADM-1)

separate tax policy from the demands of brokerage politics.

Taxation and Electoral Politics: 1978-80

The federal government approached the end of its mandate in 1978 faced with a series of difficult political choices in balancing policies designed to control inflation, promote economic growth and curb the growing federal deficit. Trailing in the polls through most of 1978, the federal Liberals were in the unusual position of having to compete with opposition parties which had mapped out their proposed economic policies with considerable clarity.[76]

These issues could be dealt with in several ways: by pursuing a more restrictive fiscal policy involving higher taxes, more rigid spending constraints, or a combination of both; by attempting to protect selected groups either with targeted tax preferences or more comprehensive indexation; or by a more comprehensive system of regulatory controls, including a tax-based incomes policy (TIP).

The Liberals' emphasis on deficit reduction through spending cuts, while short-lived, was abruptly introduced by Prime Minister Trudeau in a nationally televised speech on August 1, 1978. Trudeau's speech announced plans for $ 2 billion in cuts from planned spending, new initiatives to spur domestic and foreign business investment, and greater selectivity in social services as part of a broader plan to increase the competitiveness of the Canadian economy in international markets.[77]

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[76] Simpson, *The Discipline of Power*, (Toronto, Personal Library, 1980), 59-65.

[77] Prime Minister's Office. Transcripts. "Notes for the Prime Minister's Address on National Television", August 1, 1978.

This package, which Trudeau had prepared without consulting his cabinet or any but his closest personal advisors,[78] was followed by a series of announcements by senior cabinet Ministers. Many spending "cuts" involved reductions in planned rather than actual spending.[79] One major exception was a series of proposed revisions to the Unemployment Insurance Act, including reduced benefits, increases in the number of weeks worked to qualify for benefits, and a tax "clawback" on UI benefits paided to individuals earning more than $ 22,000 per year.[80]

These changes were the most controversial feature of the planned spending reductions Unemployment Insurance had become a form of guaranteed annual income for much of Atlantic Canada, Eastern Canada, and single industry communities across the country. The proposed changes were originally intended to yield $ 580 million in savings in 1979-80 and $ 700 to 900 million in savings when fully implemented in 1980-81, some of which would have been recycled into improved training and labour adjustment programs. However, Employment Minister Bud Cullen's effort to strengthen the insurance elements of the program prompted a backlash within the Liberal caucus and a series of changes to reduce the proposals' impact on seasonal workers.[81] As much as any other factor, the Unemployment Insurance debate convinced the Liberal cabinet that large-scale reductions

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78 McCall-Newman, *Grits*, 236-7; Chretien, *Straight from the Heart*, 117-18; Interview, former PCO official. (D3)

79 *The National Finances*, 1978-79, (Toronto, Canadian Tax Foundation, 1979), 37-38.

80 Hon. Bud Cullen, "Statement on Proposed Amendments to the Unemployment Insurance Act", (Ottawa, Department of Employment and Immigration, September 1, 1978). The proposals were tabled in Parliament as Bill C-14, on November 2, 1978, amended in several areas in Committee hearings before receiving approval by Parliament and Royal Assent on December 22, 1978.

81 Cullen, "Statement", September 1, 1978; Department of Employment and Immigration, "News Release" (78-48) on First Reading of Bill C-14, (Ottawa, the Department, November 2, 1978); House of Commons, *Debates*, November 9, 1978, 2215-27, 2235-47; Paul G. Thomas, "The Role of National Party Caucuses", in Peter Aucoin, ed., *Party Government and Regional Representation in Canada*, (Toronto, University of Toronto Press, 1985), 96-97.

of federal spending carried a greater political cost than persistently high levels of deficit spending.

Jean Chretien's pre-election budget of November 1978 was a relatively conservative "stay-the-course" budget, reflecting the views of senior Finance Department officials that any economic stimulus had to be carefully targeted to avoid a resurgence of inflation.[82] The budget included a number of increases in investment incentives, primarily for resource, pulp and paper and housing firms. The manufacturers' sale tax was reduced from 12 percent to 9 percent for most products.[83] Chretien's limited efforts at closing loopholes, aimed at improving the targeting of tax incentives for small businesses introduced by his predecessors, provoked a protracted squabble with tax professionals and small business lobbyists, and a further series of complex amendments.[84]

The Conservative opposition had responded to Trudeau's August television speech by adopting a quasi-Keynesian agenda of budgetary stimulus and direct appeals for popular support through general and targeted tax reductions -- the most popular of which were the promises of mortgage interest and property tax deductibility, which were unveiled before a series of by-elections in October 1978.[85] The Tories' tax proposals were carefully

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82 Chretien, *Straight from the Heart*, 118-19; Michael A. Walker, "The Budget: Two Views", *Canadian Public Policy* V(1), [Winter 1979], 105-10.

83 Hon. Jean Chretien, *Budget Speech*, (Ottawa, Department of Finance, Nov. 16, 1978). The Federal Sales Tax reductions were an effort to stimulate consumption while avoiding the political fiasco which had accompanied the offer in Chretien's April 1978 budget to subsidize across-the-board reductions in provincial retail sales taxes when Quebec tried to substitute targeted reductions of its own. (For summary, see Millie Goodman, "Checklist", *Canadian Tax Journal* XXVI(3), May June 1978, 363-4.; Chretien, *Straight from the Heart*, 103-7.)

84 Robert Goodwin, *Report of Proceedings of the Thirtieth Annual Tax Conference, 1978*, (Toronto, Canadian Tax Foundation, 1980), 67-96; Richard Shead, Ibid., 275-291; Report on Bill C-37, Income Tax Act, Senate Banking Committee, *Proceedings*, Issue # 31, March 8, 1979, 6-7.

85 Jeffrey Simpson, *The Discipline of Power*, 59-65.

targeted at groups with large number of middle-class swing voters: to suburban homeowners with large mortgages, the promise of mortgage interest and property tax deductibility, to small businesses, more tax breaks for new business investment, and to investors and professionals, the elimination of capital gains on shares in Canadian companies. A general $ 2 billion tax cut was intended as a populist gesture to convey the impression that the Tories supported the interests of the average taxpayer against those of "the government".[86] While specific tax measures are rarely considered politically significant in the sense of shifting large number of votes, the PC mortgage interest proposal is credited with prompting a swing of 3 percent of voters in the close 1979 election.[87]

The NDP, its union allies, and much of the Canadian left wanted either to ignore inflation altogether or to cushion lower and middle income groups against its impact through comprehensive indexing. Its proposals failed to make much headway outside this limited constituency.

When the Tories took power as a minority government in April 1979, the economic promises which had been so appealing on the campaign trail were sharply curtailed in the face of Finance Department warnings about a worsening deficit situation, the 1979 round of OPEC-driven oil price increases and the cabinet's unwillingness to risk the political dangers of major spending reductions.[88] The debate over new tax incentives led to serious conflict between the new government and Finance Department officials whose

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86 Ibid.

87 Interview, Dr. Jim Gillies.

88 Simpson, *The Discipline of Power*, 210-231.

views of appropriate tax policy were sharply at odds with those of Prime Minister Clark and his senior advisors.[89]

Paradoxically, the appointment of economist Grant Reuber as Deputy Minister of Finance in August 1979 to replace career civil servant William Hood helped to defuse the conflict. Clark sought to restore the Department to its traditional position as the government's principal advisor on economic policy. Reuber enjoyed the confidence of the Prime Minister and his senior advisors that Hood had lacked -- a prerequisite to enjoying the independence of policy judgment necessary to strengthen the Department's position. Finance Minister John Crosbie proved to be a strong advocate in cabinet for the restrictive medium-term fiscal policies advocated by Reuber and the Department to deal with inflation and a persistent balance of payments problem.[90]

However, the most critical issue which shackled the Clark Government's freedom of action on fiscal and budgetary policy, and which ultimately brought down the government, was the rapid escalation of world energy prices in mid-1979. This resulted in a three-cornered conflict with the governments of Alberta and Ontario over energy pricing and revenue sharing. The federal government's seeming inability to achieve an energy agreement with Alberta which would balance the interests of energy producers and

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[89] Much of this conflict and the resulting mutual suspicion could be traced to the Conservatives' view of the appropriate role of a civil service allegedly "politicized" by the Trudeau Liberals, and the Department of Finance's proud tradition of independence and control over economic policy advice to the Government. It was reinforced by two key events: the dismissal of Deputy Minister William Hood in July 1979, and the Department's stubborn resistance to [illegible]ge interest and property tax deductibility on grounds of equity and cost. [Interviews, PMO, Department of Finance - PMO-2, ADM-1] The property tax measures were introduced as limited tax credits, rather than deductions, in September 1979. Bill C-20 received first reading on October 29, before the budget, but died on the order paper when the Clark government was defeated. (Dept. of Finance Releases, Sept. 17/79, Oct. 25/79).

[90] Wayne Cheveldayoff, "Inflation, payments deficit, jobless Crosbie's priorities in first budget", *The Globe and Mail*, June 26, 1979, B1; Interview, Dr. Grant Reuber]

consumers seriously eroded its popularity and perceived competence as managers of the national economy.[91]

The rapidly growing cost of subsidizing imported oil threatened to wreak havoc with the government's deficit projections.[92] In the absence of an energy pricing and revenue-sharing agreement with Alberta, Crosbie could not introduce a budget.[93] Meanwhile, the Bank of Canada had raised interest rates from 12 to 15 percent between the election of May 1979 and the December 1979 budget -- a reflection of rising inflation, increasing U.S. interest rates and the need to offset a growing Canadian balance of payments deficit. Under these circumstances, the "stimulative deficit" and other feel-good economic policies which had been a major element of the Conservatives' election strategy were replaced by warnings of the need for further economic restraint and new tax increases.

Pierre Trudeau's announcement of his retirement as Leader of the Opposition in November 1979 appeared to give Crosbie an opportunity to bring in a deficit-reducing budget, including higher gasoline taxes, despite the government's minority position in the House of Commons. Clark, Crosbie and their advisors did not expect a leaderless Liberal opposition to provoke an election over the budget, even with the government trailing by 20 percent in the polls. They expected that the government would be able to introduce another budget in 1980, containing more of its promised stimulative measures, to set the stage for an election in 1981.[94] They were wrong.

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[91] Simpson, *The Discipline of Power*, 178-205; Foster, *The Sorcerers' Apprentices*, 116-124.

[92] The Oil Import Compensation Program was introduced in 1973 to subsidize energy imports and maintain a single national price for oil. The federal government's "energy deficit" increased from $ 926 million in 1978-79 to $ 1,768 million in 1979-80 and $ 2,599 million in 1980-81. (*The National Finances*. 1978-79, 1979-80, 1980-81.)

[93] Interviews, Dr. Jim Gillies, Dr. Grant Reuber. Some tax measures, including the mortgage interest bill were introduced separately during the fall sitting of Parliament.

[94] Interview, former PMO official. (PMO-4)

Crosbie's budget of December 1979 presented three main themes: fiscal restraint and gradual deficit reduction, economic restructuring and energy development. It introduced a series of measures aimed at tying new revenue sources to specific policy objectives. For example, the budget's most visible measure, an 18c per gallon increase in the excise tax on gasoline, was intended to fund a National Energy Bank to finance new energy projects and related infrastructure development.[95] Similarly, rather than eliminating the capital gains tax or indexing it to inflation in response to sustained pressure from much of the business and investment communities, Crosbie proposed a Canadian Common Stock Investment Plan to encourage new investments in publicly-traded Canadian businesses.[96] The budget also contained a wide range of technical measures, many of which had been carried over from the November 1978 budget.[97] However, these proposals became a dead letter when the three opposition parties combined to defeat the budget in the House of Commons.

While the higher energy taxes were a major issue in the February 1980 election campaign which followed, the election was fought more on the general theme of leadership than on specific fiscal or tax policy issues.[98] Trudeau seized on the conflict between Alberta and

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[95] Hon. John C. Crosbie, *Budget Speech*, (Ottawa, Department of Finance, December 11, 1979), 10-13. For a discussion of the energy pricing and taxation negotiations which led to the budget, see Simpson, *The Discipline of Power*, 178-205.

[96] The plan was a targeted version of the PC campaign proposal to eliminate capital gains on the shares of Canadian corporations. It was designed to exempt investments placed in an RRSP-type fund from capital gains taxes until withdrawn from the fund. It was intended to promote new investment by removing part of the inflation penalty from capital gains taxes which often amounted to more than 100% of after-inflation gains. A modified version of this proposal was recycled in the June 1982 budget, and later implemented as the Indexed Security Investment Plan by Marc Lalonde in 1983.

[97] M. Goodman, *Tax Memo*, (Toronto, Canadian Tax Foundation, 1979).

[98] Harold Clarke, et al, *Absent Mandate*, (Toronto, Gage Publishing, 1990), 94-6, 140-3. "The real (Liberal) strategy was to coast to victory on the proven reliability of opinion polls, keeping Trudeau out of the limelight. In other words, the Liberals would do best by doing and saying as little as possible." Johnston, *Up the Hill*, 58.

the federal government during the campaign to highlight the difference between his centralized "nation-building" concept of federalism and the more decentralized "community of communities" advocated by Joe Clark and the Conservatives. The Liberals proposed an expansion of federal fiscal and regulatory powers as a direct response to the centrifugal forces of regionalism and Quebec separatism.

These proposals to shift the economic balance of power were a direct parallel to Trudeau's long-standing commitment to repatriate and reform the Canadian Constitution.[99] The fiscal and economic crisis which faced the revitalized Liberal government in 1980 offered a political opportunity to introduce radical changes to the economic constitution. Embodied in the National Energy Program of 1980 and the tax reform budget of November 1981, these changes were not long in coming.

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[99] *Toronto Star*, January 26, 1980, 1. The ability of Liberal campaign strategists to exploit the energy issue and the Ontario Conservative Government's harsh criticisms of the federal energy plan for failing to protect the interests of Ontario consumers were central to the Liberals' regaining 20 of the 23 Ontario swing seats lost in the 1979 election. Doern and Toner, *The Politics of Energy*, 5; Milne, *Tug of War*, 23-34; Simpson, *The Discipline of Power*, 350-352.

CHAPTER 7 - INFLATION, ENERGY AND THE POLITICS OF DEFICIT CONTROL -- THE THIRD NATIONAL POLICY: 1980-81

> Money is, with propriety, considered as the vital principle of the body politic; as that which sustains its life and motion and enables it to perform its most essential function. A complete power, therefore, to procure a regular and adequate supply of revenue, as far as the resources of the community will permit, may be regarded as an indispensable ingredient in every constitution.
>
> Alexander Hamilton[1]

INTRODUCTION

The Trudeau Government, which voters returned to office in February 1980, faced several concurrent problems that had proven themselves beyond the ability of successive federal governments to manage within the existing framework of fiscal, economic and tax policies. These included high and persistent inflation, spiralling energy prices, and steadily growing deficits which resulted from previous federal efforts to mitigate the impact of these and other economic problems on Canadians. The energy standoff, the looming Quebec referendum and Trudeau's own proposals for unilateral constitutional change led to federal-provincial confrontations on an even broader range of issues.

The Keynesian synthesis upon which the federal Liberals had built a durable governing coalition for most of the period since 1945 seemed incapable of addressing these mounting challenges which, taken together, posed a political and economic crisis sufficient to threaten the existing structure of Canada's economic constitution.

The federal government sought a new policy paradigm that would restore its economic power and political legitimacy. To do this, it needed a means of generating enough tax revenue to give it sufficient economic leverage both to promote a restructuring of the

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[1] Alexander Hamilton, "Federalist # 30", from *The Federalist Papers*, Clinton Rossiter, ed., (New York, Mentor Books, 1961), 188.

Canadian economy and to create a new "distributive coalition" capable of sustaining it in office. The economic elements of this strategy were the equivalent of a new National Policy -- the economic equivalent of the government's efforts to force through changes to the political constitution.

This chapter examines the factors which contributed to the political and economic crisis of 1980-82 and the Trudeau Government's resort to major tax reforms as part of a coordinated response to that crisis. It addresses the seemingly intractable problem of inflation and the Finance Department's efforts to square policies to restrain inflation with its traditional mandate of promoting economic growth. It outlines the ideas which influenced the development of the federal government's new National Policy, and the political coalition which the new government hoped to mobilize in support of its policies. Chapter 9 will examine the specific impact of these policies on the government's tax reform budget of 1981.

Managing Change in a Time of Crisis

The multiple crises facing the re-elected Trudeau Government in 1980 have been described as the "non-military equivalent of a five-front war".[2]

First, both domestic and international economic factors led to persistent and growing inflation which became increasingly disruptive to a wide range of economic relationships. The Bank of Canada's decision to parallel the highly restrictive monetary policies of Canada's major trading partners undermined many conventional policy assumptions and forced the federal cabinet to look for new ideas in its desire to reconcile popular demands

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[2] Donald V. Smiley, *The Federal Condition in Canada*, (Toronto, McGraw-Hill-Ryerson, 1987), 183.

for short-term economic growth with growing pressures for medium and long-term structural change.

Second, spiralling world energy prices, a major catalyst for inflation, also led to intense federal-provincial conflict over oil and gas pricing and revenue sharing, and its impact on the balance of fiscal, economic, political and constitutional power in Canada.

Third, federal-provincial conflicts over control of energy and economic development policies combined with the looming Quebec referendum on sovereignty to challenge the very political and economic legitimacy of the federal government. Existing institutional structures proved inadequate to contain or resolve these conflicts.

Fourth, the government's attempts to accommodate competing interests and retain electoral support throughout the 1970s had resulted in a growing federal budget deficit which threatened its ability to meet its political goals. On the one hand, the government faced political pressures to spend more to buy the political support of different regions, interests and voter groups. On the other, higher deficits threatened to fuel the inflation and higher interest rates that would choke off the economic growth necessary to achieve its economic objectives and win reelection.

Fifth, the government's efforts to come to grips with these problems during a period of declining economic growth inevitably led it into direct conflict with a wide range of societal interests which came to believe that the government could not pursue its declared objectives except at an unacceptable cost to their social and economic well-being.

The Liberal platform of 1980 was a striking attempt to mobilize the powers of the federal government in order to resolve this very challenge -- how to manage structural economic change in a society in which competing interest groups had mobilized to defend or enhance various economic advantages or "entitlements" enjoyed directly or indirectly as a result of government policies.

The National Energy Program of 1980 and the 1981 tax reform budget were conceived as efforts to break out of the dilemmas of slow economic growth, fiscal constraints on government and institutional deadlock. As outlined in the 1980 Throne Speech, "Canada's resource-base" was to become the foundation of "a vigorous industrial policy" that would "provide jobs, spur growth, improve regional balance and improve Canadian ownership and control of the economy".[3] Complementing its energy strategy, this commitment became the basis for efforts to design a megaprojects-based industrial strategy.[4] In turn, this strategy, though in its formative stages, could be used to justify the wholesale rationalization of tax incentives and subsidies as part of a comprehensive process of tax reform.[5] Such a strategy would be extremely difficult to implement in the absence of coordinated support from the Departments of Finance, Industry and Regional Economic Development, or without the active cooperation of major elements of the business community.[6]

The Trudeau government's unilateral efforts to change a number of vital institutional relationships through the National Energy Program and the 1981 tax reform budget were

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[3] Ibid., 6.

[4] *A Report by the Major Projects Task Force on Major Capital Projects in Canada to the Year 2000*, (Ottawa, June 1981).

[5] G. Bruce Doern, "Liberal Priorities: The Limits of Scheming Virtuously", in Doern, ed., *How Ottawa Spends: National Policy and Economic Development 1982*, (Toronto, James Lorimer, 1982). This vision was aggressively articulated by Liberal strategists such as Jim Coutts and enjoyed considerable support on the left-wing of the Liberal cabinet However, it lacked support from the senior officials at the Departments of Finance and Regional Economic Development whose responsibility it would have been to implement such a policy. (Interviews, former Deputy Ministers [D3, D5]); Christina McCall and Stephen Clarkson, *Trudeau and Our Times, Vol. 2: The Heroic Delusion*, (Toronto, McClelland and Stewart, 1994), 217-23.

[6] Interview, former Deputy Minister. (GFO)

the economic equivalent of the federal government's unilateral efforts at constitutional patriation. Instead of creating the basis for a new consensus on economic policy, they led instead to an intense political confrontation with business (and the provinces) without creating a countervailing coalition of interests that would have been necessary to win public support in the midst of an economic upheaval unprecedented since the Great Depression.

However, before addressing the National Energy Program and the political factors leading to tax reform, this chapter will examine the underlying dilemma of inflation and its impact on Canada's fiscal structure and economic policies.

INFLATION, THE DEFICIT AND TAX POLICY

> Another characteristic of the present economic environment is that it is a period of slow growth or slowth. Growth is the solvent which dissolves much of the potential conflict in a society that is increasingly conscious of redistributive norms -- the poor can become richer without the rich becoming poorer. Unfortunately, with slowth it becomes progressively more difficult to escape from the rigours of scarcity -- we are bound up at best in a zero-sum game and, after tax, often a negative-sum game.[7]

Inflation remained the most intractable economic problem facing the federal government from the autumn of 1975, when Prime Minister Trudeau announced the imposition of wage and price controls and the creation of the Anti-Inflation Board, until the summer of 1982, when Finance Minister Allan MacEachen partially deindexed personal income taxes as part of the "six and five" program of public sector controls.

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[7] Courchene, "The Citizen and the State, A Market Perspective", in George Lermer, ed., *Probing Leviathan: An Investigation of Government in the Economy*, (Vancouver, The Fraser Institute, 1984), 48.

The anti-inflation policies of the late 1970s and early 1980s challenged the prevailing political orthodoxy which had made economic growth and job creation the most important political priorities of successive post-war governments. Inflation and the policies intended to constrain it further destabilized the political and intellectual consensus surrounding economic and tax policies. They brought into the open a wide range of competing public expectations which were unsustainable in the absence of the surpluses generated by real economic growth. In the absence of adequate revenues resulting from economic growth, the deficit reduction policies necessary to help contain inflation became a zero-sum game, requiring a reallocation of real income and wealth from one function and group of interests to another, and implicitly, a change in the balance of institutional power.[8]

Inflation has been described as the "hot potato" of Canadian politics during this period.

> Since prices respond to costs which are somebody else's costs, the final result can only be higher inflation. ... We end up tossing the hot potato from one to another, and no one wants to be caught holding the thing when the game ends.[9]

The indexation of personal income tax rates, exemptions and selected transfer programs in 1973, together with repeated ad hoc adjustments to the tax system to offset "unfair" inflation-related taxes during the 1970s, were meant to eliminate the hidden or inflationary component of tax increases and reduce the political incentive to allow inflationary increases in federal spending. This policy was immensely popular, and arguably helped the federal government to avoid the middle-class anti-government

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[8] MacEachen, "Address, Conference Board of Canada", (Ottawa, Dept. of Finance, May 6, 1981); Lester Thurow, *The Zero Sum Society*; Ian A. Stewart, "Global Transformation and Economic Policy", from Thomas A. Axworthy & Pierre E. Trudeau, eds., *Towards a Just Society: The Trudeau Years*, (Markham, ON, Penguin Books Canada, 1990), 107-125.

[9] Hon. Allan J. MacEachen, "Address, Conference Board of Canada", (Ottawa, Department of Finance, May 6, 1981), 3.

backlash embodied in the tax revolts of California's Proposition 13 and its imitators in the United States in the late 1970s.[10] However, in the absence of effective political constraints on the growth of spending, the automatic revenue constraints resulting from indexing contributed to the steady growth of the federal deficit between 1974 and 1978 -- the so-called "scissors crisis in public finance".[11] (See Table 7-1)

The growing deficit was only one of the problems faced by the Department of Finance in attempting to design an appropriate response to the problems of inflation and slow economic growth.

TABLE 7-1

THE SCISSORS CRISIS IN CANADIAN PUBLIC FINANCE: 1974-81

	1974	1975	1976	1977	1978	1979	1980	1981
Inflation(CPI)	10.8%	10.8%	7.5%	8.0%	9.0%	9.1%	10.2%	12.4%
Real Federal Spending (1973 = 100)	115.8	129.8	131.5	138.1	141.4	139.3	146.8	154.0
Federal Spending as % of GDP	18.8%	20.8%	19.6%	20.3%	20.3%	19.1%	19.8%	20.3%
Federal Revenues (1973 = 100)	118.6	113.6	117.8	112.6	107.9	112.2	118.8	135.7
Federal Revenues as % of GDP	19.6%	18.6%	17.9%	16.9%	15.8%	15.7%	16.4%	18.3%
Surplus/(Deficit) as % of GDP	0.8%	(2.2%)	(1.7%)	(3.4%)	(4.5%)	(3.4%)	(3.4%)	(2.1%

(source: National Accounts, *Economic Reference Tables*, Department of Finance, August 1992.)

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10 John Bossons, "The Effect of Inflation-Induced Hidden Wealth Taxes", *Report of Proceedings from Thirty-Second Tax Conference*, (Toronto, Canadian Tax Foundation, 1980), 17.

11 Tarchys, "The Scissors Crisis in Public Finance". *Policy Sciences* 15 [1983], 205-24.

Inflation and the Tax System

> It is clear enough as a matter of principle that all assets and liabilities should be adjusted for changes in price level and that accretion should be measured in real terms. Yet it is hardly possible in practice to carry out all these adjustments. With minor exceptions such as inventory valuation, the income concept is, in effect, defined in money terms. In view of this, equity may be impaired rather than improved by piecemeal adjustments to all for price-level changes in selected parts of the system.[12]

The debate over the relationship between inflation and the tax system reflected the diverse mandate of the Department of Finance: to promote stable levels of economic growth; to collect adequate revenues to pay for the growing costs of government; to encourage the competitiveness of Canadian industry; and to maintain the equity and integrity of the tax system.

Neither the Carter Commission Report of 1967 nor the tax reform legislation of 1971 made provision for inflation adjustment in the income tax system. However, the growth of tax-driven inflation both as a significant economic issue and a source of political discontent made inflation adjustment one of the central tax policy issues of the 1970s and early 1980s.[13] The political arguments for indexation have already been discussed in Chapter 6. However, the persistence of inflation through the 1970s raised a host of technical arguments for the extension of indexation from personal income tax rates to other deductions and to the taxation of business and capital income as a whole.

Inflation imposes a large number of distortions on budgetary and tax policies and on a wide range of economic decisions. It reduces the relative value of unindexed exemptions

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[12] Richard A. Musgrave, *The Theory of Public Finance*, (New York, McGraw-Hill, 1959), quoted in Roger A. Smith, *Tax Expenditures: An Examination of Tax Incentives and Tax Preferences in the Canadian Federal Income Tax System*, Canadian Tax Paper # 61, (Toronto, Canadian Tax Foundation, 1979), 38.

[13] John F. Helliwell, "Inflation and Tax Reform", *Canadian Tax Journal* XVIII(2), [March-April 1970], 124-30; see also *Report of Proceedings of Thirty-Second Tax Conference, 1980.*

and deductions, and increases the relative tax burden on lower and middle-income earners.[14] It also artificially inflates business profits unless adjustments are made for the higher costs of replacing inventories and depreciable assets. It increases the difficulty of business planning because input costs often rise at differing rates. Inflation may result in effective tax rates of more than 100% by turning nominal capital gains into real capital losses on medium and long-term investments.[15]

The 50 percent valuation of capital gains for inclusion in taxable income was often viewed as a rough-and-ready offset for the impact of inflation on the value of long-term investments. However, it was also one part of a complex series of political and philosophical trade-offs made to facilitate the introduction of capital gains taxation in 1969-71.[16] As such, it remained a matter of controversy between those who saw the capital gains tax as a substitute for wealth and inheritance taxes, and those who saw it as a punitive form of income surtax.[17]

Each of these issues involved the Department in a running debate with private sector tax professionals, other federal departments, elements of the business community, and an

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[14] This was one of the major arguments in favour of the conversion of many deductions into tax credits. Smith, *Tax Expenditures*, 93-95. This concept, introduced through the Child Tax Credit amendments of 1978 (see below) were later generalized in the 1987-88 *White Paper* on Tax Reform.

[15] Smith, *Tax Expenditures*, 39-40.

[16] Douglas G. Hartle, *Political Economy of Tax Reform*, Discussion Paper # 290, (Ottawa, Economic Council of Canada, 1985), 56-84. Among the trade-offs meant to increase the political acceptability of the capital gains tax were the exemption for homeowners' principle residences (1971), (Hartle, ibid., 191) and the introduction of partial exemptions or "rollovers" for the first $ 200,000 on the transfer of small businesses or family farms to spouses or children. (1971, 1977)

[17] "Submission to the Department of Finance from Four Stock Exchanges and the Investment Dealers' Association", September 1974, cited in Hartle, ibid., 186-7; Royal Commission on Corporate Concentration, *Report*, (Ottawa, Supply and Services Canada, 1978), 274-6. For arguments in support of taxing nominal capital gains without regard to inflation, see Department of Finance, *Review of the Taxation of Capital Gains in Canada*, (Ottawa, The Department, November 1980).

assortment of social and tax policy advocates. Each group tended to view the income tax system from a substantially different perspective. There also appears to have been a lively debate within the Department, both on the role of the tax system in dealing with inflation, and on the likely impact of various measures proposed to correct the effects of inflation.[18]

The phasing-out of the Anti-Inflation Board controls in 1977-78 saw increased political pressures from the business and investment communities for further changes to the tax system to increase its competitiveness with those of Canada's major trading partners and to offset the punitive impact of inflation on business and capital gains taxation. Bossons estimates that 44% of federal Corporate Income Tax revenues in 1978-79 were the result of the inflation-induced overstatement of taxes.[19] Tax changes suggested included the indexing or even elimination of capital gains taxes,[20] full inflation-adjustment for inventory valuation,[21] matching selected foreign provisions for corporate financing and loss-sharing, and maintaining or even enriching the full range of capital investment allowances.[22]

Senior Departmental officials, particularly in the Tax Policy Branch, were determined to limit the spread of indexing and other inflation allowances despite appeals from the

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[18] Interviews, current and former Finance Department officials. (ADM-3, F02)

[19] John Bossons, "The Effect of Inflation-Induced Hidden Wealth Taxes", 32-33.

[20] Royal Commission on Corporate Concentration, *Report*, 275-6; Michael A. Walker, "Perspective on Capital Gains Taxation", *Report of Proceedings of Thirty-Second Tax Conference, 1980*, (Toronto, Canadian Tax Foundation, 1981), 535-49.

[21] Usually adoption of the U.S. LIFO (Last-in, first out) method instead of the Canadian FIFO (First-in, first-out) method, less 3% adjustment for inflation.

[22] W.A. Macdonald, "How Competitive is Canada's Business Taxation System", *Report of Proceedings of Thirtieth Tax Conference, 1978*, (Toronto, Canadian Tax Foundation, 1980), 6-14. Apart from being a respected tax lawyer, Macdonald was also a law partner and close friend of former Finance Minister John Turner.

business and tax professions to provide inflation protection for capital income comparable to the indexing of Personal Income Tax brackets.[23]

The Tax Policy Branch's handling of these issues after 1978 largely reflected the institutional values of the Department and its attempts to resist external pressures to adapt piecemeal or politically-driven responses to inflation. These include:

* the reassertion of Finance Department autonomy and control over the tax system and the revenue base against all comers;

* an emphasis on tax neutrality -- an effort to limit the use of the tax system to favour one group of taxpayers or form of economic activity over another, except where dictated by overriding reasons of equity; and

* increasing professional and staff resources to quantify the costs and benefits of new and existing tax preferences to advance the other two objectives.

A new tax analysis branch was established within the Department's tax policy branch to review the cost and economic impact of existing and proposed measures.[24] Senior officials of the Department commissioned studies on the cost and extent of tax preferences, the competitiveness of the Canadian tax system with that of the United States, and the role of capital gains taxation within the income tax system.[25]

Ultimately, the efforts of interest groups and tax theorists to build greater protection against inflation into the tax system were blocked by growing pressures from many of the

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[23] Interview, former Finance Department officials. (D3, ADM-1) See also *Tax Systems of Canada and the United States*, (Ottawa, Department of Finance, November 1978), and *A Review of the Taxation of Capital Gains*, 1980.

[24] The Quantitative Analysis Branch was formed in 1978 to study the economic impact and projected cost of individual tax measures. (Interviews, ADM-1, ADM-3, F03).

[25] Each of these initiatives reflected a conscious effort by the Department to retain control over the tax base and the terms of political discourse. Tax professionals were increasingly critical of selected tax measures which placed their clients at a competitive disadvantage with competitors in the United States. (Macdonald, "How Competitive is Canada's Business Taxation System".)

same groups to make deficit reduction a central element in the federal government's anti-inflation strategy.

This policy was embraced reluctantly by Prime Minister Trudeau in August 1978 and more enthusiastically by Conservative Finance Minister John Crosbie in his ill-fated budget of December 1979. Rising interest rates largely outside the government's control added a growing political urgency for some form of government action for most of this period. (See Table 7-5.)

The campaign promises of the Clark Government to introduce new inflation hedges into the tax system for homeowners and investors demonstrated the hardening of attitudes within the Finance Department. Mortgage interest and property tax deductibility were fiercely resisted by tax policy officials on grounds of cost, distributive equity and their potential to undermine the Bank of Canada's anti-inflationary high interest rate policies[26] Modest versions of the Conservatives' election proposals, modified to accommodate the technical criticisms of Department officials, were included in the Crosbie budget of December 1979, only to be discarded after the 1980 election returned the Liberals to power.[27]

The political and economic pressures to move towards a more restrictive fiscal policy, whether in the form of higher taxes, reductions in real government spending, or a combination of both, had to overcome a political culture still committed to the values and

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26 Simpson, *The Discipline of Power*, 130-1; 216-20; Interviews, Dr. Jim Gillies, senior Departmental officials (D6, ADM-1)

27 Hon. Allan J. MacEachen, *Debates*, House of Commons, April 21, 1980, 242-3. Two of these proposals were distinctly inflation-driven: mortgage interest and property tax credits, and the Canadian Common Stock Investment Plan. The latter, intended to shield new investments in Canadian equities from capital gains taxation until withdrawn from the fund, was the equivalent of an RRSP plan for equity investors. The CCSP was recycled in modified form into the Indexed Security Investment Plan (ISIP) introduced in the federal budgets of June and November 1982.

expectations of the previous generation. Given these expectations, a policy of gradual adjustment to changing economic conditions seemed the safest political course available to federal politicians.

GRADUALISM AND THE POLITICS OF STRUCTURAL ECONOMIC CHANGE

> The government was not about to turn the clock back. It was not about to undermine the level of security that Canadians had worked so hard to achieve. That is what gradualism is all about. It means making the transition to the new reality of the 1980s in the smoothest possible way.[28]

The political and economic crisis which faced the Trudeau government in 1980 was partly the result of forces beyond its control. However, it was also in large measure the result of its own failed policies and the political expectations it had helped arouse during the 1970s.

A large and growing share of the deficit was made up of "non-discretionary" elements in federal spending which had effectively passed beyond the control of the federal government as a result of unilateral policy decisions, federal-provincial agreements, international economic conditions, and the expansion of entitlement programs during the 1960s and early 1970s. These institutional factors, which included rapidly growing federal transfers to the provinces, compensation payments for imported oil and the growing cost of servicing the federal debt created powerful constituencies with a vested interest in the maintenance of existing levels of federal spending.

The process of partisan political competition during this period both fed and responded to public expectations that governments could and should simultaneously spend more and more money on public services and income transfers to protect Canadians from economic

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28 Hon. Allan J. MacEachen, "Speech", Canadian Club, Toronto, (Ottawa, Department of Finance, February 2, 1981), 7.

uncertainty and forego inflation-driven tax increases which would erode the average citizen's standard of living. All major political parties had fostered the idea that that change, if it could not be avoided altogether, could be made as painless as possible through skillful government intervention.

Thus, while other major industrial nations were forced to resort to economic shock-therapy in adjusting to international economic disruptions, Canadian Finance Ministers hesitated to incur the political and economic costs of such policies: higher unemployment, greater social dislocation and the potential for a political backlash from those voters and interests most directly affected. Instead, Finance Ministers deferred to their political instincts and attempted to introduce structural change by a gradual, incremental process.[29] This policy of *gradualism* involved three major elements:

- the slow harmonization of fiscal and monetary policies to minimize the economic disruption resulting from anti-inflationary policies;
- the gradual transfer of resources towards areas of greater economic potential to assist the restructuring of the Canadian economy; and
- the insulation of politically sensitive or volatile constituencies, particularly regions of chronically high unemployment, against an "excessive" share of the costs of economic adjustment.

These policies often involved avoiding difficult choices and subsidizing gradual adjustments to pressing economic problems, usually with borrowed money. Income tax indexing, wage and price controls, regional development subsidies, the Conservatives' promise of mortgage interest deductibility for home owners and the Liberal Party's 1980

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[29] It is not coincidental that all three Finance Ministers during this period, Jean Chretien, John Crosbie, and Allan MacEachen came from areas of chronically high unemployment and dependence on government subsidies; 79 of the Liberal government's 141 MPs in the 1974-78 Parliament and 103 of 147 Liberal MPs in the 1980-84 Parliament came from areas of chronically high unemployment in Atlantic Canada, Quebec and Northern Ontario. *Canadian Parliamentary Guide*, (Toronto, Globe and Mail Publishing, 1976, 1981.)

campaign against John Crosbie's 18 cent gasoline tax were all policies intended to defer or cushion the impact of economic change.

Thus, the tax policy agenda of the federal government during this period was set largely by partisan political considerations. The growing demands of federal spending commitments and public resistance to higher direct taxation generally outweighed the political pressure to constrain a growing federal deficit.

Conservative Finance Minister John Crosbie acknowledged the political limits of economic change in a speech just before his 1979 budget.

> Our economy is too large and complex to expect immediate success in dealing with any of these fundamental difficulties. As with our goal of energy self-sufficiency by the 1990s, it makes sense over a decade: to try to achieve it in two or three years would be madness.[30]

Elected on a platform which rejected Crosbie's program of "short-term pain for long-term gain" as "the most regressive (budget) since R.B. Bennett shook hands with Calvin Coolidge",[31] MacEachen inherited the same problems of domestic and imported inflation with even less inclination to constrain federal spending.

> Inflation is a number one concern. Does this mean that I worry less about unemployment, that I have abrogated my Liberal ideals? So there will be no doubt about this, let me assure you that it was to create jobs, improve living standards and promote greater equity that I took on the position of Minister of Finance.[32]

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30 Hon. John C. Crosbie, "Speech", in *Report of Proceedings of Thirty-First Tax Conference, 1979,* (Toronto, Canadian Tax Foundation, 1980), 598. MacEachen expressed similar sentiments in several speeches attempting to promote his even more gradualist policies on several occasions. MacEachen, *Budget Speech*, October 28, 1980, 3; House of Commons, *Debates*, January 16, 1981, 6283; "Address", Canadian Club, Toronto, (Ottawa, Department of Finance, February 2, 1981), 7.

31 Pierre Trudeau, quoted in John Honderich, "Tight fists beat the bogey of public debt", *Toronto Star*, January 26, 1980, A1.

32 Hon. Allan J. MacEachen, "Speech", Halifax, NS, (Ottawa, Department of Finance, September 8, 1980), 3.

A policy of fiscal gradualism in combating inflation was even more critical for MacEachen than for his predecessors. The major structural changes contemplated in the Liberal program would take time to design, implement and yield the desired economic results. The short-term impact of anti-inflationary policies -- whether constraints on the spending initiatives of cabinet colleagues or higher taxes on middle class taxpayers already squeezed by the effects of inflation and high interest rates -- could not create such a severe economic shock that the government's structural reform policies would be discredited and the government forced to seek a new political accommodation with the business community.[33] Ironically, this is precisely what happened when record interest rates and the tax increases in the 1981 budget provoked the country's slide into a massive recession.

If Canadian political realities seemed to indicate a cautious approach to structural economic change, fiscal and economic pressures demanded that the federal government locate new sources of revenue to reduce its deficit, lower inflation and allow for reductions in the unprecedented levels of interest rates -- all without undermining the government's electoral coalition.

Liberal Party strategists viewed this dilemma as an opportunity to redesign the political agenda of Canada's "natural governing party" and to restore the federal government to its proper leadership role in Canadian society.

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[33] Hon. Allan J. MacEachen, "Speech", Canadian Club, Toronto, (Ottawa, Department of Finance, February 2, 1981), 7.

THE LIBERAL PROGRAM OF 1980 - TOWARDS A NEW NATIONAL POLICY

When the Liberals returned to power in 1980, Prime Minister Trudeau and his advisors interpreted the election results as a repudiation of the politics of restraint attempted during the late 1970s and a mandate to carry out a program of centralizing political and economic power in the hands of the federal government.[34]

Trudeau's 1978 program of fiscal restraint and increased support for business investment had done little to restore Liberal support within the business community or to build consensus on economic policy.[35] The government's perceived conservatism had cost the Liberals support in marginal seats seriously contested by the NDP in the 1979 election -- particularly in Western Canada and the industrial cities of Ontario. Trudeau's political strategists perceived the future of the Liberal Party as being dependent on a coalition of voters and interests heavily reliant on government intervention as a source of economic security, social mobility and status. These included not only the party's traditional base in Quebec and the "bilingual belt" of Ontario and New Brunswick, but the educated "new middle classes" centered in major cities and dependent on the broader public sector for employment, industrial workers and farmers seeking protection from the vagaries of the marketplace through expanded social programs and supply management.[36] Trudeau and his political advisors concluded that the government was unlikely to attract any significant business support for measures designed to solidify this political base while addressing the

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[34] Donald Johnston, *Up the Hill*, (Montreal, Optimum, 1985), 53-68.

[35] "The effort to cultivate business support for a revised menu of economic policies, through a steady stream of tax reductions, was both costly and ineffective." Ian A. Stewart, "Global Transformation and Economic Policy", 119.

[36] McCall and Clarkson, *Trudeau and His Times*, Vol. 2, 145-6, 157-9.

country's pressing economic problems. Therefore, it made little political sense for the government's economic policies to be conditional on business support.[37]

> The lesson drawn by ... senior Liberals was that the Liberals had lost the support of the business community, and therefore the broad policy structure of the government should be developed without any illusion that they could win the support of the business community.[38]

Bruce Doern calls the 1980 Liberal program "the most coherent assertion of political belief and principle by the Liberals since the early years of the Pearson government".[39] The Liberal election platform of 1980 proposed a further expansion of federal fiscal and regulatory powers as a direct response to the centrifugal forces of regionalism and Quebec separatism and as a direct parallel to Trudeau's long-standing commitment to the repatriation and reform of the Canadian Constitution.[40] According to his former Principal Secretary, Tom Axworthy, a major architect of the new strategy,[41]

> Mr. Trudeau made the concept of a national will and a strong central government to represent it a centerpiece of his approach to governance. ... Under his direction, the Liberal Party became a proponent of Canadian independence leaving the continentalist impulse to the Tories. Confronting the enormous power of the foreign multinationals, or the dimensions of cultural importation, or the hegemony of the superpowers on the paramount issue of arms control, Mr. Trudeau initiated corrective

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[37] Johnston, *Up the Hill*, 61-65. A more conciliatory attitude towards business was visible in the views of some English-speaking cabinet ministers and MPs, notably Treasury Board President Don Johnston, Alberta Senator Bud Olson, and rookie MP Jim Peterson, whose parliamentary task force produced a strongly pro-business report on Regulatory Reform. However, they tended to represent a minority view within Cabinet and caucus until the 1982 recession made conciliation with business a political necessity.

[38] Interview, former senior PCO, Finance Dept. official (D3).

[39] G. Bruce Doern, "Liberal Priorities 1982: The Limits of Scheming Virtuously", in Doern (ed), *How Ottawa Spends Your Tax Dollars*, 1.

[40] *Toronto Star*, January 26, 1980, 1. The ability of Liberal campaign strategists to exploit the energy issue and the Ontario Conservative Government's harsh criticisms of the federal energy plan for failing to protect the interests of Ontario consumers were central to the Liberals' regaining 20 of the 23 Ontario swing seats lost in the 1979 election. Doern and Toner, *The Politics of Energy*, 5; Milne, *Tug of War*, 23-34; Simpson, *The Discipline of Power*, 350-352.

[41] McCall and Clarkson, *Trudeau and His Times*, Vol. 2, 158-61.

> action. He used the powers of the state to balance the equation: CDC, FIRA, a strengthened CRTC, Petro-Canada and the NEP are part of this legacy.[42]

Donald Smiley has described this strategy as a Third National Policy. Trudeau and his advisors viewed the separatist movement in Quebec, the "province-building" economic strategies of other provincial governments, and the entrenched resistance of business groups to increased government control over the economy in much the same light -- as encroachments of narrow interests on the federal government's ability to pursue policies in the interests of the nation as a whole.[43] The new government's priorities had been outlined by Trudeau during the campaign, and were clearly reflected in its Throne Speech of April 1980. It directly linked the government's economic initiatives with its campaign to preserve national unity against the forces of Quebec separatism and self-aggrandizing provincial governments. Constitutional reform was to be accompanied by changes in Canada's economic constitution.

> The forces of disintegration -- whether they be economic or political in origin -- must be opposed in every part of the land.[44]

It linked "security of energy supply at a fair price for all Canadians"[45] with the nation-building railway policies of the 1880s[46] -- evoking images of the original National Policy.[47] Smiley comments that

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[42] Tom Axworthy, "After 1984 -- A Liberal Revival", *Canadian Forum*, [November 1984], 6.

[43] Milne, *Tug of War*. Most of these groups responded that the federal government was incapable of distinguishing its own institutional interests and those of its Central Canadian supporters from a broader concept of the national interest.

[44] House of Commons, *Debates*, April 14, 1980, 4-5

[45] Ibid., 4.

[46] Ibid., 5.

[47] Donald V. Smiley, *The Federal Condition in Canada*, 178-84.

> the common impulse behind the various elements of the Third National Policy was that of countering the provincializing influences in the Canadian polity and economy by making the federal government more pervasive and visible in the lives of individual citizens and thus to reinforce the allegiance of citizens to the national political community.[48]

A senior public servant involved in the process has described the development of an industrial strategy linking major changes to energy, tax and economic development policies as a "political initiative" emerging from cabinet and the Prime Minister's Office after the 1980 election campaign.[49] It was driven by four major factors:

- the failure of the policy coordination activities of the 1970s to evolve a coherent set of industrial policies;
- a continuing effort to reconcile the efficient promotion of economic development with the redistribution of economic growth to poorer areas through direct government intervention;
- an increased emphasis on the "equity" and "fairness" considerations of structural change, which were held to require strong and interventionist economic leadership by the federal government; and
- the perspective, held by Finance Minister MacEachen and others, that the distribution of economic development incentives through the tax system was less efficient than a system of targetted subsidy and expenditure programs, and did not provide the government with sufficient political credit relative to their cost.[50]

Further changes in federal-provincial revenue-sharing, economic development and social programs would enable the federal government to develop a more direct economic relationship with Canadians in all regions of the country.[51] Fiscal surpluses from new energy pricing and revenue-sharing arrangements with the provinces would give Ottawa the leverage to direct public and private investment to areas of long-term growth

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[48] Smiley, ibid., 181. The emphasis on the visibility of the federal presence is a continuing refrain in the public and private comments of Liberal Ministers and backbenchers during this period. (Interviews, M4, M5).

[49] Interview, former Deputy Minister. (D7) See also, McCall and Clarkson, *Trudeau and Our Times, Vol. 2*, 150-61.

[50] Ibid.

[51] House of Commons, *Debates*, April 14, 1980, 6; Doern, "Liberal Priorities 1982:...", 14.

potential.[52] Thus, the restructuring of Canada's system of taxes on energy production and consumption became the lynchpin for the new National Policy.

Energy Taxes, Federal-Provincial Conflict and the National Energy Program of 1980

Energy policies were the focal point of the Liberals' first year back in office after the 1980 federal election, reflecting the impact of the continuing spiral of world oil prices and the ongoing conflict with Alberta over energy pricing and taxation. If restaining inflation while still promoting economic growth was the most intractable economic challenge facing the federal government between 1975 and 1980, after 1980 the political and fiscal crisis created by world oil price shocks of 1979-80 became its most serious challenge.

The Liberal policy was intended to favour energy consuming provinces, which had voted against higher oil prices and taxes in the 1980 election. This ran directly counter to the interests of the energy producing provinces and the oil industry, which had few advocates within the Liberal cabinet or caucus.[53] This was a conscious departure from the Liberal Party's traditional posture of presenting itself as the party of national unity on economic and social issues as well as regional and linguistic issues.[54] This shift was cloaked in the language of "sharing" and "national unity", but it was clearly intended to shift the balance of political and economic power from the provinces and the private sector to the federal

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[52] "One thought one saw in 1980 the solution to the structural deficit problems and ... government savings which could fund the energy megaprojects." Interview, former Deputy Minister of Finance. (D3)

[53] Interviews, M4, M5. The Liberals had elected only two MPs west of Ontario in 1980 -- none west of Winnipeg.

[54] A former Liberal cabinet minister put it bluntly. "There were only 19 seats in Alberta, and none of them elected Liberals. Next time, we'll just lose them by more votes." (Interview, former Liberal cabinet minister, MP) (M4)

government.[55] John McDougall comments that the National Energy Program owed its "existence to a 'once-in-a-lifetime' conjunction of international events and domestic circumstances."[56]

Energy taxation and development policies during the 1970s had reflected a careful balance on two levels -- between areas of federal and provincial jurisdiction, and between the interests of energy producing and energy consuming provinces. These interests became increasingly divergent as world oil prices increased. When world oil prices increased from about US$ 2.59 per barrel to US$ 11.65 per barrel[57] after the 1973 Arab-Israeli War, the federal government used its powers over interprovincial trade to set a blended price for oil and natural gas well below the world price. It levied an export tax on exported crude oil and natural gas and used the proceeds to subsidize purchases of imported oil in Quebec and Atlantic Canada.[58] When Ottawa attempted to limit the deductibility from income taxes of increased provincial royalties and reduced the annual write-off on energy industry development costs, the rapid drop in exploration and development forced both federal and provincial governments to reduce their tax

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[55] Milne, *Tug of War*; Marc Lalonde, "Riding the Storm: Energy Policy 1968-84" in Axworthy & Trudeau, *Towards a Just Society*; Ian. A. Stewart, *Minutes*, Senate Committee on National Finance, May 27, 1980, 24-29; MacEachen, "Speech", Halifax, NS, (Ottawa, Department of Finance, Sept. 8, 1980), 3-7.

[56] John N. McDougall, "Natural Resources and National Politics" in Doern, ed, *The Politics of Canadian Economic Policy*, (Toronto, University of Toronto Press, 1985), 171.

[57] Lalonde, "Riding the Storm: Energy Policy 1968-84", 54.

[58] J. Harvey Perry, *Background on Current Fiscal Problems*, Canadian Tax Paper # 68, (Toronto, Canadian Tax Foundation, 1982,) 133. The National Oil Policy of 1961 created the so-called Ottawa Valley line. Consumers in Quebec and Atlantic Canada would use (then) cheap imported oil, while the consumers of Ontario and Western Canada provided a guaranteed market for the oil producers of Alberta and Saskatchewan. Simeon and Robinson, *State, Society and the Development of Canadian Federalism*, (Toronto, University of Toronto Press, 1990), 236.

demands.[59] The only other major federal energy-specific tax before 1978 was the excise tax on gasoline.[60]

The federal government gradually allowed the Canadian price of oil and gas to increase to about 80 percent of the world price between 1975 and 1979.[61] This was partly in response to political pressures from oil-producing provinces and partly an effort to reduce the net cost of its Oil Import Compensation Fund. However, the fiscal costs of energy price gradualism became untenable when world oil prices shot from US$ 14.20 per barrel in January 1979 to US$ 29.27 per barrel a year later and the Carter Administration persuaded Congress to deregulate oil and natural gas prices.[62] The ten-fold increase in world oil prices between 1973 and 1980 amounted to a fundamental challenge to Canada's economic and political order.

The conventional economic wisdom of the 1990s might suggest that Canada should have followed the United States in moving to world oil prices, perhaps capturing a portion of the resulting economic rents through a windfall profits tax as did the Americans. McDougall argues that such a policy would have been politically risky for a government dependent mainly on the political support of energy consumers, especially given the high visibility of energy prices to consumers, Canadians' high energy consumption levels (traditionally subsidized by governments), and the geographic separation of the vast

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59 *The National Finances, 1980-81*, (Toronto, Canadian Tax Foundation), 2.

60 As part of a 1978 agreement with Alberta, the federal government imposed a 10 cent per barrel excise tax on all domestic and some imported oil to finance development of the Syncrude tar sands project in Alberta. This was increased sharply in 1980 before being replaced by a range of taxes under the National Energy Program. Lalonde, "Riding the Storm", 59.

61 Ibid., 240.

62 Energy Information Administration, *Historical Monthly Energy Review*, (Washington, DC, U.S. Department of Energy, 1989), 211.

majority of Canadians "whose exclusive interest in energy is in its consumption" from the minority "whose primary interest is in its production".[63]

The energy price shocks of the 1970s led to a massive redistribution of wealth and income within Canada.(See Table 7-2).

TABLE 7-2
CHANGES IN RELATIVE PROVINCIAL GDP : 1971-86
(Canada Average = 100)

	Quebec	Ontario	Sask.	Alta.	B.C.
1971	90.1	117.8	84.4	106.4	105.1
1973	87.9	115.5	87.6	115.1	109.6
1974	86.6	112.3	99.9	134.1	106.6
1978	89.5	106.8	96.6	142.1	108.9
1980	87.9	104.1	101.5	155.7	110.2
1981	86.2	102.6	104.3	156.2	111.6
1982	87.1	101.8	101.9	154.8	108.7
1986	90.7	111.2	86.3	122.2	98.7

SOURCE: *Economic and Fiscal Reference Tables*, (Ottawa, Dep't. of Finance, September 1994), 16.

Under existing energy pricing a taxation rules, the federal government was limited to less than 10 percent of oil and gas sector revenues while it bore a disproportionate share of the economic adjustment costs.[64] For example, the cost of the Oil Import Compensation Fund increased from $ 157.4 million in 1973-74 to more than $ 3.1 billion in 1980-81 -- a subsidy of $ 21.00 per barrel.[65] The total federal government's "energy deficit" increased from $ 331 million in 1975-76 to $ 2.6 billion in 1980-81. (See Table 7-3) The giant foreign-owned firms who dominated the refining and distribution of oil and

[63] McDougall, "Natural Resources and National Politics", 172.

[64] The federal share of energy revenues in 1979 was 8.8 percent. Lalonde, "Riding the Storm", 64. While federal revenues increased from $ 182 million in 1973 to $ 876 million in 1978, the provincial share increased from $ 681 million to $ 4.3 billion during the same period, triggering a major increase in federal equalization payments. Simeon & Robinson, *State, Society and the Development of Canadian Federalism*, 240.

[65] *The National Finances 1980-81*, (Toronto, Canadian Tax Foundation, 1981), 12; *Public Accounts of Canada*, 1981-82.

gasoline at this time and the "blue-eyed sheiks" of the Alberta Government who had received the lion's share of economic rents from high world prices were convenient political targets under such circumstances.

TABLE 7-3
FEDERAL ENERGY TAX REVENUES AND EXPENDITURES: 1975-83
(in $ millions)

	Energy revenues	Energy-related expenditures	Surplus/ (Deficit)
1973-74	$ 286	$ 555	($ 269)
1974-75	$ 1,669	$ 1,656	$ 13
1975-76	$ 1,488	$ 2,297	($ 809)
1976-77	$ 1,261	$ 1,738	($ 477)
1977-78	$ 960	$ 2,073	($ 1,113)
1978-79	$ 844	$ 1,676	($ 1,769)
1979-80	$ 1,571	$ 3,244	($ 1,673)
1980-81	$ 2,902	$ 5,709	($ 2,807)
1981-82	$ 7,082	$ 5,752	$ 1,330
1982-83	$ 8,784	$ 6,736	$ 2,048
1983-84	$ 5,951	$ 5,449	$ 502
1984-85	$ 6,675	$ 6,445	$ 230

[SOURCE: *Public Accounts of Canada; The National Finances*, (Toronto, Canadian Tax Foundation, 1973-74 - 1984-85)

However, the federal government's half-measures in adapting to high world oil prices during the 1970s left both energy producing and consuming provinces bitterly dissatisfied. Ontario charged that allowing the oil industry and the producing provinces to reap a windfall profit from higher world oil prices would "rip the country and the economy apart".[66] Alberta argued that any change to jurisdiction over energy taxes would be a "clear attempt to alter the basic arrangements of Confederation by tampering with provincial ownership rights",[67] and that Ottawa's refusal to move to world prices

[66] Ontario Treasurer Frank Miller, quoted in Richard Simeon, "National Resource Revenues and Canadian Federalism: A Survey of the Issues", *Canadian Public Policy* VI(1), Winter 1980, 183.

[67] Ibid., 184.

was forcing the energy-producing provinces to provide a massive subsidy to the rest of the country.[68]

The Clark Government's difficulties in brokering a new energy pricing and taxation agreement satisfactory to both the governments of Alberta and Ontario, the main energy producing and consuming provinces respectively, were central to its loss of political credibility and the Tories' subsequent defeat in the 1980 federal election.[69]

The debate over energy policy rehearsed most of the subsequent conflicts over constitutional reform. Did provincial ownership of resources require that any changes to federal and provincial roles be negotiated as the product of a federal-provincial consensus? Or did the federal government have the right to take unilateral action in areas of disputed jurisdiction in order to enforce its view of the national interest?[70]

The Liberal's new Energy Minister, Marc Lalonde, was one of the few cabinet ministers of the Trudeau "Restoration" who had taken the time while in opposition to develop detailed policy alternatives and to build support for them with the Prime Minister, his caucus colleagues and the Liberal Party as a whole.[71] After the 1980 election, Lalonde and a small handful of officials from the Energy and Finance Departments fleshed out the details of a comprehensive energy strategy which would combine the Liberal campaign promises of greater Canadian ownership, oil and gas prices lower than those contemplated

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68 The Economic Council of Canada estimated that in 1980 alone, Canada's refusal to move to world prices resulted in a $ 12-15 billion loss to the Alberta treasury. Simeon and Robinson, *State, Society and the Development of Canadian Federalism*, 238.

69 Doern & Toner, *The Politics of Energy*, 5; Lalonde, "Riding the Storm", 61; interview, Dr. James Gillies.

70 Simeon, "National Resource Revenues and Canadian Federalism", 184-85.

71 Interview, Hon. Roy MacLaren; see also, McCall and Clarkson, *Trudeau and Our Times, Vol. 2*, 148-57.

by the Clark Government, a larger federal revenue share, and long-term security of supply.[72]

Doern and Toner have described in detail how the "ENFIN" (Energy and Finance) Task Force became the equivalent of a temporary central agency, developing what became the National Energy Program outside the regular cabinet and departmental policy channels.[73] Energy was given a separate revenue and spending envelope in the budgetary process. This allowed Lalonde and his officials to bypass the Economic Development Committee of Cabinet, and to deal directly with Trudeau's Priorities and Planning Committee. ENFIN's power was reinforced by Lalonde's close political relationship of almost 20 years with Trudeau, his mastery of the policy process, and his personal and intellectual dominance in both cabinet and the Liberal caucus. Moreover, MacEachen and his Deputy, Ian Stewart, a former Deputy Minister at Energy, provided institutional support for this circumvention of normal bureaucratic procedures by agreeing to incorporate the energy plan as the centrepiece of their 1980 budget. This not only guaranteed the secrecy of the process, but also insulated it from potential internal criticism or dilution by Lalonde's cabinet colleagues and their senior officials.[74]

The National Energy Program, unveiled in Finance Minister Allan MacEachen's budget of October 28, 1980, sought to address the government's need for additional revenues to

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[72] Doern & Toner, *The Politics of Energy*, Chapter 2; McCall and Clarkson, *Trudeau and Our Times, Vol. 2,* 170-75.

[73] Ibid, 41-43, 300-306.

[74] Ibid., 174. McCall and Clarkson describe Stewart's approach in preserving Finance's institutional control over this policy process as "a reverse take-over of his department's political competitors".

finance economic restructuring and deficit reduction. It became a model and an impetus for the government's national economic strategy.[75]

The National Energy Program combined a range of tax, spending and regulatory measures intended to assert federal control over the price of oil and gas, the balance of federal and provincial revenues, the incentive structures for energy development, and the ownership of the Canadian oil industry. These measures amounted to a unilateral change in the constitutional balance of power over natural resources and a direct challenge to the conventions of federal-provincial negotiations in areas of overlapping jurisdictions. While Lalonde expected that negotiations with Alberta and the other producing provinces would be necessary to implement the government's agenda in full, he sought to strengthen his political bargaining position by taking a preemptive strike that would allow Ottawa to control the public agenda.

The NEP projected a steady series of increases in world oil prices that would permit Canadian oil prices to double within five years, while still maintaining a discount of almost $ 20 per barrel from world prices. It set a blended price for oil and gas found from different sources by combining a lower price for conventional oil and gas production, with near-world prices for heavy oil (tar sands) and frontier oil and gas production. This was intended to shift a major share of the industry's exploration and development activities from Alberta to frontier lands under direct federal jurisdiction. In addition, a new differential pricing system for natural gas would encourage large-scale consumer conversion to the latter.

The 1980 budget also introduced a range of new energy taxes -- mainly the Petroleum Gas Revenues Tax (PGRT) and the Natural Gas and Gas Liquids Tax (NGGLT) -- which were

[75] Hon. Allan MacEachen, *Budget Speech*, October 28, 1980; Canada, Department of Energy, Mines and Resources, *The National Energy Program*, (Ottawa, The Department, October 1980)

excise taxes levied on net production revenues rather than income taxes levied on corporate profits. These were a direct federal attack on a traditional area of provincial tax jurisdiction, and provoked a bitter federal-provincial conflict which led the Alberta Government to impose production cuts on the industry as a way of enforcing its fiscal and regulatory authority.[76] A new Petroleum Compensation Charge levied on consumers effectively offset this response by providing an alternative source of revenues to pay for the increased costs of imported oil.[77]

The objective of these taxes was to increase the federal share of energy revenues from an average of 9.6 percent between 1975 and 1980 to an average of 22 percent between 1981 and 1986.[78] (See Table 7-4)

However, a paper by University of Alberta economists Brian Scarfe and Bruce Wilkinson claims that, even after the federal and Alberta Governments reached a compromise agreement in September 1981, the federal share would be closer to 32 percent of revenues -- 47 percent of revenues if the federal subsidy on world priced imports if counted as a federal "tax ... on domestic producers to pay foreign oil producers".[79]

Lalonde had also intended that his measures shift the balance of pricing and tax incentives for oil exploration and development towards Canadian-owned firms and away from foreign-owned multinationals. This was to have been a vital element in cultivating political support for the NEP among energy industry groups. However, it turned out that

[76] Doern and Toner, *The Politics of Energy*, 266-75; McCall and Clarkson, *Trudeau and Our Times, Vol. 2*, 177-81.

[77] Foster, *The Sorcerers' Apprentices*, 167; McCall and Clarkson, *Trudeau and Our Times, Vol. 2*, 178. The distinction between the PCC and John Crosbie's ill-fated 18 cent gasoline tax of 1979 appears to have been mainly cosmetic.

[78] Energy, Mines and Resources Canada, "Do Governments Take Too Much", (Ottawa, The Department, 1982), 5-6, cited in Doern & Toner, *The Politics of Energy*, 341.

[79] Doern and Toner, *The Politics of Energy*, 337.

it disrupted the cash flow of many Canadian-owned independents instead, and led to a sharp drop in drilling activity. This contributed to a much higher degree of political opposition than might otherwise have been the case, and called much of the government's economic expertise into question in the public mind.[80]

TABLE 7-4
ENERGY REVENUE SHARE PERCENTAGE ESTIMATES

	Federal Government	Provincial Governments	Oil & Gas Industry
Average Revenue Shares 1975-1980	10%	45%	45%
NEP Revenue Sharing 1981-86			
-- Federal projection	22%	32%	46%
-- Alberta projection	32%	28%	40%
Canada-Alberta Agreement of September 1981	29%	35%	36%
NEP Update (May 1982)	22%	32%	46%
1984 Revenue Sharing	16%	28%	56%

SOURCE: Doern & Toner, *The Politics of Energy*, 336-7, 341

The NEP also proposed to recycle up to 90 percent of the revenues thus generated in a range of energy development, import subsidy and import substitution programs. It created a new set of federal development grants, the Petroleum Incentive (PIP) Program, to replace existing tax incentives for energy development. These provided significant advantages to larger Canadian companies but also gave much greater regulatory control over the industry to federal officials. The 1981 budget estimate indicated that the government hoped to generate a net surplus of about $ 32 billion from energy revenues

[80] Doern and Toner, Ibid., 249-51; McCall and Clarkson, *Trudeau and Our Times, Vol. 2*, 183. Drilling activity dropped from a peak of 425 rigs in 1979-80 to about 200 in 1984 -- the latter spurred by a combination of higher taxes reinforced by declining prices. (Doern and Toner, 347.)

which it planned to use to reduce the deficit and finance other government activities in the five years after 1980-81.[81]

As part of a broader strategy of promoting Canadian ownership in major industries, the NEP included a number of provisions to promote the acquisition by Canadian-owned companies of more than 50 percent of oil and gas industry assets. This included a "Canadian Ownership Charge" to finance Petro-Canada's takeover of a major multinational company's Canadian operations, and a sliding scale of PIP grants tied to an energy firm's level of Canadian ownership. Most controversially, it provided for a retroactive "back-in" provision allowing state-owned Petro-Canada to acquire a 25 percent interest in producing properties on federal Crown Lands after they came into production.[82] While these measures were intended to build a political constituency for the NEP among Canadian corporate executives and Canadian-owned energy firms, as well as the energy consumers who expected to benefit from lower-than-world oil prices, they provoked instead a massive corporate reaction against what they viewed as the nationalization of private property without due process or adequate compensation.[83]

A number of studies have chronicled the battles between Ottawa, the Alberta Government and various elements of the oil industry, which followed the federal government's

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[81] Canada. Department of Finance, *The Budget in More Detail*, November 12, 1981, 56-74; Perry, *Background of Current Fiscal Problems*, 149.

[82] Lalonde's declared motivation for this measure was to obtain a net return to the federal government when it would be recycling the bulk of its energy revenues to subsidize costly frontier and non-conventional oil developments. In response to the business backlash, Lalonde later offered to compensate firms penalized by the back-in provisions. Doern & Toner, *The Politics of Energy*, 50-54, 111.

[83] Doern and Toner note that responses to different aspects of the NEP differed widely among Canadian subsidiaries of foreign-controlled multinationals, major Canadian oil producers and junior independents. However, the back-in provisions provoked general industry resistance as "confiscation without compensation". Doern and Toner, Ibid., Chapter 6.

unilateral restructuring of energy policies in November 1980.[84] After a ten-month stand-off, the federal and Alberta governments came to a compromise agreement which made some technical changes to the NEP and allowed Alberta to claim that it had protected its jurisdiction but met most of Lalonde's original objectives through the expedient of a faster move towards world prices.[85] However, a slackening of world oil prices and declines in domestic oil and gas production led to a number of concessions to industry cash-flow needs in the so-called "NEP Update" of May 1982,[86] and a series of additional tax concessions in June 1983.

The National Energy Program -- Piecemeal Tax Reform as Constitutional Change

The National Energy Program was clearly intended to change the fundamental economic and political relationships governing Canadian society. While piecemeal tax reforms were at the policy's core, the NEP's implications ranged far beyond the politics of tax policy. Energy prices had an unusual political and budgetary salience in the late 1970s and early 1980s. Rising world oil prices, while only partially reflected in Canada, had resulted in a massive redistribution of wealth from Central and Eastern Canada to the energy-producing provinces of the West, and undermined the federal government's ability to exercise leadership in economic policy without the consent *and participation* of the provinces. Provincial power was reinforced by constitutional guarantees of provincial

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84 Doern and Toner, *The Politics of Energy*; Foster, *The Sorcerers' Apprentices*; Milne, *Tug of War*.

85 *Memorandum of Agreement between the Government of Canada and the Government of Alberta relating to the pricing and taxation of energy*, September 1, 1981. In return for higher prices and revenues than originally provided for under the NEP, Alberta assumed the responsibility and the cost of administering PIP grants within the province -- at a cost of about $ 600 million. McCall and Clarkson, *Trudeau and Our Times, Vol. 2*, 180.

86 Hon. Marc Lalonde, *NEP Update*, (Ottawa, Energy, Mines and Resources Canada, May 1982).

resource ownership and conventions of federal-provincial cooperation in matters of overlapping jurisdiction. These institutional constraints led to a prolonged political deadlock in 1978-80 -- and gave political salience to the central idea driving Trudeau's "new National Policy": the reassertion of the federal government political and economic power against the perceived encroachments (and at the expense) of the provinces and the private sector.[87]

The substitution of direct federal subsidies for tax preferences and federal-provincial transfers was the key economic concept intended to link the political and economic objectives of the Liberal Government. These objectives were to impose greater fiscal discipline and political control over the economy, to foster economic efficiency, and to create a new political coalition. The NEP was intended to shift discretion in investment decisions away from the foreign-controlled oil companies which dominated much of the oil and gas industry, and towards federal officials through the substitution of discretionary grant programs for traditional tax incentives. It was also intended to finance a series of resource-related megaprojects[88] and, in the process, create new client groups for the federal government among an emerging group of large, Canadian-owned energy firms, along with the corporations and workers who would receive economic spin-offs from these projects. Together with the benefits of lower-than-world oil prices enjoyed by energy consumers, and the expanded economic rents that could be used by Ottawa to expand social programs, these policies were intended to create a broad political coalition capable of sustaining the federal Liberals in office indefinitely.

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[87] Milne, *Tug of War*.

[88] Major Projects Task Force, *Report* ..., June 1981; Canada. Department of Finance, *Economic Development for Canada in the 1980s*, (Ottawa, The Department, November 1981).

The actual results, however, turned out very differently from what federal policy planners had anticipated. Ottawa was first forced to compromise with the provinces in its struggle for jurisdictional control over energy resources as a condition of its constitutional patriation agreement in 1982 -- a clear example of institutional constraints over structural policy change. Internal infighting within the federal government and growing private sector scepticism undermined plans for a comprehensive industrial policy to complement the NEP. Then declining industry activity and a sharp reduction in world oil prices after 1982 resulted in additional tax concessions to the industry.

Ironically, it was Canada's vulnerability to the same international economic forces, which had made the NEP seem politically and economically feasible, that ultimately proved its undoing when the forecasts of further world price increases on which it depended proved to be wrong. The benefits of proposed megaprojects also proved largely illusory as the costs of frontier exploration subsidies absorbed dwindling energy revenues and most new projects proved uneconomic without massive government subsidies.

Perhaps most importantly, the National Energy Program also aroused a deep ideological loathing of the Trudeau government in large segments of the Canadian business community -- leading them to become a leading element in the growing coalition arrayed against the Liberal government's policies. The recession of 1981-82 sufficiently eroded the government's popularity that it was belatedly forced to seek a political accommodation with both big and small business -- ironically, under the leadership of Marc Lalonde as Minister of Finance. By this time, however, the reversal of the National Energy Program had become a key political priority of the Alberta government, much of the oil industry and of a federal Conservative Opposition seeking to capitalize on Western and business alienation from the Trudeau Government.[89] This provided the core of a new political coalition that swept Brian Mulroney and the Conservatives to power in the 1984 general election and reversed most of the provisions of the National Energy Program within two years.

In the short-term, the substance of the National Energy Program and the unilateral, confrontational process through which it had been introduced, while perhaps unavoidable, virtually guaranteed that any serious attempt at tax reform would be met with the unreserved hostility of the business community. And in November 1981, that is exactly what happened.

FISCAL POLICY, INFLATION AND THE PRESSURES FOR TAX POLICY CHANGE

The Liberal government that was returned to power in February 1980 was based on an uneasy coalition of interests dependent on it for protection against external economic shocks and looking to it for high levels of public spending to reduce social and economic disparities. This social democratic coalition remained supportive of the government only as long as its policies continued to deliver material gains for its members. Its inherent fragility became increasingly visible as interest rates continued to rise, threatening to push Canada into a recession.

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[89] Falling oil prices permitted the Conservative to scrap the NEP between 1984 and 1986 without serious effects on the federal deficit. However, the memory of federal restrictions on their oil exports provided an ample incentive for Western premiers to lobby for the Canada - U.S. Free Trade Agreement as a more durable institutional safeguard against future federal intrusions on provincial tax and management rights over natural resources. G. Bruce Doern and Brian Tomlin, *Faith and Fear: The Free Trade Story*, (Toronto, Stoddart, 1991).

The social Liberals who dominated the post-1980 cabinet, including Finance Minister Allan MacEachen,[90] were deeply committed to an expansionary fiscal policy to maintain economic growth and promote distributive equity among regions and income groups. MacEachen's initial strategy was to recycle most of the expected revenues from the NEP energy conservation and development projects. Steadily growing oil prices were expected to help reduce the deficit and fund other government commitments without the need for increases in personal and corporate income taxes.[91] However, the government's activist economic strategy also anticipated major new expenditures on various aspects of economic development, industrial adjustment and manpower retraining.[92] These, together with cabinet pressure to maintain the growth of existing spending envelopes at or near the economy's rate of growth, meant that the government's political commitments could only be met either by increasing the deficit or by general tax increases.[93]

Two months after his appointment in March 1980, Deputy Finance Minister Ian Stewart was predicting that inflation could only be constrained through reductions in the federal deficit, direct federal investments to assist economic restructuring and higher personal and corporate income taxes.

> Revenues are now about two-thirds of expenditures and ... though they will grow more rapidly, they will not grow enough, unless there are some

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[90] MacEachen, *Debates*, House of Commons, January 16, 1981, 6283; "Address", Canadian Club, Toronto, February 2, 1981, 7; Interviews, former Deputy Minister (D7), senior Finance Department officials. (FO1), former Liberal MP (MP3).

[91] Hon. Allan J. MacEachen, *Budget Speech*, October 28, 1980, 3; MacEachen, "Speech", *Report of Proceedings of Thirtieth Tax Conference, 24-26 Nov., 1980,* (Toronto, Canadian Tax Foundation, 1981), 589; MacEachen, "Address, Canadian Club of Montreal", (Ottawa, Department of Finance, February 23, 1981), 6.

[92] Together with proposals for a series of energy-related megaprojects, the latter became the core of the government's proposed industrial strategy paper tabled with the 1981 budget. [Canada, Department of Finance, *Economic Development for Canada in the 1980s*, (Ottawa, The Department, November 1981)]

[93] Interview, former senior Finance Department official. (D3)

> changes in taxes. ... The deficit problem is going to have to be solved by generalized tax increases ultimately across the board.[94]

MacEachen himself, while extolling the Canadian tax system as "one of the best in the world" in his 1980 budget speech, hinted at the possibility of higher taxes the following year and at a preference to reduce the number and extent of existing tax preferences rather than to increase tax rates.[95]

However, the contingencies and inconsistencies in MacEachen's policy caused it to come unravelled when challenges by "the most devastating international economic shock of the Trudeau era".[96] The spillover from the U.S. Federal Reserve Board's interest rate shock treatment for inflation, which drove the Canadian prime lending rate from 12.75 percent in October 1980 to 18 percent in January 1981 and 22.75 percent in August 1981 (See Table 7-5) left no alternative but a return to restrictive fiscal policies. Additional constraints on federal spending or higher general tax rates were thought likely to hurt the core constituencics of the Liberal Party more than the elimination of tax preferences whose benefits were enjoyed primarily by the more affluent members of society.[97]

MacEachen and Stewart began to explore the possibility of structural changes to the tax system to increase its coherence and raise the additional revenues needed to deal with its short term policy crisis. In the short-term, Department officials argued that a more

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94 Stewart, *Minutes*, Standing Committee on National Finance, May 27, 1980, 26.

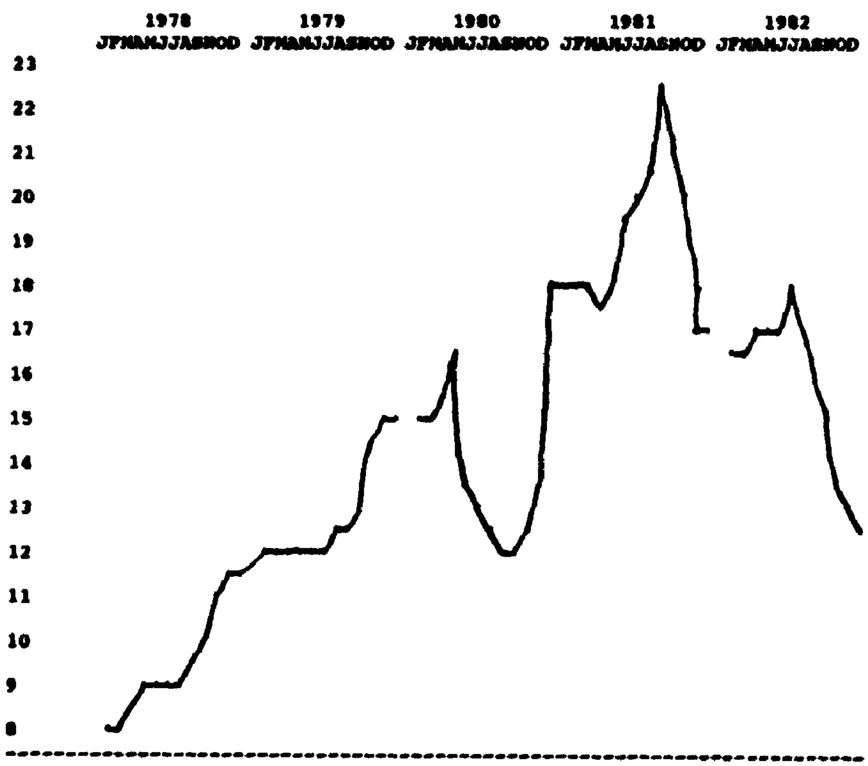
95 MacEachen, *Budget Speech*, October 28, 1980, 4, 14-15.

96 Stewart, "Global Transformation", 121.

97 Martin Goldfarb and Thomas Axworthy, *Marching to a Different Drummer*, (Toronto, Stoddart, 1988), 20, 142-3. A former senior Finance Department official comments that MacEachen under-estimated the extent to which the Liberals had become a party of the middle class with insurance policies, small businesses, company cars and other economic interests that would be challenged by the proposed tax reforms.[D3] See also Jon H. Pammett, "Class Voting and Class Consciousness in Canada" in J. Wearing, ed., *The Ballot and its Message: Voting in Canada*, (Scarborough, ON, Copp Clark Pitman, 1991), 138.

broadly-based income tax would contribute to short-term stabilization. In the medium-term, it would complement the NEP in generating the additional revenues necessary to finance the government's planned industrial strategy, usher in a new era of national prosperity and confirm the Liberals as Canada's natural governing party.[98] It would also also help to rationalize the conflicting policy priorities which had been incorporated into the tax structure during the 1970s, often against the policy preferences of tax policy officials within the Department of Finance.

TABLE 7-5
PRIME LENDING RATE, CANADA - 1978-82



[98] Officials responsible for the preparation of the budget disclaim any connection in their minds with a larger political strategy, and emphasize the short-term fiscal and revenue implications of the budget. However, this implies a degree of separation of a "political" cabinet-level decision-making process and an "apolitical" departmental policy process which would be atypical of federal decision-making on an issue of this importance.

As a result, MacEachen's tax reform budget of 1981 would be intended primarily to broaden the federal revenue base in order to offset the cumulative impact of inflation and high interest rates on the federal deficit.[99] MacEachen's need to raise taxes to ease the upward pressure on interest rates was an unusual opportunity to redefine the tax system to achieve the goals intended by Carter and Benson -- and to reassert Departmental officials' deeply-held views of "the good tax system".

The following chapter reviews the internal policy debate over tax reform options within the Department of Finance and explains how the Department's officials took the opportunity afforded by the looming economic crisis to make that vision the basis for the most sweeping restructuring of the income tax system in many years.

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[99] Stewart, Ibid., 122-23; Interviews, Department of Finance.

TABLE 7-6

ENERGY-RELATED REVENUES - GOVERNMENT OF CANADA - 1974-85
(in $ millions)

	Gas tax	Oil Export Charge	Petro. Levy/COC[4]	NGGLT[1]	PCC[2]	PGRT[3]	Other	Total
1973-74	0	286	0	0	0	0	0	286
1974-75	0	1,669	0	0	0	0	0	1,669
1975-76	425	1,063	0	0	0	0	0	1,488
1976-77	600	661	0	0	0	0	0	1,261
1977-78	598	432	0	0	0	0	0	960
1978-79	516	328	0	0	0	0	0	844
1979-80	421	750	400	0	0	0	0	1,571
1980-81	453	842	1,393	187	27	0	0	2,902
1981-82	436	519	3,792	998	473	864	0	7,082
1982-83	408	392	3,851	1,264	807	1,960	102	8,784
1983-84	386	215	805	524	1,750	2,106	165	5,951
1984-85	404	408	850	-16	2,208	2,563	258	6,675

ENERGY-RELATED EXPENSES - GOVERNMENT OF CANADA - 1974-85
(in $ millions)

	OISP[5]	Misc. Energy Programs	Pay'ts to Provs. (OET)[6]/ PIP[7]	Petro-Canada	PCF[8]	Energy-Related Equalization[9]	Total
1973-74	157.4	5.0	143.3	0	0	249	554.7
1974-75	1,163.2	4.2	111.1	0	0	377	1,655.5
1975-76	1,583.6	20.6	0.2	236.7	0	456	2,297.1
1976-77	946.6	59.6	0	257.0	0	475	1,738.2
1977-78	924.8	266.8	0	150.0	0	731	2,072.6
1978-79	628.8	94.4	0	280.0	0	673	1,676.2
1979-80	1,633.4	102.3	0	80.9	406.4	1,021	3,244.0
1980-81	3,163.6	145.0	0	440.0	915.0	1,045	5,708.6
1981-82	3,471.1	474.2	0	129.0	737.1	941	5,752.4
1982-83	4,411.8	594.1	0	555.1	769.0	406	6,736.0
1983-84	2,242.7	499.5	1,745.5	612.5	0	349	5,449.2
1984-85	3,463.7	804.4	1,752.8	17.0	0	407	6,444.9

[SOURCES: *PUBLIC ACCOUNTS OF CANADA, 1973-74 - 1984-85; THE NATIONAL FINANCES*, (Toronto, Canadian Tax Foundation, 1973 -84.)]

1 NGGLT - Natural Gas and Gas Liquids Tax
2 PCC - Petroleum Compensation Charge
3 PGRT - Petroleum & Gas Revenue Tax (also includes Incremental Oil Revenue Tax "IORT" after 1981)
4 COC - Canadian Ownership Charge (replaced Petroleum Levy)
5 OISP - Oil Import Substitution Program
6 OET - Payments to Provinces under Oil Export Tax (1973-75)
7 PIP - Petroleum Incentive Program (under NEP)
8 PEF - Petroleum Compensation Fund
9 Share of equalization payments based on provincial energy revenues. Taken from annual estimates published in *The National Finances*. No comparable figures available in Public Accounts.

CHAPTER 8 – TOWARDS THE 1981 BUDGET: IDEAS, INSTITUTIONS, INTERESTS AND THE DEPARTMENT OF FINANCE

> There is no part of the administration of government which requires extensive information and a thorough knowledge of the principles of political economy so much as the business of taxation. The man who understands those principles best will be least likely to resort to oppressive expedients, or to sacrifice any particular class of citizens to the procurement of revenue.
>
> Alexander Hamilton[1]

The introduction of comprehensive income tax reforms was not on the Liberal Government's agenda when it returned to office in 1980. Nor was it on the initial agenda of the new Finance Minister, Allan MacEachen, or his senior officials. Instead, the possibility of tax reform gradually emerged over the first year of the new government's mandate.[2]

The political decision to pursue tax reform during the summer of 1981 was the by-product of other pressures which set a general direction for the operations of the tax policy community within the Department of Finance. These pressures included the need to meet federal revenue requirements to fulfil campaign promises for more social spending,[3] the demands of fiscal policy at a time of unprecedented real and nominal interest rates, and cabinet's decision to impose fiscal restraint through tax increases rather than through

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[1] Alexander Hamilton, "Federalist # 35", in *The Federalist Papers*, Clifton Rossiter, ed., (New York, Mentor Books, 1961), 216-7.

[2] Interviews, Ian A. Stewart, federal MP and cabinet minister (M5). A senior PMO official suggests that MacEachen anticipated the reduction of tax expenditures to finance social program increases during the 1980 election campaign, but that tax reform was never formally discussed as Liberal Party policy. (Interview, PMO-3.)

[3] A senior PMO official comments that during the 1980 federal election, there had been "general agreement" among Liberal strategists "on using tax expenditure closing to finance social program increases. Allan could and did say that the only way we could act on the platform was to consider tax reform." Interview, PMO-3.

spending limitations.[4] However, it was MacEachen's choice to respond to these pressures through a massive restructuring of the Income Tax system rather than through generalized or targeted increases in personal and corporate tax rates.

The decision to use the 1981 budget to introduce a comprehensive tax reform program also reflected the strongly-held views of officials within the Department of Finance, many of whom saw in the government's growing financial needs an opportunity to restructure the tax system to reflect their theoretical and ideological concepts of a "good tax system". The internal discussion of tax reform reflected strenuous debate within the Department over the appropriateness of measures to accommodate inflation within the tax system, especially in its treatment of capital income, the degree to which the tax system should accommodate private savings and investment as opposed to "government savings",[5] and the concept of "tax expenditures" as a means of identifying and limiting the costs and benefits of the many economic and social policy objectives built into the tax system.

This chapter will examine the major internal policy debates within the Department of Finance, the use of the so-called "tax expenditure" concept to justify and later promote the tax reform budget of 1981, and the flawed internal process which translated these theoretical concepts, without adequate political or technical preparation, into one of the most controversial budgets in modern Canadian history.

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[4] MacEachen, *Speeches*, May 6, July 6, 1981; Interviews, current and former Finance Department officials. (PMO-3, D3, ADM-3, ADM-8, F01, F04).

[5] "Government savings" was a term used during this period to describe an increase in government revenues that could be reinvested in a megaprojects-based industrial strategy intended to generate major economic spin-offs during a period of slow economic growth. Ian A. Stewart, "Global Transformation and Economic Policy" in Thomas A. Axworthy and Pierre E. Trudeau, *Towards a Just Society*, (Markham, ON, Penguin Books Canada, 1990), 107-125.

INFLATION, REDISTRIBUTION AND COMPETING INTERESTS

> Tax reform grew out of an increasing threat to the federal revenue base caused by the combination of inflation and high interest rates. For those who drew a substantial share of their income from property sources and for corporations offering packages of non-monetary perks to their employees, inflation and high interest rates were offering a massive incentive to mechanisms of tax avoidance. The burden of the system was shifting massively and inequitably to the shoulders of employed wage earners.[6]

The internal policy debate over tax reform took place amid an economic crisis in which conventional economic wisdom offered uncertain guidance for public policy-makers.[7]

The departure of Assistant Deputy Minister Ed Neufeld at the end of 1979 had left the tax policy branch without clear direction in determining how or whether inflation should be accommodated within the tax system. Extensive studies were made of the feasibility of a Tax-Based Incomes Policy,[8] but these were unable to devise a system that would distinguish between inflationary increases in wages and profits and increases resulting from greater productivity, innovation and economic restructuring.[9]

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[6] Stewart, "Global Transformation and Economic Policy", 122-23. Canada. Department of Finance, *Review of the Taxation of Capital Gains*, (Ottawa, The Department, November 1980), 38-9. Bossons notes that investors received a much higher after-tax return from debt-financed investments than those financed from retained earnings or equity investments. (Bossons, "The Effects of Inflation-Induced Hidden Wealth Taxes", *Report of Proceedings from Thirty-Second Tax Conference*, (Toronto, Canadian Tax Foundation, 1980), 24-27).

[7] See Chapter 7.

[8] McCall and Clarkson suggest that one of the reasons that the Department failed to predict many of the pitfalls of its base broadening measures in the 1981 budget was that much staff time was "squandered" in the exploration of the TIP concept. Christina McCall and Stephen Clarkson, *Trudeau and Our Times, Vol. II: The Heroic Delusion*, (Toronto, McClelland & Stewart, 1994), 235-6. For discussion of TIP, see: Hon. Allan J. MacEachen, "Speech" to Conference Board of Canada, (Ottawa, Department of Finance, May 6, 1981), 8-9; Ian A. Stewart, *Minutes and Proceedings*, Senate Committee on National Finance, May 27, 1980, 26-27; Ibid., May 27, 1981, 27-28; Alan Short, quoted in "Understaffed dep't. prepared budget -- official", *The Citizen*, Ottawa, November 26, 1981, 15.

[9] Glenn Jenkins, the newly-appointed ADM-Tax Policy, commented that "it was my main effort to kill that thing. (TIP) It didn't make sense." Interview, Glenn P. Jenkins.

The discussion of alternative approaches to inflation and its impact on effective tax rates and tax comparability also masked a growing ideological conflict both within the Finance Department and between the Department and the broader tax policy community over the priorities and purpose of the income tax system. Internal debates over tax policy have traditionally taken place between advocates of a normative ("good") tax system and "pragmatists" who stress the need to minimize both the disruption of normal business practices and the risks of causing political embarrassment for the Minister of the day. The controversy over the definition and use of tax expenditure analyses fueled this debate by opening a wide range of previously unquestioned business practices to scrutiny and challenges from tax policy officials.

Some officials within the Department supported the government's base-broadening initiatives for pragmatic rather than ideological reasons. These officials tended to view the hodgepodge of investment incentives within the tax system as distortions of economic efficiency which hindered the operations of the market system, and created incentives for competitive rent-seeking and tax avoidance. For this group, marginal rate reduction became a primary objective of tax reform -- both as an incentive to risk-taking and entrepreneurship, and as a response to the personal and corporate tax cuts passed by the U.S. Congress in 1981.[10] Rather than seeking to eliminate tax incentives as undeserved gifts to businesses and investors at the expense of other taxpayers, they sought to equalize the *effective* tax rates of investments in different economic sectors as a means of treating different groups of businesses and investors more consistently.[11] However, following

[10] One participant in the process comments that the upper income tax cuts, while an afterthought in the process, were judged necessary to sell the budget. (Interviews, Department of Finance officials. (MP3, ADM-2, ADM-8, F01.)

[11] This approach became the explicit objective of corporate tax reforms introduced by the Department in 1985-86 and 1987-88. Hon. Michael H. Wilson, *Budget Speech*, (Ottawa, Dept. of Finance, May 23, 1985); Robert D. Brown, "Corporate Tax Reform: Necessary but Not Sufficient", in *Report of Proceedings of Thirty-Seventh Tax Conference, 1985*, (Ottawa, Canadian Tax Foundation, 1986)

neo-Keynesian orthodoxy, MacEachen and Stewart looked with mild horror at the supply-side heresies of the Reagan administration,[12] and insisted that lower rates be fully offset in the short-term by base-broadening measures.

The predominant viewpoint within the Department at this time was that the elimination of inflation as a policy goal was preferable to its piecemeal accommodation through the tax system. Musgrave, Carter and others had argued that equitable taxation required either the comprehensive adjustment of the tax system for inflation, or no adjustment at all.[13] The principle of horizontal equity (or "tax neutrality") demanded that if the inflationary portion of interest income and capital gains were to be exempted from taxation, deductibility should be removed for financing costs attributable solely to inflation.[14]

Inflation also increased the value of tax deferrals. The theory of tax expenditures espoused by some economists within the Department equated tax deferrals with direct subsidies -- whether the cause of the deferral was creative tax avoidance or market conditions beyond the taxpayer's control.[15] This implied that both assets and liabilities should be valued annually, even though this would greatly increase complexity,

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[12] Stewart, *Minutes and Proceedings*, Senate Committee on National Finance, May 27, 1981, 24; Interview, Hon. John Evans, former Parliamentary Secretary to Minister of Finance.

[13] Musgrave, *The Theory of Public Finance*, 169. Royal Commission on Taxation, *Report*, Volume II, 33. cited in Roger S. Smith, *Tax Expenditures*, Canadian Tax Paper # 61, (Toronto, Canadian Tax Foundation, 1979), 38.

[14] Smith, *Tax Expenditures*, 40. This later became the basis for the "Indexed Security Investment Program" introduced in the 1982 federal budget. Canada. Department of Finance, *Inflation and the Taxation of Personal Investment Income*, (Ottawa, The Department, June 1982); *Indexed Security Investment Plan*, (Ottawa, the Department, March 1983).

[15] From this perspective, tax deferrals were seen to increase the relative tax burden for individuals who didn't enjoy the flexibility to engage in tax planning (usually wage and salary earners with limited investment income). They were also seen to reduce the real value of government tax revenues by allowing the payment of taxes in depreciated dollars -- although this factor was more than offset by the effect of inflation on the taxation of nominal corporate profits

administrative costs, and problems of valuation -- especially for small firms and the agricultural sector where limited markets made property valuations both arbitrary and highly volatile. Arguments for greater symmetry in the tax treatment of inflation had carried relatively little weight during the mid-1970s, when the Department had been receptive to addressing inflation issues one problem at a time under the business-oriented leadership of Finance Ministers Turner and MacDonald, and the technical guidance of Marshall Cohen. However, they were deeply felt by many officials within the Department who considered themselves not only the guardians of the tax system's technical integrity but also of the concepts of fair taxation rooted in the principles of progressive tax rates and ability to pay.[16]

Both Finance Minister MacEachen and Deputy Minister Ian Stewart were averse to lightening the burden of business and capital taxation at a time when contract settlements for unionized employees were steadily falling behind the rate of inflation and when the demands of fiscal policy called either for more spending restraint or higher taxes.[17] They also questioned the effectiveness of a number of tax measures in promoting economic growth, rather than merely sheltering various groups of taxpayers from inflation.

Thus, arguments for a reduction in "tax expenditures" began to merge with concerns over the misallocation of resources by "market-based" incentives contained in the tax system

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[16] Interviews, Dr. Jim Gillies, senior departmental officials. (ADM-1, F01)

[17] Stewart, ibid., May 27, 1981, 28. MacEachen, *Debates*, House of Commons, December 18, 1981, 14236-7; for example, persons with taxable income under $ 25,000 accounted for 93 percent of the number of taxpayers reporting capital gains in 1978, but only 33.3 percent of the value of taxable capital gains and 18.3 percent of capital gains taxes paid. *Review of the Taxation of Capital Gains in Canada*, 12-14.

and the opportunities to coordinate economic development policies through a more or less *dirigiste* industrial strategy.[18]

In the fall of 1981, the preoccupation of senior Finance Department officials with a growing interest rate crisis, and the need to seek new revenues in order to shift the burden of fighting inflation from monetary to fiscal policy, easily outweighed the Tax Policy Branch's concern with the micro-economic effects of tax changes on individual business decisions. From a political standpoint, a government committed to restoring federal leadership in economic policy had to take dramatic and decisive action to demonstrate its control over the economic situation. And the Liberal philosophy of an "equitable sharing" of the burdens of economic adjustment meant that upper-income taxpayers would be expected to bear the largest economic sacrifices in the national interest.

These factors played into the hands of officials who wanted to purify the income tax system of many of the tax preferences or "tax expenditures" added during to it during the 1970s -- not only in order to broaden the federal tax base in the interests of economic efficiency, but also to increase government power and the redistributive character of the income tax system.

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[18] At least two former Deputy Ministers interviewed for this study have suggested that the government's megaprojects-based strategy, advocated by the Major Projects Task Force Report of June 1981 and given a lukewarm endorsement in the 1981 budget paper, *Economic Development for Canada in the 1980s*, (Ottawa, Department of Finance, November 1981), was a compromise effort by senior federal officials intended to head off a much more nationalist and interventionist policy proposed by Industry Minister Herb Gray and former Trudeau Principal Secretary, Jim Coutts. (Interviews, D3, D7). See also McCall & Clarkson, *Trudeau and Our Times*, Vol. 2, 219-23.

THE TAX EXPENDITURE CONCEPT AND THE POLITICS OF TAX REFORM

> Tax expenditure budgeting is a normative exercise. No matter how scientific analysts pretend to be, value judgments about which provisions are tax preferences will have to be made. The whole process consists of comparing an actual tax system to a 'normal' system. But on the other hand, the purpose of a tax expenditure budget is not, or should not be, to analyze or judge tax provisions. ... It is thus clear that there is a fundamental conflict between a tax expenditure budget's purpose and the way in which it must be constructed.[19]

Allan MacEachen's budget of 1981 cannot be understood outside the perspective of the debate over so-called "tax expenditures". While the 1979 Crosbie budget included a summary of tax preferences and their ostensible cost to the federal treasury,[20] the budget's defeat in the House of Commons, the subsequent Liberal election victory and the introduction of the highly controversial National Energy Program meant that there was little public debate over the implications of the tax expenditure concept for the redesign of the tax system. However, the assumptions underlying the tax expenditure concept were sufficiently at variance with the conventional political wisdom of Canadian tax policy during the 1970s that any serious attempt to apply them promised -- or threatened -- a revolution in Canadian tax policy.

The tax expenditure budget[21] was introduced as a way of requiring other federal departments and interest groups to curb their requests for direct spending or tax abatements by combining tax and spending measures in a single accounting framework. However, this process became more than just an exercise in budgetary self-discipline. Interests both inside and outside the Department of Finance saw the tax expenditure

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[19] Nick LePan, "Tax Expenditure Analysis: Some Conceptual Problems", *Canadian Taxation* 1(2), Summer 1979, 15.

[20] *Government of Canada Tax Expenditure Account*, (Ottawa, Department of Finance, December 1979).

[21] Tax expenditure budget: an accounting of the costs of individual "tax expenditures" -- departures from a benchmark (or normative) tax system -- to the federal government.

concept as a means of legitimizing major tax increases by expanding the tax base. They also recognized that a renewed emphasis on redistributing income and wealth through the tax system could justify an expanded role for the state and a subordination of the private economy to the objectives of social and economic planners.[22]

Other policy-makers saw in the tax expenditure concept an opportunity to make the tax system a more efficient instrument of economic policy by reducing or eliminating special tax preferences which distorted investment decisions and recycling the benefits to individual and business taxpayers in the form of lower marginal tax rates.[23]

In either case, depending on the principles chosen to define a normative or benchmark tax system, the systematic application of tax expenditure budgeting had the potential to overturn a wide range of existing economic and social relationships -- and to challenge the foundations of the existing economic constitution. Thus, what began as a relatively uncontroversial accounting exercise designed to promote a greater degree of fiscal discipline within the federal government became the center of a raging political controversy over the extent of the government's right to tax.

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22 This included important elements of the Liberal cabinet and caucus, including Allan MacEachen. Interview, senior PMO official (PMO-3). National Council of Welfare, *The Hidden Welfare System* and *The Hidden Welfare System Revisited*, (Ottawa, November 1976 and March 1979); *Canadian Taxation* 1(1); Neil Brooks, "Making Rich People Richer", *Saturday Night*, [July 1981], 30-35; Woodside, "The Political Economy of Policy Instruments: Tax Expenditures and Subsidies in Canada"; David A. Wolfe, "The Politics of the Deficit", in G. Bruce Doern, ed., *The Politics of Economic Policy*, (Toronto, University of Toronto Press, 1985).

23 Interview, Department of Finance. (F01, MP3)

Tax Expenditures -- Concept and Origins

> The structure and use of tax expenditure budgeting as a tool of policy analysis depends on several major factors. These include the definition of a benchmark tax system, the normative assumptions of taxation and the nature of property rights, the economic policy assumptions of government decision-makers, the legitimacy attached to the accommodation of existing business practices as a guide to the design of tax policy, and the perceived relationship between the taxpayer and the state.[24]

The concept of the "tax expenditure budget" was pioneered in the United States in 1968 to quantify the cumulative cost of "special" departures from a "normal" tax system in order to permit policy-makers to analyze the relative costs and benefits of tax preferences in comparison to other policy instruments designed to achieve the same objectives.[25]

Stanley Surrey, the senior U.S. Treasury Department official who popularized the concept, has summarized its underlying assumptions, most important of which is the existence of a "normative" tax structure. Surrey based the American tax expenditure budget on the Haig-Simons definition of comprehensive annual income with certain specific exceptions considered beyond the appropriate range of taxation.[26] Any departure from that normative tax base was assumed to be the equivalent of direct government spending.[27]

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24 John Sargent, "Introduction", in Bruce, ed., *Tax Expenditures and Government Policy*, (Kingston, ON, John Deutch Centre for the Study of Economic Policy, Queens University, 1988), 3-19.

25 Surrey, "Tax Expenditure Analysis: The Concept and Its Uses", 3-14.

26 The Haig-Simons definition of "net income" is "the algebraic sum of the market value of the rights exercised in consumption and the change in the value of property rights between the beginning and end of a period", summarized in plain English as "funds accumulated or spent, less the costs of obtaining those funds". Ibid., p. 3.

27 "Tax expenditure programs, though clothed in tax language, are really spending programs." Ibid. p. 7

Public finance economists contend that the development of a tax expenditure budget allows policy-makers to make their decisions on the basis of economic efficiency in meeting specific policy objectives.

> Should funds be spent for this purpose, and if so, how much? Should the program be open-ended or should there be a cap on the governmental assistance? Should the program be relatively simple with the beneficiaries essentially deciding their eligibility and with auditing to come later; or should there be more questions asked and eligibility determined before funds are handed out?[28]

Supporters of the tax expenditure concept stress that the same value-for-money criteria should be applied to tax preferences as to any other form of regulatory assistance or direct government subsidy, since the resulting reduction in tax revenues effectively increases tax rates for other taxpayers.[29] As tax preferences in Canada were rarely subjected to effective cost-benefit analysis before 1978,[30] tax incentives for economic development received less effective scrutiny for their cost-effectiveness than might have been the case for alternative forms of government assistance.[31]

When the first *Tax Expenditure Analysis* was commissioned by senior officials of the Department of Finance in 1979, it had three main purposes: analytical, policy-related and political.[32] The analytical purpose was to document the erosion of the tax base during the 1970s and quantify the costs of various tax initiatives which had been seen as "cost-free"

[28] Ibid., p.7.

[29] *Tax Expenditure Account*, December 1979, 1-2.

[30] The Quantitative Tax Analysis Section of the Tax Policy and Legislation Branch was formed in 1978 specifically to analyze the fiscal and economic effects of specific tax preferences and policy initiatives. [Interviews with current and former Department officials] [ADM-3, F03]

[31] This point is made particularly for tax incentives for business investment, which are largely self-monitoring, compared with loan and grant programs, which are usually subject to intensive bureaucratic scrutiny. (Woodside, "The Political Economy of Policy Instruments", 173-197.)

[32] Interview, former senior tax policy official. (ADM-1)

by sponsoring Ministers and Departments because they had not been assigned against the Department's permanent or "A-base" budget allocations. The policy-related purpose was to equate indirect spending through the tax system with departments' direct spending programs -- both for purposes of public information and as a means of enforcing greater budgetary discipline on spending Departments. The political purpose of publishing a tax expenditure budget was to send a message to spending departments that, in future, the tax system was to be off-limits as a source of off-budget spending.[33] When the short-lived Clark Government set up its system of "spending envelopes" to monitor and control the growth of government spending in 1979, any discretionary increase in the cost of tax preferences within a particular envelope was to be counted against the allowed increases in direct expenditures.[34]

After the Liberal government returned to office in 1980, it maintained the expenditure envelope system. Deputy Finance Minister Ian Stewart, who strongly approved of tax expenditure analysis as an analytical tool for rational policy management, directed the Tax Analysis Division of the federal Department of Finance to carry out a comprehensive analysis of the cost of all major tax preferences shortly after his appointment in March 1980.[35]

Many officials in the tax policy branch believed that government intervention through tax preferences were distorting economic decision-making and encouraging tax avoidance

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33 Interview, former senior tax policy official. (ADM-1) The tax expenditure budget also served as a useful tool for Ministers of Finance to challenge new tax incentives proposed by the opposition -- a feature which did not escape the attention of officials deeply sceptical of the avalanche of Conservative tax promises in the pre-election campaign of 1978-79.

34 *Tax Expenditure Account*, December 1980, 1-2; Woodside, "The Political Economy of Policy Instruments", 179; Simpson, *The Discipline of Power*, (Toronto, Personal Library, 1981), 216.

35 Ian A. Stewart, *Minutes and Proceedings*, Senate Committee on National Finance, May 27, 1980, 26-27.

and evasion by making marginal tax rates higher than would otherwise have been necessary to raise equivalent revenues. As tax policy evolved during the 1970s, the supply of tax expenditures was seen to create its own demand. Some Tax Policy and Legislation Branch officials believed that the tax system would function more efficiently by eliminating or restricting tax preferences, using the resulting "savings" to lower tax rates, and allowing market forces greater freedom to direct savings and investment decisions. Others believed that while such economic subsidies might serve a useful policy purpose, they could be distributed more efficiently by government officials in charge of direct spending programs than by market forces or taxpayers with access to aggressive tax planning advice.[36]

The internal conflicts within the Department are reflected in the arguments used to define a benchmark tax system in its 1979 *Tax Expenditure Account*. On the one hand, it warned that:

> the definition of the benchmark system should not depart dramatically from the public perception of the current tax system. This *pragmatic criterion* is dictated by the fact that the purpose of the tax expenditure account is to provide information and not to engage in the academic exercise of defining an ideal tax system.[37]

On the other, it clearly leaned towards asserting a presumptive right of taxation in any area of dispute.

> Whenever there is uncertainty or disagreement about the treatment of a given tax provision, the analysis should err on the side of *comprehensiveness*. ... A tax provision may be neutral for all taxpayers

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36 The "pragmatists", interested primarily in rationalizing tax preferences and lowering rates, came mainly those from a legal or accounting background. The "purists" were mainly tax policy economists who equated all tax preferences with government subsidies. Interviews with Finance Department Officials. (D5, ADM-3, F01.)

37 *Tax Expenditure Account*, Dec. 1979, 5; emphasis in original. A senior tax policy official describes this outlook towards tax expenditures as "an accounting exercise". (D7)

> while at the same time clearly being *functionally equivalent* to a direct spending program.[38]

These two views reflect very different perceptions of the normative basis of an appropriate tax system -- pure rationality based on abstract notions of equity and efficiency, or a pragmatic acknowledgement that tax systems reflect a balance of competing political and economic objectives and interests.

The choice of tax norms influences decisions on whether and how a tax expenditure budget should accommodate structural issues such as the tax distortions caused by inflation, the partial integration of personal and corporate income or the co-existence of annual and multi-year income streams in the same tax structure. Normative decisions can turn provisions which reflect a presumptive "cost" to the government in the form of tax expenditures into "negative tax expenditures" or "tax penalties" which represent a net cost to taxpayers.

Thus, the measurement of tax expenditures may vary widely, particularly when measures such as inflation indexing or the integration of personal and corporate income taxes may be accepted or rejected as basic principles of the tax system. For example, Roger Smith estimates that the net tax cost to business of inflation in 1975 was $ 3.0 billion -- compared with $ 4.8 billion in "official" tax expenditures. Similarly,

> treating a separate Corporate Income Tax as part of the 'normal' income tax structure would result in a positive tax expenditure of $ 5 billion; if full integration were viewed as normal, the result of the existing corporate income tax would be a negative tax expenditure of $ 8 billion.[39]

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[38] Ibid.; emphasis in original.

[39] Roger S. Smith, "Tax Expenditure Analysis: Definitional Problems", *Canadian Taxation* 1(2), Summer 1979, 19-22; Smith, *Tax Expenditures*, Canadian Tax Paper # 61; Nick LePan, "Tax Expenditure Analysis: Some Conceptual Problems", *Canadian Taxation* 1(2), Summer 1979, 15-18; and Neil Bruce, "The Tax Expenditure Debate", in Bruce, *Tax Expenditures and Government Policy*. See also Glenn Jenkins, *Inflation, Its Financial Impact on Business in Canada*, (Ottawa, Economic Council of Canada, 1977).

If a tax expenditure budget is to be a practical tool for policy analysis, to what extent should it incorporate practical administrative concerns or the cultural norms of society -- as compared with those of a small eli'e of tax experts?

The internal debates within the Department of Finance as to whether the tax expenditure budget should be used as an accounting tool to facilitate cost-benefit analysis of current and proposed tax measures or as a political tool to promote major structural policy change mirrored the increasingly bitter debate within the tax policy community over the role of the tax system and of government itself in promoting economic development and the redistribution of social and economic power.

Tax Expenditures -- Ideologies and Interests

A number of left-wing academics and elements of the anti-poverty lobby sought to popularize the tax expenditure concept in Canada during the late 1970s as a political vehicle to promote a return to the Carter Commission's vision of "tax equity" and the use of the income tax system as a vehicle for the systematic redistribution of income and wealth.

These advocates challenged the constraints on direct federal spending that were imposed under the anti-inflation programs of the late 1970s by arguing that the growth of tax preferences -- not runaway government spending -- was the most direct cause of growing federal deficits.[40] They also argued that most such preferences amounted to "corporate

[40] The National Council on Welfare published studies in 1976 and 1979 to publicize the extent of tax expenditures and the possibility of financing increases by narrowing the gap between effective tax rates and the existing progressive tax rate structure. National Council on Welfare, *The Hidden Welfare System*, (Ottawa, November 1976) and "The Hidden Welfare System Revisited", *Canadian Taxation* 1(1), Spring 1979. The most comprehensive argument for this position is found in David Wolfe, "The Politics of the Deficit".

welfare" and, by eroding the tax base, were undermining governments' ability to maintain or expand the welfare state.[41] Rather than the then conventional view of tax preferences as a way of allowing individuals and businesses to hang on to a larger share of their incomes or profits while also promoting various public policy objectives, the revisionist perspective argued that

> the tax expenditure concept ... rests on the view that whenever the government grants a tax concession, for whatever purpose, it is paying a subsidy. What the government fails to collect for some special reason, it is in effect giving away.[42]

This outlook was shared to some degree by much of the left wing of the Liberal Party. A senior party official comments that during the party's policy discussions prior to the 1980 election,

> every protagonist on social policy reform used the tax expenditure document [to justify demands for increased social spending.] ... If we did something on tax expenditures, we could do something on GIS and other social policy spending.[43]

Some supporters of the tax expenditure concept such as Neil Brooks, editor of *Canadian Taxation,* resorted to the rhetoric of class warfare in attempts to whip up public outrage at the tax system, and so increase public support for tax reform.

> The high income taxpayer is given the right to allocate large sums of government money [through tax preferences such as charitable donations]; the lower-income taxpayer is given no such right. ... The rich generally benefit from income tax subsidies, but it is the capitalists -- rich capitalists or "poor" capitalists who benefit the most.[44]

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[41] This campaign was a continuation of NDP leader David Lewis' assault on the "corporate welfare bums" during the 1972 federal election campaign. Lewis, *Louder Voices: The Corporate Welfare Bums*, (Toronto, James Lorimer, 1972); Woodside, "The Political Economy of Policy Instruments", 176-78.

[42] Brooks, "Making the Rich Richer", 32.

[43] Interview, senior PMO official (PMO-3).

[44] Brooks, "Making the Rich Richer", 33.

However, this campaign also helped to fuel opposition to the tax expenditure concept within the broader tax policy community -- especially among tax lawyers, accountants and business organizations.[45] This opposition was founded on a mixture of ideological, practical and technical grounds.

> Many economists and tax experts ... do favour subsidies rather than tax incentives, and argue persuasively for them. But in the course of making these arguments, a very interesting rhetorical transformation takes place. ... *You are implicitly asserting that all income covered by the general provision of the tax laws belongs of right to the government, and that what the government decides, by exemption or qualification, not to collect in taxes constitutes a subsidy.*[46]

While many business people might have been persuaded to reexamine or relinquish a range of their tax preferences, especially in return for lower tax rates and a promise of greater economic rewards for successful investments,[47] relatively few were willing to do so if the result was likely to be higher taxes and more bureaucratic interference in business and investment decisions.

The Trudeau Government's willingness to entertain the tax expenditure concept as a basis for tax reform deeply alarmed many business and professional people who had come to view the growth of government with concern, and who questioned both the ability of

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[45] Finance Department officials assert that the Haig-Simons income concept was not at the root of the tax expenditure model. Arguably, this is valid for the 1985 and 1992 Tax Expenditure Analyses. However, a careful reading of the 1979 and 1981 Tax Expenditure Accounts and the testimony of Department officials before the Senate Banking Committee in 1982 clearly indicate that the principle of comprehensive taxation took precedence over the "pragmatic criterion" of public understanding on a wide range of issues. See *Minutes and Proceedings*, Senate Standing Committee on Banking, Trade and Commerce, Issues # 90,91,97, May 12, May 18 and June 8, 1982.

[46] Irving Kristol, "On Taxes, Poverty and Equality", *The Public Interest* 37, [Fall 1974], 14-15.

[47] This is precisely the strategy followed by Michael Wilson between 1985 and 1988 in selling corporate tax reform to the business community. MacEachen's Parliamentary Secretary, John Evans, MP, attempted to put a similar interpretation on the 1981 tax reforms in his speaking tour to promote the budget, but in the highly polarized political environment of the time, he was shouting into a hurricane. Interview, Hon. John Evans.

politicians and bureaucrats to intervene effectively in day-to-day business decisions in which they had no personal stake and limited technical expertise.[48] This alarm had been further aggravated by the government's largely dismissive attitude towards much of the business community after its re-election in 1980, its threats of major new restrictions on foreign investment and an interventionist industrial strategy, and its unilateral introduction of the National Energy Program. These policies, combined with some of the more extreme statements of tax reform advocates, were exploited by opponents of tax reform to create a growing climate of fear and loathing against a government perceived as ideologically hostile towards business and verging on incompetence in its management of economic policy.[49]

The Tax Expenditure Concept and the 1981 Budget Strategy

The political decision in September 1981 to try to reduce the federal deficit through a major broadening of the personal and corporate income tax bases in the upcoming budget of November 1981 made the *Tax Expenditure Analysis* a focal point of the government's efforts to sell its tax reform package to the Canadian public. Rather than a highly technical document which would seek to convince experts in the economic and tax policy communities that the government had an intellectually rigorous and balanced approach to analyzing the fiscal and economic effects of its tax policies, the 1981 *Tax Expenditure Analysis* tabled with the budget was a highly partisan document designed to market a political and ideological product. This was clearly reflected in its "soak the rich" tone and

[48] William Simon, *A Time for Truth*, (New York, McGraw-Hill, 1978).

[49] For typical responses from private sector tax analysts, see Donald G. Huggett, *Canadian Tax News*, (Toronto, Coopers & Lybrand, monthly) and Arthur B.C. Drache, *The Canadian Taxpayer*, (Ottawa, monthly.) Brooks' campaign contributed directly to the backlash against the 1981 budget when he was identified as one of a few outside consultants who had contributed to the budget. See discussion of reaction to 1981 budget in Chapter 9.

in MacEachen's simplistic argument in his budget speech that tax rates could have been reduced by almost half in the absence of tax expenditures.[50]

The 1981 *Tax Expenditure Analysis* ignored most of the cautions made by Department officials and outside consultants in designing previous editions. It trumpeted the cumulative cost of $ 47.3 billion of various preferences to the federal tax base -- while making no provisions for the economic effects of withdrawing such stimulus on economic activity and tax revenues without their replacement with comparable direct expenditures by the federal government.

By including in the normative tax base such measures as the taxation of imputed income on homeowners' equity, which had never been subject to taxation in Canada, the *Analysis* raised the spectre of a hidden agenda of future tax increases on the middle class which was used by budget opponents to call into question the judgment and motives of the Finance Department officials who had prepared it.[51]

Such features seriously undermined the budget's communications strategy, which reflected an uneasy mix of political objectives targeted at various elements of the Liberal constituency. MacEachen presented his tax reform package as a compromise between the twin extremes of comprehensive government planning and laissez-faire economics by offering competing justifications of the budget's base-broadening measures.

On the one hand, the business and professional communities were expected to respond favourably to tax reform's contribution to economic efficiency.[52] On the other, "social

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[50] See Chapter 9. Hon. Allan J. MacEachen, *Budget Speech*, Nov. 12, 1981, 3; Department of Finance, *Analysis of Federal Tax Expenditures for Individuals* ("Tax Expenditure Analysis"), (Ottawa, the Department, November 1981), 1,29.

[51] See Chapter 9.

[52] Interview, Hon. John Evans.

progressives" and lower and middle income families which made up an increasingly important share of the Liberal coalition were expected to applaud an increased emphasis on redistributive taxation that would permit greater spending on social programs.[53] In appealing to this latter constituency, the *Tax Expenditure Analysis* emphasized the disproportionate benefits accruing to upper income taxpayers from the existing tax system, while downplaying the widespread use of tax preferences by lower- and middle-income earners to reduce their tax liabilities.[54]

This strategy, while perhaps well-intentioned, reflected a total lack of understanding of the increasingly polarized political environment surrounding these issues. Each side in the ideological debate perceived the government to be siding with its enemies -- and its attempt to balance market-oriented and redistributive arguments for its tax reform program as hypocritical double-dealing.

The politicization of the tax expenditure concept was a major tactical error by the Department of Finance which drove a wedge between it and the broader policy community of tax professionals. It aggravated the ideological conflict surrounding federal economic policies and the operation of the tax system, and reinforced the mistrust of many taxpayers in the good faith of the federal government.

The lack of an effective, coherent strategy to build political support for the 1981 budget was only one reflection of a budget process which seriously underestimated the political and technical difficulties of managing a major tax reform initiative through the political process. The following section examines that process in greater detail.

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[53] Interview, former senior PMO official. (PMO-3)

[54] *Tax Expenditure Analysis*, November 1981, 11-26.

THE PROCESS OF TAX REFORM: 1981 -- THE BEST LAID PLANS ...

> "It was like the sorcerer's apprentice type of mechanism."
> Anonymous Tax Policy Official

The process for developing major structural changes differs from the normal budgetary process both in the number of political and economic issues which must be balanced, their degree of technical complexity and their potential for unanticipated consequences. Managing a large scale program of tax reform thus requires either a significant increase in the management and staff resources needed for the development and consideration of these changes or a considerable lead time for the preparation of the budget.

The possibility of tax reform was signalled first by Ian Stewart in May 1980[55] and later by MacEachen his October 1980 budget speech.

> The incentives and preferences identified in the tax expenditure analysis raise important issues. They are expensive and it is incumbent on Ottawa to ensure that the incentives are effective and that their cost is justified. ... We have now a tax system characterized by higher tax rates relieved by a complex system of incentives and tax preferences. One questions whether the economy might not be better served by a tax system with lower rates but fewer and more selective incentives.[56]

However, while options for base broadening measures were developed by mid-ranking and junior officials of the Department of Finance responsible for various specialized area of tax policy during the next year, the fiscal framework for the budget was not set until the cabinet meeting of early September 1981 at Ingonish, Nova Scotia. Thus, the serious effort to prepare the government's base broadening package and general strategy for tax

55 "We are carrying out a major study of the revenue system as a whole to look for the most reasonable opportunities for additional tax revenue for the federal government. We are also attempting to look at that incentive structure in the tax system and to ask whether it does serve the purpose for which it was created and, therefore, to move on some of these incentives which seem ineffective. ..." Ian A. Stewart, from *Minutes and Proceedings*, Standing Committee on National Finance, The Senate, May 27, 1980, 26-27.

56 Hon. Allan J. MacEachen, *The Budget*, (Ottawa, Department of Finance, October 28, 1980), 15.

reform only began about two months before the budget, and few, if any, provisions were made for the technical implementation or political marketing of these reforms.[57]

The decision to pursue tax reform through the budget process and the haste with which the budget was prepared left the Department with no time to expand its staff resources, even while it was wrestling both with tax reform and a large number of issues left over from the previous budget.[58] As a result, the practical tasks of converting economic theory into administrative and business reality were left to the chaotic days after November 12, 1981.

The Role of Senior Management

A second factor influencing the lack of detailed preparations for the budget was the relative lack of senior management coordination of technical preparations for the budget. This breakdown was partly a result of the enormous time and policy pressures under which the budget was prepared, and partly a reflection of the outlook of senior Department managers, which emphasized macro-economic approaches to policy over their micro-economic impact on individual businesses or industry sectors. These factors short-circuited the political warning lights which normally would have alerted the Minister and Deputy Minister to the political dangers inherent in large scale tax changes. Similarly, no advance warning was given to the Prime Minister's office to alert it to the need for a major effort to shape public opinion.[59]

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[57] Interviews, current and former Finance Department officials. [D3, ADM-3, F01, F04]

[58] "Understaffed department prepared budget - official", *The Citizen*, Ottawa, November 26, 1981, 15.

[59] Interview, former senior PMO official. (PMO-3)

Deputy Minister Ian Stewart was fully absorbed in large scale issues of fiscal and economic policy: proposals for a White Paper on Economic Development Programs, preparations for a major renegotiation of Federal-Provincial Fiscal Arrangements, and the fiscal spillover of the ongoing energy war with Alberta and large segments of the oil industry. In any event, his management style was to provide general policy directions and then leave the details of their implementation to trusted subordinates.[60]

Stewart's attitudes towards the tax structure and tax reform were similar to those of his Minister. A budget with major tax increases not only had to distribute the sacrifices of fiscal restraint equitably, it had to be seen to do so.[61] In any event, Stewart lacked a technical background in tax policy and would normally have depended in large measure on the advice of the Assistant Deputy Minister, Tax Policy and Legislation. This position, however, had been vacant since the departure of Ed Neufeld in December 1979 Sid Rubinoff, acting ADM until August 1981, was largely preoccupied with his normal responsibilities for Economic Development Programs, and was not able to provide the direct management oversight normally associated with major budgetary changes. Rubinoff, a career Finance Department official, is described by his officials as a cautious manager who, despite his lack of technical tax experience, was sensitive to the Department's tradition of risk avoidance and careful policy analysis on key issues.[62]

A new Assistant Deputy Minister, Glenn Jenkins, arrived from Harvard in August 1981 to inherit a budget process which had already developed a momentum of its own, but without the checks and balances customary within the Department.[63] Jenkins was a

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60 Interviews, Ian A. Stewart, former senior Finance Department official (ADM-4).

61 Interview, Ian A. Stewart.

62 Interview, senior Finance Department official. [ADM-3]

63 Interviews, current and former Finance Department officials. (ADM-2, ADM-3, FO1)

conceptual thinker with a strong theoretical economic policy background who had conducted extensive research into the impact of inflation on business taxation and government revenues. He was strongly opposed to the ad hoc, piecemeal approach to tax policy formation which had characterized the Department for much of the 1970s. Jenkins brought an economic theorist's perspective to the tax reform process which stood in sharp contrast to that of the professional tax practitioners who made up much of the tax policy community. Like many academics, he was a strong supporter of comprehensive tax reform as the most effective way of rationalizing tax preferences and removing the economic distortions and perverse incentives for tax avoidance and the pursuit of group advantages through the tax system.

However, Jenkins paid little attention to the short-term economic impact of reversing previous policy measures which had encouraged businesses and investors to carry out various tax-favoured activities in the first place. While problems with technical provisions could be fixed between the time of the budget and the introduction of new legislation -- as the Department had done in previous years[64] -- Jenkins advised against transitional measures[65] in the budget, partly because of the pressure to raise sufficient revenues to allow for significant tax rate cuts, partly because of the fiscal policy stance advised by economists in the Fiscal Policy Branch, and partly to generate enough short-term revenues for both levels of government that MacEachen would be able to sell his planned reductions in transfer payments to the provinces in upcoming federal-provincial negotiations.[66]

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64 McCall and Clarkson, *Trudeau and Our Times, Vol. 2*, 237; interviews, tax policy officials (ADM-2).

65 Transitional Measures -- technical provisions intended to limit the economic disruption caused by tax policy changes on business decisions already in force at the time of a budget and to facilitate transition to the new rules.

66 Interviews, tax policy officials. [ADM-2, ADM-3, F04]

> The idea was to go in tough so that when the final legislation came in, you would move the effective dates. The guys had been successful in doing this in a few previous budgets. They'd gone out ... and worked things out. My sense of what got away on that budget was the overload. The problem comes when you have 160-odd measures ...[67]

The lack of adequate transitional arrangements was perhaps the most significant omission of the budget package, and the one that could have been most easily remedied, either by adequate prior consultation or by the presence of an experienced tax policy practitioner at the upper levels of management.[68] The number of transitional changes which had to be made after the tabling of the budget, both technical and substantive, placed the Department on the political defensive in trying to promote its economic policies and rebuild its credibility with the broader tax policy community.[69]

The Role of Tax Policy Officials

The cabinet decision to approve significantly higher spending levels for the 1982-83 fiscal year while reducing the deficit by $ 2 billion left little room for tax policy officials to manoeuvre in bringing in across-the-board tax rate reductions. Those officials therefore had to scramble to assemble a package of measures which would generate enough revenue to lower the top marginal federal-provincial tax rate to the psychologically important 50 percent level. As a result, a large number of budgetary and technical proposals were churned through the system with little analysis to determine their effect on

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67 Interview, Glenn P. Jenkins.

68 Interviews, Tax Policy Officials [ADM-3, F01, F04]; senior private sector tax professionals [P3,P6].

69 Interviews, former senior PMO official, tax policy officials. (PMO-3; F01, F04)

various economic interests.[70] Most of these had been submitted and rejected by senior management during the previous ten years.[71]

Preparations for the 1981 budget had begun shortly after the October 1980 budget and the tax analysis branch had drawn up a list of possible tax expenditure reductions by July 1981.[72] Even so, there appears to have been relatively little coordination between economists in the tax analysis division and the lawyers and accountants in the tax legislation division of the tax policy branch.[73] Unlike previous budgets in which most budgetary proposals were initiated "from the top",[74] this was a "civil servants' budget" according to a senior participant in the process.[75]

While new budgetary proposals would not normally be accepted later than a month before budget day in order to provide adequate time for senior management and Ministerial consideration, new proposals were still being inserted into the 1981 budget as late as the first week of November.[76] The number of Ways and Means Motions indicating an intent to change specific provisions of the Income Tax Act grew from 130 to 162 during the two

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[70] One senior official commented that "we were trying to do ... a numbers exercise; there was no attempt to make a qualitative assessment of the numbers". Interview, senior tax policy official (F01)

[71] Interview, former cabinet minister. (M4)

[72] Bob Hepburn, "Make or break budget just a toss up", The Toronto Star, Nov. 14, 1981, B1, B5.

[73] This lack of coordination and ongoing policy conflicts within the Tax Policy Branch were reflected in weak support for the budget and various efforts at blame shifting by junior officials which surfaced in the news media. Jamie Lamb, "Please don't bother to explain", *Vancouver Sun*, Nov. 17, 1981, A4; Arthur Drache, "What really went wrong inside Finance", *The Financial Post*, Dec. 19, 1981, 1-2.

[74] Drache, "Introduction to Tax Policy Formulation in Canada", 6.

[75] Interview, former Department of Finance official. (F04)

[76] Interviews, Hon. John Evans, MP, former tax policy officials (ADM-3, F04)

weeks prior to the budget, leaving virtually no room for the usual management scrutiny or internal debate.[77]

Individual tax policy officers who specialized in various areas of tax policy -- for example, real estate, insurance, small business or corporate reorganizations -- had identified a wide range of measures with the potential to raise revenues. Many of these involved the reversal of previous budgetary incentives or measures taken to provide horizontal equity -- now considered anomalies in the tax system. The result was that a number of initiatives which, in previous years, might have been considered as budgetary measures requiring political and senior management attention, were relegated to the status of technical adjustments of little interest except to a handful of tax specialists.

Thus, the Minister was handed a ticking time bomb whose political significance grew in direct proportion to the economy's slide into recession.

The Minister's Role

The Minister, Allan MacEachen, was widely thought of as a political wizard by his cabinet and caucus colleagues. First elected to Parliament in 1953, an eighteen-year veteran of six cabinet positions first appointed by Lester Pearson in 1963,[78] MacEachen had won the affection and respect of most Liberal veterans by his canny management of Liberal strategy, first during the minority government interlude of 1972-74, then by his orchestration of Pierre Trudeau's return from retirement and the unexpected defeat of the

[77] Interview, former tax policy official. (F04)

[78] Minister of Labour, Apr. 1963 - Dec. 1965; Minister of National Health and Welfare, Dec. 1965 - July 1968; Minister of Manpower and Immigration, July 1968 - Sept. 1970; President of the Privy Council, Sept. 1970 - Aug. 1974 and Sept. 1976 - June 1979; Secretary of State for External Affairs, Aug. 1974 - Sept. 1976 and Sept. 1982 - May 1984; Minister of Finance, Mar. 1980 - Sept. 1982.

Crosbie budget in December 1979.[79] MacEachen's political skills gave him a place next only to Prime Minister Trudeau in the respect and deference of Liberals in Parliament. More important, his loyalty and astuteness had earned him a freedom of initiative which Trudeau had rarely conceded to previous Finance Ministers.[80]

MacEachen's view of the tax system and its place in the overall scheme of government policy was a product of his background and experience in federal politics. A former economics professor at St. Francis Xavier University in Nova Scotia, MacEachen saw himself as a part of that generation of Liberals who had used the powers of the federal government to expand the welfare state and enhance the social opportunities and economic security available to most Canadians. MacEachen believed that budgets could be used as "attempt(s) to realign the economy and social attitudes".[81] However, he explicitly rejected the kind of economic shock therapy introduced by the Carter and Reagan Administrations in the United States, and by the Thatcher Government in Great Britain.

> ... the government was not about to turn the clock back. It was not about to undermine the level of security that Canadians have worked so hard to achieve. This is what gradualism is all about.[82]

Perhaps because his cabinet career before 1980 had given him responsibility for social rather than economic portfolios, MacEachen tended to look at the tax system primarily as an instrument of raising government revenues and of income redistribution rather than as

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79 Simpson, *The Discipline of Power*, Chapter 1; McCall and Clarkson, *Trudeau and Our Times, Vol. 2*, 227-29; interviews, former Liberal MPs. (M4, M5).

80 A former senior official in the Prime Minister's Office comments that "we trusted Allan to keep us out of trouble". [Interview - PMO-3]

81 Hon. Allan J. MacEachen, "Address to Canadian Club of Toronto", (Ottawa, Department of Finance, February 2, 1981), 6.

82 Ibid., 7. MacEachen expressed similar views in an interview with the Financial Post a month before the 1981 budget. Barry Critchley, "What MacEachen says about the economy and the issues facing him", *The Financial Post*, 1-2.

a vehicle for economic development. He had few links to the business community, and his exposure to regional development policies through the prism of Nova Scotia and Maritime politics generally tended to reinforce his predilection for government-centered rather than market-based initiatives. As a result, he lacked either a broad understanding of or sympathy for business concerns -- an attitude which came to be heartily reciprocated. This led him to ignore or dismiss the possible economic impact of various budgetary measures on various parts of the business community, and to discount the need for transitional measures to avoid undue disruption of economic activity.

MacEachen disclaimed any anti-business sentiments or intentions in framing his budget. However, his experience and understanding of economic policy and the role of government provided him with little basis to win the trust or even the grudging acceptance of business on which previous Finance Ministers had often relied to build credibility and support for their economic and tax policies. While many middle and upper income Canadians viewed their tax preferences as a means of ensuring equity, in effect, "paying as little tax as anyone else",[83] MacEachen and many of his officials saw tax preferences as exceptions which undermined the rule of progressive tax rates necessary for the achievement of equitable taxation. In their view, it was preferable, if tax increases were necessary as part of the "difficulty and unpleasantness caused by the need to moderate inflation", that the government should reduce tax preferences for the relatively affluent and increase its spending on particularly vulnerable groups "to ensure that policies of restraint are borne equitably by all Canadians".[84]

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[83] Wolfe Goodman, "The Small Business Credit: A Critique of the Proposed Changes", *Canadian Taxation* 1(2), Summer 1979, 38-39.

[84] Hon. Allan J. MacEachen, "Address to Vancouver Board of Trade", (Ottawa, Department of Finance, July 6, 1981), 8. One tax policy official was more direct. "He (MacEachen) wanted to make sure that there were enough screams to make sure that he wasn't accused of catering to big business." [Interview, F01]

Other Factors

Two other factors combined to undermine the effectiveness of the 1981 budget process -- the convention of budget secrecy and the lack of staff resources necessary to analyze and refine the large number of major policy changes contained in the budget. MacEachen, who as Liberal house leader had steered the Benson tax reform legislation through the Commons in 1971, may have wished to avoid the protracted consultations and negotiations that had forced Benson to make significant concessions. There is no indication that MacEachen seriously considered a consultative approach to his tax reform process -- either through the tabling of a White Paper, or through a post-budget consultation process as suggested by economist Irwin Gillespie.[85] While a small number of outside consultants were hired to analyze and make recommendations on particular budget proposals, the impact and implementation of several major budgetary measures were only given detailed study *after* the Minister tabled the budget in the House of Commons.[86]

Under normal circumstances, the political and economic objectives of Ministers and senior management in making budgetary changes to the tax system would be balanced by the arguments of technical specialists within the Department as to the administrative practicality and efficiency of proposed tax measures. These checks and balances clearly broke down in the preparation of the 1981 budget. Instead of challenging the credibility, efficiency and fairness of the existing tax system, as intended, the budget process ignored

[85] Interviews, Department of Finance, Jan. 1993; Gillespie, "The 1981 Federal Budget: Muddling Through or Purposeful Tax Reform?", *Canadian Tax Journal*, Vol. 31:6, [November-December 1983], 975-1002; Gillespie, *Tax Borrow and Spend*, (Ottawa, Carleton University Press, 1991), 197-201. Gillespie's theory that the 1981 budget was intended as a basis for consultation and negotiations with private sector interests and the tax community was bluntly dismissed by all past and present departmental officials interviewed for this study. The Department's willingness to consider adjustments was strictly limited to technical and transitional changes. [Interview ADM-2, F01, F04]

[86] Interviews, senior tax policy officials. (ADM-2, ADM-3, F04)

enough of the Department's own management practices to give its critics ample ammunition to question the competence and judgment of the Minister and officials who had prepared it.[87]

The secrecy and haste with which the budget was prepared, the failure to prepare public opinion for a major shift in tax policy, the failure to include measures capable of generating a supportive constituency for the budget, and the refusal of senior management to accept the advice of their officials to build in transitional measures, were major errors in political judgment. They ensured that the government would face an uphill political battle in attempting to win public support for its tax reform program and navigate the Parliamentary process.

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[87] This may be unfair to a number of officials who indeed did counsel the inclusion of adequate transitional measures -- but partisan politics and fairness are often as hard to reconcile as fairness and taxation.

CHAPTER 9 -- THE TAX REFORM BUDGET OF 1981 AND ITS AFTERMATH

> Necessity, especially in politics, often occasions false hopes, false reasonings, and a system of measures correspondingly erroneous.
>
> Alexander Hamilton[1]

The 1981 federal budget was an unprecedented attempt to impose large-scale unilateral changes on Canada's economic constitution, paralleling the government's initiatives in the fields of energy policy and constitutional repatriation. This chapter explores the key elements of that budget and the public debate which followed it. It reviews three specific case studies in which public and/or interest group pressures forced the modification or reversal of budget provisions and examines the shift in policy which allowed Finance Minister Allan MacEachen to regain some measure of control over the policy process, even while abandoning significant elements of his tax reform plan. It will also suggest the key lessons learned by Departmental officials in attempting to introduce structural reforms to the tax system -- lessons applied in large measure during the extended tax reform process of 1986-88.

PRESENTING THE BUDGET

The federal budget of November 12, 1981 attempted to introduce a far-reaching set of tax reforms to make major structural changes not only to the federal income and sales tax systems, but also to the principles of taxation underlying them.

In his budget speech, Finance Minister Allan MacEachen justified his income tax reform proposals both in terms of egalitarian rhetoric and the logic of market-based economics. The three overarching themes of his speech were "restraint, equity and economic

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1 Alexander Hamilton, "Federalist # 35", in *The Federalist Papers*, Clifton Rossiter, ed., (New York, Mentor Books, 1961), 213.

renewal".[2] Restraint was defined in terms of deficit reduction and tax increases to support the anti-inflation policies of the Bank of Canada. Economic renewal would be based on the government's objectives of lowering inflation and interest rates, and on the results of a consultation document, *Economic Development for Canada in the 1980s*, tabled with the budget.[3] Equity was defined in the context of tax reform and limited relief measures for groups hardest hit by high interest rates.

As discussed in Chapter 8, MacEachen also used the Department's tax expenditure budget as justification for his reforms, claiming that personal income exempted from tax through tax expenditures amounted to $ 47 billion. While this definition of income far exceeded any tax base ever contemplated by the federal government, it permitted him to claim that if tax preferences were eliminated, "rates of tax could be halved without reducing federal revenues".[4]

The Finance Minister thus sought to combine an appeal to populist resentment of the rich and their easy access to tax "loopholes" with an appeal to business and professional taxpayers based on the prospect of a simpler, more market-oriented tax system. On the one hand, he hammered at the unfairness of tax provisions which gave disproportionate benefits to higher income Canadians at the expense of higher tax rates for all citizens.

> Many Canadians find our tax system unfair, and I agree with them. They realize that taxes are necessary to pay for important government services, but they feel that rates of tax are too high. They sense that others, the well-advised or the wealthy, very often pay less than their fair share. ... Some higher-income individuals are able to reduce their tax rate to well below

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[2] Hon. Allan J. MacEachen, *Budget Speech*, (Ottawa, Department of Finance, Nov. 12, 1981), 1.

[3] Ibid., 2-3; Canada. Department of Finance, *Economic Development for Canada in the 1980s*, (Ottawa, The Department, November 1981).

[4] MacEachen, *Budget Speech*, 2-3.

> that paid by lower-income Canadians. Some can escape paying taxes entirely. This is unacceptable.[5]

At the same time, he offered upper-income Canadians the incentive of lower tax rates to enjoy a larger after-tax share of their efforts.[6]

> A cutback of tax preferences will permit a lowering of tax rates. Lower tax rates will improve the incentives to work, save and invest. These incentives will be direct, easy to understand and available to all. Lower tax rates will also reduce the tendency for taxpayers to devote wasteful effort and money in finding artful ways of avoiding tax. For these reasons, I propose to end a number of special tax preferences, to restrict others and to lower marginal rates.[7]

MacEachen's rhetorical performance was also artful. He sketched the broad objectives of his tax reform plan in less than five minutes, mentioning eight measures in one short paragraph, but leaving the media and the public to flounder through a huge mass of technical detail in a thick stack of budget papers.

Hidden in the fine print were the most fundamental proposals for restructuring of the tax system since Edgar Benson's White Paper. While base broadening (or "loophole closing", depending on the audience) and rate reduction were emphasized for popular consumption, the fine print contained a series of conceptual changes designed to make major changes in the definition of income and the concept of tax preferences.

The benchmark for personal income taxation would be the annual income of a salaried employee or wage-earner. Income from most forms of savings, investments and professional practice would be taxed on an accrual basis, as with corporate income, rather

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[5] Ibid., 3.

[6] While only one marginal tax rate for middle-income earners was changed, the low-income exemption level was increased and maximum tax rates reduced to a combined average federal-provincial rate of 50 percent for Canadians with taxable income over $ 53,376 -- about ten percent of taxpayers in 1981. *The Budget in More Detail*, (Ottawa, Department of Finance, Nov. 12, 1981,) 32; Revenue Canada-Taxation, *Taxation Statistics*, (Ottawa, The Department, 1983).

[7] MacEachen, *Budget Speech*, Nov. 12, 1981, 3.

than when received in cash by the taxpayer. The budget also attacked a wide variety of income and tax deferral measures, some on theoretical economic grounds, other on grounds of abusive tax planning. Tax deferrals permitted for economic reasons would be matched by the deferral or capitalization of expenses. Some of these measures were broadly-based in application. Others targeted specific sectors, including real estate, insurance and small business, for major changes to existing policy measures and the underlying principles of taxation.

The budget papers contained a ways and means motion with 162 separate measures, and a series of statistical analyses to justify these measures either on grounds of distributive justice or cost savings to the federal government. These claimed that the budget would generate $ 5.7 billion in new tax revenues over two years from its trimming of tax preferences, while returning $ 2.4 billion as a result of rate reductions, coupled with around $ 200 million in new federal spending.[8]

However, instead of evidence of a fairer tax system and firm government leadership in economic policy, MacEachen's tax increases came to be associated in both media commentary and the public mind with massive economic dislocation and the 1981-82 recession. In essence, the budget declared war on a large number of entrenched economic interests without developing any constituency for the proposed reforms. As Bruce Doern has noted,

> the Budget purported to tax the rich by closing off lucrative tax expenditures and distributing the benefits to as many as twelve million Canadians in the form of reduced taxes. This proposal provided for an infinitesimal gain to the members of a dispersed constituency of largely middle class and upper income Canadians. It provided for losses to

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[8] *The Budget in More Detail*, November 12, 1981, 11. 50. Finance Department officials later discovered that they had underestimated the impact of budget changes by more than $ 700 million -- or 28 percent of the original first year changes.

> powerful and cohesive economic interests. It rightfully earned the Liberals little support and much criticism.[9]

While vigorous criticism from the opposition and major interest groups was predictable, the political fate of MacEachen's tax reform budget would depend on the ability of the Minister and his officials to win the subsequent public relations contest with these interests for media support and the general acceptance of Canadians. However, while many of the government's proposed structural changes and all its biggest tax increases survived the budget debate more or less intact, the outcome of the public relations contest was little short of disastrous for MacEachen and the government as a whole.

THE UNRAVELLING OF TAX REFORM : "SWARMING" THE DEPARTMENT

Media and Public Response

Media response to the budget was comparatively restrained for the first three or four days until the full extent of the changes in the budget's technical papers had sunk in for various interest groups, businesses and their professional advisors. Much of the popular press concentrated on the fiscal emphasis of the budget. Most of their commentaries reflected existing editorial positions on economic policy and paid only superficial attention to the budget's tax reform elements.[10] At first, it appeared that Department officials had

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[9] G. Bruce Doern, "Liberal Priorities 1982: The Limits of Scheming Virtuously", in Doern, (ed.), *How Ottawa Spends Your Tax Dollars: National Policy and Economic Development 1982*, (Toronto, James Lorimer, 1982), 10.

[10] Editorial responses ranged from cautious or even enthusiastic approval of the government's fiscal stance ("A stingy budget", *Vancouver Sun*, Nov. 13, 1981, A4; "Pledge to cut deficit best news", *London Free Press*, Nov. 13, 1981, A6) and its apparent approach of tax reform ("Closing Loopholes", *The Globe and Mail*, Nov. 13, 1981, 6); to a "wait and see" approach ("The budget: the real thing", *The Chronicle Herald*, Halifax, NS, Nov. 14, 1981, 6); to stinging criticism from traditional Keynesians ("MacEachen's ineffectual budget: No Relief in Sight", *Toronto Star*, Nov. 13, 1981, A8) and advocates of comprehensive controls ("Recipe for Recession", *The Citizen*, Ottawa, Nov. 13, 1981, 8).

convinced many economic policy analysts and journalists that MacEachen had produced a minor miracle.

> The political professionals around Ottawa all marvel at the adroitness of the move, the sheer brilliance of a fundamental revision of Canada's tax system which, subsequently, has been termed 'housekeeping' by some officials.
> In other words, MacEachen has achieved what Edgar Benson, a decade ago, flubbed. There may yet be a rush of second thoughts, and three-piece-suited picketers may yet appear on Parliament Hill. But for the moment, MacEachen must be quietly proud of his astonishing success.[11]

While business economists were virtually the only group enthusiastic about the budget as a macro-economic document,[12] most editorial writers applauded the intent of MacEachen's tax reform measures, generally seeing what they wanted to see -- greater fairness among income groups, greater economic efficiency or a lower federal deficit.[13]

However, MacEachen's attempt to promote the contents of the "restraint budget" to selected members of the Parliamentary Press Gallery four days after the budget turned into a public relations disaster when details of the three-hour, six-course luncheon became public.[14] But even this embarrassment paled into insignificance as a series of revelations about the short-term economic damage done by the budget forced MacEachen to make

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[11] Fred Harrison, "Finance, it seems, can tell a good shelter from a bad", *The Financial Post*, November 21, 1981, 8. The same edition of the Post contained a cautious editorial endorsement of the budget -- which was reversed shortly afterward. Several other newspapers picked up the "housekeeping" label in early budget coverage.

[12] Most business economists quoted in the print media were generally supportive of the medium-term fiscal strategy contained in the budget, and the tax measures as one element of that package. Michael Walker of the Fraser Institute was one of the few open critics among this group. Jack McArthur, "Fine tuning economy may be a fool's game", *Toronto Star*, Nov. 20, 1981, B13.

[13] "Behind the smoke screen", *Winnipeg Free Press*, Nov. 13, 1981, 6; Richard Gwyn, "A clearing in the jungle", *The Citizen*, Ottawa, Nov. 14, 1981, 7; "Mixed fallout from simpler tax life", *Financial Post*, Nov. 21, 1981, 10; "MacEachen's ineffectual budget", *Toronto Star*, Nov. 13, 1981, A8.

[14] "MacEachen in the soup over lunch", *The Vancouver Sun*, Nov. 17, 1981. A1; Bob Hepburn, "MacEachen's 'restraint' includes $ 2,000 lunch", *Toronto Star*, Nov. 17, 1981.

one change after another. Most of these, while relatively minor in themselves, conveyed a public impression of poor preparation and questionable understanding of the workings of the economy. In the face of a growing recession, the cumulative impact of these mistakes was politically devastating.

The Interest Group Counterattack -- The Budget Unravels

The simultaneous shift in federal fiscal and tax policies and the suddenness with which many of the changes were implemented aroused a broadly-based chorus of criticism. Within days of the budget, both MPs and Tax Policy officials began to hear from constituents, businesses, interest groups and tax professionals claiming that various provisions in the budget would cause major economic disruptions or hardships.

These reflected four major themes: the charge that MacEachen's restrictive fiscal policies would deepen the recession and increase unemployment; the short-term economic impact of various tax changes on existing economic arrangements, especially real estate development and corporate reorganizations; the overlapping structural impact of tax changes on several sectors, most notably small businesses and independent professionals, insurance, investment and manufacturing; and the growing perception that government had set one standard of restraint for the general public, and another, less rigorous one for itself and its employees. As a result, MacEachen began to backtrack on technical details of the budget almost immediately.

The central issue in the first stage of the tax reform debate was the retrospective application of many of the tax changes. Unlike previous structural or technical tax changes, which were usually structured to prevent budget decisions from having an adverse economic impact on most economic decisions taken under existing rules,[15] senior tax professionals claimed that at least 35 of the 162 Ways and Means Motions tabled with the budget were retrospective if not retroactive in effect. As most tax professionals did not make this distinction, the attack on "retroactive taxation" became a rallying cry for many opponents of the budget.[16]

Within five days of the budget, MacEachen revised the rules governing "soft costs" and the deductibility of interest expenses on funds borrowed by first purchasers of MURBS.[17] Critics had noted that while reductions in tax incentives for the heavily subsidized rental construction industry were immediate, it would take six to twelve months for federal and provincial governments to negotiate the alternative subsidy programs announced in the budget. With industry cash-flow already strained by interest rates in excess of 20 percent, the budget threatened to hamstring much of the rental construction industry for more than six months. Industry statistics compiled by Vancouver MP Pat Carney indicated that construction had ceased on 12,916 units within a

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[15] The Senate Banking Committee Report on the 1981 Budget distinguishes between retroactive and retrospective legislation. "A retroactive statute [is] 'one that operates at a time prior to its enactment. ... A retrospective statute is one that operates forward, but it looks backwards in that it attaches new consequences for the future to an event that took place before the statute was enacted.'" *Report of the Standing Committee on Banking Trade and Commerce*, Issue # 114, December 1, 1982, 10. Senator Salter Hayden and the Banking Committee were jealous guardians of this principle -- often forcing amendments to tax legislation through the 1970s. See reports on Bill C-37 (1978), Bill C-17 (1979), Bill C-48 (1981) and the 1981 budget (1982).

[16] *Canadian Tax News*, (Toronto, Coopers & Lybrand, November 18, 1981), 66-71.

[17] Soft costs: administrative and technical costs related to construction expenses. MURBS: Multiple Urban Residential Buildings - rental housing.

week of the budget, compared with subsidies for 15,000 new rental units promised in the budget.[18]

The next day, budget provisions on the tax treatment of corporate reorganizations were revised to avoid gutting the $ 700 million purchase of Hudson's Bay Oil and Gas by Dome Petroleum -- a major spin-off of the National Energy Program efforts to promote greater Canadian ownership of the oil industry.[19] While MacEachen hinted at the possibility of budget adjustments, these mishaps prompted a series of scathing editorials from newspapers across the country calling for a major overhaul.[20]

The budget contained many measures whose impact tended to fall on middle class taxpayers: insurance agents, small business people and travelling sales people, many of whom were the leaders and financial supporters of Liberal riding associations. Even commentators well disposed to the government concluded that instead of attacking the rich, the budget constituted a broad swipe at the middle class while cutting taxes for upper income groups.[21] The life insurance industry, the small business lobbies and the

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18 Denis Grayhurst, "MacEachen 'killed' rental construction, economist says", *Toronto Star*, Nov. 14, 1981, A8; Patricia Lush, "'Soft cost deduction changes jeopardize 20,000 rental units", *The Globe and Mail*, Nov. 17, 1981, B2. Michael Valpy, *The Globe and Mail*, Nov. 20, 1981, 6. Later changes deferred the budget rules on the tax treatment of rental construction to 1983 prompting a last minute surge of new construction as investors took advantage of the delay. (Department of Finance, "Release", December 18, 1981; *Minutes and Proceedings*, Senate Banking Committee, Issue # 91, May 18, 1982, 10-15.)

19 P. Taylor, "Tax changes threaten Dome bid for HBOG", *The Globe and Mail*, Nov. 14, 1981, B2; T. Walkom, "Return of tax breaks allows Dome to proceed with HBOG share bid", Ibid., Nov. 19, 1981, B1.

20 "Still Not Right", *The Vancouver Sun*, Nov. 20, 1981, A4; "Budget needs a massive rewrite", *The Citizen*, Ottawa, Nov. 30, 1981, 8; Charles Lynch, "Budget like exploding cigar", *The Citizen*, Nov. 18, 1981, 7; "Let's open up the budget process", *The Financial Post*, Dec. 5, 1981, 9; "Scrutiny by the elected", *The Globe and Mail*, Dec. 18, 1981, 6.

21 Eric Kierans, "A sermon misdirected", *Vancouver Sun*, Nov. 17, 1981, A6; Richard Gwyn, "Big tax hurdle sure to stymie the small businessman", *The Toronto Star*, Nov. 19, 1981, A10; Richard Gwyn, "The very rich look at the budget and chortle", *The Citizen*, Ottawa, November 24, 1981, 8.

Automobile Dealers' Association launched major publicity and lobbying campaigns against the budget which had a major impact on the Liberal caucus.[22] Tax professionals sent out scathing commentaries in newsletters to well-connected clients.[23]

Business and investment interests were not the only critics of the budget. The Canadian Labour Congress organized a massive demonstration on Parliament Hill to attack the government's economic policies for leading Canada into a recession.[24] Provincial governments, especially Ontario, attacked various areas of the budget for their impact on investment in regional economies, and provincial government services.[25] MacEachen's attempt to buy provincial support for tax reform and for his proposed changes to federal-provincial revenue sharing arrangements was not helped by his admission that he had overestimated provincial revenue gains from his base broadening measures by more than 20 percent.[26]

The cumulative impact of this uproar was to create a widespread impression that the budget was the product of poor planning, and that wealthy and influential interests were able to obtain changes in the budget while large numbers of middle and working class

[22] "Budget called threat to business", *The Citizen*, Ottawa, Nov. 18, 1981, 43; James Dow and Carol Goar, "Insurance industry plans anti-budget campaign", *Toronto Star*, Nov. 20, 1981, B11.

[23] For examples, see Donald R. Huggett, "Turning Off the Lights", *Canadian Tax News*, November 18, 1981, 1-5; Arthur B.C. Drache, "Ken Carter Rides Again", *The Canadian Taxpayer* III(22), Nov. 17, 1981, 169-170.

[24] Hugh Paterson, "Angry thousands scorn budget, interest rates", *The Citizen*, Ottawa, Nov. 23, 1981, 1.

[25] Rick Haliechuk, "Budget cut incentive, not loopholes: Miller", *Toronto Star*, Nov. 20, 1981, B13; Jim Robb, "Ontario seeks budget changes to aid investors", *The Citizen*, Ottawa, Nov. 24, 1981, 4; Carolyn Pestieau, "Minds don't meet on revenue sharing", *Financial Post*, Dec. 9, 1981, 9.

[26] Revised forecasts were to give the provinces $ 3.1 billion in new revenues over five years, rather than the $ 3.8 billion originally forecast. However, MacEachen's proposed changes in cost sharing formulae were to cost them $ 5.9 billion. "MacEachen cites budget goofs", *Vancouver Sun*, Nov. 23, 1981, A8.

taxpayers were left to pay the costs of the government's restraint program. Rather than tax reform, critics charged, the government had engaged in a tax grab which would drive the economy deeper into recession.[27]

This impression was reinforced by MacEachen's unpreparedness for a major political battle and by the Department's initial defensiveness and clumsiness in responding to its critics. While MacEachen's Parliamentary Secretary, Ottawa MP John Evans, toured the country meeting with Liberal and business groups to promote the budget, MacEachen made almost no appearances outside the House of Commons and even went to Scotland for a five-d- vacation.[28] Finance Department officials expressed not quite off-the-record scepticism of the Minister's grasp of his policy proposals, and of the process which had produced them.[29] Senior Department officials received such a hostile response at the Canadian Tax Foundation Conference in late November that they tried to conciliate the assembled tax specialists by promising to reexamine selected areas of the budget as long

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[27] "Social group sizes up MacEachen budget: a Robin Hood he isn't", *The Globe and Mail*, Nov. 18, 1981, 7; W.A. MacDonald, "Push for economic renewal lost in rush for revenue", *The Financial Post*, Nov. 21, 1981, 13; "Crowd's anger justified" (editorial), *The Citizen*, Ottawa, Nov. 24, 1981, 8.

[28] Carol Goar, "'Prepared' to change budget: MacEachen", *Toronto Star*, Dec. 4, 1981, A1. McCall and Clarkson allege that the budget backlash "got so bad that MacEachen went incommunicado ... trying to distance himself from what had so suddenly become a fiasco". *Trudeau and Our Times, Vol. 2*, (Toronto, McClelland & Stewart, 1994), 235. While this prompted an outraged denial from MacEachen (*Globe and Mail*, Toronto, Dec. 13, 1994) and a carefully negotiated qualification from the authors, (Ibid, Apr. 1, 1995, D-7), there is little doubt his comparative inertia in promoting the budget hurt the government and allowed the opposition to seize the political initiative. (Interviews, M2, MP3)

[29] Jamie Lamb, "Please don't bother to explain", *Vancouver Sun*, Nov. 17, 1981, A4; Arthur Drache, "What really went wrong inside Finance", *Financial Post*, Dec. 19, 1981, 1-2.

as its major policy thrusts were not subject to change. MacEachen made similar assurances of flexibility in Parliament a few days later.[30]

While some groups and media commentators advised a cautious approach to the budget to avoid driving MacEachen and his officials into a political corner, others pressed to take advantage of the seeming confusion within the Department by attacking with even greater vigour. Departmental officials began to enter into sector-by-sector discussions with various interest groups, some of which were supplemented by meetings at the political level. Business groups began to coordinate their activities in a loose coalition which grew from twenty-three organizations in early December to more than fifty by the spring of 1982.[31] Full page newspaper advertisements called for the referral of the entire budget to a Parliamentary Committee.[32]

Six weeks after the budget, MacEachen initiated a major effort at damage control, introducing eighteen amendments to the budget, most of them transitional measures designed to mitigate many of its retrospective provisions. Five policy areas were referred to Parliamentary Committees[33], and a number of other measures were deferred.[34]

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[30] Gordon Pitts, "Ottawa's budget open, within limits, to new changes", *The Financial Post*, Dec. 5, 1981, 1-2; C. Goar, "'Prepared' to change budget: MacEachen", *Toronto Star*, Dec. 4, 1981, A1. The Joint Taxation Committee of the Canadian Bar Association /Canadian Institute of Chartered Accountants, which usually avoided political comments on budgets, made an unprecedented response which deplored the lack of prior consultation or transitional measures for such a major series of legislative amendments. ("Brief charges major tax reform causing hardship", *Toronto Star*, Dec. 9, 1981, F14.)

[31] "Adjusting the budget", *Globe and Mail*, Nov. 27, 1981, 6; "Let's open up the budget process", *Financial Post*, Dec. 5, 1981, 9; Stanbury, Business-Government Relations in Canada, (Toronto, Methuen, 1986), 380.

[32] National Citizens Coalition, *Toronto Star*, Dec. 1, 1981, B5; CFIB, "The MacEachen budget is not what it seems to be", *Toronto Star*, Dec 8, 1981, B8.

[33] Taxation of life insurance policies, charitable foundations, corporate reorganizations, professional work-in-progress and employee retirement allowances.

However, while MacEachen might claim that the changes were mainly technical and that the basic thrust of his budget was unchanged, his credibility and that of departmental officials were seriously damaged.[35]

However, these changes did little to mitigate business hostility. Lib^ral MP Roy MacLaren wrote later that:

> already rattled by persistent high inflation and other current economic ills, many in the business community seem to regard the budget as a final confirmation of hostility towards themselves on the part of the Liberal Party in general and of Trudeau in particular.[36]

After December 18, 1981, the Department was forced to fight a series of rearguard actions, sector by sector, to preserve the major policy thrusts of its tax reform plan and the tax principles on which they were based. The debate over tax policy largely disappeared from the public eye and reverted to a series of compartmentalized debates with selected interest groups and interested tax professionals.

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[34] Hon. Allan J. MacEachen, *Debates*, House of Commons, December 18, 1981, 14236-14238; "Notes on Transitional Arrangements and Adjustments Relating to Tax Measures Announced November 12, 1981".

[35] Don McGillivray, "Budget retooling fails to stop complaints", *Vancouver Sun*, Dec. 19, 1981, A1; Charles Lynch, "Budget and its maker dismantled", *The Citizen*, Ottawa, Dec. 19, 1981, 9; William A. Wilson, "Shakeup in Ottawa hierarchy needed for economic recovery", *The Financial Post*, Jan. 9, 1982, 8.

[36] Roy MacLaren, *Honourable Mentions*, 84-85. Entry from MacLaren's diary following MacEachen's announcement of budget changes on December 18, 1981. This view became the received wisdom in much of the business community. See also Arthur Drache, "Budget aims at controlled economy", (*The Financial Post*, Feb. 6, 1982, 9) and Drache, *The Great Tax Rip-Off*, (Toronto, McClelland & Stewart, 1982). Drache, a tax lawyer and former tax policy official, promoted opposition to tax reform as an ideological crusade, much as I.H. (Izzy) Asper had during the Carter-Benson period.

THE 1981 TAX REFORM BUDGET – THREE CASE STUDIES

The broader political backlash against the 1981 federal budget obscured a number of sectoral political disputes over specific areas of tax policy. Three of these conflicts in particular symbolized the political and economic issues raised by the budget: the taxation of insurance policies, the deductibility of interest on funds borrowed for investment purposes, and the taxation of small businesses.

The policy changes introduced in each of these areas, while debatable among reasonable observers, became highly charged symbols of the alleged anti-business animus of the Trudeau Government to their main beneficiaries. Each of these areas had its own specialized policy community, with interests claiming recognition within the tax system on grounds of horizontal equity and/or contribution to economic development. Each had its own specific principles of taxation to justify existing tax preferences and to challenge the budget's attack on them. Each case had its own political and technical factors which shaped the outcomes of very different struggles. Two of the three groups, insurance brokers and the small business lobbies, perceived at least some of the budget measures affecting their sectors to pose a direct threat to entrenched and economically significant business practices which touched upon their fundamental interests.

The sectoral budget debates illustrate both the difficulty of introducing major tax policy changes affecting large numbers of taxpayers, and the need for effective economic analysis and technical preparation before doing so. Both the insurance industry and the small business sector could mobilize large numbers of voters whose interests were directly attacked by the budget, using relatively simple, easily understood arguments. The investment industry, while numerically small, enjoyed a central position in a capitalist economy reliant on private investment, especially during a major recession. While the Department of Finance succeeded in securing higher revenues from each sector in the short-term, these pyrrhic victories forced it to re-evaluate its approach to the development and marketing of tax policy.

Case Study 9-1 - Taxation of Whole Life Insurance and Employee Insurance Benefits

Taxing Insurance -- Conflicting ideas

The insurance industry was a major target of the 1981 budget emphasis on the elimination or reduction of tax deferrals for individual policy holders. The industry identified thirty-two significant issues in the insurance and benefit-related measures referred by Finance Minister MacEachen to Parliamentary Committees.[37]

The budget's philosophy of taxation considered tax deferral illegitimate for four main reasons. Employment income, the basic standard for income taxation, was and is recognized and taxed annually for most Canadians. Therefore, tax deferral gave an unfair advantage to individuals able and willing to engage in long-term savings rather than liquid, short-term savings or current consumption. Tax deferral was also attacked for reducing taxes owing at a time of high inflation, thus shifting the relative tax burden from savers, presumably those with high incomes and greater ability to pay, to consumers, presumably those with lower incomes. Some high income taxpayers were using insurance policies and other income deferral measures such as Income Averaging Annuity Contracts (IAACs) to "artificially" reduce taxable income, rather than to accumulate personal savings.[38] And from a macro-economic perspective, federal officials felt that it was

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[37] *Minutes and Proceedings*, Senate Banking Committee, Issue # 101, June 16, 1982.

[38] The insurance industry also had a booming business in Income Averaging Annuity Contracts (IAACs), which lent themselves to creative tax avoidance measures for individuals with surplus income. For example, see Virginia Galt, "It may be a good investment to buy annuities before budget", *The Globe and Mail*, Nov. 9, 1981, B7.

inappropriate to provide incentives to a higher private savings rate when the federal government was running higher and higher deficits.[39] The initial fiscal savings estimated by the Department for these measures was $ 1,070 million -- 83 percent from the elimination of IAACs, the rest from the taxation of employee benefits.[40]

The industry sought changes to three major areas of the budget: the taxation over three years of interest income accrued in whole life policies[41], the elimination of tax exemptions on employer-paid employee benefits, and the taxation of interest on unregistered savings annuities.[42]

Not surprisingly, the insurance industry, agents and its clients took a much different view of the relevant tax principles. The tax system had long recognized the importance of systematic savings as a means of avoiding individual dependence on the state. These savings provided a major source of private capital formation for recycling through financial institutions into private business investment and government debt. The industry promoted insurance partly as a service and partly as a form of long-term savings analogous to pension savings -- which were also subject to tax deferral.[43] The blending of insurance and savings elements and the complex finances of insurance companies made the identification of taxable income both difficult and somewhat uncertain, leading to the

39 Interview, Ian A. Stewart.

40 *The Budget in More Detail*, November 12, 1981, 50. No financial estimates were made within the Department on the taxation of accrued interest on life insurance policies, suggesting a last-minute addition to the budget. (Interview, senior Finance Department official) (ADM-3)

41 The interest build-up within whole life insurance policies had been exempt from taxation before the budget.

42 Priorities identified by Gerald Devlin of the Canadian Life and Health Insurance Association. James Dow, "Budget irks insurance firms", *Toronto Star*, Nov. 14, 1981, B9.

43 A number of current and former Finance Department officials have commented on the Insurance industry's attempt to identify with the pension sector to justify its favoured tax status.

prospect of arbitrary and unfair taxation. Industry officials emphasized that more than 80 percent of insurance policy holders were not upper-income taxpayers but individuals and families with annual incomes under \$ 25,000 (\$ 44,000 in 1995 dollars) for whom insurance and home ownership were the two major forms of capital formation.[44]

One of the most controversial parts of the *Tax Expenditure Analysis* was its inclusion of "imputed rental income"[45] and capital gains exemptions from owner-occupied housing, which was alleged to confer a taxable benefit of between \$ 4.5 and 7 billion. The Dominion Life Insurance Company even sent its policy holders excerpts from the *Analysis* suggesting that if small savers were to be taxed on unrealized income from insurance policies, the next step could be to tax them on imputed income from the equity built up in their homes.[46]

The highly partisan tone of the 1981 *Analysis* and the allegations of tax reform advocates that these sums were "government money" were seen by many as a declaration of war on the middle class. Rather than seizing the high ground of "tax fairness" as intended in the budget speech, MacEachen and the Department found themselves on the political

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[44] However, this argument was not applicable to IAACs, a favourite upper income tax shelter which had become subject to complex tax avoidance manoeuvres. J. Dow and C. Goar, "Insurance industry plans anti-budget campaign", *Toronto Star*, Nov. 20, 1981, B11. Among the more creative tax avoidance devices was a "wrap-around" IAAC financed by loans whose repayment terms effectively matched IAAC payments and had the same term. Virginia Galt, "It may be a good investment to buy annuities before budget", *The Globe and Mail*, Nov. 9, 1981, B7.

[45] The income that would be derived if the homeowner's equity was invested at market rates of return.

[46] Hon. Allan J. MacEachen, in *Minutes and Proceedings*, Standing Committee on Finance, Trade and Economic Affairs, Issue # 80, (Ottawa, House of Commons, Apr. 30,1982),15-16.

defensive in an increasingly bitter ideological battle over the budget's implications for individual savings and private property ownership.[47]

The vast majority of Canadians enrolled in group life, health and dental insurance plans were employees of large and medium-sized corporations, some of whom paid the full cost of employee benefits, some of whom shared the costs with their employers. Finance argued that a benefit conferring a tax deduction on employers should confer a taxable benefit on employees.

> Both employers and employees have an incentive to convert cash remuneration into non-cash benefits that are taxed on a preferential basis. Because non-taxable benefits are worth more than an equivalent cash remuneration to employees, employers can indirectly obtain some of the benefits of these tax concessions by reducing their total remuneration but providing it in a tax-exempt form. The tax concessions may thus amount to a subsidization of wage costs to employers, with little or no benefit to employees.[48]

This argument carried little weight with large numbers of salaried employees and wage-earners who faced significantly higher taxes on housing loans, the use of company vehicles, health and dental insurance, employee transportation passes, and termination or retirement benefits transferred to RRSPs. These provisions provoked widespread media coverage which did little to support the government's arguments that tax reform was primarily an attack on tax loopholes enjoyed by the rich.[49]

Employers, insurers and unions argued, on pragmatic grounds, that taxing benefits could lead either to higher employee wage claims or to the dismantling of benefit plans by some employers -- and ultimately to political pressures to increase government social programs

[47] *Analysis of Federal Tax Expenditures*, 1981, 31; Neil Brooks, "Making Rich People Richer", July 1981, 33.

[48] *The Budget in More Detail*, Nov. 12, 1981, 38.

[49] "The vanishing perk", *Winnipeg Free Press*, Nov. 19, 1981, 6; Mike Grenby, "Ottawa to tax more perks", *Vancouver Sun*, Nov. 26, 1981, A1; K. MacGray, "Budget unfair Davis tells PM", *Toronto Star*, Dec. 5, 1981, A3.

While the technical and policy details of these measures went far beyond public understanding, these measures further fuelled the media and public perception of the budget as an attack on middle class taxpayers rather than an exercise in tax fairness.

Taxing Insurance -- The Interests

The major industry associations representing the insurance industry were and are the Canadian Life and Health Insurance Association (CLHIA), then representing 120 insurance companies, and the Life Underwriters Association of Canada (LUAC), representing 19,000 insurance agents.[50] There were approximately 13 million Canadians with whole life insurance policies in 1981.[51] While no organized group spoke directly for policy-holders, the LUAC presented itself as their effective representative.

The insurance companies targeted their representations to the Tax Policy Branch of the Department of Finance, specifically Assistant Deputy Minister Glenn Jenkins, the Director of Tax Analysis, Satya Poddar, his Assistant Director, Nick Le Pan and the tax policy officers responsible for insurance matters. The CLHIA tax committee was able to draw on the expertise of the senior tax executives of major companies, along with experienced association staff.

While the LUAC also met with Tax Policy officials, it focused its major public relations effort on Members of Parliament and the general public. The industry had mounted a campaign in 1978 which succeeded in reversing proposals to tax death benefits on insurance policies. Life insurance agents were integral parts of both Liberal and

[50] J. Dow and C. Goar, "Insurance industry plans anti-budget campaign", *Toronto Star*, Nov. 20, 1981, B11; "Life insurers are protesting new levies, end to holders' tax-free policy income", *Globe and Mail*, Nov. 21, 1981, B5.

[51] LUAC presentation, *Minutes and Proceedings*, Senate Banking Committee, Issue # 85, Apr. 29, 1982, 5.

Conservative riding associations in every part of the country, and succeeded in exerting considerable pressure on individual Members of Parliament.

According to association officials, there was little coordination between the efforts of the two groups either in lobbying tactics or the presentation of a united front to the Department of Finance.

Taxing Insurance -- Institutions and Process

The highly complex financial and technical details of taxing the insurance sector and the industry's advantage in being able to generate authoritative financial data allowed it to deal with the Department on something resembling equal terms. Following their entry into complex technical negotiations (or discussions) with Finance officials in January, 1982, CLHIA officials acted with great discretion, and were cautious in public statements and appearances before Parliamentary Committees. Industry and Department officials met on a regular basis to discuss more than 30 policy and technical issues arising from the budget.

CLHIA officials conceded that "IAACs were dead in the water" and concentrated their lobbying efforts on what they considered to be "winnable" issues -- the grandfathering of tax rules on existing insurance policies, the development of a formula that would enable them to shield "insurance-oriented" policies from direct taxation, and removing employer-paid health and dental plan premiums from the definition of taxable income.[52]

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[52] Interview, senior CLHIA official. (AE-3) In this context, "insurance oriented" policies are distinguished from those with a relatively high tax-free savings component in excess of the actuarial requirements necessary to fund a given policy.

Taxation of life insurance was one of the five policy areas referred to Parliamentary Committees by Finance Minister MacEachen in December 1981.[53] While the Commons' Finance Committee deferred its hearings on the budget until the tabling of legislation at the end of 1982, the Senate Banking Committee, chaired by 41-year Senate veteran Salter Hayden, held detailed hearings into these policy areas. Hayden and Committee Counsel sharply questioned senior Finance Department officials on the objectives, principles and economic impact of the proposed changes.[54] Unlike the Commons' Finance Committee, which was under tight political control, the Senate Committee began its study of the Budget before legislation was tabled in the House. The Committee was served by experienced tax advisors who were given considerable latitude in briefing Senators, preparing questions and cross-examining witnesses. Hayden and his Committee saw themselves both as guardians of individual taxpayers' interests and of the legal traditions protecting taxpayers against arbitrary or retrospective taxation. They proved to be among the budget's strongest and most effective critics.

The insurance industry held two advantages in the 1981-82 debate. The highly technical nature of the tax issues at stake allowed the industry to pose as a protector of the interests of the average taxpayer, insured employee or insurance policyholder rather than the interests of high-income or corporate beneficiaries of tax expenditures. And the measures' potential impact generated a greater level of political reaction from individual taxpayers than any other provision in the budget.[55]

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[53] House of Commons *Debates*, Dec. 18, 1981, 14237-8.

[54] *Minutes and Proceedings*, Senate Banking Committee, Issues # 90, 91, May 12, 18, 1982.

[55] MacEachen's Parliamentary Secretary John Evans comments that 20,000 of the 21,000 letters received by the Department of Finance were related to changes in the taxation of insurance. Interviews, Hon. John Evans, Finance Department officials.

Taxing Insurance -- The Outcome

The June 28, 1982 budget announced agreement on a number of new rules governing life insurance which reflected a compromise reached between the government and the industry. Insurance policies were to be divided for tax purposes on the basis of whether or not they provided "significant amounts of insurance protection relative to the income built-up" or whether their purpose was "tax deferral".[56] Regulations were drawn up, following negotiations with the industry, to distinguish between the two. Non-exempt policies would be subject to taxation on accrued income every three years. Exempt policies would be subject to partial taxation if cashed in during the purchaser's lifetime. The Department largely succeeded in defending its attempts to tax the proceeds of life insurance policies held by corporations on their owners and senior officers, despite arguments of double taxation from the industry.[57] An industry tax specialist comments that:

> we won the battle of the accrual premiums but it was not business as usual. The industry had to redesign most of its policies. More than fifty percent of products had to be scrapped because they were no longer saleable. ... Savings-oriented policies were a null set. Hardly any taxable policies have been sold since 1982.[58]

The Department was successful in closing off IAACs as a means of tax deferral or avoidance. Tax policy officials were not about to compromise on the budget's second largest tax increase -- and the industry settled for minor transitional changes on the issue as only a small proportion of its clients were involved.

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[56] "Report on Budget Tax Changes (No. 1)", *Minutes and Proceedings*, Senate Committee on Banking, Trade & Commerce, Issue # 114, December 1, 1982, 26.

[57] Ibid, 27-28.

[58] Interview, CLHIA official (AE-3).

The taxation of widely available fringe benefits, particularly group insurance and retirement allowances, resulted in considerable public pressure on Liberal MPs, not only from the insurance industry but also from unions and provincial governments. While MacEachen refused to make significant changes to these provisions, Marc Lalonde's October 1982 Economic Statement rolled back proposals to tax premiums paid on employee health and dental plans, and modified tax rules affecting several other areas of employee benefits packages. As a general rule, it appears that the more numerous and visible the targets of Finance's 1981 base-broadening measures, the more likely that political pressure by interest groups was able convince the Liberal caucus and cabinet to extract concessions from the Department.

In subsequent budgets, the Department of Finance shifted its tax strategy from the beneficiaries of insurance policies to increasing taxation on the capital and investment income of insurance companies themselves. These arcane disputes took a number of years, and represent a distinct and highly complex field of tax policy in which discussion has been almost entirely limited to the Department and industry tax professionals.

The three-year accrual rule on interest income was applied to a variety of long-term bonds and other savings instruments.[59] However, since then the Department has generally steered clear of attempts to extend the principle of taxing accrued capital gains and other investment income to avoid the political controversy and administrative complexity that would result from any such action.[60]

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[59] It has subsequently been replaced by an annual accrual rule.

[60] The 1994 federal budget provided for the accrual taxation of market gains on shares held by financial institutions. It remains to be seen whether this principle will be extended in subsequent budget.

Case Study 9-2 -- Deductibility of Investment Interest Expenses

Restricted Interest Deductibility -- The Budget Provisions

A oasi· rinciple of the Income Tax Act is that expenses incurred in the process of earning business or investment income are deductible from income. Budget resolutions 23 and 24 sought to modify this principle by attempting to restrict the deduction of expenses to the level of investment earnings in the same year. A related provision allowed the deduction of 50% of surplus investment-related expenses against capital gains earned in the same year.[61] The Department estimated annual savings from this budget measure at $ 190 million in 1983-84.

Restricted Interest Deductibility -- Conflicting Ideas

This was another measure in the 1981 budget which attempted to match the timing of income and expenses in the recognition of personal investment income for tax purposes. It was seen by many taxpayers as an illegitimate way of depriving them of the right to deduct actual costs of investment in the year they occurred. However, Finance Department officials argued that allowing taxpayers to write off interest and carrying charges in excess of annual investment income shifted much of the risk of long-term investing from the investor to the government and, hence, to other taxpayers.

Finance officials also sought to create a distinction between investments intended to yield income and those structured to defer income and yield a higher proportion of capital gains instead. As nominal capital gains were only be taxed at 50 percent of marginal personal

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[61] Department of Finance, *The Budget in More Detail*, (Ottawa, November 12, 1981, 37).

or corporate tax rates, then investment carrying costs in excess of related income should only attract a similar write-off.[62]

Budget critics charged that these provisions ignored the "lumpy" character of investment income, and that individuals' income and ability to pay had always been taxed on the basis of cash flow -- not deferrals against an uncertain future income. If much economic growth resulted from capitalist risk taking, why should "risk investments" in business expansion face exactly the same tax rate as risk-free savings in Canada Savings Bonds?

Department officials countered that a large share of tax write- offs resulted from relatively low-risk real estate investments, especially those under the MURB tax shelter program. To what extent did government subsidies to real estate development constitute a cost-effective incentive to economic development?

Thus, the debate over restricted interest deductibility boiled down to a trade-off between its technical impact on the distribution of the overall tax burden, and its impact on the financing and investment decisions of individual businesses dependent on various forms of external financing.

Restricted Interest Deductibility -- Interests and Processes

Apart from real estate developers and the rental construction industry, whose reaction to the budget has already been discussed the principal interests involved in the debate over restricted interest deductibility (RID) were investment dealers, tax professionals, and elements of the small business community.

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[62] Satya Poddar, *Minutes and Proceedings*, Senate Banking Committee, Issue # 97, June 8, 1982, 27-34. This distinction was widened with the introduction of the lifetime capital gains exemption in 1985, but narrowed somewhat by the increase in the inclusion rate for capital gains to 75 percent after the 1988 tax reform bill and the elimination of the capital gains exemption for most investments between 1991 and 1994.

The most vocal opponents of the RID were the Investment Dealers' Association (IDA), representing most of Canada's stock brokerage firms and the small Western stock exchanges in Vancouver and Calgary which financed much of the equity investment in high risk or speculative junior resource companies.[63] The IDA is an influential, well-connected lobby with a research capacity capable of documenting the economic impact of the budget proposals. Its efforts were quietly reinforced by the federal Energy Department, which was concerned at the impact of declining oil and gas exploration, carried on mainly by small independent firms, on its revenues under the National Energy Program.[64]

Senior tax professionals also argued that the RID proposals would interfere with the ability of tens of thousands of small businesses to finance their operations through shareholder loans at a time of growing recession and credit restrictions imposed by financial institutions. These arguments were usually made in private discussions between representatives of major legal and accounting firms with tax policy officers in the Department of Finance.

Restricted Interest Deductibility -- The Outcome

MacEachen's initial response, in his December 18 package of budget revisions, was to allow continued deductibility of up to $ 10,000 in annual carrying costs in excess of investment income. This matched existing American tax practice, and limited the impact of the provisions to fewer than 5,000 investors -- most of them in the real estate and

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[63] Dennis Slocum, "Budget seen as blow to risk securities", *The Globe and Mail,* Nov. 17, 1981, B5; George Linton, "Brokers attempting to convince MacEachen to change budget", *The Globe and Mail,* Nov. 21, 1981, B3.

[64] Hyman Solomon, "Canada will use perks to see NEP succeeds", *Financial Post*, Feb. 6, 1982, 3.

resource sectors.[65] He later deferred the implementation of the RID proposals in his June 28, 1982 budget. His successor, Marc Lalonde, withdrew them entirely in his October 1982 *Economic Statement* for all but investments in RRSPs. The issue had become a symbol of the ideological rift between the government and an influential part of the business community. Lalonde's return to the traditional tax rules was a clear attempt to close that rift.

Case Study # 9-3 -- Small Business Taxation

The 1981 budget's efforts to revise and reduce the tax preferences available to small businesses triggered a bitter political and ideological conflict. Many small business owners had come to view these benefits as economic entitlements which balanced the substantial tax advantages available to many larger corporations. MacEachen's attempt to limit the number of companies eligible for these benefits without prior consultation was widely perceived by small business as a reflection of the Trudeau government's ideological hostility. The size and political visibility of small business as a major group of "swing voters", its growing importance in terms of job creation, and the rapidly growing cost of small business tax preferences helped to make small business tax reform one of the budget's most controversial issues.

Taxing Small Business -- The Budget Provisions

Several major elements in the budget affected Canada's more than 300,000 small business corporations. Most important were changes to Section 125 of the Income Tax: the Small

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[65] MacEachen, Statement to House of Commons, December 18, 1981; *Canadian Tax News*, November 12, 1981, 12; Senate Banking Committee, *Minutes and Proceedings*, Issue # 97, June 8, 1982, 28.

Business Deduction (SBD).[66] The SBD had been the object of repeated budget changes since the 1977 budget introduced "over-integration" provisions which made it more attractive for business-owners to draw income through dividends rather than salaries. This created major incentives for creative tax planning and the sheltering of personal and business income which often had little to do with the business development objectives of the provision.[67]

MacEachen retained the lower small business tax rate. He increased the annual profits ceiling for the SBD from $ 150,000 to $ 200,000, and the cumulative deduction account[68] (CDA) -- in effect, the ceiling on eligibility for the low tax rate -- from $ 750,000 to $ 1,000,000. However, the budget offset these measures by introducing a 12 1/2 percent "Corporate Distribution Surtax" on small business dividends to ensure equal tax treatment of income taken as salary or dividends. It also removed the ability to "refresh" the CDA through the payment of dividends, thus raising the prospect of many small firms paying the 50 percent top federal-provincial corporate tax rate instead of the 25 percent small business rate.

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[66] Small Business Deduction -- lower federal tax rate (15 percent in 1981 vs. 36 percent for most corporations) on the first $ 150,000 ($ 200,000 after 1981) in annual income earned by "Canadian-controlled private corporations". All provinces have parallel measures.

[67] *The Budget in More Detail*, November 12, 1981, 45; Income tax provisions relating to small business were subject to almost continuous change between 1975 and 1982, and are the subject of regular discussion at Canadian Tax Foundation Annual Conferences during this period. Bernard Shinder, "The Taxation of Small Business - An Historical and Technical Overview", *Symposium on the Simplification of the Small Business Provisions of the Income Tax Act*, (Toronto, Canadian Tax Foundation, July 11-13, 1983), mimeo.

[68] Cumulative Deduction Account -- before 1981, only companies with retained earnings (after tax profits less dividends) under $ 750,000 could claim the small business deduction.

Other major budget changes affecting small businesses included the elimination of capital gains reserves[69] on installment sales of businesses -- which forced business owners to pay capital gains on the sale of businesses at the time of sale, regardless of the cash flow available to pay the taxes -- and the restricted deductibility of interest expenses, which limited the financing options available to small business owners. Higher taxes were imposed on company cars available for personal use by business owners and employees. Self-employed professionals were to be taxed on "work-in-progress" -- that is, expenses incurred on files not yet billed to clients.

Taxing Small Business -- Competing Ideas

Some of these measures were designed to limit creative tax planning. However, most reflected an attempt to restructure small business tax preferences from a broadly-based, more or less permanent package of tax preferences to a package of temporary incentives which could be targeted at new and expanding businesses.[70]

The traditional arguments for the small business deduction were based on the dependence of small firms on the reinvestment of profits for expansion and the importance of small firms to job creation in the Canadian economy.[71] The SBD was also seen as a structural

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[69] Capital gains reserves -- amount of capital gain on which taxes are deferred when business-owners receive installment payments for their shares over a number of years.

[70] *The Budget in More Detail.* Nov. 12, 1981, 45. The strongest statement of the economic argument for targeting the small business deduction is found in Donald G. McFetridge, "Small Business, Economic Development and Tax Policy".

[71] While total figures varied year by year, businesses with fewer than 100 employees created more than 70 percent of the net new employment (job gains minus job losses) created in Canada -- significantly more outside Ontario. Ontario, Ministry of Industry, Trade and Technology, *The State of Small Business, 1987.*

adjustment in the tax system roughly comparable to the huge tax write-offs available to capital-intensive large firms.[72]

Finance officials argued that the huge cost of the SBD, more than $ 1.5 billion in 1979, and the wide range of other small business allowances within the tax system, gave tax preferences to businesses based on their size rather than their economic performance Why, they asked, should there be tax incentives for business expansion which could be preserved by taking dividends out of the business -- and which also benefited businesses which had long since ceased to expand?[73] Why should a stable business earning $ 200,000 a year pay a lower tax rate than an individual earning a similar amount?

Critics responded that the budget would erode the cash flow small firms needed to survive during times of economic instability. Payroll, property and business taxes not sensitive to profit levels made up a much larger share of small business costs than those of larger firms or individuals. The elimination of capital gains reserves could significantly lower the value of many small firms, and lead to greater corporate concentration as retiring business owners tended to favour purchasers with sufficient cash financing to meet the seller's tax obligations.[74]

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[72] The effective tax rates resulting from the SBD in small business dominated sectors such as retailing and wholesaling were roughly equivalent to those resulting from such measures as accelerated depreciation, earned depletion for resource industries, and the Investment Tax Credit which provided disproportionate benefits to the capital-intensive resource and manufacturing sectors traditionally dominated by large corporations. Department of Finance, *Account of the Cost of Selective Tax Measures*, (Ottawa, the Department, August 1985); C. David Weyman, "Restructuring the Corporate Income Tax: Directions for Change", in *Report of Proceedings of the Thirty Seventh Tax Conference, 1985*, (Toronto, Canadian Tax Foundation, 1986).

[73] *The Budget in More Detail*, November 12, 1981, 45.

[74] "Report on Budget Tax Changes (No. 1)", *Minutes and Proceedings*, Senate Committee on Banking, Trade & Commerce, Issue # 114, December 1, 1982, 19-20

Taxing Small Business -- The Interests

Tax policy has been the most salient issue facing the small business community over the past thirty years. Economic insecurity, business owners' resentment of growing taxes and government waste, and the growth of highly combative small business lobby groups during the 1970s combined to make any threat to the small business owner's tax status a potential political battleground.

The largest small business lobby, the Canadian Federation of Independent Business (CFIB), had about 63,000 members in 1981. It had been formed out of the small business tax protests against the tax reform White Paper of 1969-71. The CFIB, and other lobby groups including the Canadian Chamber of Commerce and the Canadian Organization of Small Business (COSB), responded angrily to MacEachen's budget measures, spurring their members to bombard local MPs with letters, telephone calls and surveys. W.T. Stanbury[75] has outlined four main parts to CFIB's anti-budget strategy. First, outspoken public statements by CFIB President John Bulloch and other Federation offi :.ls polarized debate and mobilized small business and public opinion against the budget. In various statements, Bulloch characterized the budget as:

> "a bag of snakes ... a cancerous abortion ... a combination of Ronald Reagan and Karl Marx", reflecting a "shocking lack of practical business knowledge".[76]

Second, CFIB assembled a coalition of twenty-three business organizations to oppose large elements of the budget and recommend its referral to a Parliamentary Committee for detailed study. This coalition, which grew to more than 50 organizations over the next few months, was intended to create a common political front to counter the Finance

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75 W.T. Stanbury, *Business-Government Relations in Canada*, 379-85.

76 Hugh Anderson, "Budget leaves Gazette's experts unimpressed", *The Gazette*, Montreal, Nov. 14, 1981, 17; "Budget called threat to business", *The Citizen*, Ottawa, Nov. 18, 1981, 43; Stanbury, ibid., 380.

Department strategy of negotiating one-on-one with various interest groups to amend technical budget provisions on the basis of demonstrable hardship. It also helped CFIB to spread a consistent anti-budget message through member groups to thousands of firms outside its own membership base, and defend itself against government charges that it was unrepresentative of business opinion.[77]

CFIB also ran two full-page ads in newspapers across the country. One, on December 2, was a fairly reasoned appeal for reconsideration of the budget's tax reform strategy aimed at informed business and professional opinion. The second ad, which ran in twenty-three newspapers on December 8, was a direct attack on the Minister and his officials which sought to discredit the budget on ideological and economic grounds. Under a picture of hands playing a "shell game", the ad stated:

> The MacEachen budget is not what it seems to be.
> It is a sly, devious document that nearly fooled us all.
>
> Only now are we able to see what the result will be from the more than 163 technical amendments that are proposed. The unanimous conclusion of the best tax minds in the country is -- disaster. A disaster for small business, farmers, working Canadians, professionals and the unemployed. In short, the whole economy. ...
>
> The budget must not be passed until Parliamentarians have had the opportunity to hear from knowledgeable individuals who, unlike the budget drafters, have to function in the Canadian economy.[78]

The ideological intensity of the campaign, the mutual antipathy between MacEachen and his officials and CFIB President John Bulloch, and the clear contempt which each side had for the other, limited the short-term effectiveness of the CFIB campaign -- even as it helped to poison the attitudes of hundreds of thousands of small business owners across

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[77] Interview, CFIB official (AE-1); News Release (#81-121);(Ottawa, Department of Finance, Dec. 10, 1981).

[78] *Toronto Star*, December 8, 1981, B9; CFIB officials stated that the ad was run when it became clear that the Department was not open to compromise on substantive issues as opposed to transitional measures.

the country against the government's economic policies. Years later, CFIB staff justified the extraordinary bitterness of the campaign, commenting that Ottawa's unilateral actions on energy and tax policies had

> destroyed the climate of trust between Ottawa and the provinces ... and the private sector. ... Against this backdrop [of Ottawa's relations with business since 1980], there was no sense in going the road of quiet diplomacy. ... Quiet diplomacy, given the way the Trudeau Government operates, wouldn't work on this one. They take all your possessions, give them back to you one by one, and expect you to be grateful. They took away too much from us for that.[79]

The CFIB also prepared a more technical critique of the budget, *Federal Budget: Report No. 2*, a 113-page analysis by the Federation's tax advisors which was circulated widely to Members of Parliament and the news media. However, this impact of this analysis was diluted by the escalation of the political and ideological conflict.[80]

CFIB's efforts to change the budget were based on the premise that it could persuade Liberal MPs and cabinet ministers to force MacEachen into a political retreat, overruling his Departmental policy advisors -- a high risk strategy under most circumstances. This strategy was based on CFIB's experience in helping to reverse the small business proposals of the Benson White Paper proposals of 1969-71.

> Your previous history really does colour your attitudes and approaches. ... John [Bulloch] knew the danger signals [from the 1981 budget] way back to the Benson days. ... Bulloch recalled our success with the Benson White Paper. From day one we figured we would get a retreat on the substantive issues because they were politically and economically wrong-headed.[81]

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[79] Interview, CFIB official (AE-1).

[80] Stanbury's analysis of the CFIB's tactics raises an interesting question about conflicting cultures of small business and the federal bureaucracy. "Were CFIB's actions aimed more at solidifying the support of its own members than at changing some of the provisions of the budget? These questions are very difficult to answer." Stanbury, ibid., 383-4.

[81] Interview, CFIB official (AE-1).

The intensity of the small business campaign may have contributed to the limited restoration of capital gains reserves for family farms and small businesses in December 1981. It may also have prompted MacEachen to defer the 12 1/2 percent dividend surtax to 1983 to allow for business adjustments during the height of the recession. However, it also effectively torpedoed communication between the CFIB and Department officials in considering substantive revisions to the budget until a change of Minister and Deputy Minister resulted in a change in the government's political and tax policy priorities.

Taxing Small Business -- The Outcome

MacEachen introduced a number of transitional rules for small businesses in his December 18 package of budget changes. In his June 1982 budget, he deferred other changes, including the corporate dividend surtax and the taxation of professional work-in-progress. The latter was eventually cancelled in Marc Lalonde's October 27, 1982 economic statement.

CFIB officials contend that their campaign set the stage for long-term gains for small business in which MacEachen's successor, Marc Lalonde, and the Conservative government elected in 1984 effectively reversed or neutralized most of the budget's measures to increase small business taxation. The degree of polarization resulting from the budget debate, the size of the small business community, and the government's belated recognition of its need to reconcile the business community as a whole to its policies to bring about recovery from the recession add some credence to this argument -- at a political level.

> Part of Lalonde's mission was damage-control, especially with the small business community, because we were such a bloody nuisance. ... The tax changes of 1984-86 began in 1981.[82]

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[82] Ibid. (AE-1)

The separate campaigns of business organizations at the political level and tax professionals at the technical level to rationalize and simplify small business taxation at something comparable to pre-budget levels complemented one another. However, major structural changes to the small business tax system had to await the election of a new government more sympathetic to the small business agenda.

MACEACHEN RECOVERS THE INITIATIVE -- THE SIX AND FIVE BUDGET

The fiscal and tax policy situation faced by Allan MacEachen in January 1982 was little short of a political and fiscal disaster. Yet, the canny Finance Minister succeeded in maintaining the basic elements of his fiscal and tax policies and even recovered the initiative in a second budget, in June 1982, which gave the Trudeau Government a political breathing-space in the middle of the worst recession to hit Canada in fifty years.

MacEachen faced a series of challenges in navigating the political and economic storm that engulfed its first budget. The growing recession resulted in a revenue short-fall of almost twenty percent of the 1981 budget's projected revenues, a sum more than four times the net tax increases projected in the budget. While MacEachen managed to sustain his two largest sources of added revenue, the new half-year rule in claiming depreciation ($ 1.1 billion/year) and the elimination of Income Averaging Annuity Contracts ($ 895 million), projected income and sales tax revenues dropped by almost $ 8 billion between November 1981 and June 1982.[83]

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[83] *The National Finances 1982-83*, (Toronto, Canadian Tax Foundation, 1983). The deferral or elimination of other revenue sources from the budget ultimately cost the government about $ 670 million in additional revenue in 1983-84. (*Minutes and Proceedings*, Senate Committee on Banking, Trade and Commerce, Issue # 113, December 9, 1982, 9-11.)

The softening of energy prices and the problems faced by conventional Canadian oil and gas producers in Western Canada forced both the Alberta Government and the Department of Energy, Mines and Resources to reduce their royalties and taxes on the industry, further increasing the deficit and gutting the budget's anti-inflation strategy.[84]

TABLE 9-1
BUDGET FORECASTS: 1982-83
(in $ millions)

	Nov. 1981	June 1982	Oct. 1982	1982-83 Actual
Revenues	$ 64,960	$ 58,600	$ 55,660	$ 55,123
% difference	--	- 9.8%	- 14.3%	- 15.1%
Expenditures	$ 75,450	$ 78,100	$ 79,210	$ 79,776
% difference	--	+ 3.5%	+ 5.0%	+ 5.7%
Deficit	$ 10,490	$ 19,600	$ 23,550	$ 24,653
% difference	--	+ 86.8%	+ 124.5%	+ 135.0%

(sources: *The National Finances*, 1981-82, 1982-83, 1983-84
Hon. Allan MacEachen, *The Budget*, June 28, 1982, 2-3.)

The government was under extreme pressure to stimulate the economy to counter rising unemployment, at the risk of abandoning its anti-inflation campaign. Former Trudeau Principal Secretary Jim Coutts has been highly critical of MacEachen's restrictive fiscal policies, and a growing number of Liberal backbenchers became increasingly restless as the recession deepened.[85] Canadian Labour Congress President Dennis McDermott

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[84] These changes were hinted at by Deputy Energy Minister Marshall Cohen in January 1982, (Hyman Solomon, "Canada will use perks to see NEP succeeds", *Financial Post*, Feb. 6, 1982, 3) and implemented by Energy Minister Lalonde in his NEP Update of May 1982. (Hon. Marc Lalonde, *NEP Update*, Ottawa, Department of Energy, May 31, 1982).

[85] "Coutts Hits Liberals Hard", *The Citizen*, Ottawa, November 28, 1981, 1; Iain Hunter, "Liberal MPs upset with budget", ibid., February 11, 1982; Keri Sweetman, "Opposition Gloats ... ", ibid., May 26, 1982.

conducted a vitriolic campaign of abuse at the government's fiscal and monetary policies.[86]

In March 1982, the government tabled the White Paper on Sales Tax Reform promised in the 1981 budget, only to receive scores of briefs and delegations condemning its proposal to shift the Manufacturers' Sales Tax to the wholesale level. Finance Department advisory committees had suggesting this change in 1975 and 1977, only to run into stiff opposition from manufacturers and retailers for its complexity and distorting effects on competition.[87]

As noted above, the government was engaged in protracted negotiations with the insurance industry and other groups with which it had agreed to review budget provisions in December 1981. Compromises were reached on a number of technical issues, but draft legislation was not ready for Parliament for almost eight months after the November 1981 budget.[88]

MacEachen was also subjected to sustained pressure from a wide range of interest groups whose criticisms had been barely appeased, if at all, by MacEachen's December

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[86] McDermott's vitriolic abuse of the government alienated several senior policy makers, and convinced many Liberal cabinet ministers and MPs that it was pointless to cultivate CLC support. Instead, MacEachen and his colleagues went out of their way to cultivate the building trades unions which had broken away from the CLC and joined to form the Canadian Federation in Labour in March 1982. James Bagnall, "McDermott's attacks push Liberals away", *The Financial Post*, Dec. 5, 1982, 18; "Chasm grows between CLC and Ottawa", ibid., Dec. 26, 1981, 9.

[87] MacEachen announced plans to defer the wholesale tax in March 1982, and later,in his June 1982 budget in the face of continuing political and professional opposition. Finally, MacEachen's successor, Marc Lalonde, appointed an Advisory Committee under prominent Toronto lawyer Wolfe Goodman, which urged him to shelve the idea altogether. "Release" (82-50), (Ottawa, Department of Finance, April 30, 1982); Lalonde, *Financial and Economic Statement*, October 27, 1982; Wolfe Goodman, Chairman, *Report of the Federal Sales Tax Revenue Committee*, (Ottawa, May 1983). See Chapter 10.

[88] Bill C-139 was not introduced for first reading until early December 1982, thirteen months after the budget and three major sets of changes later.

concessions on transitional arrangements. Another source of pressure came from the Senate Banking Committee, whose eighty-six year old chairman, Salter Hayden, had helped to derail Edgar Benson's Tax Reform White Paper in 1970. The Committee's hearings, which began in April, allowed various interest groups to ventilate their concerns with the budget. But more importantly, they subjected Finance Department officials to intense cross-examination by Hayden, Committee members and counsel in a way that highlighted major philosophical as well as technical differences over budget measures.[89]

A new budget was vital, both as a formal way of accounting for the federal government's radically changed fiscal position and to demonstrate political leadership in the midst of the deepest recession in fifty years.

Packaging the Six and Five Budget

MacEachen's budget presentation of June 28, 1982 was a remarkable political recovery, borrowing liberally from critics' arguments, making a handful of spending initiatives to counter the recession, but holding to the fight against inflation as the dominant element of the government's economic policies. At the same time, the Finance Minister introduced a major and potentially controversial change to the tax structure -- the partial deindexing of personal income taxes -- which recovered all of the revenues lost to the budget revisions of the past seven months, but at relatively low political cost.

The "Six and Five" program was a continuation of the government's efforts to constrain inflation, by other means. MacEachen had rejected either a tax-based incomes policy or

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[89] *Minutes and Proceedings*, Senate Committee on Banking, Trade and Commerce, Issues # 90-92,94,97, May-June 1982; Issue # 113, Dec 12, 1982.

comprehensive wage and price controls before his 1981 budget.[90] Reviewing this decision in January 1982, the Policy and Priorities Committee of cabinet again rejected controls on the strong advice of MacEachen's Deputy, Ian Stewart, but held in reserve the possibility of public sector controls.[91]

The June 1982 budget tacitly acknowledged opposition, interest group and media charges of a double standard in curbing public expectations. The tax increases contained in the November 1981 budget, and their effect in deepening the recession, had reduced private sector incomes, but had barely constrained the growth of the federal public sector and done little to reduce inflation by the spring of June 1982.[92] Yet, increasing budgetary stimulus seemed to defy economic logic when inflation remained virtually untamed at 11.6 percent in the middle of a major recession.[93] Instead, MacEachen slapped controls on wages, salaries, and administered prices in the federal public sector and encouraged the provinces and the private sector to follow his example.

> If all of us -- governments, business, labour and individual Canadians -- rally to greater discipline in our income demands and other inflationary behaviour, prices will at long last go down, and so will interest rates. The economy will start growing again. Industry will be able to make a decent profit and to increase production. Laid-off workers will be recalled. New jobs will become available.[94]

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[90] Barry Critchley, "What MacEachen says about the economy and the issues facing him", *Financial Post*, Oct. 17, 1981, 2.

[91] Fred Harrison, "Ottawa policy not cast in stone", *Financial Post*, Feb. 13, 1982, 4.

[92] Budget documents had projected a 16 percent increase in federal spending -- 4 percent over the projected inflation rate. The gap between the budget's rhetoric and reality was repeatedly commented on by media commentators and interest group leaders. James Gray, "'Frightening' business leader says", *Toronto Star*, Nov. 13, 1981, A13; "An unabated spending appetite", *The Globe and Mail*, Dec. 17, 1981, 6; Keith Spicer, "Civil servants have unfair advantage in tough times", *The Leader-Post*, Regina, June 25, 1982, A6.

[93] MacEachen, testimony to Commons' Finance Committee, *Minutes and Proceedings*, (Issue # 79, April 29, 1982), 34.

[94] MacEachen, *The Budget*, (Ottawa, Dept. of Finance, June 28, 1982), 1.

In a related move, the indexing of personal income tax rates was capped at 6 percent in 1983 and 5 percent in 1984. The $ 1.1 billion in additional revenue forecast in 1983-84 more than offset the impact of deferring or cancelling even more measures from the 1981 budget.[95]

Unlike the November 1981 budget, the June 1982 budget was the product of a cabinet consensus carefully orchestrated by Trudeau himself, and by his economic advisors in the Privy Council Office, led by Deputy Cabinet Secretary Robert Rabinovitch.[96] While Stewart had initially opposed the de-indexing of personal income taxes, he was effectively circumvented by PCO officials who virtually "hijacked" much of the budget process.[97]

MacEachen also involved the Prime Minister's Office in the development of a comprehensive public relations campaign to sell the 6 & 5 package.[98] A series of hints were spread by government officials before the budget to prepare public opinion. Liberal staffers sought to mobilize public and interest group support for the budget -- preparing glossy folders of materials to help MPs sell the 6 & 5 program in their constituencies. Parliamentary hearings for the wage restraint bill were convened shortly after the budget -- unlike the November 1981 budget measures, which were not sent to the Commons'

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[95] MacEachen announced increases in the child tax credit worth $ 250 million, further budget changes totalling $ 325 million, and $ 350 million for first year revenue losses due to the proposed investment income indexing measures. The latter were not implemented until 1983-84. Finance officials estimate the total cost of budget rollbacks at about $ 269 million in 1982-83 and $ 685 million in 1983-84. MacEachen, *The Budget,* June 28, 1982, 10; Nick Le Pan, Senate Banking Committee, *Minutes,* Issue # 113, Dec. 9, 1982, 9-11, Thomas A Wilson & D. Peter Dungan, *Fiscal Policy in Canada: an Appraisal,* Canadian Tax Paper # 94, (Toronto, Canadian Tax Foundation, 1993), 26-28.

[96] This process is described in McCall and Clarkson, *Trudeau and Our Times, Vol. 2,* 249-54.

[97] Ibid., 255-7.

[98] Interview, senior PMO official. (PMO-3) McCall & Clarkson, *Trudeau and Our Times, Vol. 2,* 257-9.

Finance Committee until early in 1983. While public and media reactions to the budget were mixed, the government succeeded in isolating organized labour politically and in reversing the Liberals' slide in the polls.[99]

The emphasis on public sector wage restraint -- and the political outcry from organized labour which resulted -- also helped to distract public attention from a series of deferrals and reversals of the budget's tax reform measures affecting the insurance industry, small business, restricted investment expenses and corporate reorganizations.[100] The budget's package proposing the indexing of selected investment income and related expenses has been noted elsewhere.

MacEachen also used the June budget to showcase the government's new policy of consultation on tax policy changes, which had been announced in April.[101] In addition to consultations on the proposed Sales Tax changes, also announced in April, MacEachen formed a blue-chip panel of economists to study his investment indexing package and referred the 1981 budget proposals to tax professional work-in-progress to a committee of income tax professionals.[102] These changes represented an explicit opening of the budget process, under controlled circumstances, and an effort by the Minister and his senior officials to regain the confidence of senior tax professionals which had been seriously damaged by the content and process of introducing the tax reform budget. The new consultation process was both an effort to co-opt senior business-people, professionals

99 Gallup Canada, "Liberals gain, but PCs retain backing of 46%", *The Gazette*, Montreal, Dec.8, 1982, B6.

100 MacEachen, *The Budget*, June 28, 1982, 6-7.

101 Hon. Allan J. MacEachen, *The Budget Process, A paper on budget secrecy and proposals for broader consultation*, (Ottawa, Department of Finance, April 1982)

102 The "Lortie Committee" studying the Registered Investment Savings Plan reported in September 1982, recommending major changes to the package. The "work-in-progress" committee recommended that the proposal be quietly buried by the new Finance Minister, Marc Lalonde. It was.

and academics into the policy making process, and a concession that during the recession, the price of encouraging business and investor confidence in the government's policies was to allow selected representatives of these groups increased access to the policy process.

THE LEGACY OF TAX REFORM

The 1981 federal budget attempted to make the most comprehensive changes to the personal and corporate income tax systems since Edgar Benson's tax reforms of 1971. Driven by a mixture of economic necessity and ideological conviction, Finance Minister Allan MacEachen sought to impose major changes upon the tax structure in the same unilateral, confrontational fashion in which his government had introduced both its energy policies and its proposals for constitutional repatriation. This challenge to Canada's economic constitution provoked an intense political backlash.

The *Tax Expenditure Analysis* tabled with the budget provided MacEachen with an intellectual and ideological rationale for raising taxes by eliminating or pruning tax preferences. However, his decision to emphasize the connection between the tax expenditure concept and the redistributive functions of the tax system helped to polarize the tax reform debate without convincing most taxpayers that his proposals met either the objectives of redistributive justice or reduced tax rates. While organized business interests were almost unanimously opposed to the budget, MacEachen was unable to assemble a countervailing coalition of interests supportive of his tax reform proposals in the face of a deepening recession. Under these circumstances, tax reform failed both the tests of economic and political viability.

The budget's technical errors were, to some degree, the product of institutional failure. The inability of the Minister and his senior officials to anticipate the economic effects of so many changes to the tax structure and their unwillingness to introduce transitional measures to limit the inevitable economic disruption resulting from tax reform severely eroded their credibility with tax professionals, media commentators and the general public. This failure was magnified by the comparative haste with which the budget was assembled, by the Minister's almost complete failure to prepare public opinion for the extent of his proposed changes, and by the lack of any effective attempt to build a coalition of interests capable of offsetting the predictable backlash from those who had most to lose from the budget.

The three formal sets of budget revisions made in the year following the budget were the biggest setback for a Minister of Finance since the ill-fated Gordon Budget of 1963. These changes set the effective political limits for tax reform for most of the 1980s and heavily influenced the style and substance both of Marc Lalonde's short tenure as Minister of Finance and of Michael Wilson's eventual income tax reform program of 1985-88.

Nevertheless, the 1981 budget demonstrated that a determined Finance Minister backed by a Parliamentary majority could introduce both major tax increases and structural changes to the tax system despite widespread public opposition. MacEachen succeeded in implementing most of his major revenue-raising measures despite massive opposition because of the highly disparate nature of the coalition against him and the mutually antagonistic and inconsistent nature of their policy alternatives. While MacEachen sought to accommodate both sets of critics, the Trudeau cabinet was forced by the growing recession to choose between the even more radical changes to Canada's economic constitution proposed by the Liberal nationalists, organized labour and the NDP and a more cautious approach to economic and tax changes to appease business and investment interests and large sections of the middle class. The Liberals opted for a return to incrementalism and the politics of accommodation as the safer course.

After MacEachen's departure in September 1982, the Department of Finance quietly moved away from its emphasis on tax expenditure analysis as a catalyst for structural change and towards an emphasis on comparability of effective tax rates for different groups of individual and business taxpayers.[103] Finance officials pursued their policy objectives in a series of incremental, piecemeal efforts to streamline the tax system, using extensive political and technical consultations to build consensus with the broader tax policy community. This tacitly acknowledged that governments possessed limited political autonomy in pushing more ambitious tax reform measures through the political process.

Building on the lessons of 1981, the Department came to recognize that structural tax changes could not be imposed on an increasingly sceptical public, but had to be marketed as a positive-sum game in which potential winners could be cultivated and potential losers compensated in other areas. This involved a major change not only in the policy process but in the policy-making culture. The introduction and consolidation of these changes would be the major tasks of the new Finance Minister, Marc Lalonae and his Deputy Minister, Marshall Cohen.

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[103] John Sargent, "Introduction", in N. Bruce (ed.,), *Tax Expenditures and Government Policy*, 19.

PART III

THE TAX REFORM CYCLE: 1982-88

CHAPTER

CHAPTER 10 -- MARC LALONDE, PIECEMEAL TAX REFORM AND THE POLITICS OF ACCOMMODATION: 1982-84.

> Good budgets must be based on a high degree of consensus in order to be effective budgets. The point is not to ensure the popularity of budgets but to build the essential level of public support to make them work. A full and effective two-way consultation process is the vital foundation.
>
> Marc Lalonde[1]

Every major tax reform initiative in recent Canadian history has been followed by a shuffling of Finance Ministers and a change of emphasis in the tax policies of the federal government. The new Minister attempts to make a distinct political impression by conciliating major interests antagonized by his predecessor, reversing or mitigating some of his more controversial measures, and introducing at least one major structural change to the Income Tax Act.

Marc Lalonde's tenure as Minister of Finance between September 1982 and September 1984 is an excellent reflection of this pattern. Lalonde vastly expanded the tax policy consultation process as part of the federal government's attempt to conciliate senior tax professionals and major business and other interest groups alienated as a result of the 1981 tax reform budget. He reversed several controversial measures from the 1981 budget, and introduced a series of technical changes to simplify the small business tax system. Lalonde's pre-election budget of February 1984 also introduced an overhaul of the retirement savings provisions of the Income Tax Act in a major departure from the Trudeau government's previous social policy emphasis.

Lalonde's appointment as Minister of Finance resulted in a significant shift in the tone and content of the federal government's tax and economic policies. This shift reflected three major challenges facing the new minister: to promote recovery from the worst recession

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[1] Hon. Marc Lalonde, "Address to Canadian Club of Toronto", Release # 84-8, (Ottawa, Department of Finance, Jan. 23, 1984), 1.

in fifty years without refuelling inflation at the same time; to restore the political and economic credibility of the Department of Finance with the business and investment communities following the 1981 budget and its failure to anticipate the 1982 recession; and to rebuild the federal Liberal coalition in time for an election in 1984.

Lalonde's responses to these challenges were to hold the course of the medium-term fiscal policies which he inherited from Allan MacEachen; to formalize and extend his Department's consultation processes, especially with business; to take a more activist approach to the integration of economic and social policy objectives within the tax system; and to virtually ignore the deficit except for limited tax increases -- most of which were to be phased in following the election anticipated in 1984.

Lalonde's policy can be described as the politics of accommodation. While committed to activist economic and tax policies, he chose to work within existing political and economic constraints -- rather than challenging them on a broad front as he and his colleagues had done in the two years following the 1980 election.[2] This decision to manage change through persuasion instead of confrontation was reflected in a series of piecemeal tax reforms and in Lalonde's commitment to a process of systematic consultation with all major actors in the policy communities clustered around his department.[3]

Together with his Deputy Minister, Marshall Cohen, who followed Lalonde to Finance from Energy in November 1982, Lalonde sought to rebuild bridges to business and other interest groups which had been antagonized by the government's relatively nationalist and

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[2] Ibid., 2-4.

[3] "Central to this change of attitude is a new understanding that we are all in this game together, we are all on the same side." Hon. Marc Lalonde, "Address to Canadian Chamber of Commerce", Winnipeg, Release # 83-133, (Ottawa, The Department, Sept. 27, 1983), 1.

interventionist policies between March 1980 and September 1982. This chapter examines Lalonde's political strategy and its impact on the tax policy process. It also examines the implications of Lalonde's politics of accommodation for three piecemeal tax reforms emerging from the Liberal agenda of 1980-82: sales tax reform, the R&D initiatives of the 1983 budget and pension reform.

MANAGING POLITICAL AND ECONOMIC RECOVERY

Canadian tax policy in 1983-84 should be understood in the context of an integrated political and economic strategy aimed at the reelection of the Liberal government under a successor to Pierre Elliott Trudeau. The political recovery of the Liberal Party was directly linked to its success in promoting economic recovery -- defined not only in terms of aggregate economic growth but also in visible increases in investment and employment in politically sensitive industries and regions. While Lalonde emphasized the language of business-government partnership and a private sector-led recovery in his frequent speeches to business groups, he also pursued economic and industrial policies designed to direct extensive financial support to key industries and regional development projects in areas of high unemployment, especially Quebec and Atlantic Canada -- areas critical to Liberal re-election prospects.

The recession of 1981-82 was the sharpest and deepest economic decline to affect Canadians since the Great Depression. Canada's Gross Domestic Product dropped 5.5 percent between the growth peak of 1981 and the second quarter of 1982.[4] This was the sharpest drop of any major industrial country. The national unemployment rate rose to

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[4] Thomas A. Wilson & D. Peter Dungan, *Fiscal Policy in Canada: An Apprai...* , Canadian Tax Paper # 94, (Toronto, Canadian Tax Foundation, 1993), 29.

12.8 percent[5] by the end of 1982. At the same time, the rapid growth of the federal deficit and Canada's increasing exposure to international capital markets enforced a degree of anti-inflationary discipline upon the government. Lalonde had inherited the "6 & 5" anti-inflation program from Allan MacEachen. But the Minister's own instincts, the counsel of his economic advisors and the political interests of the Liberal Party combined to put selective economic stimulus ahead of deficit reduction as the major emphasis of his economic strategy.[6] The result was a practical separation between federal tax and spending decisions -- the revenue and expenditure budgets -- which left a legacy of structural deficit financing to Lalonde's successors.

MacEachen's pursuit of anti-inflationary policies during the 1981-82 recession had provoked a serious conflict among cabinet members and senior Liberal officials both over the character of the Liberal Party and its expression in economic, industrial and tax policies. Social democratic nationalists had argued for cushioning the shock of economic change through the combination of a centralized industrial strategy, a more redistributive tax system, and an expanded welfare state. More traditional, business-oriented Liberals had emphasized policies to encourage economic growth and wealth creation as a necessary precondition to improvements in income transfers and public services.[7]

Lalonde, an intensely pragmatic politician, sought to bridge the gap between the two groups. His political strategy had three main parts: first, to restore business confidence in

[5] Seasonally adjusted data. Using "unadjusted data", unemployment peaked at 13.9 percent in March 1983. *Historical Labour Force Statistics*, Cat.# 71-201, (Ottawa, Statistics Canada, 1989), 214.

[6] Hon. Marc Lalonde, *The Federal Deficit in Perspective*, (Ottawa, Department of Finance, April 1983); interview, Prof. David Laidler.

[7] Donald Johnston, *Up the Hill*; Johnston, "Banquet Speech", from *Report of Proceedings of Thirty-Fifth Tax Conference, 1983*, (Toronto, Canadian Tax Foundation, 1984), 7-12; Roy MacLaren, *Honourable Mentions*, (Toronto, Deneau, 1986); Christina McCall and Stephen Clarkson, *Trudeau and Our Times, Vol. 2*, (Toronto, McClelland & Stewart, 1994).

the government's policies by attempting to accommodate business interests in its broader economic strategy, and so speed economic recovery; second, to convince the Liberal social policy constituency that cooperation with business did not mean the retrenchment of income transfer programs or the abandonment of the government's reformist social policy plans; and third, to use all policy tools at his disposal to reinforce the federal government's support in Quebec in its protracted struggle with the Parti Quebecois government of Rene Levesque. These measures sought to balance and placate the two main factions within the cabinet and party while pursuing the government's larger political and economic goals. Lalonde's economic statement of October 1982 and his budgets of 1983 and 1984 contained a mix of benefits for constituents of each group.

The Role of the Minister

> Mon coeur a gauche, ma tete au centre; je suis un pragmatiste dans ce sens la.[8]

Marc Lalonde was one of the most dominant and durable political figures of the Trudeau era. After serving as Trudeau's Principal Secretary between 1968 and 1972, Lalonde was elected to Parliament in 1972 and took on a series of demanding cabinet assignments. As Minister of National Health and Welfare between 1973 and 1977, he presided over a major expansion of social benefits with major implications for tax policy and federal-provincial relations.[9] As Minister of State for Federal-Provincial Relations between 1977 and 1979, he was responsible for managing the federal government's two-front "war"

[8] Interview, Hon. Marc Lalonde

[9] The biggest structural change proposed under Lalonde's stewardship of Health & Welfare, a guaranteed annual income (GAI), died under the spending restraints of the federal anti-inflation program of 1976-78. A similar fate would befall much of the ambitious pension reform program initiated by Lalonde and pursued by his successor at Health and Welfare, Monique Begin. The ultimate result of Lalonde's pursuit of a GAI was the introduction of the child tax credit in 1978.

against the sovereignist government of Rene Levesque and the pressure of other provincial governments intent on establishing their fiscal and economic independence from Ottawa. Lalonde became Trudeau's most respected and feared political associate, the undisputed "boss" of the Liberal Party machine in Quebec, and the natural choice to confront Alberta and the other energy-producing provinces as Energy Minister when Trudeau returned to office after the election of 1980.[10]

As Minister of Finance, Lalonde enjoyed three major advantages. Prime Minister Trudeau's unquestioning support gave him considerable leverage in dealing with cabinet colleagues on policy or spending issues.[11] As head of the federal Liberal organization in Quebec and the political mentor of most of its rising Parliamentary stars, he also enjoyed great personal credibility and authority within cabinet and caucus. As a strong and experienced Minister, he knew how to use ministerial power to provide effective direction for the public service managers who worked for him.

> It's the Minister's job to set out the broad strategic goals, and leave the administration of the Department to Deputies. ... When bureaucrats make policy, it is usually because there is a vacuum (and) the Minister doesn't know where he wants to go.[12]

Lalonde's partner in this process was his Deputy Minister, Marshall Cohen. If Lalonde provided the political leverage and direction to restore the power of the Department of Finance to direct federal economic policy, Cohen provided an extensive knowledge of tax policy and an unparalleled flair for the management of bureaucratic politics.

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[10] G. Bruce Doern and Glen Toner, *The Politics of Energy*, (Toronto, Methuen, 1985).

[11] Lalonde's power as Finance Minister was also enhanced by Trudeau's decision to appoint veteran civil servant Gordon Osbaldeston as Clerk of the Privy Council after Michael Pitfield's departure in 1982. Osbaldeston's management style helped to reduce the degree of competition for power over economic policy decisions between Finance and the PCO. (Interview, former senior Finance official.) (D5)

[12] Interview, Hon. Marc Lalonde.

The Role of the Deputy Minister

> A new Deputy Minister would send a signal to the business community that things would change.[13]

Marshall (Mickey) Cohen was one of the most visible and controversial mandarins of the Trudeau era. Recruited to the Department of Finance in 1970 by Jim Brown, co-author of the Benson White Paper, Cohen had been a prominent tax lawyer in Toronto and a counsel to the Commons' Finance Committee which had helped to mangle the White Paper. Cohen succeeded Brown as Assistant Deputy Minister, Tax Policy, where he served between 1972 and 1977 -- the longest stint for anyone in that position since Kenneth Eaton in the 1950s and 1960s. As ADM-Tax Policy, Cohen proved himself a creative and resourceful policy entrepreneur, introducing a wide variety of new policy vehicles into the tax system. In the process, he helped Finance Ministers Turner and Macdonald to dismantle much of the tax structure created by Edgar Benson. This made him a controversial figure among those tax policy officials who saw themselves as the guardians of the Carter-Benson legacy.[14] After a short sabbatical at Harvard, Cohen went on to become Deputy Minister of Energy in 1978 and Deputy Minister of Industry under the Clark Government in 1979. When the Liberals were re-elected in 1980, Cohen returned to Energy. He oversaw the creation of the National Energy Program and the twists and turns of resource taxation and development policies until October 1982.

As Deputy Minister of Finance under Lalonde, Cohen was responsible for developing the detailed policies necessary to carry out Lalonde's broader political vision. This involved

[13] Interview, Hon. Marc Lalonde.

[14] Response to the memory of Mickey Cohen is perhaps the best litmus test to distinguish tax policy pragmatists from purists. For pragmatists, "Mickey was the best salesman the Department ever had". (ADM-3) Tax policy purists discuss Cohen's record with varying degrees of distaste. (Interviews, current and former Finance Department officials). Some of Cohen's Carterite critics came to view him with unbridled loathing. See especially, Linda McQuaig, *Behind Closed Doors*, Toronto, Viking/Penguin, 1987).

the active stimulation of the economy using both direct spending programs and a range of tax incentives. It also involved a series of piecemeal changes to the remnants of the 1981 MacEachen budget.

Cohen's role in promoting the active use of the tax system as an instrument of social and economic policy between 1982 and 1985 highlights the major policy differences over the objectives of the tax system within the Department of Finance.

> [There are] people with a fixed view of what the tax system ought to be, and ... (those) for whom the tax system is just an instrument of policy. Our role as officials was to devise and execute what the government of the day wanted to do. There was no golden truth. I didn't come in with a pre-ordained ideological view of the tax system.
>
> Would you always give the same advice to the Prime Minister regardless of who was in power? The ideologues said yes. I didn't. At the end of the day, nobody had elected me. ... The role of the functionary is to execute (Ministerial policies), not to pursue his view of the golden truth.
>
> The Deputy's role (was) to balance the demands of good tax policy with the political necessities of the day. The Deputy Minister had to make more trade-offs. Sometimes, it was better to screw up the tax system than to have another expenditure program.[15]

Negotiations between Deputy Ministers play a central role in the development of budgetary policy, spending priorities and limits. These negotiations are carried on both through the cabinet committee system and bilateral dealings between Finance and other Departments. Policy entrepreneurship, the skilled use of the policy process to obtain desired outcomes in cooperation -- or competition -- with other departments and the Privy Council Office, is an art form, one mastered by Cohen during his fifteen years in Ottawa.

> Cohen had an unparalleled grasp of the levers of power in Ottawa. He was very impressive. ... Mickey could get things done.[16]

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[15] Interview, Marshall A. Cohen.

[16] Interview, former Ministerial aide. (F02)

In taking over the management of economic policy at the depth of the 1982 recession and of the political fortunes of the Liberal government, Lalonde and Cohen took the same pragmatic course that John Turner, Simon Reisman and Cohen had taken a decade earlier. The government's future would depend on the promotion of economic growth. This was more easily done by cooperating with the business community, large and small, and encouraging private investment than by engaging in confrontation and mutual recrimination.

Courting Business -- Expanding the Consultation Process

Lalonde's first step as Minister was to reconcile the ideological antagonism between the federal government and the business community -- large and small, domestic and foreign. Lalonde's economic statement of October 1982 emphasized the primary role of the private sector in promoting new employment and economic recovery. It also pledged to remove unnecessary obstacles to new investment and job creation measures.[17] This new emphasis was reinforced by a series of speeches to business and professional groups across the country.

> Budgets or governments alone cannot solve all of a country's economic woes. Governments can do some pulling or prodding or even pushing but it is only the private sector and individuals that can really assure a country's recovery and ultimate economic health. The role of government

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[17] Lalonde identified "six basic principles of economic management": i) fiscal responsibility through restraints on government spending; ii) preservation of existing social security programs; iii) relying "primarily on the dynamism and creativity of the private sector as the engine of growth"; iv) promoting "order and stability in international economic relations; v) more effective consultation and vi) building on the 6&5 program to promote economic recovery. Hon. Marc Lalonde, *Statement on the Economic Outlook and the Financial Position of the Government of Canada*, (Ottawa, Dept. of Finance, October 27, 1982), 3-4.

> is to provide what help it can and to create a climate in which business and individuals can prosper.[18]

Lalonde initiated an extensive series of consultations with business and other groups to diffuse their almost visceral hostility to the Trudeau government, regain their confidence in its economic management, and develop a consensus on the details of specific policy initiatives. In sharp contrast to the 1980-82 period, he made "the need for consensus" a central element of the budgetary and tax policy processes.[19]

Consultation took several forms. First, frequent Ministerial meetings were arranged with interest groups.

> Improvements of the consultation process are premised on the fundamental reality that government initiatives rarely succeed without the cooperation of major players in the economy and ... that it is just as important for the private sector to be fully aware of the constraints and problems facing government as for the government to understand the position of private sector groups.[20]

An expanded Communications group within the Department, renamed the Consultation and Communications Branch, was given responsibility for coordinating meetings and non-technical publications.[21] Ministerial meetings were complemented by systematic consultations by Finance Department officials with various industries.

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[18] Hon. Marc Lalonde, "Address to Manitoba Chamber of Commerce", Brandon, Release # 83-50, (Ottawa, The Department, Apr. 23, 1983), 2. See also Lalonde, "Address to Canadian Tax Foundation", Toronto, November 23, 1983; "Address to Canadian Club of Toronto", (Ottawa, The Department, Jan. 24, 1983), and Budget Speech, (Ottawa, The Department, Apr. 15, 1983), 1.

[19] Lalonde, "Address to Canadian Club of Toronto", Release # 84-8, January 23, 1984.

[20] Hon. Marc Lalonde, "Address to Young Presidents' Organization", Ottawa, Release # 83-159, (Ottawa, The Department, Nov. 3, 1983), 4.

[21] Department of Finance, Release # 83-107, August 4, 1983. Discussion Papers and technical policy papers remained the responsibility of the Tax Policy and Legislation Branch until the centralization of communications functions in the Department in 1990. (Interview, Peter Liebel, ADM: Consultations & Communications).

Second, Discussion Papers and "White Papers" were used extensively to solicit professional and interest group responses to proposed tax changes and policy initiatives prior to their inclusion in tax legislation. Every major policy initiative during this period was introduced through a White Paper or Discussion Paper.[22]

Third, Lalonde made frequent use of advisory committees both to build consensus on macro-economic policy and to diffuse controversy over the government's unpopular proposals for federal sales tax reform.[23] A more traditional route, a Special Committee of the House of Commons, was used to develop a public consensus on pension reform following the release of the Green Paper in December 1982. MacEachen's proposals for the indexation of investment costs and income had already been referred to an independent advisory committee headed by Montreal Stock Exchange President Pierre Lortie in June 1982. Lalonde subsequently accepted the Lortie Committee's recommendations[24] and implemented them with minor modifications in his 1983 budget.[25]

Fourth, Lalonde accelerated the release of draft legislation for expert and public comment on the details of proposed tax legislation. Though little noticed except by tax professionals, this measure was intended to strengthen relations between the Department's

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22 These included the Green Paper on Pension Reform (December 1982), Research and Development related tax changes (April 1983), mortgage rate insurance (February 1984), small business tax simplification legislation (February 1984), "gains sharing" for workers (February 1984), and legislative proposals for pension reform (February 1984).

23 Wolfe D. Goodman, Chmn., *Report of the Advisory Committee on the Federal Sales Tax*, (Ottawa, Dept. of Finance, May 1983); Interviews, Hon. Marc Lalonde, Dr. David Laidler.

24 Hon. Marc Lalonde, *Statement on the Economic Outlook*, (Ottawa, The Department, Oct. 27, 1982), 18-19.

25 Hon. Marc Lalonde, *The Indexed Security Investment Plan*, (Ottawa, Department of Finance, April 19, 1983)

tax policy branch and the tax professions, and to limit unintended consequences arising from the increasingly complex task of legislative drafting.

Fifth, executive interchanges between the Department of Finance and private sector professionals were increased. The Department continued to use contract consultants on specific policy issues during this period. However, it also sought to broaden its expertise and links with the tax professions by hiring officials through executive exchange arrangements with the private sector. Deputy Minister Cohen and Glenn Jenkins, the ADM - Tax Policy, shared the view that "there weren't enough practitioners in the tax policy branch."

> I was always looking to bring more practitioners into the branch. ... The guys in the Department didn't know enough about what was going on the the field. We had to fertilize (the branch).[26]

"Five or six officials", about 20 percent of the division's professional staff, were hired through this process in 1983-84.[27]

The expanded consultation process served both political and administrative agendas. The Finance Department hoped to restore its credibility with the business and professional communities, which had been badly damaged by the NEP and the 1981 budget. As part of this process, it sought to ensure that tax legislation would reflect practical business considerations and not just theoretical economic objectives. At the same time, Finance officials wanted to give private sector interests a better understanding of the Department's objectives in the hope that this would limit their tendency towards special interest pleading.

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[26] Interview, Marshall Cohen. Cohen and his ADM Tax Policy, Glenn Jenkins, appeared to share the view that a good tax policy required the interaction of competent economists, tax lawyers and accountants.

[27] Interviews, (ADM-2, F05). This process culminated with the appointment of David Weyman as Jenkins' successor as ADM - Tax Policy & Legislation in 1985.

These hopes were realized to some degree. The expanded consultation process helped Finance to rebuild its political ties with business and to reassert its primacy over fiscal and economic policy decision-making, which had been eroded since the bureaucratic power-struggles of the early and mid-1970s. Arguably, the expansion of the consultation process had even greater value as a public relations exercise legitimating eventual government decisions than as a means of producing more effective public policy. It definitely helped to lay the foundations both for the policies and the processes which led to widespread tax changes in the years after 1984.

THE 1983 and 1984 BUDGETS

The objective of the April 1983 federal budget was to promote economic recovery by shifting demand forward through a combination of enhanced investment incentives for business, public works projects, and federal expenditures on key industries within federal jurisdiction. The budget contained $ 470 million in tax reductions and $ 1.3 billion in new spending, mainly on direct job creation and capital projects.[28] Investment Tax Credits (ITCs) were enriched. Corporate loss transfer provisions were enhanced to ease the cash flow positions of large and small firms. A new system of Research and Development Tax Credits was also proposed to stimulate an increased inflow of R&D investment, especially into smaller, innovative companies.[29] (See Case Study 10-2). Lalonde also implemented tax changes proposed by the financial sector, indexing some

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[28] Lalonde, *Budget Speech*, April 19, 1983, 3-6,11-13; Wilson & Dungan, *Fiscal Policy in Canada*, 46-47.

[29] Measures included allowing application of ITCs against business income of other years on the same basis as business losses, a three-year refundable ITC on flow-through shares and other selected investments, enhanced for small businesses, and a deferral of the NEP's Incremental Oil Revenues Tax (IORT) on old oil until mid-1984. Lalonde, *Budget Speech*, April 19, 1983, 4-10; Lalonde, *The Indexed Security Investment Plan*, (Ottawa, Department of Finance, April 19, 1983); Lalonde, *Research and Development Tax Policies*, (Ottawa, Dept. of Finance, April 1983).

investment income under a proposed new Indexed Security Investment Program.[30] The budget was generally welcomed by business groups as a "return to sanity"[31], if not the pre-NEP status quo, after almost three years of conflict and mutual suspicion.

However, Lalonde also stressed his commitment to maintaining the Liberal government's traditional commitments to social programs and the alleviation of regional disparities in regular gestures to the party's left wing -- even at the cost of significantly higher budget deficits.

> In Canada, the firm commitment of the federal government to assist the victims of recession carried a large price in dollars -- and has been measured by sharply higher deficits. We made a promise not to reduce, at precisely the time it was most needed, the support needed through the social security system. Unemployment has a human face; government can show no less in helping the unemployed.[32]

Beginning with his economic statement of October 1982, he began to shift federal spending into localized job creation programs -- often subject to the influence of local Members of Parliament.[33] This policy was expanded in the 1983 budget with large public investments in local development programs, public works, and subsidies to major industries. Lalonde's strategy complemented his role as senior political minister for Quebec as these measures strengthened federal Liberal efforts to secure the loyalty of key

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30 Lalonde, *Indexed Security Investment Program*, ibid.

31 Marianne Tefft, "'Return to sanity', says small business", *The Financial Post*, April 23, 1983, 7.

32 Hon. Marc Lalonde, "Address to Reuters' Board of Directors", Toronto, Release # 83-66, (Ottawa, The Department, May 19, 1983), 8.

33 James Rusk, "Liberal favoritism alleged in job grants", *The Globe and Mail*, Nov. 30, 1983, 10; House of Commons, *Debates*, 32nd Parliament, June 4, 1980, 1475-6; Feb. 24, 1981, 7612-14; Nov. 29, 1983, 29292-[illegible].

interest groups in Quebec in the highly partisan struggle with the Parti Quebecois government of Rene Levesque.[34] Lalonde comments that:

> we were preoccupied by the economic implications of the independence movement's success ... (which was) resulting in a slow haemorrhage of businesses from Quebec. This required a much more aggressive response to stimulate the Quebec economy ... (by) assuring a positive economic role for the federal government in Quebec.[35]

However, for all the government's attention to local and regional political concerns, economic recovery took precedence over the pursuit of the Liberal left's social policy agenda. Lalonde used his expanded consultation process not only to consult various interests on economic and tax policy priorities, but also in an attempt to shape public expectations.

> Canadians have developed over the years an expectation ... that federal budgets will deal with all social, cultural and broadly political problems as well as economic and fiscal matters. These diverging and often conflicting demands cannot all be satisfied. This does not mean that the government cannot or does not deal with the full range of its responsibilities in a wide variety of ways. But it does mean that the budget must concern itself primarily with the 'bread and butter' priorities of economic recovery and development.[36]

The budget cemented Lalonde's position as the leading "pro-business" spokesman in cabinet and the leading federalist figure, after the Prime Minister, in Quebec. His political and economic strategies reflected the classical Keynesian prescriptions of the post-war period: purchasing political and social consensus through a moderate enhancement of

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[34] Hon. Marc Lalonde, "Address to Association Quebecoise de Planification Fiscale et Successoriale", Release # 83-144, (Ottawa, Dept. of Finance, Oct. 6, 1983); "Quebec and the Recovery", Address to Quebec Chamber of Commerce, Release # 83-162, (Ottawa, the Department, Nov. 7, 1983); "A Development Strategy for Quebec", Address to Canadian Club of Montreal, Release # 83-168, (Ottawa, the Department, Nov. 14/83); "Address to Aerospace Industries Assn. of Canada", Release # 84-53, (Ottawa, The Department, Apr. 14, 1984); "Address to Canadian Shipbuilding and Ship Repairing Assn.", Quebec City, (# 84-69), (Ottawa, the Department, May 31, 1984).

[35] Interview, Hon. Marc Lalonde.

[36] Lalonde, "Address to Canadian Club of Toronto", January 8, 1984, 2.

welfare state programs, an "open-for-business" political climate, the increasing liberalization of international trade and investment policies, and a reliance on economic growth to close the political and fiscal gap between spending and taxes. However, this rosy fiscal forecast was seriously damaged by the decline of world oil prices and the vanishing surpluses forecast from the National Energy Program. (See Table 10-1.)

TABLE 10-1
ENERGY REVENUES AND SPENDING -- 1981-82 - 1984-85
(in $ millions)

Year	Revenues	Spending	Surplus
1981-82	$ 7,082	$ 5,752	$ 1,330
1982-83	$ 8,784	$ 6,736	$ 2,048
1983-84	$ 5,951	$ 5,449	$ 502
1984-85	$ 6,675	$ 6,445	$ 230

Lalonde's February 1984 budget followed the same formula. It contained relatively little new direct spending or tax incentives. Instead, the government's consultation process produced a number of medium-term changes to the tax system. His main theme was "creating jobs through partnership".[37]

> The private sector must be the main creator of jobs. But the government can help -- by providing assistance where desirable, by lightening the burden of administration where feasible, and leading directly where necessary.[38]

Proposed pension reforms avoided the worst fears of the business community -- mandatory private pensions, mandatory pension indexing, or a big increase in the Canada and Quebec Pension Plans that would have resulted in higher payroll taxes.[39] Instead, Lalonde proposed to phase in the equal tax treatment of Registered Retirement Savings Plans and private pensions, mainly by phasing in increases in the maximum RRSP

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[37] Lalonde, The Budget Speech, February 15, 1984, 1.

[38] Ibid.

[39] See Case Study # 12-3; Hon. Marc Lalonde, *Action Plan for Pension Reform*, (Ottawa, Department of Finance, February 1984)

deduction from $ 5,500 to $ 15,500 over four years.[40] The budget also included measures to encourage "gains sharing" through company profit sharing and employee share ownership plans.[41] Changes to simplify the small business tax system addressed a number of grievances left over from the 1981 budget.[42] This was followed in April 1984 by an announcement of changes to Revenue Canada's administration of the tax system, which had prompted widespread accusations of the abuse of power in the House of Commons and the news media.[43]

While the broad outlines of Lalonde's budgetary policies provide a general picture of his political and economic strategies, his approach to consensus building -- and its consequences for tax policy in the 1980s -- can best be seen by an analysis of three specific case studies in piecemeal tax reform -- the abortive sales tax reforms of 1981-83, the Scientific and Research Tax Credit (SRTC) program, and the federal government's long-awaited pension reform initiative.

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[40] The package also proposed improvements to the Guaranteed Income Supplement, a wide ranges of changes to the Canada Pension Plan and federal pension regulations. See Case Study # 10-3: Pension Reform.

[41] Lalonde, *Gains Sharing for a Stronger Economy*, (Ottawa, Dept. of Finance, Feb. 1984). These proposals were quietly shelved following the 1984 federal election.

[42] The budget proposed the elimination of the Cumulative Deduction Account for about 280,000 small businesses, effectively reversing the most complex and controversial small business measure of the 1981 budget. Hon. Marc Lalonde, *Budget Speech*, (Ottawa, Dept. of Finance, February 15, 1984).

[43] "Consultant hired to probe charges of abuse by tax officials", *The Gazette*, Montreal, Jan. 20, 1984, B1; "Tax quotas termed bankruptcy cause...", *The Globe and Mail*, Jan. 23, 1984, 5; Perrin Beatty, Chmn., *Report of the Task Force on Revenue Canada*, (Ottawa, Progressive Conservative Party of Canada, April 8, 1984); Geoffrey Hale, "Reforming Revenue Canada", *Policy Options* 5(5), September 1984, 56-62.

PIECEMEAL TAX REFORM – THREE CASE STUDIES

Marc Lalonde's tenure as Minister of Finance was characterized by a series of compartmentalized changes to the tax system which sought to tidy-up many of the "loose ends" left over from the Liberal Government's ambitious economic and social policy agendas of 1980-82, to target selective economic stimulus to promote recovery from recession, and to present the voters with an image of compassionate managerial competence in preparation for the federal election anticipated for 1984.

This section will examine three of the most significant measures: Lalonde's skilful retreat from his predecessor's White Paper on Sales Tax Reform, his well-intentioned, but poorly designed effort to increase investments in research and development, and his building of a consensus package on pension reform.

All three cases reflect the politics of pragmatism and interest accommodation in managing changes to the tax system. They also illustrate the quasi-constitutional character of the tax structure and its resistance to radical change. The sales tax reforms introduced by Allan MacEachen in March 1982 withered under the concentrated attack of business groups, in the absence of any major constituency for structural policy change. The SRTC, a classic example of the over-enthusiastic use of tax incentives to shape market forces, became one of the costliest fiscal disasters of any such measure in Canadian history. The pension reform issue is significant from three perspectives: Finance's capacity to take control of a major policy issue with tax implications from another department, the deliberate use of a tax expenditure as an alternative to a direct spending program advocated by another department, and the importance of tax-assisted retirement savings to the concept of the income tax as a *hybrid* income-consumption based tax.

CASE STUDY # 10:1 -- FEDERAL SALES TAX REFORM: 1981-83

> For the most part, the federal commodity tax structure, despite the partial rationalization of the sales tax embodied in the last three budgets, continues to resemble a historical hodgepodge of piecemeal legislative changes that do not necessarily add up to anything defensible.[44]

The Department of Finance had been studying the reform of the federal manufacturers' sales tax (FST) for at least seven years when Allan MacEachen announced his intention to shift the tax to the wholesale level in the November 1981 budget. This decision was the culmination of a long series of reports critical of the FST, its inconsistencies, complexities and economic distortions.

The 1956 Report of Kenneth Carter's Sales Tax Committee had recommended a shift in the tax to the wholesale level -- that is, the level at which retailers purchase goods. Further federal reports in 1975 and 1977 repeated this proposal, despite widespread criticisms of its potential inequities, costs and complexity from virtually all sectors affected by the proposed tax.[45]

Douglas Hartle lists seven major criticisms of the FST: 1) its tendency to promote "pyramiding", the imposition of tax upon tax; 2) its non-neutrality: the taxation of goods at different rates, depending on their countries of origin and distribution channels; 3) its invisibility: an invitation to higher taxes and government spending; 4) its arbitrariness,

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44 Richard M. Bird, "Federal Sales Taxes: The End of the Tale?", *Canadian Tax Journal* 30(2), [March-April 1982], 215.

45 Sales Tax Committee, *Report to the Minister of Finance*, (Ottawa, Queen's Printer, 1956), in Hartle, *Political Economy of Tax Reform, Six Case Studies*, Discussion Paper # 290, (Ottawa, Economic Council of Canada, November 1985); Department of Finance, *Discussion Paper: Federal Sales and Excise Taxation*, (Ottawa, The Department, June 1975); *Report of the Commodity Tax Review Group*, (Ottawa, Department of Finance, June 1977). A later government report notes than only 10 percent of submissions received in response to the 1975 Green Paper endorsed the wholesale tax proposal. Wolfe Goodman, *Report of the Sales Tax Advisory Committee*, (Ottawa, Department of Finance, May 1983), 10.

especially in calculating taxes on notional values[46] rather than market prices in certain cases; 5) its discrimination against "brand name" goods in favour of "private brand" goods; 6) its impact on business location decisions, through the differential taxation of transportation costs before and after manufacture; and 7) its discrimination against domestic goods and in favour of certain imported goods.[47] The cumulative impact of these inequities and distortions was to create a strong economic incentive to reorganize business activities to minimize the incidence of Federal Sales and Excise Taxes. By 1981, increasingly aggressive tax management practices by manufacturers, distributors and importers were beginning to erode federal revenues. Businesses successfully used the courts to broaden the scope of FST exemptions, preferences and special rulings in the name of horizontal equity.[48]

Finance Ministers Crosbie and MacEachen had attempted piecemeal budgetary changes to the FST to correct these and other anomalies. A 1979-80 budget measure shifted the tax on cosmetics and photofinishing to the wholesale level. The October 1980 budget extended the FST to cover some, but not all, newspaper advertising inserts;[49] and

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[46] Notional values: estimated prices based on industry averages or more-or-less arbitrary bureaucratic estimates of wholesale prices rather than actual market prices.

[47] Douglas G. Hartle, *Political Economy of Tax Reform*, 214-16.

[48] Interview, Eric Owen, Canadian Manufacturers' Assn.

[49] The cosmetics tax was was one of several budget measures carried over from the ill-fated Crosbie Budget of December 1979 to MacEachen's *Economic Statement* of April 1980. The 1980 budget proposed that inserts printed by firms other than newspapers be taxed, but that those printed as part of the newspaper remain tax free. The principal beneficiaries of this measure were large metropolitan chains of weeklies, some of which had close ties to the Liberal Party. Joseph R. Brown, "Recent Developments arising from federal budgets", in *Report of Proceedings of Thirty-Second Tax Conference, 1980*, (Toronto, Canadian Tax Foundation, 1981), 832-3, 838.

attempted to rectify discrimination against domestic manufacturers by extending the tax to cover "marginal manufacturing".[50]

These half-measures created as many inequities in the FST system as they resolved. They also led to an administrative nightmare both for Revenue Canada and for thousands of business taxpayers. Officials responsible for commodity tax policy convinced MacEachen that the only practical way out of the morass was to revisit the twice-frustrated wholesale tax. The result was a White Paper containing draft legislation, tabled in Parliament in April 1982.[51]

Sales Tax Reform -- The White Paper

The White Paper was a complex document which sought to achieve neutrality in the application of federal commodity taxes in several areas. It tried to equalize taxation of domestically manufactured and imported goods to remove the latter's price advantage. It attempted to remove disparities of taxation between products purchased by retailers. Most complex of all, it also attempted to equalize the sales tax effects of different distribution channels -- private label vs. brand name, direct sales to retailers vs. long distribution chains, and multiple distribution arrangements. A Large Retailer Tax (LRT) of up to 1.35 percent for firms paying over $ 200,000 in FST was intended to compensate for potential transfer pricing advantages of large integrated retailers. As wholesalers often operated in a fluid business environment, the White Paper proposed different arrangements for wholesalers averaging 50 percent or more sales to the retail level,

[50] "Marginal manufacturing" frequently involved minor processing, repackaging or preparation for sale of finished or semi-finished goods, often bulk shipments of imported goods. This further complicated an already complex statute. Brown, "Recent Developments ...", 833-5.

[51] Hon. Allan J. MacEachen, *Proposal to Shift the Federal Sales Tax to the Wholesale Trade Level,* (Ottawa, Department of Finance, April 30, 1982).

compared with those averaging 30 percent or less -- the so-called 50/30 rules. Provisions were made for notional valuations of various goods under certain circumstances. Separate rules were proposed for the construction sector, which had been subject to a lower five percent tax rate and special administrative arrangements under the manufacturers' sales tax. As compensation for the higher revenues expected from moving the FST to the wholesale level, the White Paper proposed a rate reduction from 9 percent to 8 percent after a six- month transition period.

Sales Tax Reform -- Institutions and Processes

The government had considered three options to reform the FST: further piecemeal change, shifting the tax to the wholesale level, or shifting it to the retail level. The piecemeal option was rejected as inadequate to the growing problems of maintaining the tax base or maintaining horizontal equity in a system with almost 20,000 special provisions for about 60,000 registered vendors. The retail sales tax option was rejected as it involved an invasion of provincial jurisdiction likely to create unmanageable political problems and lengthy delays in implementation.[52] The wholesale tax option therefore appeared to be the "least worst" option available to the federal government.

The impetus for the introduction of the Wholesale Tax proposal came from mid-ranking officials in the Tax Policy and Legislation Branch and in Revenue Canada concerned with the growing erosion of the Federal Sales Tax base as a result of adverse court rulings. Firmly convinced of the practicality of their proposals and dismissive of business interests unable or unwilling to advance a better alternative, they convinced their superiors in the

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[52] *Report of the Federal Sales Tax Review Committee*, ("the Goodman Committee") 9-10.

Department, including the Minister, that no satisfactory alternative was available to avoid the eventual disintegration of the sales tax system.

The leading business supporters of the Wholesale Tax were the motor vehicle manufacturers -- who faced a noticeable price disadvantage as the marketing and distribution costs of imported cars incurred within Canada were not subject to FST.[53] However, the White Paper also revealed strong opposition from a wide range of business groups which had already organized to oppose the MacEachen budget. Many of these groups had opposed the wholesale tax proposals of the mid-1970s. More than 125 submissions were received in response to the White Paper, most of them strongly opposed to the Wholesale Tax. As a result, its implementation was postponed twice -- first to January 1983, and then to mid-1984 by Lalonde in his Economic Statement of October 1982.

The sales tax debate was confined almost completely to the business community and its tax advisors. Business challenges to the proposed tax centered on the arbitrary valuation of goods due to notional valuations, excessive administrative complexity, and the substantive tax increases faced by many groups.[54] Discussions between Department officials and business reflected the mutual mistrust, verging on contempt, which was a by-product of the bitter debates over tax reform. Public discussion of the sales tax measures was largely limited to the business press. A business coalition spearheaded by the Canadian Manufacturers' Association, the Canadian Chamber of Commerce and the Retail

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[53] Hartle, *Political Economy of Tax Reform*, 226-7. Domestic manufacturers' sales prices, on which FST was imposed, included a major share of marketing costs, while these were added on at the wholesale level by importers.

[54] Particularly criticized were the Large Retailer Tax, provisions for deemed sales (e.g. FST payable on consignment sales), administrative rules for wholesalers with fluctuating sales to retailers and to other wholesalers (the "50/30 rules"), the inequities of the FST's "marginal manufacturing" rules and the problems created for the construction sector. Goodman Committee, *Report*, 18-20; interview, Wolfe D. Goodman.

Council of Canada, all strong critics of the White Paper, pressed for an independent review of the sales tax reform proposals similar to those granted to other 1981 budget proposals.[55]

By early 1983, Lalonde and his senior officials had concluded that the proposed wholesale tax would create as many administrative problems as it would resolve, and that the government needed an excuse either to salvage the proposal or to "legitimate" its withdrawal.[56] Informal discussions between Deputy Minister Cohen and senior business and professional representatives led to the appointment in February 1983 of an independent Advisory Committee chaired by Wolfe Goodman, an eminent Toronto lawyer and Cohen's former law partner. Its Vice Chairman, Joseph Brown of Arthur Andersen, was a prominent accountant closely allied to critics of the Wholesale Tax.[57] The Committee included a representative cross-section of professional, consumer and business interests.

The Goodman Committee's terms of reference were to examine options for sales tax reform which could increase tax neutrality and reduce fiscal discrimination against domestic producers, and to recommend improvements and/or alternatives to the White Paper proposals.[58] The Committee met with senior Department officials, a number of prominent academics specializing in commodity taxation, and a number of professionals and interest groups. The overwhelming majority of witnesses, including the academic experts, took the position that a broadly-based consumer-level tax was more effective

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[55] Interview, business association representatives. (AE-1, AE-2)

[56] Cohen, whose officials had proposed the wholesale tax in the 1970s, hoped to salvage the White Paper. Lalonde was much less committed to the project. Interviews, Hon. Marc Lalonde, Marshall Cohen.

[57] Interview, business association representative. (AE-2)

[58] Goodman Committee, *Report*, 2-3.

than the wholesale tax in achieving equity, neutrality and administrative simplicity, and that this could be obtained most effectively through cooperation with the provinces.[59]

Sales Tax Reform -- The Outcome

The Goodman Report recommended that the wholesale tax be shelved as an inadequate response to the acknowledged problems of the Federal Sales Tax, except for specific sectors such as the auto industry which faced major price disadvantages as a result of the existing system. In its place, Goodman recommended a choice among three options: a multi-stage sales tax similar to European value-added taxes, which could be administered by the federal government, a similar tax managed through federal-provincial cooperation, and a combined federal-provincial retail sales tax.[60]

Lalonde accepted Goodman's report, and Finance Department officials began working almost immediately on proposals for a multi-staged sales tax to replace the manufacturers' sales tax. This was the genesis of the Business Transfer Tax proposals of 1985-86 and the Goods and Services Tax introduced in 1989-90. The Department also implemented a number of the Committee's other recommendations, including application of the wholesale tax to imported cars, and changes to non-arms-length transfer pricing regulations.

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[59] Interview, correspondance, Wolfe D. Goodman. One of the witnesses, John F. Due, noted that the wholesale tax was an "anachronism ... a second best tax" in the absence of a value-added or comprehensive retail sales tax, which had been abandoned by every country except Australia and New Zealand. John F. Due, "The Wholesale Sales Tax in Australia and New Zealand", *Canadian Tax Journal* 31(2), [March-April 1983], 227.

[60] Goodman Committee, *Report*, 55-58. The general sentiment of the Committee was in favour of federal harmonization with the provinces, either in a VAT or a general retail sales tax. Correspondance, Wolfe D. Goodman.

The repeated failure of the Department of Finance to implement its preferred policy option, the Wholesale Tax, is a clear example of the ability of a concerted private sector lobby to block major changes to tax policy on issues of narrow public visibility. Major structural reforms to the sales tax would require three factors absent in the 1981-83 debate: a clear sense of public crisis over a disintegrating FST system, Finance's ability to recruit a strong coalition of interests committed to its plans for reform, and a Finance Minister and federal cabinet willing to invest the political capital necessary to build a new policy consensus and overcome the inevitable political resistance to structural change.

CASE STUDY # 10-2 -- THE SCIENTIFIC RESEARCH TAX CREDIT

> The most popular tax shelter ever to hit the Canadian scene.[61]

> We cancelled this program from beginning to end in 10 months. We inspected what we saw; we did not like it, we went to Finance and Finance took the decision to cancel it in 10 months. I know of no other government program that had a life of 10 months from passage into legislation into a moratorium.[62]

The Scientific Research Tax Credit (SRTC) was one of the most innovative tax measures introduced during Lalonde's period as Minister of Finance. Replacing existing tax provisions to encourage private sector research and development, the SRTC was aimed at making federal tax assistance available to small, private research-based companies which had previously been unable to take advantage of federal tax incentives and grants. The

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[61] Sidney Sweibel, "Tax Shelters: Present and future", in *Report of Proceedings of the 37th Tax Conference, 1985,* (Toronto, Canadian Tax Foundation, 1986), 47-21.

[62] Harry Rogers, Deputy Minister, Revenue Canada - Taxation, Standing Commons Committee on Public Accounts, *Minutes and Proceedings*, Issue # 19, June 6, 1985, 12.

vehicle chosen was a refundable tax credit transferable to investors in R&D-based companies.[63]

Designed after extensive consultation with private sector interests, the SRTC turned into a Finance Department official's nightmare: an easily accessed, demand-driven program with few checks on possible misallocation or abuse. Instead of the anticipated annual cost of about $ 200 million,[64] the SRTC program resulted in federal revenue losses of more than $ 2.8 billion[65] in less than two years of operation -- much of it resulting from the marginal or fraudulent use of the program. The SRTC program is cited to this day as an example of how not to use the tax system to bribe the private sector to carry out public policy objectives.

SRTC -- Background

The promotion of greater technological sovereignty had been a pillar of the federal Liberal government's proposals for an industrial strategy since the early 1970s. Domestic research and development (R&D), both public and private, was seen as a way to promote industrial restructuring and provide Canadians with a wide range of high-skill, high wage jobs. The R&D community, including both large and small firms, university and government researchers, was considered a natural Liberal constituency. Its reliance on long-term capital investment and the uncertainty of its returns made it highly dependent

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[63] Refundable tax credit -- unlike most tax credits, refundable credits are payable even when the taxpayer has no net taxable income. Although such measures have become fairly common to target social benefits to low-income families through the personal income tax system, the SRTC is the first and, to my knowledge, the last use of a refundable tax credit in the corporate income tax system.

[64] Hon. Marc Lalonde, *Research and Development Tax Policies*, (Ottawa, Department of Finance, April 1983), 27.

[65] See Table 10-2.

on government intervention to promote the long-term development of the industry -- both through direct government spending and tax assistance. The Liberals pledged to increase R&D levels to 1.5 percent of Canada's GDP during the 1980 federal election campaign. While this promise was subsequently watered down, the industrial strategy paper tabled with the 1981 budget emphasized the need to increase industrial research and innovation.[66]

However, rather than the centralized, government-driven industrial policy advocated by the Science Council, Industry Minister Ed Lumley and senior industry and economic development officials advocated a "bottom-up", market-driven strategy which involved close cooperation with industry on a sector by sector basis. These principles were reflected in the R&D consultation paper tabled with the 1983 budget.[67] R&D incentives should be private sector firm-driven rather than state driven, conducive to sound business practices, of immediate financial benefit to firms, and easy for companies to access.

SRTC -- The Interests

The policy community for federal R&D policies and programs in the early 1980s included the Department of Finance (Economic Development and Tax Policy branches), the Ministry of State for Economic Development (MSED), several sector branches within the Department of Regional Industrial Expansion (DRIE), the National Research Council (NRC) and several granting agencies with close links to university research communities.

Private sector interests were broadly divided into three groups. Large industrial firms with a continuing commitment to extensive R&D, especially in the telecommunications and

66 *Economic Development in Canada in the 1980s*, (Ottawa, Department of Finance, November 1981), 15-16.

67 Lalonde, *Research and Development Tax Policies.*

aerospace industries, were sufficiently profitable to benefit from existing tax incentives for R&D-related capital investment, mainly the Investment Tax Credit. Medium-sized growth firms, especially in the information technologies sectors, were beneficiaries both of many grant programs and tax credits for incremental R&D.[68] A large number of small, often recently formed companies, including spin-offs from the other two groups, added a dynamic and innovative, but financially unstable component to the high technology sector.

Existing programs were criticized for excluding many smaller companies, especially recently formed firms with limited cash flow, profits, and hence taxable capacity against which to offset R&D deductions.[69] Many businesses were critical of government grant programs, an alternate source of funding, as being complex, costly and cumbersome to access. The 1983 consultation paper on R&D Tax Policies was heavily targeted towards smaller companies which had been unable to take advantage of previous tax incentives.[70]

The Discussion Paper proposed the replacement of the existing 50 percent deduction of incremental R&D expenses with a 20 percent refundable tax credit. This was enriched for investments in Atlantic Canada or Gaspe (30 percent) or by small businesses (35 percent).

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68 Roger Chesser, "Tax treatment of R&D from the perspective of new and smaller performers", *Report on Proceedings of Thirty Fifth Tax Conference, 1983*, (Toronto, Canadian Tax Foundation, 1984), 548-55.

69 Before the SRTC, small companies with heavy R&D investments were able to use only about 15 percent of the tax allowances available to them. Peter Ladner, "While the getting was good", Canadian Business, [February 1985], 88. A 1983 study by McFetridge and Warda "found that the tax environment for R&D in Canada compared very favourably with other countries" D.G. McFetridge, "The Effect of the Proposed Amendments on the Incentive to Engage in Industrial R&D", in *Report of Proceedings of the Thirty-Fifth Tax Conference, 1983*, 516.

70 McFetridge, "The Effect of the Proposed Amendments...", 506-520.

The SRTC could also be flowed through[71] to investors in eligible R&D firms through a 50 percent tax credit applicable to a wide range of financial instruments.[72] The result was a tax incentive which was much more user-friendly than the average government grant -- one specifically designed to draw large amounts of private sector investment capital into the cash starved industry.

SRTC -- Institutions and Process

While the SRTC was a logical outcome of the federal government's Industrial Strategy consultations, its design and implementation were purely a Finance Department responsibility. Deputy Minister Cohen and others had noted the success of tax incentives for flow-through shares and limited partnerships in financing high-risk, long-term investments in the mining and energy sectors. The SRTC would carry this process a step further. Mid-ranking Finance Department officials, many of whom were extremely sceptical of the process, described it as having been "politically driven".[73]

Finance officials had observed that existing tax incentives, which rewarded increases in research activity, promoted stop/go patterns of private sector R&D.[74] The Department carried out informal consultations with companies carrying out industrial R&D, including meetings with individual firms and their professional advisors to understand the industry's financial and business patterns.

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71 "Flow through" instruments are derived from elements of U.S. tax law which permit corporations to attribute profits, losses and/or tax benefits directly to shareholders or lenders.

72 Lalonde, *R&D Tax Policies*, 2.

73 Interview, current and former Finance Department officials. (F04, F05)

74 A.G.R. Caie, "Tax treatment of R&D from the perspective of a large and established R&D performer", *Report of Proceedings of the 35th Tax Conference, 1983*, 542.

> Instead of representative groups coming to us, ... we went out and found companies of various kinds that we thought would represent a sample that would be instructive to us.[75]

The Consultation Paper in the 1983 budget was the mid-point in this process. It was followed by meetings with key industry groups, including the Canadian Advanced Technology Association (CATA), the Investment Technology Association of Canada (ITAC) and the Canadian Manufacturers' Association, as well as individual R&D firms. While Department officials consulted informally with professional "matchmakers" in the informal small business capital market, there were few discussions with the financial sector.[76]

Revised legislative rules which extended the SRTC even further were tabled in October 1983. The Minister's decision to implement the legislation on the date of its tabling in the Commons in order to encourage an immediate industry response meant that drafting arrangements were left relatively loose -- to be adjusted as needed following the election anticipated for 1984.[77]

One former Finance official comments that the Department's key mistake in this process was to allow SRTC contracts for firms in which the principals did not have any of their

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75 Stanley Hartt, Deputy Minister of Finance, in Standing Committee on Public Accounts, *Minutes and Proceedings*, Issue # 33. May 29, 1986, 22; see also N. LePan, ibid, Issue # 18, May 30, 1985, 26-28.

76 Le Pan, ibid., 27-28.

77 The SRTC legislation passed January 17, 1984 was retroactive to October 1, 1983. Revenue Canada officials expressed concerns with the quick flip and prefunding elements of the program, but as substantial investments had been committed during this time, Finance decided to implement the program on a trial basis. Commons' Public Accounts Committee, *Minutes and Proceedings*, Issue # 19, June 6, 1985, 29-30.

own capital at risk -- wholesalers or "warehousers".[78] The result was an explosion of private financing arrangements, many involving "quick flips" of contracts from one investor to another. The number and speed of these transactions made monitoring, let alone control, of the SRTC process negligible. The SRTC rules allowed "prefunding" of R&D projects through the proceeds of federal tax credits -- with the government effectively serving as a banker for the high-tech sector.

> The government was very anxious to get more R&D done, and very anxious to get that R&D done by small business, small performers, start-up performers and so on. And the prefunding seemed to be a mechanism that would be helpful in that regard.[79]

R&D firms without taxable profits were allowed to transfer the tax credits to investors through "quick flips" in which the latter could make a short-term loan to R&D performers equivalent to the value of the tax credit, plus a commission which averaged 10 percent of the transaction's value.[80] These "quick-flips", which totalled 80 percent of the cash transactions under the SRTC program, left R&D companies with a cash shortfall in fulfilling their research commitments under the SRTC contract -- at the risk of becoming liable for a "Part VIII tax" equivalent to the tax credit.[81] The Auditor General was highly

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[78] Interviews, former Finance Department official (F05). Ladner, "While the getting was good", op. cit.; for a discussion of SRTC-related compliance and anti-abuse policies, see Geoffrey G. Briant, "Structuring Post-moratorium R&D financings", in *Report of Proceedings of the Thirty-Sixth Tax Conference, 1984*, (Toronto, Canadian Tax Foundation, 1985), 589-617.

[79] Marshall A. Cohen, in Commons' Public Accounts Committee, *Minutes and Proceedings*, Issue # 18, May 30, 1985, 35-36.

[80] Harry G. Rogers, "Statement" to Commons' Public Accounts Committee, *Minutes and Proceedings*, Issue # 31, March 11, 1986, 6-7.

[81] This shortfall amounted to $ 3.4 billion, including $ 2.8 billion in Part VIII tax liabilities. Only 37 percent of SRTC firms had access to secondary financing to carry out their obligations under the program. Rogers, ibid., 6-10; Standing Committee on Public Accounts, *Fourteenth Report*, Issue # 35, June 25, 1986, 5.

critical of this arrangement.[82]

SRTC -- Outcome

Finance Department estimates placed the anticipated cost of the SRTC program at $ 185 million in 1983-84 -- about double the level of tax assistance in the previous year.[83] However, by the end of January 1984, this figure had been exceeded by almost 200 percent.[84] Revenue Minister Pierre Bussieres announced plans for a systematic audit of all SRTC recipients in June 1984 -- after $ 900 million in tax credits had been disbursed.[85] Even before the Mulroney government took office in September 1984, Finance officials knew they had a fiscal time-bomb on their hands, with more than $ 2 billion in outstanding claims under the program. Revenue Canada audits indicated that many SRTC claims were for research of dubious value or were utterly fraudulent. However, the impending election prevented the government from capping or redesigning the SRTC program in June 1984.[86]

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[82] Kenneth Dye, Statement to Commons' Public Accounts Committee, *Minutes and Proceedings*, Issue # 18, May 30, 1985, 7.

[83] Lalonde, *R&D Tax Policies*, 27.

[84] SRTC claims for $ 542 million were submitted for the 1983 tax year between October 1 and December 31, 1983. Commons' Public Accounts Committee, *Minutes and Proceedings*, Issue # 19, June 6, 1985, 8.

[85] Ibid., Issue # 31, Mar. 11, 1986, 44. Senior Finance Department officials have commented that the impending election prevented the government from capping or redesigning the SRTC program in June 1984.

[86] Giles Gherson, "Tax credit party gives Ottawa costly hangover", *Financial Post*, July 6, 1985, 4. The program's total cost was $ 2.8 billion, including $ 925 million in Part VIII tax which had to be written off as uncollectable. Gordon Pitts, "Ottawa deepens tax credit probe", *Financial Post*, July 5, 1986, 3.

Finance Minister Wilson announced a moratorium on the "quick flip" SRTCs on October 10, 1984, about three weeks after taking office.[87] However, R&D financing projects initiated before that date remained eligible for the refundable tax credits to avoid a "retroactive" application of the tax charges. Finance officials later conceded that the "grandfathering" provisions may have been too loosely written. Almost $ 900 million in SRTC credits were claimed between October 10, 1984 and December 31, 1985, even though the SRTC program was cancelled in the May 1985 budget.[88]

The SRTC fiasco strongly reinforced the prejudice of Department officials against using the tax system to micro-manage economic behaviour. It demonstrated the capacity and willingness of tax professionals to develop abusive tax avoidance devices to apply tax incentives to measures well beyond those contemplated or desired by the Department -- turning "incentives" into gaping "loopholes" in the process.

TABLE 10-2
FEDERAL REVENUE LOSSES FROM SRTC
(in $ Millions)

Oct.-Dec. 1983	$ 540
Jan.-Oct. 1984	$ 1,460
Oct. 1984 - May 1985	$ 1,200
After May 23, 1985	$ 300
Sub-total	$ 3,500
Less "rollovers"	($ 700)
Total	$ 2,800

Source: Harry G. Rogers, "Statement to Commons' Public Accounts Committee", Minutes and Proceedings, Issue # 11, (House of Commons, Mar. 11, 1986), 9.

[87] Briant, "Structuring Post-moratorium R&D financings", 589.

[88] Stanley Hartt, Commons' Public Accounts Committee, *Minutes and Proceedings*, Issue # 33, May 29, 1986, 38; Rogers, "Statement", Commons' Public Accounts Committee, Issue # 31, Mar. 11, 1986, 8.

The SRTC fiasco and the complex safeguards to limit the abuse of new tax incentives which followed it[89] helped to steer the government away from the use of targeted corporate tax incentives in favour of a general lowering of rates, balanced by reductions in tax preferences, culminating in Michael Wilson's tax reform program of 1987-88.

CASE STUDY # 10-3 – PENSION REFORM

The federal government's handling of pension reform in 1982-84 reflects the ability of the Department of Finance to take control of a major social policy initiative and to integrate it with broader political, economic and jurisdictional concerns. Rather than attempting a major extension of universal social programs as proposed by the Liberals' social democratic wing in the early 1980s, Finance Minister Lalonde emphasized an overhaul of the tax treatment of pensions, along with targeted increases in public programs.

Pension Reform -- Background

Components of the Canadian Pension System

The Canadian pension system has had five major elements since the introduction of the Canada and Quebec Pension Plans (C/QPP) in the mid-1960s. The other elements are the Old Age Security pension (OAS), the income-tested Guaranteed Income Supplement (GIS), (supplemented by comparable provincial plans), private, earnings related pension plans (RPPs), and private retirement savings plans (RRSPs).

The expansion of the Canada Pension Plan to cover 50 percent of pre-retirement earnings was a major goal of organized labour and much of the Canadian left during the late 1970s and early 1980s. However, this goal faced four major constraints. First, any changes to

[89] N. LePan, Commons' Public Accounts Committee, *Minutes and Proceedings*, Issue # 31, Mar.11, 1986, 17. Arguably, the SRTC fiasco opened the door to the broadly-based anti-avoidance (GAAR) rules of the 1987-88 tax reform program.

the CPP had to be approved by two-thirds of the provinces with two-thirds of Canada's population. Second, the aging "baby boom generation" would face tax increases from the current 3.6 percent of payroll to the range of 10 percent by 2010 -- even without a significant increase in benefit levels. Third, an expansion of the CPP could be expected to reduce overall savings rates, limiting the growth of Canada's financial sector and increasing Canadian dependence on foreign capital. Fourth, the business community was almost unanimous in its opposition to higher payroll taxes, which are not profit sensitive, and which fall most heavily on labour-intensive sectors responsible for the bulk of job creation.[90] CPP expansion became the most politically sensitive issue of the pension reform debate.

The Old Age Security (OAS) pension had been financed by a payroll tax before 1971. However, during the 1970s and early 1980s, it was a universal pension payment funded from general government revenues. The burgeoning federal deficit made expansion of the OAS a political non-starter. However, it was not until the mid-1980s that politicians began to speak about targeting the OAS to lower and middle-income earners through the tax system.

The Guaranteed Income Supplement (GIS) is a means-tested benefit intended to provide a basic standard of living for needy seniors. It is supported by provincial income supplements in several provinces. Indexed to inflation through the 1970s, it was originally intended to be reduced in importance as the CPP matured. However, the growth in the number of women in the paid work-force, the erosion of private pensions by inflation and increasing labour mobility meant that a growing percentage of single elderly, especially women, were dependent on the GIS.

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[90] Ontario. Small Business Advocacy, Ministry of Industry, Trade and Technology, *State of Small Business 1987*, (Toronto, The Ministry, 1988), 120-22.

The private employment pension system is largely regulated by the provinces under their respective Pension Benefits Standards Acts (PBSA). The federal government attempted to promote uniform pension standards in such areas as vesting, portability, and credit splitting and survivors' benefits.[91] However, several provinces including Ontario, Quebec and Saskatchewan produced major reports during the early 1980s proposing major changes to the private pension systems within their respective provinces.

Pension Reform -- Institutions and Processes

The federal government initiated a wide-ranging review of social benefits, including pensions, in 1976.[92] This process was complemented by the appointment of an Ontario Royal Commission on Pension Policy in 1977, the study of the Senate Committee on the Retirement Age, released in 1979, and parallel studies in several provinces.[93]

The National Pensions Conference was organized jointly by the Departments of National Health and Welfare and Finance in April 1981. Pension, labour, business, women's' and

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[91] Vesting: the locking-in of both employer and employee contributions into a pension fund: usually after 10 years (before 1986) in many defined-benefit plans. Portability: employees' ability to carry their accumulated pension contributions and those of their employers from one job to another. Credit splitting: the entitlement of each spouse to 50 percent of the other's pension entitlements through the period of their marriage. Survivors' benefits: benefits available to surviving spouses and children of a deceased employee.

[92] Health and Welfare Canada. "News Release", (Ottawa, the Department, April 18, 1986); "A Credo of Social Security Values", (Ottawa, the Department, April 18, 1976); "Strategies for a New Social Security System", (Ottawa, the Department, April 18, 1976)

[93] Canada. Senate. *Retirement without Tears, Proceedings of the Special Senate Committee on Retirement Age Policies,* Issue # 1, (Ottawa, The Committee, April 15, 1980). The report of the Ontario Royal Commission on Pension Policy, (Toronto, Queen's Printer, 1981), along with reports in Quebec and Saskatchewan, had increased pressure for mandatory private pension plans and some form of mandatory indexing.

social policy organizations met in Ottawa to exchange points of view.[94] However, a vast gulf emerged between business and financial sector associations at the conference and the network of labour, women's and social policy organizations pressing for a major expansion of the public pension system. This was mirrored in the federal cabinet in the split between Health Minister Monique Begin and other "welfare Liberals" and "business Liberals" who urged incremental changes to the pension system and a delay of more far reaching measures that might interfere with capital markets and slow the process of economic recovery.

Marc Lalonde's appointment as Minister of Finance in September 1982 facilitated cabinet approval of the latter strategy and its release through a Green Paper by Lalonde and Begin in December 1982.[95] As a former Minister of Health and Welfare, Lalonde was familiar with the file. In contrast to Begin, Lalonde was strongly committed to the principle that the state should encourage individuals to take responsibility to save for their own retirement. Preferring to avoid lengthy negotiations with the provinces, a majority of which had already expressed strong opposition to CPP expansion, Lalonde opted for the development of a consensus package in areas within federal jurisdiction which could be implemented before an election expected in 1984.[96]

The Green Paper addressed five major issues: pension coverage, indexation, portability, flexibility, and women's issues. However, it avoided firm positions on the two major issues: whether and how to achieved increased mandatory coverage and adequate inflation protection. The issue of equal tax treatment of RPPs and RRSPs, while addressed in

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[94] *Proceedings of the National Pensions Conference*, March 31, April 1-2, 1981, (Ottawa, Supply & Services Canada, October 1981)

[95] *Better Pensions for Canadians*, (Ottawa, Supply & Services Canada, December 1982).

[96] Interviews, Hon. Marc Lalonde, Andrea Vincent, senior Finance Department official (D8).

passing, was left to a subsequent Discussion Paper to be prepared by Finance Department officials.

In February 1983, the government struck an all-party committee of the House of Commons, led by Begin's former Parliamentary Secretary, Doug Frith, with the objective of developing a consensus on policy reforms capable of immediate implementation. The Committee faced a double challenge: to agree on a package of recommendations that could be implemented prior to the next election within a policy framework that could survive the demographic, fiscal and political changes of the next generation. The policy process surrounding the hearings took place at three levels: the Committee and its staff, the competition among interest groups to influence the policy agenda, and the federal bureaucracy.

After initial briefings for the Task Force to familiarize MPs with the complex range of issues involved in the Green Paper, Frith attempted to establish a course independent from Task Force staff and PCO officials, most of whom were strongly committed to the Health and Welfare position of expanding the CPP.[97] The Committee identified four major factors which shaped its eventual consensus. Changes in career patterns were pointing towards multi-employer careers for most Canadians, rather than patterns of stable employment with a single company. This suggested the need for greater flexibility in retirement savings plans and a greater emphasis on personal pension ownership. The feminization of the work force meant that women had to have opportunities to accumulate retirement savings in their own right, not just as part of a family savings pattern. Demographic changes pointed to a rapidly aging workforce with workers supporting more than twice as many pensioners for longer periods of retirement early in the next

[97] Interview, Hon. Douglas Frith.

century. This in turn made the enormous intergenerational transfers implicit in an expanded CPP unsustainable both on political and economic grounds.[98]

By early July 1983, the Liberal and P.C. members of the Task Force had agreed that the broad outline of their report would center on a package of tax measures, along with targeted improvements of federal programs to meet the needs of specific constituencies. The Committee then hired private sector consultants to reduce its dependence on the data provided by Committee staff and Health and Welfare officials.[99]

Th. Parliamentary Task Force on Pension Reform held extensive hearings in centres across Canada, hearing presentations from 162 organizations. (See Table 10-3)

TABLE 10-3
SUBMISSIONS TO PENSIONS TASK FORCE: 1983

Business/Professional Groups	43	26.5%
Labour Groups	38	23.5%
Women's Groups	25	15.4%
Seniors/Pensioners	25	15.4%
Public Sector (prov. & mun. governments, economic councils and crown corporations)	10	6.2%
Social Policy/Anti-Poverty groups	8	4.9%
Politicians	3	1.9%
Pension/Financial Groups	3	1.9%
Other	7	4.3%
Total	162	

Source: Parliamentary Task Force on Pension Reform, *Third Report*, (Ottawa, House of Commons, Nov. 1983), 113-17.

The battle lines at the Committee hearings paralleled those of the National Pensions Conference two years before. Organized labour, most women's groups and social policy advocates argued for an expansion of the Canada Pension Plan, mandatory indexing of private pensions, and provisions for "housewives' pensions". The major national business

98 Ibid. Intergenerational transfer -- the subsidy paid by one generation to support benefits for its predecessors beyond those which can be sustained by the return from pension plan assets.

99 Ibid.

groups, while presenting separate briefs on individual sectoral concerns, developed a consensus position through the Business Committee on Pension Policy (BCPP). The BCPP commissioned extensive economic and actuarial research on the costs of various pension reform issues, the extent and nature of pension coverage, and the impact of proposed changes on capital markets.[100] These studies were effective in challenging the economic assumptions of the Green Paper. They helped to shift the terms of debate towards the targeting of specific income disparities as the key goal of pension reform rather than the sweeping, broad brush proposals advanced by much of the social policy lobby.

While this was happening, the bureaucratic policy process resulted in the Department of Finance preempting the lead role in pension reform rather than having to negotiate its details through the Privy Council Office or the Ministry of State for Social Development.[101] As changes to the Pension Benefits Standards Act (PBSA) and the Canada Pension Plan would have to be negotiated with the provincial Finance Ministers, Cohen was able to exploit Finance's role as the central agency of fiscal federalism to seize control of the policy agenda.

The political and bureaucratic policy streams were drawn together at a meeting between Frith and Lalonde in late September 1983. Frith argued that the pension reform package should provide for the equalization of benefits in the tax treatment of RPP and RRSP contributions.[102] The existing RPP ceiling provided for a maximum "tax assisted"

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[100] Business Committee on Pension Policy, *The Consensus Brief*, (Toronto, The Committee, September 1983); William M. Mercer Ltd., *The Cost Study*, 5 volumes, (Toronto, BCPP, September 1983); K. Ambachtsheer and D.D. Ezra, *Capital Markets Study*, (Toronto, BCPP, September 1983).

[101] A senior Finance Department official comments that "Mickey (Cohen)'s mastery of the operations of government was vital" to the eventual shape of the 1984 pension reform proposals. Interview, senior Finance Department official. (D8)

[102] Interview, Hon. Douglas Frith.

pension of about $ 62,000 -- about three times the Average Industrial Wage (AIW). Politically, it made more sense to phase in an increase in the RRSP ceiling to this level than to reduce the earnings ceiling for defined benefits pensions.[103]

The Task Force Report in November 1983 reflected a consensus of the Liberal and Conservative members, with NDP members preparing a dissenting report. The Committee report recommended a series of technical reforms in the Pension Benefit Standards Acts which supported most of the Green Paper's recommendations -- and went well beyond the proposals of the business community. This included proposals for expanding CPP credits for women taking leave from the paid work-force for up to seven years. However, the main proposal of the Committee's report was to equalize the tax treatment of RPPs and RRSPs over five years.

> The Task Force recommends that limits on contributions to tax-assisted retirement savings plans be amended so that: a) the same comprehensive limit applies regardless of the retirement savings vehicle or combination of vehicles used; and b) for workers with the same total earnings during their working years, the same comprehensive limit applies irrespective of differences in year-by-year earnings.[104]

The Committee's proposals also included a pension ceiling of one-and-a-half times the average wage and a tax clawback of individual tax-assisted pension earnings in excess of

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103 The latter included not only corporate managers and professionals, but also a large number of unionized workers, whose pensions were usually calculated on the basis of the average of their final three years earnings. Author's note: there is a discrepancy here between the text of the Frith Committee's report and the above discussion. The Committee proposed that tax assisted pensions provide for the replacement of up to 60 percent of pre-retirement earnings up to a maximum of $ 55,000 -- a level which would cover 90 percent of men and 98 percent of women. Accumulated benefits above this level would be subject to a tax clawback. This suggests that Frith was able to convince Lalonde of the merits of higher tax preferences for retirement savings but not his Committee colleagues.

104 Special Committee on Pension Reform, *Minutes and Proceedings*, The Second and Third Reports to the House, Issue # 38, (Ottawa, House of Commons, November 23, 1983), 101-102.

the ceiling.

Pension Reform -- The Outcome

While the broad outlines of the Committee's report had been "sold" to Finance in September-October 1983, the details of its implementation were left entirely in the hands of Departmental officials. The Social Policy and Federal-Provincial Relations Branch took responsibility for the proposed PBSA and CPP changes, while the Tax Policy and Legislation Branch managed the tax changes. The two processes took place independently, with coordination primarily at a level of mid-ranking and junior officials.[105]

The proposed changes were tabled in two discussion papers in the 1984 budget -- one relating to the Canada Pension Plan and entitlements under the Pension Benefits Standards Act,[106] the other to proposed changes in federal tax policies.[107] The first set of proposals became part of extensive federal-provincial negotiations over the financing of the Canada Pension Plan. Inherited by the Mulroney Government after the 1984 election, they became law in modified form in 1986.[108]

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105 Interview, senior Finance Department official. (ADM-5)

106 Hon. Marc Lalonde, *Action Plan for Pension Reform*, (Ottawa, Department of Finance, February 1984).

107 Lalonde, *Building Better Pensions for Canadians.*

108 The tax-related proposals included phased annual increases in CPP premiums of 0.2 percent between 1986 and 2005 to maintain its medium-term viability. Earlier proposals for "housewives' pensions" were sharply scaled back as actuarially unsound.

The tax-based proposals included an increase in the RRSP deduction ceiling to $ 10,000 in 1985 and a phased increase to $ 15,500 by 1988, with subsequent indexation.[109] Unused RRSP contribution levels could be carried forward to future tax years for up to seven years. The equalization of RRSP and RPP tax benefits resulted in the reduction of pension entitlements for some upper-income executives.

This had major implications for the tax system. In addition to the medium-term revenue loss, it firmly established the income tax system on a mixed "income-consumption base" by equalizing the savings opportunities of different groups of employees on a multi-year basis. It thus became another factor in burying the Carter Commission's vision of a comprehensive income tax which had been the basis for MacEachen's proposed 1981 tax reforms.

The Mulroney Government accepted the principles of pension reform set out by Lalonde in the 1984 budget, but deferred their implementation for several years. Michael Wilson's 1985 budget renewed the pledge to adjust and index contribution limits by 1989. A White Paper was issued in October 1986, together with detailed rules and procedures extending the phase-in period to 1988-91.[110] Integrated with the 1987 *White Paper* on Tax Reform,[111] the tax changes were deferred again -- to 1989-95. Actual implementation began in the 1991 tax year. Amazingly, through all these changes, while the value of the 1984 tax changes were eroded somewhat by inflation, their basic contents remained unchanged.

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109 These changes were intended to offset the impact of inflation since the last ceiling adjustment in 1977.

110 Department of Finance, *A Better Pension System: Saving for Retirement -- Improved Tax Treatment: Detailed Rules and Procedures,* (Ottawa, the Department, October 1986).

111 Hon. Michael H. Wilson, *Tax Reform 1987: Income Tax Reform*, (Ottawa, Dept. of Finance, June 18, 1987), 22-3, 66, 73, 78, 82.

The pension reform debate illustrates the ability of provincial governments to impose effective limitations on federal tax changes overlapping their jurisdictions. It also demonstrates the ability of a united business community to impede major structural changes to social policy detrimental to its fundamental interests. While the federal government was able to introduce widespread piecemeal improvements to public and private pensions, it did so within a structural framework which respected the existing economic constitution. This made it possible for Ottawa to coopt business interests through a major expansion of the tax preferences for private retirement savings and, with them, the expansion of private savings available for investment through capital markets.

CONCLUSION: THE LALONDE YEARS -- AN EVALUATION

Marc Lalonde's achievements as Minister of Finance were mixed. Their evaluation will inevitably reflect the observer's attitudes towards public finance, normative goals of tax policy, and the role of the state in economic management. Lalonde's policies as Minister of Finance reflect both a commitment to a pragmatic approach to tax policy -- balancing competing political and economic objectives in order to build a broad consensus on economic policy -- and to strengthening the institutional leadership of the Department of Finance in setting framework economic *and* social policies for the federal government.

His two budgets continued the unraveling of the MacEachen tax reform proposals of 1981. They further entrenched the principle of the income tax system as a hybrid income-consumption tax and a means of encouraging private savings, capital formation, and a wide range of social and economic activities. The rationalization and gradual expansion of retirement savings incentives was the most significant and lasting example of this policy.

By his own standards, Lalonde succeeded in his objectives of restoring a greater degree of consensus in the management of economic policy. He presided over the beginnings of a sustained economic recovery, and left the Department of Finance in a stronger position to direct federal economic policy than at any time since 1971. The consultation process which matured under his leadership established a model for federal and provincial policy-making which contributed greatly to the political success of Michael Wilson's tax reform initiatives of 1986-88.

However, Lalonde was less than successful politically, particularly in the legacies of increasing deficits and debt left to his successors. The federal Conservatives outbid the Liberals for business and middle-class support in the 1984 federal election. While two of Lalonde's innovations, pension reform and small business tax simplification, became the basis for a bi-partisan federal policy for the next decade, another, the Scientific Research Tax Credit (SRTC) opened the door to some of the largest tax frauds in Canadian history.[112] These successes and failures typify both the strengths and weaknesses of the pragmatic approach to tax policy favoured by Lalonde and Cohen.

Under Lalonde, a wide cross-section of interests, both private and governmental, succeeded in securing virtual entitlements to federal spending or to "competitive" levels of taxation based either in lower American marginal tax rates or horizontal equity in the allocation of tax preferences. Federal spending decisions were effectively disengaged from tax policy decisions. The rest of the 1980s were spent in a largely fruitless effort to reestablish contact between the two.

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[112] Revenue Canada estimated fraud in 84 cases involving $ 338 million in tax value. Gordon Pitts, "Ottawa deepens tax credit probe", *The Financial Post*, July 5, 1986, 3.

CHAPTER 11 – MICHAEL WILSON, PIECEMEAL TAX REFORM AND THE POLITICS OF ACCOMMODATION

> You have to take a pragmatic approach to these things. One of the important considerations in the development of tax policy we have followed during our term of office is an evolutionary way, rather than a revolutionary way, so that you gradually move in certain directions. We have indicated what those directions are; and as we move in steps, we achieve the goals, but not in a way that leaves people with major adjustments to make in their after tax income.
>
> Michael Wilson, April 22, 1986[1]

Viewed in retrospect, the Mulroney Government of 1984-93 presided over a wide range of structural changes to economic policy which involved the most thoroughgoing revisions to Canada's economic constitution since the aftermath of the Second World War. The most prominent of these changes was, of course, the negotiation of the Canada-U.S. Trade Agreement. Others included significant changes to Canada's Competition and Bankruptcy Acts, along with full or partial economic deregulation of several industry sectors, most notably transportation, telecommunications and financial services. Most significant to this study, Finance Minister Michael Wilson won parliamentary approval for significant tax reform programs which substantially redesigned the corporate and personal income tax systems between 1985 and 1988 and replaced the antiquated Federal Sales Tax with a much more broadly-based Goods and Services Tax in 1989-90.

However, with the exception of free trade, a non-issue in 1984 which became the centrepiece of its economic strategy after the release of the Macdonald Commission Report of 1985,[2] the government's fiscal and economic policies often resembled a process

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[1] Hon. Michael H. Wilson, Testimony to Commons' Finance Committee, *Minutes and Proceedings*, Issue # 10, (Ottawa, House of Commons, April 22, 1986), 10.

[2] Canada. Royal Commission on the Economic Union and Development Prospects for Canada. *Report*, 3 Volumes, (Ottawa, Supply & Services Canada, 1985).

of trial and error in assembling a giant jigsaw puzzle whose final dimensions were only vaguely glimpsed at first.

Mulroney's overriding goal was to win a second successive majority government and to establish the Conservatives as Canada's natural governing party.[3] To do this, he had to "reinforce his core supporters" and "look different from the previous government" while trying to build a consensus in support of moderate change.[4] But while Mulroney wanted to "redefine the political centre" in the manner of the pragmatic, non-ideological Conservative governments which had ruled Ontario from the 1940s until the 1980s, he lacked both the confidence in his electoral mandate[5] and the firm core of principle necessary to introduce major policy changes to the government as a whole. This lack of political confidence, reinforced by the government's declining popularity between late 1984 and mid-1987, became the overriding political constraint on Michael Wilson's ambitions for deficit reduction and tax reform.

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[3] David Bercuson, J.L. Granatstein, W.R. Young, *Sacred Trust? Brian Mulroney and the Conservative Party in Power*, (Toronto, Doubleday Canada, 1986), 27. Interview, senior Finance Department official. [D4].

[4] Interview, political staff, Dept. of Finance. (F02); "Speech from the Throne", Canada. House of Commons, *Debates*, November 5, 1984, 5-8. Public documents in 1984-85 repeatedly referred to "national reconciliation", "consultation" and "consensus".

[5] A senior government official comments that Mulroney and his closest associates regarded the 1984 election results as a rejection of the previous Trudeau government as much as a popular mandate for major political change under the Tories, and were therefore much more cautious about introducing major policy changes than in their second term. Interview, senior government official. (D4)

The government's 1988 election agenda, based largely on Free Trade, Meech Lake and tax reform, was the product of tactical adaptation and improvisation to unforeseen events[6] rather than of any strategic plan visible in 1984. Nowhere is this tactical improvisation clearer than in its handling of tax policy and tax reform.

The process of income tax reform went through three main stages between 1984 and 1988: the initial consultations and piecemeal, often tentative measures taken between November 1984 and June 1986; the growth, evolution and formalization of Wilson's tax reform plan between July 1986 and the tabling of the White Paper in June 1987; and the parliamentary and bureaucratic process which concluded in the passage of an amended Bill C-139 in September 1988.

This chapter will explore the first stage: the political and economic strategies of 1984-86 and Wilson's two-and-a-half budgets of this period. It will also examine the evolution of the government's fiscal and tax agendas between the *Economic Statement* of November 1984 and Wilson's decision to pursue comprehensive tax reform in mid-1986, along with three tax policy initiatives which reflected the interplay of institutions, ideas and interests during this period: the lifetime capital gains tax exemption of 1985, the alternative minimum tax and the broadening of the corporate income tax base.

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[6] Free trade was introduced to the national political agenda by the report of the Macdonald Royal Commission in 1985. Doern & Tomlin argue strongly that cabinet's acceptance of the Free Trade option was the result of protectionist pressures in the United States and policy entrepreneurship in the public service rather than any deep-seated ideological conviction. (G. Bruce Doern and Brian W. Tomlin, *Faith and Fear*, Toronto, Stoddart, 1991). Comprehensive tax reform was rejected as a political option until it became clear that Canada had to respond to unforeseen cuts in U.S. personal and corporate tax rates, or face losses in industry and investment.

BALANCING ECONOMIC AND POLITICAL AGENDAS: 1984-86

> In putting together his platform, Mulroney had not promised the moon, but he had come very close.[7]

The Progressive Conservatives who took office in September 1984 had become a party of perpetual opposition, of interests left out of or neglected by previous Liberal coalitions. During the 1984 election campaign, the new government had simultaneously promised to reduce the deficit, cut taxes, to reduce government regulation and red tape, to increase opportunities for business growth and job creation, and to preserve and even expand income transfer programs and public services. The cumulative price tag for these promises was estimated at more than $ 20 billion.[8] Like the Liberal government it succeeded, the new Tory government rapidly divided into competing wings. One emphasized government retrenchment and market-oriented reforms to economic and social policies. The other stressed the need to build a durable electoral coalition of groups benefiting from large-scale government spending and/or selective tax reductions. To complicate matters, the new government also inherited a record federal deficit, which reached $ 38.5 billion in 1984-85 despite spending cuts announced in Wilson's Economic Statement of November 1984.

It took the government almost four years to resolve these conflicts. Prime Minister Brian Mulroney's approach to government reflected a combination of managerial pragmatism and an instinctive leaning towards brokerage politics.[9] Finance Minister Wilson and his

[7] John Sawatzky, *Mulroney: The Politics of Ambition,* (Toronto, Macfarlane, Walter and Ross, 1991), 548.

[8] Sawatzky, *Mulroney: The Politics of Ambition,* ibid.

[9] Aucoin, Bercuson, Hoy and others argue that Mulroney was not driven by a clear ideological agenda. This is confirmed by discussions with senior government officials. [PMO-1, D4, ADM-9] Peter Aucoin, "Organizational Change in the Machinery of the Federal Government: from rational management to brokerage politics", *Canadian Journal of Political Science*, January 1986, 3-17; Bercuson et al, *Sacred Tr st?*, 27; Hoy, *Friends in High Places*.

pro-business colleagues in cabinet would be given considerable freedom to pursue their economic policy reforms, subject to their ability to mobilize support from producer groups and the provinces. Proposals for social policy reform and deficit reduction would be limited by pressures of public opinion and the need for provincial cooperation.

The Mulroney Government went to great lengths during its first term to present the impression of having a wide-ranging agenda for political and economic change. The economic elements of this agenda were spelled out in the *Economic Statement* of November 1984: deficit reduction, major changes to energy and foreign investment policies, reforms at Revenue Canada[10], and a review of social programs. The Neilsen Task Force was set up to oversee a wide ranging review of spending programs.[11] The Western and Atlantic Accords began the process of dismantling the National Energy Program. However, with limited exceptions, the Tories defined their program by opposition to what they regarded as the nationalist and statist excesses of the Trudeau years rather than by proposing radical changes of their own.

Most of the first Mulroney cabinet was firmly committed to the active use of government intervention to support economic development in their regions or areas of responsibility. The major difference from Trudeau-era intervention appears to have been a general preference for federal policies to complement market forces and support business rather than attempting to anticipate or dictate to them. This theme was most clearly articulated by Wilson in his *Economic Statement* of November 8, 1984:

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[10] Revenue Minister Perrin Beatty implemented the report of the P.C. Task Force on Revenue Canada, introducing the Taxpayers' Bill of Rights, amending tax laws to conform with the Charter of Rights, introducing customer service programs and wide-ranging administrative changes at Revenue Canada. Arthur Drache, *The Canadian Taxpayer*, March 19, 1985, 41-2.

[11] Hon. Erik Neilsen, *New Management Initiatives: initial results from the Ministerial Task Force on Program Review*, (Ottawa, Supply & Services Canada, May 1985); *Reports of the Study Teams*, 17 volumes, (Ottawa, Supply & Services Canada, 1986).

> For too long, government has tried to substitute the judgments of politicians and regulators for the judgments of those in the marketplace, through excessive regulation and by trying to buy its way, with borrowed money, out of each new problem that arises. We have suffered, for too long, from the growing gap between the rhetoric of reliance on the private sector and the reality of increasing government intervention.[12]

The 1984 *Economic Statement* clearly articulated Wilson's main economic policy objectives: to make major reductions to the federal deficit, primarily through spending reductions rather than tax increases; to reduce the burden of excessive taxation, government spending and regulation on Canadians, thereby increasing their capacity to generate economic and employment growth; and to foster increased private sector productivity and competitiveness.[13] Wilson's preference for an absolute reduction in the public sector appears to have been a minority taste within cabinet.[14]

Early in his term, Wilson disclaimed any intention to introduce a general tax reform program. He all but ruled out large scale change as likely to increase uncertainty and disrupt private business activity and confidence.

> I have deliberately not launched a process of massive tax reform as a solution to the problem of tax fairness or any other problem. We could not and we must not risk creating the kind of uncertainty and instability that could undermine the effort to get Canadians investing strongly in opportunities that will lead to growth and jobs.[15]

At the same time, he initiated a series of piecemeal changes to the income tax system, most of which were later included, in one form or another, in the tax reform package of 1987-88.

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[12] Hon. Michael H. Wilson, *A New Direction for Canada: An Agenda for Economic Renewal*, (Ottawa, Department of Finance, November 8, 1984), 1; Wilson, *Economic and Fiscal Statement*, (Ottawa, Department of Finance, November 8, 1984), 2.

[13] Wilson, *Economic and Fiscal Statement*, November 8, 1984.

[14] Bercuson et al, *Sacred Trust?*, 46-7.

[15] Hon. Michael H. Wilson, *Budget Speech*, (Ottawa, Department of Finance, May 23, 1985), 15.

Wilson's tax policy agenda in 1984-86 sought to balance four major political and economic priorities in what may be described as a process of "coordinated incrementalism". First, it addressed the grievances of major constituencies resulting from the tax policies of the previous Liberal administration, hoping to build political support for Conservative economic policies. Second, it took advantage of a buoyant economy to raise taxes and reduce the deficit through a combination of federal surtaxes, partial deindexing of personal income tax brackets and transfer payments and the elimination of corporate tax preferences. Third, it sought to revise the tax-transfer system to individuals in order to shift federal income support programs towards lower and middle-income earners. Finally, it introduced a series of proposals for structural change in the tax system to reduce economic distortions and respond to large scale structural changes in the economy.

However, Wilson also discovered the limits of change early in his term. Late in 1984, the government blundered into a debate on the universality of social programs for which it was clearly ill-prepared. Wilson and Health and Welfare Minister Jake Epp appeared to be defending competing positions in their public statements. In trying to quell the debate, Mulroney effectively foreclosed the option of major changes to universal social programs.[16] This undercut Wilson, and left the government vulnerable to attack when he limited the indexing of seniors' pensions in the May 1985 budget.[17] The major spending reductions recommended by the Neilsen Task Force were watered down by cabinet

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[16] Bercuson et al, *Sacred Trust?*, 102-9; Hyman Solomon, "How serious is Mulroney about cutting the deficit", *Financial Post*, Feb. 19, 1985, 8; Richard Lipsey, Douglas Purvis, "The Poll-icies of Mulroney's reign", *The Financial Post*, March 2, 1985, 9. Several observers have attributed Mulroney's apparent overreaction to the universality debate as a combination of political inexperience and lack of political confidence rather than a deliberate decision to undercut Wilson. (Interviews, Privy Council Office, Dept. of Finance)[D1, D7] However, the political effect was still devastating.

[17] For a detailed discussion of the universality debate and the government's policy incoherence, see Bercuson et al, *Sacred Trust?*, 52, 93-120.

ministers or absorbed by new spending commitments after 1986.[18] While former Quebec cabinet minister Claude Forget was appointed to lead another task force to propose a thorough overhaul of the Unemployment Insurance system, his proposals for major structural changes received little public support and vanished in cabinet.[19] Wilson's deficit reduction program was left to stand on a combination of tax increases, reduced tax preferences, and accounting sophistries.

The Process of Policy Change: 1984-86

During its first two years in office, the Mulroney Government was often beset by indecisive leadership, confused policy priorities and a highly personalized rather than institutionalized form of leadership. Mulroney was primarily committed to change in the style and process of government rather than its substance. The Prime Minister's commitment to "style" was the most visible: expanded public consultations, efforts to

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[18] Savoie, *The Politics of Public Spending*, 132-42; Hartle, *The Expenditure Budget System*, (1988), Ch. 10.

[19] The Forget Report, released in November 1986, recommended that Unemployment Insurance benefits be fully funded by employer and employee premiums, the elimination of regional and sectoral subsidies, and a system of premiums based on employer and industry employment and layoff patterns. Other social objectives were to be integrated into other government programs paid from general tax revenues. The only major recommendation implemented was the cut-off of UI benefits from persons quitting their jobs without just cause -- in December 1992! Commission of Inquiry on Unemployment Insurance, *Report*, (Ottawa, Supply and Services Canada, 1986), "Forget Report"; Savoie, *The Politics of Public Spending*, 142-5; Hon. Don Mazankowski, *Economic and Fiscal Statement*, (Ottawa, Department of Finance, December 2, 1992), 12.

impose a centralized public relations "spin" on all initiatives, and an apparent preoccupation with polls and appearances.[20]

Mulroney's commitment to changing the *process* of government was reflected in three areas: efforts to win provincial cooperation for federal policy initiatives, substantive consultations with organized interests on key issues and the appointment of Ministerial Chiefs of Staff in the hope of providing political balance to the policy advice of Deputy Ministers.

Mulroney's commitment to change was weakest in the area of substance. According to senior government officials, the Prime Minister had little interest in the substance of policy, concentrating instead on its political implications for the government and its standing in the country.[21] While this left senior ministers with considerable independence, conflicting cabinet priorities were often resolved by *ad hoc* decision-making and/or the personal influence of individual cabinet ministers with the Prime Minister until a reorganization of the Prime Minister's office in late 1986.

During the course of his six-and-a-half years as Minister of Finance, Michael Wilson emerged as the most durable and dominant economic policy Minister since C.D. Howe. However, despite establishing his reputation early within the Department of Finance as a competent and hard-working Minister, Wilson struggled at first to establish his political credentials with the Prime Minister and his cabinet colleagues. It was some time before Wilson was able to exercise political influence consistent with his position as the

[20] Don Mazankowski's appointment as Deputy Prime Minister in June, 1986 allowed Mulroney to distance himself from day-to-day management issues, taking a more strategic approach instead. Bercuson et al, *Sacred Trust?;* interview, Hon. Michael Wilson. However, some Tory insiders argue that Mulroney's emphasis on style and process over substance was the central flaw that ultimately destroyed his government and his party. David McLaughlin, *Poisoned Chalice: The Last Campaign of the Progressive Conservative Party?*, (Toronto, Dundurn Press, 1994).

[21] Interviews, senior government officials. (D7, ADM-9).

government's senior economic policy Minister.

The Role of the Minister

Michael Wilson was one of a handful of ministers who had prepared for the responsibilities of governing while serving as an opposition critic. As the P.C. Finance critic in 1982-84, he familiarized himself with the Department's agenda and the details of tax policy. Along with Tory colleagues such as Don Blenkarn, Sinclair Stevens and Perrin Beatty, he also built close links with several of the major business lobbies seeking an alternative to the policies of the Trudeau government.[22] The result was that Wilson quickly won the respect of both his officials and the major interest groups which sought to influence tax policy formation. A senior official comments that:

> Wilson came in the very first day and sat down as if he'd been here for a long time. ... He (used) the bureaucracy as a Minister should use the bureaucracy.[23]

Wilson's relations with the Department were reinforced by his ability to establish clear priorities and by the ability of senior Department officials to anticipate the new government's agenda. As a result of this cooperation, within weeks of taking office, Wilson was prepared to present a comprehensive policy agenda to Parliament.[24] However, his attempts to direct the government's broader policy agenda from Finance

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[22] Interview, CFIB staff.

[23] Interview, senior Finance Department official. (D1)

[24] Wilson, *Economic and Fiscal Statement,* November 8, 1984.

foundered on the lack of cabinet cohesion and a breakdown of communications with the Prime Minister's Office.[25]

In his dealings with the Department, Wilson was inclined towards an "open-door management policy", often by-passing formal lines of communication to test policy ideas on mid-ranking officials. A former Wilson staffer comments that Wilson's outreach on policy was "absolutely huge".[26] He had a wide personal network in the business, and financial communities whicn he consulted on policy issues, leading one official to describe him as a "real vacuum-cleaner" on policy.[27]

This tendency was reinforced by the departure of Deputy Minister Cohen. Cohen was a highly experienced, hands-on executive with strong views on tax policy matters and a superb command of the mechanisms of government.[28] His replacement, Stanley Hartt, had no previous Finance Department experience. A Montreal lawyer and friend of the Prime Minister, Hartt had first come to Ottawa to coordinate the National Economic Summit in March 1985. Hartt provided Wilson with a Deputy Minister who enjoyed the

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[25] Interviews, former PMO, PCO and Finance Department officials. (PMO-1, D7, F02). Both PMO and Finance officials downplay the idea of competing policy priorities during this period. However, it took some time for a close working relationship to develop. This may, in part, have explained the appointment of Stanley Hartt as Deputy Minister of Finance in August 1985.

[26] Interview, former Finance Dept. officials (F02)

[27] Interview, former Finance Dept. officials. (F02, F03)

[28] Interviews, former Deputy Ministers, Assistant Deputy Ministers. (D1, D4, D8)

personal confidence of the Prime Minister.[29] His style as Deputy Minister was also collegial -- mediating among competing interests within the Department.[30]

The "CMO"[31] meetings involving Wilson, his political staff, Hartt, Assistant Deputy Ministers, and assorted officials of various ranks, allowed both Wilson and Hartt to provide a forum for debates among their officials on various aspects of tax policy and other Finance Department concerns. This resulted in an airing of many of the internal political and philosophical disputes among officials in the Tax Policy Branch[32] -- disputes which had festered for years, but which had usually been screened out by senior officials in the process of refining policy options for the Minister's consideration.

While frustrating for some senior officials, who preferred a more orderly approach to policy making, the CMO meetings strengthened Wilson's position as a Minister and allowed him a much better grasp of the strategic and technical details of the policy initiatives he would take to cabinet.[33]

Wilson took a similar consensus-building approach to policy in his relations with cabinet colleagues. Aware of Finance's reputation as the "Department of Economic Oblivion",[34]

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29 Interviews (M3, F02). A former Wilson staffer comments that "the key thing is that the Deputy Minister of Finance must have the key to the Prime Minister's office. ... Stanley (Hartt) was a personal friend (of Mulroney). Wilson and Hartt came to be so close. That was very helpful."(F02)

30 When asked about Hartt's management style, a senior departmental official commented that "Stanley ran seminars".

31 "Cabinet Minister and Officials"

32 According to a participant in the meetings, "Wilson's relations with the (Tax Policy) branch were better than relations within the Branch itself. Unresolved policy issues would be fought out in the Minister's boardroom, all the way to the top." Interviews, former Finance Dept. official (F02).

33 Virtually all officials interviewed regarded Wilson as Finance Minister with the best technical grasp of tax policy issues since the 1971 tax reform bill.

34 Interview, former Dept. of Finance official (F02)

and of the periodic sniping of the Prime Minister's Office, Wilson seems to have consulted cabinet colleagues more extensively on major policy initiatives than his predecessors at Finance.

> Wilson was a very collegial guy. Personally. He took a lot of things to his colleagues. He valued their comments.[35]

Wilson's limited success at deficit reduction is attributed by staff and colleagues to the ability of senior cabinet colleagues to end-run spending restrictions by appealing directly to the Prime Minister.[36] Early proposals for a Business Transfer Tax met a similar fate.[37] After the 1985 budget, the Department's strategy in dealing with cabinet was to "avoid getting sandbagged".[38] During this period, Wilson tended to avoid pushing decisions to confrontations with colleagues "unless he was sure of winning".

> What distinguished Wilson from others in the Finance portfolio was that he was willing to settle for half-a-loaf year after year in the knowledge that if he was able to keep gnawing at spending year after year, he would be more effective than taking a frontal assault on spending that Mulroney and the cabinet were not prepared to countenance.[39]

Following press speculation in 1984 and 1985 that Finance was at odds with officials in the Prime Minister's Office, Wilson and his officials sought to "avoid being caught in a

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[35] Interview, senior Finance Department official. (D1)

[36] Interviews, former Minister (M6), departmental officials. (F02)

[37] Wilson's first attempt at sales tax reform was apparently scuppered by Revenue Minister Elmer MacKay, who bitterly opposed the application of the Business Transfer Tax to food. MacKay, having vacated his seat for Mulroney while the latter was Leader of the Opposition, exerted considerable influence with the Prime Minister. [F02, F03]

[38] Interview, [F02]

[39] Interview, [F02]

major controversy" based on the perception that the two might have competing agendas.[40]

Wilson's ability to sell his agenda for tax reform and deficit control hinged largely on his ability to win and maintain the confidence of the Prime Minister on major political decisions.

> Wilson's office was concerned that Wilson always have the Prime Minister onside to the greatest extent possible. We were always aware of the fates of previous Ministers of Finance, and Ministers ... not being able to operate without the support of the PM.[41]

Wilson's growing political influence with Mulroney after 1986 was reflected in his extensive participation in non-Finance issues (e.g. Free Trade) and appointment as political minister for Ontario, dealing with party people and patronage issues. He gradually won the Prime Minister's confidence to the point of winning his support for a series of bitterly unpopular policies after the 1988 election -- notably the Goods and Services Tax, and the zero-inflation policies which sharpened the 1990-92 recession.[42] However, the price of winning this confidence was Wilson's step-by-step approach to rebuilding the government's credibility with his incremental policy reforms of the first term. This piecemeal, consensus-building approach to tax reform characterized Wilson's first two budgets in May 1985 and February 1986.

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[40] Interview, [F02]; Carol Goar, "PM's embrace of Wilson looks loveless", *The Gazette*, (Montreal, July 4, 1985), B3; Hugh Winsor, "Many are called, few prosper in PC cabinet", *The Globe and Mail*, (Toronto, Aug. 31, 1985), 4.

[41] Interview, former Ministerial staff. [F02]

[42] A senior Finance official comments that "over time ... Mulroney came to rely more on Wilson with every passing year." Interviews (D4, F02)

THE 1985 FEDERAL BUDGET

Michael Wilson's first budget was an ambitious document which sought to implement a wide range of policy changes over a broad front. The budget had four major thrusts: to begin the implementation of the government's broad economic policy agenda, to attack the federal deficit through a series of tax increases and medium-term limits on spending, to offset criticisms of deficit reduction by a series of social policy and "tax fairness" measures, and to introduce piecemeal structural changes to the Corporate Income Tax system. In all, the budget contained 18 notable tax initiatives.

Its political centerpiece was the introduction of a lifetime exemption of up to $ 250,000 of taxable capital gains for individuals, to be phased in between 1985 and 1990. Wilson promoted the exemption as a symbolic, high-profile incentive for individuals to invest and take economic risks, not just save, a "market-based" substitute for a wide range of tax incentives that would be wound-up or pruned back elsewhere in the government's corporate tax reform proposals.[43]

Wilson introduced several other tax provisions in fulfilment of Conservative campaign commitments. These included energy tax measures implementing the Western Accord of March, 1985, which largely dismantled what was left of the National Energy Program, provisions allowing RRSP and pension fund investments in small business,[44] a revised

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[43] The capital gains exemption addressed a wide range of political and tax policy issues. For a more detailed discussion, see Case Study # 11-1.

[44] Owner-occupied homes were eligible investments for self-administered RRSPs. Citing the shortage of equity capital for small business investment and the inability of formal capital markets to broker small scale equity placements, small business lobbyists persuaded Wilson to give owner-managed businesses similar treatment. Fearing potential SRTC-type abuse of the new measure, Finance officials complied with Wilson's request, but with such complex and convoluted regulations that the provisions remained largely inoperative.

R&D tax credit to replaced the discredited SRTC and a tax break for venture capital funds sponsored by organized labour.[45]

Wilson's second major thrust was in the field of deficit reduction. While he stressed plans to reduce federal spending and inefficient tax breaks arising from the report of the Neilsen Task Force, Wilson also introduced a series of tax increases. The most controversial measure was his decision to de-index both the federal tax system and a number of income transfer programs including Old Age Security (OAS) pensions and family allowances. The new indexing formula was based on the Consumer Price Index (CPI) less three percent. While GIS pensions for low-income seniors were exempted from the de-indexing package, partial deindexation of OAS pensions promoted an intense political backlash.[46] When even business groups questioned the wisdom and fairness of the measure, an angry Wilson restored full pension indexing and increased the income surtax on high income earners and corporations to make up the budgetary shortfall.[47]

Anticipating a possible backlash against a budget which included both tax increases for most Canadians and the capital gains exemption, Wilson tabled a series of social policy and "fairness" measures which shifted family-related benefits from middle and upper-income to lower-income families. These included an increase of one-third in the child tax

[45] Wilson, *Budget Speech*, May 23, 1985, 7. This tax preference was a largely symbolic measure intended to piggy-back Quebec incentives for the Solidarity Fund set up by the Quebec Federation of Labour. Mulroney and Wilson were anxious to encourage organized labour to adopt a stakeholder attitude towards capitalism and business investment, rather than the largely adversarial approach of the Canadian Labour Congress towards collective bargaining and market-oriented economic policies. Ontario subsequently set up a similar measure to take advantage of the dual incentive.

[46] Senior Finance Department officials had recommended that Wilson offset the impact of deindexing on the elderly poor by "super-indexing" the GIS. Wilson apparently rejected their proposal because it would have cost the government $ 860 million a year of the $ 1.6 billion saved by benefit deindexation. [Bercuson et al, *Sacred Trust?*, 112-13; interview, Finance Department official. (D8)]

[47] Bercuson et al, Sacred Trust, 118; "Tories retreat on de-indexing pensions...", *The Globe and Mail*, June 28, 1985, 1.

credit and a corresponding reduction in the dependent exemption for children.[48] Along with changes to implement past Tory criticisms of Revenue Canada's tax collection practices, Wilson introduced a Discussion Paper proposing a Minimum Tax for upper-income earners.[49]

Almost unnoticed in the budget, except among tax experts and the affected industries, was a Discussion Paper proposing the overhaul of the Corporate Income Tax system. It recommended the elimination of several major tax preferences, including the investment tax credit, inventory allowance for inflation and accelerated depreciation of business assets in return for a major reduction in corporate income tax rates.[50]

Wilson had hoped that his careful balancing act of selected tax cuts and tax increases, including targeting of social benefits, deindexation and careful piecemeal tax reform would win popular support as the "tough but fair" medicine necessary to reduce the deficit and restore the ruptured connection between taxes and spending.[51] However, the decision of both Parliamentary opposition parties to focus their attention on the pension rollbacks

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48 Wilson, *Budget Speech*, May 23, 1985, 12-13.

49 The minimum tax, promised by Mulroney during the 1984 election and supported by the opposition parties, was intended to address the anomaly of about 7,000 high-income individuals who paid little or no income tax as a result of the pyramiding of legitimate tax deductions and exemptions. For a more detailed discussion, see Case Study 11-2. Hon. Michael H. Wilson, *A Minimum Tax for Canada*, (Ottawa, Department of Finance, May 23, 1985).

50 See Case Study # 11-3. Inventory allowance: deduction of 3 percent of value of total inventory to offset inflation effect on profits from inventory turnover. Accelerated depreciation: tax provisions allowing a faster write-off for business assets, (e.g. business, machinery or equipment) than their expected use life. For example, this resulted in a 13.6 percent reduction in the tax value of depreciation on manufacturing equipment, which had been highly favoured under the old system. (Robert D. Brown, "Corporate Tax Reform: Necessary but Not Sufficient", in *Report of Proceedings of Thirty-Seventh Tax Conference, 1985*, (Ottawa, Canadian Tax Foundation, 1986), 5:4.

51 For a discussion of the government's efforts to promote its "tough but fair" message around the country, see Claire Hoy, *Friends in High Places*, (Toronto, Key Porter, 1987), 119.

as the dominant symbolic issue in the budget -- and of the national news media to accept and amplify this interpretation -- placed the government on the political defensive for more than a month until Wilson gave in to the growing clamour.[52]

The resulting backlash from seniors' groups stole the government's public relations thunder. It began a slide in the Mulroney Government's popularity. The Prime Minister's contradictory campaign promises of lower taxes, lower deficits and the protection of universal social programs as a "sacred trust" returned to haunt him. It demonstrated the public's limited concern for deficit reduction -- and eroded the government's political will to engage in further spending reductions.

PIECEMEAL TAX REFORM: 1984-86 -- THREE CASE STUDIES

The ghost of Allan MacEachen welcomed Michael Wilson to his new eminence as Minister of Finance in September 1984 and hovered in the background for most of Wilson's long tenure at Finance as a salutary warning against the dangers of rushing into large-scale tax reforms. Yet, the Tories had promised major changes to most areas of economic policy, including the tax system, in the recent election. How would the new Minister balance his partisans' expectations for change against the business community's general reluctance to risk the disruption and uncertainty that would result from reopening the basic compromises of the tax system in a new round of tax reforms?

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52 "Pensioners' fury growing over budget of 'burden'", *Toronto Star*, May 31, 1985, A1,4; "Deindexing to cost poorest $ 860 M.: Epp", *The Gazette*, (Montreal, June 6, 1985), A6; "Plans to de-index old age pensions means poverty jump, council says", *Globe and Mail*, June 11, 1985, 1-2; "'You lied to us', pensioner tells Mulroney ...", *The Gazette*, June 20, 1985, A1-2; "Pension move hurt PM: poll", *The Sun*, (Vancouver, June 28, 1985), A1-2; Elizabeth Riddell-Dixon & Gretta Riddell-Dixon, "Seniors advance, the Mulroney Government retreats: Grey power and the reinstatement of fully-indexed pensions", in Robert J. Jackson, Doreen Jackson & Nicolas Baxter-Moore, *Contemporary Canadian Politics*, (Scarborough, ON, Prentice-Hall, 1987), 282-5.

Wilson's answer was a series of piecemeal changes to discrete elements of the tax system designed to address a number of real or perceived problems without changing the fundamental character of the system. These changes were also intended to fulfil some of the sometimes conflicting promises which the Tories had made to different groups of voters before and during the 1984 election. These groups included small businesses and investors, many of whom believed themselves unfairly treated by the previous government, middle-income taxpayers somewhat envious of the tax privileges available mainly to businesses and upper-income groups, and corporations who complained increasingly about the complexity and unpredictability of the tax system.

The piecemeal tax changes and proposals for change contained in Wilson's 1985 budget reflected the challenges of balancing competing policy objectives when major elements of the tax system are caught up in the process of brokerage policies. The following section examines three of the major tax measures introduced in the 1985 budget: the capital gains exemption, the minimum tax and Wilson's proposals for corporate income tax reform.

CASE STUDY #11:1 - THE $ 500,000 LIFETIME CAPITAL GAINS EXEMPTION

> I want to encourage risk-taking, but in a way that lets the investor choose where to invest. I do not want to further distort the tax system by measures that tell Canadians where and how to invest. This government wants Canadians to pick the winners within a tax framework that rewards success.[53]

> When politicians want to be seen to skew the tax system, they tend to go to extremes. When the objective is to make people do something immediately, they generally get it wrong in the end. ... There's nothing wrong about doing it slowly and getting it right.[54]

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[53] Wilson, *Budget Speech*, May 23, 1985, 6.

[54] Interview, Robert Dart, C.A.

The centerpiece of the 1985 federal budget was the creation of a $ 250,000 lifetime exemption for taxable capital gains. The measure was the result of years of lobbying against the capital gains tax of 1971 by the business and investment communities. But it also clearly reflected the economic policy objectives of the new Conservative government and its desire to symbolize a break with what it regarded as the misguided economic policies of the Trudeau government. Its survival until the mid-1990s, despite the widespread criticism of the tax policy community, is an interesting reflection on the politics of tax policy in the 1980s and Michael Wilson's personal philosophy of taxation.

The Capital Gains Exemption: Background

The introduction of the capital gains tax was probably the most significant element of the tax reform act of 1971. Prior to 1972, most tax planning was aimed at converting taxable income into tax-exempt capital gains. The 1971 legislation represented a series of political and technical trade-offs. It taxed only 50 percent of nominal capital gains, partly as an incentive to risk investment, partly to offset the impact of inflation on nominal gains. At the same time, the federal government withdrew from the field of direct taxation on wealth.

Large elements of the business and investment communities were never reconciled to the capital gains tax. They lobbied consistently through the 1970s and early 1980s to eliminate or truncate it.[55] Successive Finance Ministers whittled away at various aspects of the tax to limit its adverse effects on small investors, farmers and small businesses

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55 The creative talents of tax professionals designed numerous methods to avoid the tax legally. "Butterfly transactions", the "Wyoming shuffle", the "Little Egypt Bump" and other tax avoidance schemes of perverse ingenuity were successively trimmed and outlawed by legislative amendments as they became too popular and/or expensive.

during the inflationary 1970s.[56] Finance Department officials attempted to counterattack by suggesting that the tax did not go far enough, and that the taxation of purely nominal gains as a result of inflation was an informal substitute for the wealth tax abolished in 1971.[57]

The Clark Government of 1979-80 had attempted to eliminate capital gains taxes on selected investments. The leading Conservative critics for economic and tax policies during the early 1980s, Michael Wilson, Sinclair Stevens and Don Blenkarn, all supported the partial or complete elimination of the tax. Wilson's Economic Statement of November 1984 committed the government to reduce barriers to risk-taking and entrepreneurship and create broadly-based incentives for economic development through the tax system. This challenged the cherished orthodoxy of the Finance Department and prompted a major internal debate within the department.

The Capital Gains Exemption: Trade-Offs

Out of power for more than twenty years, except for their short interlude under Joe Clark in 1979, the Conservatives were bursting with ideas to use the tax system to promote worthwhile economic and social objectives when they took office in 1984. The Finance Department had faced similar pressures to adapt the tax system to a new government's political objectives in 1979, when it yielded only after a bitter fight.

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[56] These included the $ 1,000 investment income and capital gains deduction, designed to offset the inflation element of taxes on interest and capital gains; the $ 120,000 rollover on intergenerational transfers of family farms; the $ 200,000 rollover on intergenerational transfers of small businesses; and provisions for phased recognition of capital gains in income on deferred sales (capital gains reserves). The ISIP program, introduced in 1982-83, provided for full indexation of selected capital gains and related interest costs, along with partial taxation of accrued gains.

[57] Department of Finance, *A Review of The Taxation of Capital Gains in Canada,* November 1980.

Facing a $ 38 billion deficit, the new Minister of Finance had little room to indulge promises for a large-scale expansion of tax preferences. Yet inaction on similar promises in 1979 had contributed to the government's electoral defeat in 1980. Wilson faced pressure from several interest groups to act on Tory promises of changes to capital gains taxation. The Investment Dealers' Association and the small business lobbies had complained for years that inflation was resulting in after-tax losses on the sale of long-term investments in shares and businesses -- or in crushing tax obligations that would jeopardize the viability of small businesses or family farms.

Despite strong reservations from tax policy officials,[58] Wilson and his Deputy Minister, Marshall Cohen, considered three major options: the complete elimination of the tax, the retroactive indexation of investment cost bases, and the lifetime exemption.[59] The first was rejected on grounds of equity, probable revenue losses and for creating excessive inducements for tax avoidance. The second was rejected for its administrative complexity and short-term revenue implications.

Cohen hoped that the inclusion of a single spectacular tax concession in the new government's first budget could defuse pressure for other tax concessions and provide cover for a significant rationalization of tax concessions in other areas.

> It was that or a Christmas tree the likes of which you'd never seen in your life. ... There were ... two hundred proposals [for tax changes] -- lights, baubles, tinsel to hang on the Christmas tree. We thought if we could do one big thing, we wouldn't have to do two hundred.[60]

The lifetime exemption met four major objectives of the government's economic program. It offered a broadly-based incentive that would allow individual investors to direct their

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58 Interviews, former Finance Department officials. (F01, F04, F05)

59 Hon. Michael Wilson, Testimony to Commons' Finance Committee, *Minutes and Proceedings*, Issue # 80, December 11, 1985, 33.

60 Interview, Marshall A. Cohen.

savings to areas of greatest return rather than targeting industries or sectors favoured by government policy-makers.

Secondly, it permitted Wilson to rationalize the tax system by replacing a series of specialized tax incentives with a broadly-based incentive which, it was argued, was less likely to distort economic activity than the Tories' other policy commitments. Tax preferences eliminated included the $ 200,000 capital gains free rollover for small businesses, the $ 120,000 rollover for family farms, the $ 1,000 annual capital gains deduction for small investors and the tax-free indexing of investment income.[61]

Thirdly, it was meant both as a symbolic and tangible gesture to encourage "average Canadians", especially in small business, by offering the hope that years of savings and effort would result in the opportunity to cash in on accrued capital gains without the government expropriating the bulk of their accumulated capital.

> When we brought in the capital gains tax in the first place, it was terribly unpopular...in the middle income range. It took away their hope chest -- the family farm, the small business. ... What's wrong with every Canadian having a piece of hope out there?[62]

Finally, it was hoped that the capital gains exemption would encourage Canadians to become more active participants in an enterprise culture -- a nation of investors, not just savers.[63]

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[61] Hon. Michael Wilson, "Address to Canadian Tax Foundation", (Ottawa, Dept. of Finance, November 1984), 3-7; "Address to National Economic Conference", March 22, 1985, 6-8.

[62] Interview, Marshall A. Cohen.

[63] Wilson, *Budget Speech*, May 23, 1985, 6; Carol Goar, "Wilson gambling on changing the Canadian character", *Toronto Star*, May 25, 1985, B2; Hon. Barbara MacDougall, "Speech, Canadian Club of Winnipeg", # 85-110, (Ottawa, Department of Finance, June 19, 1985), 3.

While the Department recommended an initial limit of $ 200,000, this was raised to $ 500,000 after discussions with Wilson's cabinet colleagues.[64] To limit the medium-term fiscal impact of the exemption, it was to be phased-in over six years, applying to cumulative taxable capital gains of $ 10,000 in 1985, $ 25,000 in 1986, $ 50,000 in 1987, $ 100,000 in 1988, $ 150,000 in 1989 and $ 250,000 in 1990.

The Capital Gains Exemption -- Response and Conclusion

Not surprisingly, the capital gains exemption received an enthusiastic response from the business and investment communities, a mixed reception from the popular press, and outrage from Tax Policy Branch officials and the political left. The Opposition in the House of Commons was heavily critical of a budget which reduced indexing for seniors' pensions and middle-income taxpayers while providing a major tax break for upper-income investors who received the principal benefit of the exemption. Table 11-1 shows that while taxpayers with annual incomes under $ 50,000 reaped significant initial

TABLE 11-1
VALUE OF CAPITAL GAINS EXEMPTION
DISTRIBUTION BY INCOME GROUP

	Under $ 50,000	$ 50,000- $ 100,000	Over $ 100,000
1986	44.3%	33.5%	22.2%
1987	32.4%	39.7%	27.9%
1988	21.3%	31.6%	47.1%
1989	17.4%	29.4%	53.2%
1990	16.6%	26.9%	56.5%
1991	17.6%	25.8%	56.6%
1992	20.2%	17.5%	62.3%

N.B. Income figures may reflect single large, non-recurring transaction involving sale of business or income property, rather than continuing income stream.

[Source: *Taxation Statistics* 1988-1994, (Ottawa, Revenue Canada), Table 12.]

64 Interview, former senior Finance Dept. official (D5)

benefits from the capital gains exemption, the tax savings were increasing skewed towards the fewer than five percent of taxpayers with incomes over $ 100,000 after 1988.

However, Liberal Finance critic Donald Johnston, a tax lawyer in private life, was more muted in his criticism, suggesting a capital gains exemption could have been more productively and inexpensively focussed on rollovers of investments in public and private Canadian companies.[65] These criticisms were echoed by a number of tax professionals and by provincial Treasurers in Ontario and Quebec.[66] The Canadian Tax Foundation noted that the anti-avoidance measures introduced to avoid tax "gamesmanship" triggered by the capital gains exemption had greatly increased the complexity of the Income Tax Act. It also suggested that the exemption might have been targeted to exclude "non-productive" investments such as "expensive jewellery, speculative land, foreign vacation properties, antiques and deep discount bonds".[67]

Several of these suggestions were adopted by Wilson in his 1987 White Paper on Tax Reform. The Capital Gains Exemption was capped at $ 100,000 for all investments except for small businesses and family farms. However, the exemption also provided Wilson with the political cover to increase the inclusion rate on capital gains to 75 percent -- compared with 50 percent before tax reform.[68] This resulted in a short-term revenue windfall for the federal government which largely offset the cost of the partial exemption.

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[65] Standing Committee on Finance, Trade and Economic Affairs, *Minutes and Proceedings*, Issue # 80, December 1985, 17-18.

[66] Hon. Robert Nixon, *1985 Ontario Budget*, (Toronto, Ministry of Treasury and Economics, October 24, 1985), 10; Quebec, Ministere des Finances, *1985-86 Budget*.

[67] Standing Committee on Finance, Trade and Economic Affairs, *Minutes and Proceedings*, Issue # 81, December 11, 1985, 5-41; William Lawlor, "Surplus Stripping and Other Planning Opportunities with the new $ 500,000 Capital Gains Exemption", in *Report of Proceedings of Thirty-Seventh Tax Conference, 1985*, (Toronto, Canadian Tax Foundation, 8:3-6.

[68] Inclusion rate -- the percentage of capital gains included as taxable income.

(See Table 11-2.)

TABLE 11-2
IMPACT OF CAPITAL GAINS EXEMPTION ON FEDERAL TAX BASE

	Taxable capital gains	Capital gains deduction	Net taxable capital gains	% of total personal income
	--------- (in $ millions)		---------	
1984*	$ 1,774.7	n/a	$ 1,774.7	0.67%
1985*	$ 2,490.9	$ 1,609.6	881.3	0.31%
1986*	$ 4,158.4	3,085.7	1,072.7	0.34%
1987*	$ 6,904.4	5,096.9	1,807.5	0.53%
1988+	$ 7,953.0	6,042.3	1,910.7	0.51%
1989+	$ 10,690.3	7,271.0	3,419.3	0.83%
1990#	$ 7,675.6	6,030.5	1,645.1	0.38%
1991#	$ 8,081.6	5,671.8	2,409.8	0.54%
1992#	$ 9,030.2	6,474.4	2,555.8	0.57%

[Source: *Taxation Statistics*, (Ottawa, Revenue Canada, 1986-94, Tables 2A, 12.]
* Valued at 50% of nominal gain
+ Valued at 2/3 of nominal gain
# Valued at 75% of nominal gain

TABLE 11-3
DISTRIBUTION OF CAPITAL GAINS TAXES PAYABLE
AFTER ALLOWANCE FOR CAPITAL GAINS EXEMPTION

	Taxable capital gains declared: Incomes over $ 50,000	Taxable capital gains declared: All taxable returns	Percent of taxable capital gains received by taxpayers with annual incomes over $ 50,000
	-------(in $ millions)--------		
1983	$ 1,085	$ 1,842	58.9%
1984	1,044	1,775	58.8%
1985	869	881	98.6%
1986	1,121	1,073	104.5%
1987	1,903	1,808	105.3%
1988	2,011	1,911	105.3%
1989	4,242	3,419	124.1%
1990	1,676	1,645	101.9%
1991	2,056	2,410	85.3%
1992	2,362	2,556	92.4%

Taxable capital gains: net capital gains taxable after capital gains deduction. Figures over 100% may reflect claims for taxable capital losses used to offset gains. Source: *Taxation Statistics*, Revenue Canada, Table 12.

Don Mazankowski, Wilson's successor as Minister of Finance, waited until 1992 to exclude gains from real estate investments and secondary residences from the $ 100,000 lifetime exemption.[69] Paul Martin finally rescinded the exemption for all investments except family farms and small businesses in his 1994 budget.

It is difficult to assess the impact of the capital gains exemption on individual saving and investing habits. The number of individuals reporting net capital gains income has declined slightly since 1984.[70] The capital gains exemption has largely exempted Canadians with income under $ 50,000 from capital gains taxes. (See Table 11-3.)

While the Capital Gains Exemption became a minor *cause celebre* for the political left, it strongly reinforced Wilson's credibility with powerful interests which might otherwise have obstructed major elements of his later tax reform program. As such, its political advantages appear to have compensated for its technical and economic short-comings for Wilson and his colleagues.

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[69] Hon. Don Mazankowski, *The Budget*, (Ottawa, Department of Finance, February 25, 1992), 13-14.

[70] The number of individuals declaring capital gains varies significantly from year to year. 1983: 720,000; 1984: 866,000; 1985: 553,573; 1986: 784,000; 1987: 844,000; 1988: 542,000; 1989: 822,000; 1990: 632,000. (*Taxation Statistics*: 1985-1992, (Ottawa, Revenue Canada), Table 12.

CASE STUDY # 11-2: THE MINIMUM INCOME TAX

> A minimum tax is an admission of failure in the design of the tax system as a whole.
>
> Ira Shapiro[71]

> The purpose of the minimum tax is cosmetic. It collects no revenue. It will never collect any revenue. ... It is cosmetic to make it appear ... that high income earners all have to pay a minimum tax.
>
> Don Blenkarn[72]

The issue of "fairness" is one of the dominant objectives attached to the tax system by the Canadian people.[73] Over the years, a widespread perception has grown that the middle class majority is overtaxed, while large numbers of upper-income Canadians are paying much less than their "fair share" of the tax burden. This perception is consistently reflected in press coverage of the tax system and in opinion surveys conducted for the federal government.[74]

The minimum tax represents a trade-off between competing political interests seeking to maintain the widespread use of tax preferences to promote economic and social objectives and those attempting to remove them and/or increase the effective tax burden of upper-income individuals and large corporations The United States introduced an add-on minimum tax for both individuals and corporations in 1969 to bridge the gap between the definition of income normally subject to income tax and actual income levels.[75]

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[71] Ira H. Shapiro, Director of Tax Policy, Coopers & Lybrand, in congressional testimony, 1985, quoted in Donald R. Huggett, "A Minimum Income Tax", 10:2.

[72] Don Blenkarn, M.P., *Minutes and Proceedings*, Commons' Finance Committee, Issue # 9, November 11, 1986.

[73] Decima: 1987; Reid: 1987.

[74] Ibid.; published polls tell a similar story. Hoy, Friends in High Places, 128.

[75] Emil M. Sunley, "Minimum Income Taxation: The U.S. Experience", *Report of Proceedings of Thirty-Seventh Tax Conference, 1985*, (Toronto, Canadian Tax Foundation, 1986), 11:1.

Minimum personal and corporate taxes have been a consistent part of federal NDP platforms since the 1970s.[76] The issue resurfaced in the national news media before the 1984 election. Subsequently, all three federal parties advocated the introduction of a minimum tax during the 1984 federal election.[77] This promise was repeated in Michael Wilson's *Economic Statement* of November 1984[78] and in the federal budget of May 1985.

A Discussion Paper, *A Minimum Tax for Canada*,[79] outlined three options for the new tax. Two were copied from various models adapted in the United States. One was similar to a minimum tax proposed in the Quebec budget of April 1985. Each proposal would disallow or defer legal tax preferences for individuals with total incomes above a certain level. This level was eventually set at $ 40,000. The Discussion Paper reviewed the extent of the perceived problem, contributing factors within the tax system, and the rationale for including or excluding various tax preferences from the expanded tax base.

Finance Department officials appear to have been sceptical about the theoretical or practical benefits of the minimum tax proposals.[80] Finance Department figures showed

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[76] David Lewis, *Louder Voices: The Corporate Welfare Bums*, (Toronto, James Lorimer, 1972).

[77] Linda McQuaig, "Many large corporations pay little tax", *The Globe and Mail*, March 30, 1984, M1; Linda McQuaig, "Select group of wealthy add nothing to taxman's pocket", *The Globe and Mail*, April 21, 1984, 1,5; Arthur Drache, "A One-Sided Discussion", *The Canadian Taxpayer* VI(10), May 22, 1984, 81-2. Mulroney announced Conservative support for the minimum tax during one of the televised leaders' debates. Arthur Drache, "The Minimum Tax: A Dangerous Concept", *The Canadian Taxpayer* VI(16), August 21, 1984, 129-30.

[78] Hon. Michael H. Wilson, *Economic and Fiscal Statement*, November 8, 1984, 12; Mulroney repeated his personal commi[illegible] to the tax shortly thereafter. (House of Commons, *Debates*, November 22, 1[illegible]-1).

[79] Hon. Michael H. Wilson, *A Minimum Tax for Canada*, (Ottawa, Department of Finance, May 1985).

[80] Interviews, former Finance Department officials (F05); Arthur Drache, "Minimum Tax Still Being Considered", *The Canadian Taxpayer* VI(23), Dec. 4, 1984, 185-6.

that while about 31,000 or 7.6 percent of taxpayers with incomes over $ 50,000 paid 10 percent of less of their adjusted taxable incomes in income taxes in 1982, there were fewer than 100 taxpayers who managed to combine such high incomes with low tax levels for four or more of the eight years sampled between 1972 and 1979.[81]

However, the idea had widespread popular support, strong political advocates, and perhaps most important, Prime Ministerial backing. The Tories' commitment to consultation permitted officials to canvass options and find ways to diffuse potential opposition to the tax -- particularly among tax professionals. This was not long in coming.

The Minimum Tax was savagely attacked by tax professionals in newsletters, private discussions with Finance officials, and at the annual conferences of the Canadian Tax Foundation.[82] Don Huggett of Coopers & Lybrand was perhaps the most outspoken.

> It seems to me contradictory, and almost stupid, to enact one very complex set of rules to provide relief, and then to enact another set of equally complex rules to take it all away, and all in the same budget.[83]

The Canadian Tax Foundation, while avoiding overtly political comment, was critical of the minimum tax's complexity and its application to notional and unrealized capital

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81 *A Minimum Tax for Canada*, 11.

82 For example, "A Cordial Invitation to a Mugging", *Canadian Tax News*, June-July 1986, 29-36; *The Canadian Taxpayer*, December 4, 1984, June 4, 1985, December 17, 1985; Robert E. Beam & Karen Wensley, "Alternative Minimum Tax -- The Political Tax, *Canadian Tax Journal* 34(1), January-February 1986, 174-202.

83 Donald R. Huggett, FCA, testimony, House of Commons, Standing Committee on Finance, Trade and Economic Affairs, *Minutes and Proceedings*, Issue # 81, December 11, 1985, 42.

income.[84] Similar criticisms came from the Commons' Finance Committee, notably Liberal Finance critic Donald Johnston.[85]

Minimum Tax: The Outcome

The Minimum Tax went into effect on January 1, 1986 for individuals with annual incomes over $ 50,000. Wilson announced changes in the February 1986 budget which put into effect most of the changes recommended by the Finance Committee, tax professionals and Departmental officials. Dividends were to be taxed on the basis on cash income, rather than their "grossed-up" value. Capital dividends were eliminated from the base. Most important, taxpayers with fluctuating levels of income and tax preferences were enabled to carry forward "excess deductions" from year to year for several years.

A more fundamental change to the pyramiding of tax preferences took place in the 1987 White Paper on Tax Reform. Several of the deductions subject to the Minimum Tax were turned into credits -- providing a uniform benefit to taxpayers at all income levels. By substituting a tax credit at a lower rate (about 17 percent) for a tax deduction at or near the

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[84] Commons' Finance Committee, *Minutes and Proceedings*, Issue # 81, December 11, 1985, 5-37. These included taxation of the "gross-up" of dividend income required for calculation of the dividend tax credit -- a notional calculation designed to eliminate double taxation of dividend income -- and its application to capital dividends, which did not yield cash income unless sold in capital markets.

[85] Commons' Finance Committee, *Minutes and Proceedings*, Issue # 80, December 11, 1985, 16.

maximum marginal rate (usually 34 percent)[86], the government collected more than in tax revenues than it ever has from the minimum tax.[87]

The minimum tax has become a fixture within the tax structure, if a largely symbolic one, since 1986. A Large Corporations Tax, subject to offset against regular CIT payments, was introduced in the 1989 budget to limit corporate tax deferrals through the pyramiding of tax preferences. However, as with the Alternative Minimum Tax, this is a means of accelerating the collection of tax revenues rather than a supplemental tax.[88]

The minimum tax debate demonstrated the classic trade-off of a progressive tax structure in an open economy. Populist pressures for the appearance of fairness -- "vertical equity" -- require relatively high marginal tax rates for upper income earners.[89] Expert pressures for fairness -- "horizontal equity" -- force technical trade-offs to limit internal contradictions and distortions within the tax system and its patchwork of economic incentives. Given the "external" political dynamics of 1984-86, Wilson's decision to adopt the minimum tax was inevitable. Once this decision was taken, Finance Department specialists were relatively free to work out a "compromise" consistent with

[86] Federal marginal rates; federal-provincial combined rates averaged about 26 percent and 50 percent respectively in 1988. Marginal rates have risen substantially since 1988.

[87] The federal government collected $ 414 million in minimum tax payments between 1986 and 1989, of which 49.8 percent was refunded to taxpayers between 1987 and 1991. This leaves an average annual net AMT revenue of $ 52 million. Gilles N. Larin and Marie N. Jacques, "Is the Alternative Minimum Tax a Paper Tiger?", *Canadian Tax Journal* 42(3), [1994], 824-5. A review of taxation statistics suggests that the substitution of credits for deductions yielded at least $ 1 billion in additional revenues from taxpayers with incomes over $ 50,000 in 1989, $ 1.2 bn. in 1990, $ 1.4 bn. in 1991, and $ 1.6 bn. in 1992. *Taxation Statistics*, (Ottawa, Revenue Canada, 1991-94), Table 2A.

[88] This debate has been renewed at the level of the Fair Tax Commission in Ontario. Even 1993 budget proposals for a minimum corporate tax released by Ontario Treasurer Floyd Laughren have had so many exceptions for normal business transactions that it has been reduced to a symbolic rather than substantive measure. See Ontario. Fair Tax Commission, *Searching for Fairness*, (Toronto, Queen's Printer, 1993); Working Group Report: *Corporate Minimum Tax*, (Toronto, Fair Tax Commission, 1993).

[89] Supra, p. 358.

other objectives of federal tax policy, one broadly acceptable to their professional counterparts.

CASE STUDY # 11-3 -- CORPORATE INCOME TAX REFORM

The federal government introduced proposals for corporate income tax reform through a Discussion Paper in the May 1985 budget. These were implemented with some changes in the 1986 budget and extended further in Phase I of the 1987-88 Tax Reform process. While the original CIT Discussion Paper proposed changes that would be revenue neutral, both the 1986 budget and the 1988 tax reform bill resulted in significant tax increases for business, especially the manufacturing, resource and financial sectors.

Many of the proposals contained in Wilson's corporate income tax changes could claim inspiration, if not direct parentage, from the tax reform measures introduced by Allan MacEachen in 1981. How did Wilson succeed in imposing significant tax increases on business with minimal political cost, while the Liberals had received savage criticism for their tax reform policies? Perhaps the best answer can be found in the five C's of tax reform: credibility, conceptualization, consultation, circumstances, and compensation.

Credibility: Wilson as "anti-politician"

> The view that Wilson wasn't political was one of the government's greater assets.[90]

Michael Wilson enjoyed one enormous advantage over Allan MacEachen, and indeed, most Liberal Finance Ministers since John Turner in winning the confidence of business interests, large and small. He was perceived as "one of them". A former executive of

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[90] Interview, senior Finance Department official. (D1)

Dominion Securities before entering politics in 1979, Wilson's earnest and often laboured delivery were another major asset -- contributing to the image of being "above politics".

The policy disappointments and set backs of the early Mulroney years were frequently laid at the door of the Prime Minister and his "poll-driven" political instincts.[91] Wilson usually escaped the blame. The result was that he enjoyed an unmatched reputation and confidence within the business and financial communities as *the* champion of fiscal responsibility and pro-business economic policies within the federal cabinet.

Ideas: The Concepts of Tax Reform

Wilson repeated several key themes in his November 1984 economic statement and in numerous speeches across the country which pointed towards his plans for corporate tax reform. He argued that business and investment decisions should be made on the basis of sound economic criteria, not distorted by tax considerations. Different industrial sectors should be subject to roughly equivalent effective tax rates. Government support for business should be delivered through broadly based tax or spending programs, whichever might be more cost-effective, but not both.

> We must review our tax and grant system to ensure that it encourages not only more investment, but more efficient investment. We believe that there is a need to move away from the current welter of special preferences to a system of more general incentives. At the same time, we must recognize the need for carefully targeted incentives to assist in regional development.[92]

They also worked to convince business interests that the wide disparities in effective tax rates in different industry sectors, reflecting radically different access to tax preferences,

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91 Lipsey & Purvis, "The Poll-icies of Mulroney's reign", *The Financial Post*, March 2, 1985, 9.

92 Hon. Michael H. Wilson, "Address to National Economic Conference", (Ottawa, March 22, 1985), 8.

should be narrowed.[93] Finance officials proposed that marginal tax rates -- and overall tax burdens -- should be competitive with those of Canada's major trading partners. In this, they argued that rather than breaking new ground in tax policy, Canada was following precedents established by several other major industrial countries, most notably Britain.[94]

The 1985 CIT Discussion Paper proposed major reductions in marginal rates from 36 percent to 29 percent for large corporations, from 32 percent to 23 percent for manufacturers, and from 15 percent to 11 percent for small businesses.[95] In return, capital cost allowances would be reduced to reflect average business use. The investment tax credit would be eliminated, except for eligible Research and Development and areas of traditionally high unemployment, notably Atlantic Canada. The 3 percent inventory allowance, retailers' major hedge against inflated taxes on business turnover, was to be eliminated.

Another proposal provided for the consolidation of corporate losses among closely-related companies to reduce complex tax avoidance transactions and limit the growing

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93 The ratio of taxable to book income ranged from 47 percent in mining and 55 percent in the transportation & utilities sectors to 87 percent in retail and 94 percent in construction. Manufacturing (70 percent) and oil and gas (67 percent) were roughly in the middle of this range. The Investment Tax Credit ranged from less than 1 percent of financial statement income in retail and service industries to 4 percent in manufacturing and 7 percent in the Agriculture, Forestry and Fishing sectors. David Weyman, "Restructuring the Corporate Income Tax: Directions for Change", in *Report of Proceedings of the Thirty-Seventh Tax Conference, 1985,* (Ottawa, Canadian Tax Conference, 1986), 5:3.

94 The technical details and three year phase-in of corporate tax changes was based on the British example. Senior Finance officials note that while the political impetus for tax reform came from the United States, the technical impetus came from the U.K. (Interview, F01)

95 Assuming an average 10 percent provincial CIT rate, this would lead to combined federal-provincial rates of 39 percent, 33 percent and 21 percent respectively.

overhang of tax losses following the 1982 recession.[96] Estimates of the potential federal-provincial liability from unused tax losses increased from $ 18 billion in 1981 to about $ 36 billion in 1985.

The other major argument made in favour of the CIT reform proposals 'as the need to reduce competitive tax avoidance and the "tax dance" of Finance officials and tax professions attempting respectively to maximize revenues and minimize tax within the law. Wilson and his officials recognized that the growth of marginal rates and the spread of tax preferences

> seems to foster an environment of restless search for new tax planning opportunities among businessmen and tax practitioners and often provokes considerable resentment outside the circle of taxpayers seen to benefit. ... A few newspaper reports may surface about a particular type of transaction. This is followed by the rapid expansion in the use of (the) technique. Financial intermediaries may start packaging syndications for sale. Tax shelters are warehoused with appropriate media advertising. Considerable publicity arises as the measure is publicly debated, supported or criticized. Tax fairness and even the integrity of the tax system itself become issues in the mind of the public generally.[97]

All these arguments had been made in defense of the MacEachen budget of 1981 -- but were either drowned out by general backlash to the budget or frustrated by MacEachen's failure to consult with business or tax professionals prior to their implementation. Wilson extended and systematized the consultation process begun by his predecessors and used it to ensure that the technical details of tax policy implementation would reinforce the political objectives outlined in his public statements.

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[96] Hon. Michael H. Wilson, *A Corporate Loss Transfer System for Canada*, (Ottawa, Department of Finance, 1985)

[97] Weyman, "Restructuring the Corporate Income Tax", 5-6.

Consultation

Tax reform during the 1984-88 period was carried out primarily through a process of consultation and consensus-building. This consensus-building took place on three levels: those of the Minister, Department officials, and the Commons' Finance Committee.

Wilson and his officials set out on a systematic exercise in consultation from the earliest days of the new government. They met with most major business associations and with representatives of key professional firms and associations. Finance officials even visited a cross-section of firms potentially affected by new tax proposals to check their estimates of financial impact against actual cash flow and balance sheet data.[98]

Even before the May 1985 budget, major business associations were asked to nominate representatives to a study team on incentives and subsidies to business sponsored by the Nielsen Task Force. This pointedly included a broad range of tax preferences and subsidies. Their recommendations were largely adopted in the Wilson's 1986 budget.[99]

The Commons' Finance Committee also held public hearings on the proposed tax changes. While these were not as extensive as later hearings on tax reform, they provided an opportunity to build a degree of political consensus in support of Wilson's proposals. One of Committee Chairman Don Blenkarn's major achievements was to build a degree of opposition support for the government's tax proposals by building a relatively non-partisan environment on the Committee for most tax issues.[100]

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[98] Interview, Tax Policy Branch officials. (F07)

[99] Ministerial Task Force on Program Review, *Subsidies and Services to Business: Report of the Study Team*, (Ottawa, Supply & Services Canada, 1986).

[100] Interview, Don Blenkarn, MP, senior Finance officials.

Another vital element in consensus-building was the emergence of the Business Committee on National Issues as an effective umbrella group for major corporate interests on broad economic issues. The BCNI's Taxation Committee produced a report which broadly paralleled the directions of the government's tax reform initiative. Chaired by Co-Steel's Gerald Heffernan, who also served on the Neilsen Task Force, and guided on policy issues by Robert Brown,[101] the BCNI prepared the way for corporate acceptance of higher corporate taxes by promoting the linkage of CIT reform with the introduction of a national Value-Added Tax. The BCNI's linkage of the two issues was partly a matter of principle and partly a tactic to hold together a coalition of disparate interests that would be affected very differently by the proposed measures.[102] The network of BCNI executives, senior tax professionals and Finance Department officials created a level of mutual understanding between the government and business leaders -- if not a common agenda -- which helped to smooth the way for corporate tax increases as part of a much larger political agenda.

Compensation

Wilson was careful in most cases to balance the major tax increases of 1985-87 with a series of trade-offs, present and promised, which allowed interest groups to receive his handling of fiscal policy with resigned acceptance, if not enthusiasm.

Tax changes introduced with the 1986 budget revealed CIT increases of $ 785 million over three years, instead of the revenue neutral package promised in the previous budget. This meant tax rate cuts of only half those proposed in 1985. Wilson cushioned the blow

[101] Senior tax partner at Price Waterhouse; member of Joint Committee of Taxation of Canadian Bar Association and Canadian Institute of Chartered Accountants; one of Canada's leading tax policy experts.

[102] Interview, Jock Finlayson, former Vice President, Business Council on National Issues.

by phasing in the tax increases over three years. However, the key factor in muting corporate grumbling was the implicit promise of imminent reform of the Federal Sales Tax -- changes that would be of particular benefit to manufacturers and exporters. These groups saw major benefits in a Value-Added Tax which would refund to them sales taxes paid on exports and business purchases.

Small business, the most vocal and anti-government segment of the business community, received preferential treatment throughout Mulroney's first term: the $ 500,000 capital gains exemption (paralleled for farmers, but capped for other investors at $ 100,000 after 1987); promised improvements in RRSP contributions; and elimination of the 12.5 percent dividend distribution tax and other measures to simplify small business taxes.[103] Small business opposition to the Business Transfer Tax was a major factor in cabinet's decision to defer sales tax reform and pursue a joint sales tax reform program with the provinces.

The oil industry, hit hard by the sharp drop of oil prices in 1986, received a cash flow boost with the elimination of the Petroleum and Gas Revenues Tax (PGRT) in 1986.[104]

The consultation process with interest groups and the provinces also allowed Wilson to derive benefits from renewing promises of federal action at different times as various tax changes inched through the policy process. It helped to build a maintaining consensus among selected interest groups and prevent the emergence of a common front against tax

[103] The dividend distribution tax was a holdover from the 1981 budget. Its removal was mainly symbolic, being balanced by a reduction in the dividend tax credit. However, the benefits of simplification were more substantive -- resulting in some administrative savings and reduced conflict between small business tax advisors and Revenue Canada.

[104] Petroleum and Gas Revenues Tax -- a federal excise tax on wellhead revenues over a basic threshold; introduced in the National Energy Program of 1980. According to the Western Accord, it was to have been phased out by the end of 1988. The PGRT was not price-sensitive during a period of sharply falling oil prices. Energy Minister Marcel Masse negotiated the September 1986 elimination of the tax in return for matching royalty reductions by Alberta.

reform. This goodwill served Wilson in good stead when he tabled his tax reform White Paper in June 1987.

Circumstances

Wilson's political success in selling corporate tax reform also owed much to circumstances beyond his control. Canada's economy enjoyed a sustained expansion through the Mulroney Government's first term, despite several months of slow growth in 1986. While the record expansion of the U.S. economy contributed greatly to this growth, Canada's economic performance outstripped that of every major industrial economy except Japan. This relative prosperity provided a favourable political climate to sell major tax changes.

But the most important factor in allowing Wilson to increase corporate taxes with political immunity was that it followed the example of the American tax reform bill passed in September 1986. Few, if any, business people were likely to criticize a policy enjoying broad bi-partisan support and copying the example of Ronald Reagan, the most pro-business American President in sixty years. U.S. tax reform created a tremendous political momentum for tax reform in Canada. Shifting a part of the tax burden on to large corporations would enable the Mulroney Government to finance a modest reduction in personal income taxes in 1987-88, thereby giving its tax reform program with a mildly populist aura. Facing the imminent polarization of the electorate over free trade, an issue on which most corporate executives passionately supported the Mulroney Government, modest increases in corporate taxes were a small price for business to pay to help re-elect the most sympathetic federal government in twenty years. And for most corporate executives, the benefits of promised sales tax reforms would more than offset the costs of higher corporate taxes.

THE 1986 FEDERAL BUDGET

The 1986 budget was much more narrowly focused than the huge policy agenda of the previous year. While Wilson took the opportunity to recite the litany of the government's achievements and policy initiatives, his major objective was deficit reduction. It was the high water mark of the Mulroney's first-term deficit reduction program. Wilson limited general federal spending increases to four percent, slightly less than the rate of inflation, and imposed $ 3.9 billion in tax increases in 1986 and 1987. The result was a federal operating surplus for the first time since 1980-81.[105]

> We must start paying the full cost of present government programs and a share of the interest burden built up over the years.[106]

The tax increases took two forms: tax rate increases and the promised restructuring of Corporate Income Taxes. Personal income surtaxes on high income earners[107] and large corporations were replaced with a 3 percent surtax on all individual and corporate taxpayers. Federal sales taxes rose to 12 percent; alcohol and tobacco taxes were increased by 4 and 6 percent respectively. CIT reforms delivered only half the level of rate relief previously promised, and involved substantial base broadening.[108]

By way of compensation, Wilson restored full integration to the taxation of small business dividends, thus eliminating the 12.5 percent dividend surtax left over from the MacEachen budget of 1981. He also hinted at the replacement of the Federal Sales Tax

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[105] Department of Finance, *Economic Reference Tables*, (Ottawa, The Department, August 1992), 91. The concept of "operating surplus" was a rhetorical/accounting device to relate tax revenues to federal "program" spending, i.e. spending other than interest on the federal debt.

[106] Hon. Michael H. Wilson, *The Budget Speech*, (Ottawa, Department of Finance, February 26, 1986), 15.

[107] Individuals with taxable income over $ 40,000 annually.

[108] Wilson, *Budget Speech*, February 26, 1986, 13-16.

with a Value-Added or Business Transfer Tax in the near future. Revenues f. ›m the new tax were expected to allow the government to eliminate the 1986 budget surtaxes.[109]

The Alternative Minimum Tax proposed in the 1985 budget was quietly slipped into place. However, the final version was carefully crafted to reflect the numerous criticisms of private sector tax professionals.[110]

Wilson was not able to meet his 1986 deficit reduction projections. Higher interest rates, a sharp drop in oil prices and revenues and a growing agricultural trade war resulted in lower federal revenues and higher spending than earlier projected.[111]

However, a series of events undermined Wilson's plans for a low-profile, step-by-step reform of the corporate and sales tax systems. Finance's proposals for sales tax reform ran into stiff opposition from cabinet. The Mulroney Government steadily continued to decline in public opinion polls throughout 1986, until the Tories fell into third place below the New Democrats in popular approval.[112] The Prime Minister and his cabinet colleagues balked at the thought of defending sales taxes on food in an upcoming election, despite apparent bi-partisan support for the new tax from the Commons' Finance

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109 Ibid., 16. Deputy Finance Minister Stanley Hartt had promised at least one group to expedite sales tax reform as a trade-off for corporate tax increases during the 1986 pre-budget consultations. [Interview, AE-2]

110 Robert E. Beam, Karen Wensley, "The Alternative Minimum Tax: The Political Tax", *Canadian Tax Journal* 34(1), [Jan.-Feb. 1986], 172-202; Donald G. Huggett, "The Minimum Income Tax", in *Report of Proceedings of the Thirty-Seventy Tax Conference, 1985*, (Toronto, Canadian Tax Foundation, 1986). See also Case Study # 15-2.

111 Hon. Michael Wilson, "An Update of the Economic and Fiscal Situation", Address to Canadian Club of Toronto, Release # 86-155, (Ottawa, Department of Finance, September 18, 1986).

112 Tory popularity dropped from the 42-43 percent range in mid-1985 to the 31-34% range in mid-1986 and bottomed out in the range of 22-26 percent through the spring and summer of 1987. *Toronto Star*, September 2, 1986, A8; Don McGillivray, "NDP may have room to grow", *The Gazette*, Montreal, June 3, 1987, B1; K. MacQueen, "NDP surge may have peaked", *The Gazette*, Sept. 4, 1987, B4.

Committee.[113] Most significant of all, the U.S. Congress passed a bi-partisan tax reform bill which sharply lowered top personal and corporate tax rates, while making major reductions in tax preferences at the same time. This drastically altered the political and economic environment for Canadian tax policy -- and opened the doors for the comprehensive tax reform program of 1987-88.

WILSON'S PIECEMEAL TAX REFORMS OF 1985-86: AN EVALUATION

Wilson's first two years as Minister of Finance tested the limits of promoting fiscal restraint and structural economic change within the self-imposed limits of national consensus and federal-provincial "reconciliation". Wilson's approach to tax policy during this period was one of coordinated incremental change. This approach reflected a blend of intellectual pragmatism -- attempting to balance competing views of "good tax policy" to win the support of different elements of the broader tax policy community, the institutional constraints imposed by Prime Minister and cabinet on major structural policy changes, and the challenges of coalition-building during a period of unaccustomed budgetary restraint.

The 1985 budget demonstrated both the flexibility of the tax structure and the limits to fundamental change. The middle class could be effectively exempted from capital gains taxes -- but the tax itself could not be abolished without a total overhaul of the philosophy and structure of income taxation. Indexing could be capped for the majority, but not abolished or denied to low-income seniors. A minimum tax could be imposed to claw back "excess tax preferences" -- but these had to be returned or spread out over several years to limit economic distortions. Some tax preferences could be skewed to benefit

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[113] McQuaig, *Behind Closed Doors*; interview, Don Blenkarn, M.P.; former cabinet minister. [M6]

upper-income earners -- but they had to be balanced by other preferences benefiting lower-income earners.

Even so, these policies severely tested the limits of public acceptance, as witnessed by the popular backlash over pension de-indexing. As a result, Wilson lost what little Prime Ministerial and cabinet support he had ever enjoyed for a radical restructuring of both taxes and federal spending. Instead, he was forced to rely on corporate tax reform and a careful pruning of tax preferences: issues which aroused little media scrutiny or public attention.

The conferring of tax benefits in every direction may have been necessary in order to create a sense of rough justice -- both "horizontal" and "vertical" -- for the majority. However, in the absence of the political will to make significant and ongoing reductions in real, not just planned spending, it would inevitably lead to higher tax rates for that same majority. This is indeed what happened in Wilson's February 1986 budget.

Wilson's Business Transfer Tax proposal, while enjoying support within much of the highly specialized sales tax policy community, fell victim to the growing public suspicion of federal tax grabs and to the Mulroney cabinet's increasing sense of political isolation. While Wilson was prepared to invest a large part of the government's remaining political capital in the tough decisions necessary to implement his economic reforms by mid-1986, Prime Minister Mulroney and his cabinet colleagues were not.[114]

The bi-partisan American tax reform bill of 1986 offered Wilson the opportunity to pursue a limited, relatively low-risk tax reform plan as part of a larger political agenda leading up to the federal election expected in 1988. His success, and the government's future, would depend on two major factors: the skill with which he could assemble a

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114 Interview, former cabinet minister. (M2, M6)

consensus tax package, and the degree to which Mulroney's other political priorities, free trade and constitutional reform, would compete for public attention.

CHAPTER 12: CHIPPING AT THE MOLD: INTRODUCING A VALUE-ADDED TAX: 1984-88

> The first problem you have in Canada is you do not have a constituency for sales tax reform. ... If you do not have a political constituency for reform, it will be seen by the general public as being a tax grab. ... Any time you mix tax reform with revenue raising it has serious political implications.
>
> John Bulloch[1]

The federal government's decision to pursue comprehensive tax reform in July 1986 was originally intended to encompass major changes to both the federal income and sales tax structures. However, while changes to the personal and corporate income tax structures involved a repackaging and extension of existing piecemeal reform proposals in response to tax reforms in the United States, sales tax reform involved a fundamental transformation of the old, hidden manufacturers' sales tax into a comprehensive value-added tax.

The management of sales tax reform between 1984 and 1988 illustrates the constitutional character of comprehensive tax reform and the difficulty in introducing major structural innovations of a base-broadening character into the tax system. Federal sales tax reform was continuously on the Finance Department's agenda during this period. But just as it had been frustrated on three previous occasions during the 1970s and early 1980s, Finance found the road to sales tax reform blocked repeatedly by political and administrative obstacles before it finally persuaded cabinet to "bite the bullet" and risk its accumulated political capital on the introduction of the Goods and Services Tax in April 1989. Initially conceived as the Business Transfer Tax, a comprehensive, hidden consumption tax applying to all goods and services, sales tax reform was repackaged twice -- the first time in the hope of financing major reductions in personal income tax rates, the second time to consolidate federal and provincial sales taxes in a single National

[1] John Bulloch, testimony to Commons' Finance Committee, *Minutes and Proceedings*, Issue # 19, (Ottawa, House of Commons, December 16, 1986, 16.)

(Value-Added) Sales Tax. Both ideas for sales tax reform came to nothing. As a result, the government's third try, the Goods and Services Tax (GST) was the political equivalent of running the gauntlet. While the runner succeeded in reaching the finish line -- the GST became law late in 1990 -- the political pounding suffered in the process largely wrecked its political standing in the country.

This chapter will review the causes and objectives of sales tax reform in the mid-1980s the internal and external barriers to reform, and Finance's repeated efforts to build a broadly-based political constituency for the new tax.

SALES TAX REFORM: CAUSES AND OBJECTIVES

Sales tax reform has a long history in Canada. First suggested by the Rowell-Sirois Royal Commission in 1940, the idea of a broadly-based national sales tax was recycled by the Carter Sales Tax Committee in 1956.[2] The Finance Department's efforts to shift the FST to the wholesale level between 1974 and 1983, as discussed in Chapter 10, were unsuccessful. Yet, the underlying logic of sales tax reform became increasingly apparent with every year during the 1980s.

Sales tax reform had three major technical goals -- all of which appeared eminently reasonable to tax theorists. It sought to equalize sales tax rates paid on all goods sold in Canada, regardless of a product's country of origin, method of distribution or end use within Canada. It was intended to capture the revenue base of the growing services sector -- about two-thirds of total consumption -- which until now had been exempt from federal taxation. In turn, this would permit a reduction in the growing tax rates levied on manufactured goods and allow the government to compensate manufacturers and other

[2] Kenneth M. Carter, Chmn., *Report of the Sales Tax Committee*, (Ottawa, Queen's Printer, 1956)

capital intensive industries for higher taxes resulting from the corporate income tax reforms of 1985-86. Finally, by exempting exports from taxation, a value-added tax would complement the federal government's emerging trade-based economic strategy, and place Canadian products on a more level playing field in U.S. and other export markets.

Canada was becoming an increasingly open, trade-dependent economy during the 1970s and early 1980s. The ability of Canadia and foreign multinationals to arrange production, marketing and distribution functions to minimize taxes led to a steady erosion of the tax base.[3] It also reinforced the biases of the federal manufacturers' sales tax (FST) in favour of imports over domestic production. Sales tax rates increased from 9 percent in 1983 to 10 percent in 1984, 12 percent in 1986, and 13.5 percent in 1989. These rate increases helped to restore the sales tax yield to 1980 levels, but also magnified incentives for tax avoidance.[4] (See Table 12-1)

Most other industrial countries relied on some form of Value Added Tax for a major portion of their tax revenues. By 1985, only Canada, Australia, New Zealand, Japan and

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[3] Importers paid FST on duty-valued prices. Domestic manufacturers paid it on their selling prices. A series of court cases increased the freedom of domestic firms to organize distribution channels to reduce sales and excise taxes payable. Wolfe D. Goodman, Submission to Commons Finance Committee, *Minutes and Proceedings*, Issue # 161A, (Ottawa, House of Commons, May 4, 1988).

[4] Wilson attempted to eliminate one such tax avoidance device by extending the Federal Sales Tax to cover marketing companies set up for wholesale distribution of manufacturers' products in the 1987 budget. This convoluted proposal was so heavily criticized for administrative inequity that the Commons' Finance Committee rejected and Wilson withdrew it after a series of public hearings. See Commons' Finance Committee, *Minutes and Proceedings*, Issues # 157-163, (Ottawa, House of Commons, April 26 - May 11, 1988).

the United States among industrial countries were without some form of VAT. And all but the latter were seriously considering the introduction of such a tax.[5]

TABLE 12-1
FEDERAL SALES TAX RATES AND REVENUES
1977-89

	FST Rate General	FST Rate Building Materials	Gross Revenue (in $ MM.)	% of Budgetary Revenues	Adjusted Tax Yield $ MM./1% FST
1977-78	12%	5%	$ 4.427.0	13.5%	$ 527.06
1978-79	9%	5%	$ 4,729.4	13.4%	$ 621.52
1979-80	9%	5%	$ 4,698.1	11.7%	$ 585.17
1980-81	9%	5%	$ 5,428.9	11.7%	$ 603.21
1981-82	9%	5%	$ 6,184.7	11.3%	$ 598.59
1982-83	9%	5%	$ 5,893.9	10.7%	$ 542.77
1983-84	9%	5%	$ 6,660.1	11.8%	$ 553.06
1984-85	10%	6%	$ 7,592.0	10.7%	$ 530.15
1985-86	10%	6%*	$ 9,345.0	12.2%	$ 543.11
1986-87	12%	8%	$ 12,022.1	14.0%	$ 615.69
1987-88	12%	8%	$ 12,984.4	13.3%	$ 610.61
1988-89	12%**	8%	$ 15,744.1	15.1%	$ 658.16
1989-90	13.5%	8%***	$ 17,768.2	15.6%	$ 628.45

* Rates increased to 11%, 7% on January 1, 1986
** General rate increased to 13% on January 1, 1989.
*** Rate on building materials increased to 9%, January 1, 1990.
\+ Adjusted for inflation, economic growth.

Finance Minister Wilson repeatedly tinkered with the tax base, following the examples of his Liberal predecessors. However, this band-aid approach only succeeded in making the tax more complex to administer and collect. The huge federal deficit required a more reliable source of revenues -- one which would have a less distorting effect on economic activities. This required fundamental sales tax reform rather than a series of budgetary band-aids.

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[5] For a discussion of failed efforts to introduce a VAT in Australia, see Paul Kelly, *The End of Certainty: the story of the 1980s*, (St. Leonards, NSW, Allen & Unwin, 1992), 155-77. New Zealand introduced a VAT, the Goods and Services Tax in 1987. Japan's attempt to introduce such a tax in 1987 was greeted by riots in the streets -- a fact not lost on Prime Minister Mulroney's advisors. (Interview, former PMO official. [PMO-1]

SALES TAX REFORM – IDEAS AND CHALLENGES

The sales tax policy community,[6] largely represented in the Goodman Committee, may have grudgingly admitted the need for fundamental reform of the federal sales tax in 1983. But Finance's repeated failure to win political support for its reform proposals between 1975 and 1983 demonstrated that theoretical support for reform was one thing. Support for a specific proposal was another.

The Goodman Committee had suggested two main options for sales tax reform: a joint federal-provincial sales tax and a broadly-based federal value-added tax (VAT).[7] The federal VAT was the preferred option of most senior Finance Department officials by the time the Conservatives took office in September 1984. The conventional wisdom was that the provinces would never agree to the federal invasion of their tax base -- or come to a consensus on the rules necessary for a joint federal-provincial tax. Harvey Perry commented that

> [such] a revision based on the cooperation of all nine provinces now imposing taxes at the retail level would be a triumph of federal-provincial negotiation equal to the original Confederation settlement.[8]

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[6] The Federal Sales Tax Policy Community was much smaller and more specialized than its Income Tax counterpart. In addition to Finance's Commodity Tax Analysis Section (Tax Policy Branch), the FST's highly specialized administrative system gave Revenue Canada a prominent role. Private sector interests were dominated by manufacturers -- especially the Canadian Manufacturers' Association and its related trade groups. However, any effort to broaden the FST base brought about active involvement from associations and professionals representing retail, wholesale, importers', small business, and transportation interests. With the exception of the Consumers Association of Canada, which played a peripheral role, other social and economic interests were almost invisible. The GST debate changed all this.

[7] Wolfe D. Goodman, Chmn., *Report of the Advisory Committee on the Federal Sales Tax*, (Ottawa, Dept. of Finance, May 1983).

[8] J. Harvey Perry, *A Fiscal History of Canada - The Postwar Years*, (Toronto, Canadian Tax Foundation, 1989), 355.

The 1985-model version of sales tax reform was the Business Transfer Tax (BTT). The brainchild of Satya Poddar, Director of Commodity Tax Analysis in Finance's Tax Policy Branch, the BTT was both theoretically simple and sweeping. Poddar persuaded Finance Minister Wilson that sales tax reform could be packaged as a simple one-page addition to the Corporate Income Tax return.[9]

The new tax would be levied on all value-added: total sales less the cost of tax-paid purchases, wages, other taxes and interest payments. It would be levied at a single rate and included in the price of all products and services sold in Canada. Imports would be taxed upon crossing the border. Exports would be "zero-rated": in effect, tax free with an input-credit[10] on the firm's purchases of goods and services. The thousands of often-arbitrary distinctions in existing FST rules -- 22,000 for the roughly 60,000 Canadian manufacturers and importers licenced to collect the federal sales tax -- would be swept away.

The BTT differed from the established Value-Added Taxes of European countries in that it would have been a tax calculated from balance sheet information (hence, "the subtraction method") rather than being calculated on the basis of individual transactions (the "credit-invoice method"). While this gave the BTT the appearance of greater simplicity, it also implied a greater political and administrative rigidity. The universal, single rate system required by the proposed tax left little room for the exclusion of politically sensitive goods or services from the tax base -- or for the making of trade-offs

[9] The initial proposal was suggested to Wilson at the Department's Christmas party in December 1984. Poddar spent the next two weeks putting together a comprehensive proposal, with the aid of consultants recruited specifically to test its assumptions. With minor modifications, the BTT became the Department's major vehicle for sales tax reform for the next three years. (Interview, S. Poddar)

[10] Input credit: sales tax refund on tax-paid goods and services purchased by the business, applied against taxes collected by it.

arising from the political process. Of course, this was a large part of its attraction to tax theorists raised in the universalist tradition of the Carter Commission.[11]

The new tax would complement the federal government's plans for free trade with the United States, expand its revenue base, and in the long-term, provide a rapidly growing source of revenues that could help to shrink the federal deficit, subject to adequate restraints on spending. Buried in every transaction, the BTT's very invisibility would lessen the political pain of deficit reduction -- after the initial transition period. Table 12-2 outlines the major criticisms of the federal sales tax and the comparative advantages claimed for the BTT.

Poddar and his colleagues began to test market the BTT concept in a series of meetings with provincial sales tax officials and private sector tax professionals in cities across Canada during the summer of 1985. While initial reaction was favourable, the same could not be said for cabinet's response. To win political approval, the BTT had to overcome several hurdles. The first was the traditional criticism of consumption taxes as economically regressive. Lower-income families, which spent most or all their incomes, would pay a larger proportion of their incomes in taxes than the relatively well-to-do. To head off this criticism, Wilson and his officials introduced a refundable, income-based sales tax credit in the 1986 budget. Packaged as a "fairness issue", it was designed to limit criticism of future sales tax reforms.[12]

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[11] Unlike most other Canadian tax reform proposals, the BTT was not based on any existing model of a functioning tax system until the introduction of New Zealand's Goods and Services Tax in 1986-87.

[12] Wilson hoped that the sales tax credit could be integrated with the child tax credit as the beginning of a potential guaranteed annual income delivered through the tax system. [Interview, former provincial Finance Minister.] [PG1]

The second was the taxation of food. While basic food products were traditionally exempt from both the FST and provincial sales taxes, the BTT could not be made to work

TABLE 12-2
SALES TAX REFORM -- FIXING A PROBLEM TAX

Criticism of FST	Benefit of BTT
1) Pyramiding/cascading (tax on tax) at different levels of production / distribution process	1) BTT paid on business inputs deductible from BTT collected from customers. Cascading of PST remains unless two taxes integrated
2) Neutrality - FST different percentage of consumer price depending on admin. rulings, distribution channels.	2) BTT levied at same rate on all goods and services, regardless of length of distribution channels.
3) Private (company) brands (competitive advantage over brand name products: see "2" above)	3) See "2" above.
4) Invisibility (Consumer not aware federal sales taxes included in prices)	4) Assumption that BTT will be transparent, even if not visibly added to consumer prices (Disputed)
5) Arbitrary use of notional prices to determine "fair market value" for FST administration	5) BTT charged as percentage of total sales. Universal tax base (if accepted) would remove need for administrative discretion on individual transactions.
6) Inclusion of transport costs in FST base.	6) BTT on transport costs deductible as business input.
7) Valuation of imports / discrimination against exports.	7) Imports, domestic manufactures taxed on same cost bases. Exports zero-rated (tax free).

if a large and elastic category of goods or services were exempted from tax.[13] Finance officials argued that the new tax would be fairer because federal and provincial sales taxes were already buried in the business inputs.[14] Income disparities could be offset by

[13] One of the most complex areas of provincial sales tax administration was the distinction between food and non-food items. These and other anomalies created administrative headaches for business-owners and their staffs.

[14] Business inputs: tax-paid purchases included in business overhead and production costs.

increasing the federal sales tax credit for lower and middle-income families. This argument proved to be a "hard-sell" for politicians and public alike.[15]

The third challenge was the difficulty of defining value-added in sectors such as financial services and housing. For example, banks, trust companies and insurance companies priced services which included a complex m.:: of financial calculations and overhead charges. Disaggregating these charges was bound to be an arbitrary and uncertain calculation. It had been handled with difficulty, if at all, by governments with existing Value-Added Taxes. Value-added could be calculated with reasonable certainty on new houses. But resale housing was a much larger challenge, and a sales tax on rental housing faced major technical and political challenges.[16]

The fourth challenge involved provincial resistance to the taxation of government-provided goods and services. Taxing government services also raised the issue of tax equity for comparable goods and services that could be delivered either through public or private sector suppliers, government-provided or contracted services. While the federal government was limited by the constitution from imposing taxes on directly on provincial governments, it could tax the broader public or MUSH[17] sector, which was heavily dependent on provincial subsidies.

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[15] The 1987 White Paper argued for the inclusion of food in the sales tax base as "64 percent of the tax savings from exempting food goes to the 50 percent of households who have incomes above the median". Food taxes could be refunded through a larger sales tax credit payable to larger and middle income families. (Wilson, *The White Paper: Tax Reform 1987*, 64,66).

[16] Economists have long suggested imposing income taxes on the "imputed rental values" of owner-occupied housing. However, a 1987 report prepared for the Economic Council of Canada suggested the costs of such an approach might well exceed the benefits. Richard-Philippe Domingue, *Assessment and Fiscal Treatment of Imputed Rents for Homeowner-Occupiers*, Discussion Paper # 319, (Ottawa, Economic Council of Canada, 1987).

[17] "MUSH" = Municipalities, Universities, Schools and Hospitals.

Expanding the sales tax base would also create disproportionate transitional and administrative costs for smaller businesses, a major part of the government's political constituency, by expanding the number of federally taxable vendors from approximately 60,000, (about 400,000 at the provincial level), to more than 1.5 million.[18]

It also fed the "leviathan" or "tax grab argument" -- the contention that expanding the government's capacity to tax would increase the scope and power of government, and reduce the already feeble constraints on government spending imposed by the growing federal deficit.[19]

While Wilson embraced the Department's commitment to sales tax reform early in his tenure as Finance Minister, it took him more than two-and-a-half years to translate the Department's views into a firm policy commitment, and more than four years to table a firm policy proposal -- the White Paper of April 1989. The following section outlines the tortuous political and institutional process necessary to convert Finance's policy preferences into formal government policy.

SALES TAX REFORM -- INSTITUTIONS AND PROCESSES

The introduction of a Value-Added Tax (VAT) -- first as a Business Transfer Tax (BTT), then as a National Sales Tax (NST) and finally as the Goods and Services Tax (GST) went through six stages before the tabling of the GST White Paper in April 1989. The first step was for officials to sell the Finance Minister, Michael Wilson, on the need for a

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[18] Plamondon & Associates Inc., *GST Compliance Costs for Small Business in Canada*, (Ottawa, Department of Finance, 1993).

[19] See comments by John Bulloch, Canadian Federation of Independent Business, in Commons' Finance Committee, *Minutes and Proceedings*, Issue # 19, (Ottawa, House of Commons, December 16, 1986); Ted Carmichael, C.D. Howe Institute, ibid., Issue # 23, (Ottawa, House of Commons, January 26, 1987).

VAT, first as a concept and then as a detailed proposal. The second was to persuade the cabinet of the VAT/BTT's political and economic viability. The third and fourth, overlapping the second, were to build a political constituency for sales tax reform and to identify the political and administrative barriers and problems to be overcome in order to convert or diffuse political opposition. The fifth was to package the new tax so that it could overcome entrenched institutional and public resistance to change. The sixth stage, beyond the scope of this study, was the tabling of the Goods and Services Tax White Paper for public discussion and eventual passage through Parliament.[20]

The ultimate political hurdle was to justify a 200 percent increase in the sales tax base to Canadian consumers, most of whom were virtually unaware of the FST's existence, and to more than 1.5 million small businesses and self-employed Canadians in the distributive and broader services sectors who would have to collect the GST for the first time. Published polls suggested that the new tax became one of the most unpopular measures in Canadian political history.[21]

Wilson was a relatively easy convert to the cause of sales tax reform. The Goodman Report's endorsement of some form of value-added or national sales tax indicated the likelihood of support from a cross-section of business interests and tax professionals, with whom Wilson had developed a close rapport, and Deputy Minister Marshall Cohen. Wilson's primary concern was to minimize the economic and administrative disruptions that comprehensive sales tax reform might cause to the private sector, especially small

[20] Phase II of tax reform, the GST White Paper, itself went through at least four stages: the federal decision to "go it alone" on sales tax reform, the preparation of the White Paper, legislation including changes suggested in the White Paper debate, including the reduction of the tax rate from 9 percent to 7 percent, and the raucous Parliamentary debate which led to passage of the GST less than two weeks before its scheduled implementation in January 1991.

[21] Gallup Poll in *Toronto Star*, January 21, 1990, A1; Neil Brooks and Anthony Doob, "Who Supports the GST?", *Toronto Star*, October 30, 1990, A25; Gallup Canada, "72% believe tax system is less fair", *Toronto Star*, December 10, 1990, A15.

business. Poddar's simple but elegant proposal for a Business Transfer Tax seemed to provide an answer to the sales tax riddle. Wilson, Cohen and Tax Policy ADM David Weyman reviewed the BTT proposal on December 22, 1984, and gave Poddar the green light to begin the serious technical work needed for its implementation.[22] Wilson signalled his intentions to move ahead with some form of Value-Added Tax in a one-line reference in the May 1985 budget.

Wilson sought to achieve a consensus with the business community and the provinces early in the process. Shortly after the 1985 budget, Finance officials began serious consultations with their provincial counterparts and senior tax policy professionals to discuss their proposals.

> We made 25-30 presentations: all 10 provinces and one or two private sector meetings per province. We didn't run into any violent reactions at all. ... The choice of instrument was undecided. We initially talked about the BTT because we didn't expect the provinces to come along.[23]

Wilson planned to introduce a White Paper on Sales Tax Reform to complement his corporate tax changes within six months of the May 1985 budget.[24] While he secured the Prime Minister's support in principle for sales tax reform, this was subject to support at cabinet.[25] Mulroney's caution on tax reform reinforced Wilson's growing tendency to consult cabinet colleagues and provincial counterparts before embarking on any major new policy initiative. Wilson did not stand on his ministerial prerogatives over sales tax

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22 Interview, Satya Poddar.

23 Interview, former Finance Dept. official (F03).

24 Ibid.

25 Interview, former PMO official, former senior Finance official. (PMO-1, D4)

reform, but took a more collegial approach to selling the proposed BTT.[26] Several ministers, most notably the newly appointed Revenue Minister, Elmer MacKay, objected strongly to the BTT's proposed tax on food.[27] While Wilson did not force the issue to a decision -- he was still rebuilding his political credibility after his defeat on pension deindexing in the 1985 budget -- he compromised by slowing down the process and continuing to build support for the BTT among business interests.

Late in 1985, Tax Policy Branch staff began to visit business groups and individual companies across the country to test market their ideas for sales tax reform, identify potential problems in implementation, and build political support. Strongest support for the new tax came from manufacturers, who faced significant tax increases as a result of the 1985 and 1986 budgets.[28] A BTT or Value Added Tax would allow manufacturers' to deduct the tax costs of business inputs, including major capital investments, from sales taxes payable. For many firms, especially those with large continuing investments in machinery and equipment, this was a vital trade-off to compensate for the tightening of depreciation rules in Wilson's corporate tax reforms of 1985-86. The Canadian Manufacturers' Association and the Business Council on National Issues became among the strongest supporters of sales tax reform.

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[26] Several close observers suggest Mulroney lacked confidence in the durability of his popular support for much of his first term, and that Wilson had been shaken by his defeats in the debates over universality and pension deindexing. Interviews, senior Finance Department officials. [D1, D4]

[27] MacKay, who had given up his Commons' seat for Mulroney in 1983, is said to have enjoyed considerable influence with the Prime Minister during this period. Interview, former PMO staff, former Finance officials. (PMO-1, D4, FO3)

[28] Interview, Eric Owen, Canadian Manufacturers' Association.

Wilson had promised a White Paper on the introduction of a Value Added Tax in his February 1986 budget speech.[29] However, it was not until the Policy and Priorities Committee's mid-summer planning meeting in Saskatoon that Wilson was able to seek cabinet's endorsement of the Business Transfer Tax proposal. While Wilson and others argued for "taxing everything" and "selling it to the public as tax simplification", several ministers including Agriculture Minister Bill McKnight and Communications Minister David Crombie argued violently against the idea of a food tax.[30] The decision was deferred once again, and Wilson announced on July 18, 1986 that as a result of the impending passage of U.S. tax reforms, the government would consider a comprehensive overhaul of the income and sales tax system.

Wilson was clearly committed to the idea of sales tax reform during this period. He seized on the idea of using simultaneous reform of the income and sales tax systems to "rebalance" the tax structure -- using the revenues from a more comprehensive sales tax base to lower personal income taxes for most Canadians.

> The rate structure of the personal income tax is the single most important element in the system of fundamental incentives for productive economic activity. ... But we must be sure to get personal income tax rates not just down, but down far enough to restore dynamic fundamental incentives to the system and make it fully competitive with the systems of other countries. ... Restoring a better balance among the major elements of the tax system will enable us to achieve that goal. At the same time, it will help address the trend that has seen both corporate and sales taxes providing a declining share of total revenues over the years.[31]

One of Wilson's officials put it more bluntly.

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[29] Wilson, *Budget Speech*, February 26, 1986, 16. Wilson's speeches during this period suggest that sales tax reform was his first priority, and that further changes to the personal and corporate tax systems were only added to the agenda as a result of U.S. tax reform.

[30] Interview, former PMO official (PMO-1).

[31] Wilson, "Meeting the Challenge of Tax Reform", in *Report of Proceedings of the Thirty-Eighth Tax Conference, 1986,* (Toronto, Canadian Tax Foundation, 1987), 2:7.

> We came to the conclusion that the only way we would save the day for sales tax reform was to bring in income tax reform.[32]

Wilson's announcement of *Guidelines for Tax Reform* in October 1986 began the formal consultation process. Parliament referred the *Guidelines* to the Commons' Finance Committee, which carried out public hearings between October 1986 and April 1987, and solicited the views of major interest groups, economists, and tax experts.

Wilson continued to carry on private discussions with his provincial counterparts and private sector interests to refine and build support for his reform proposals. These included the now customary meetings with interest groups, as well as a range of informal meetings with provincial Treasurers, tax experts and corporate leaders. Internal policy development continued on separate tracks on income tax reform and sales tax reform in the hope that these proposals could be implemented before the federal election expected in late 1988 or early 1989.

Finally, the Finance Minister tried to persuade an increasingly restive Conservative caucus of the merits of his tax reform proposals. While the passage of tax reform legislation in the United States created strong pressures for similar measures in Canada, the Finance Committee hearings became the focal point of the debate over whether sales tax reform could or would be used to finance a series of American-style income tax cuts.

INTERESTS: TRYING TO SELL SALES TAX REFORM

The debate over sales tax reform which occurred during the fall and winter of 1986-87 reflected three distinct political processes. The Commons' Finance Committee was the centre of the public debate as large corporate and manufacturing interests squared off with a diverse group of interests united on little except their opposition to the proposed

32 Interview, former Finance Department official. [D4]

Business Transfer Tax. This debate was reflected within the Tory and Liberal caucuses as MPs sought to reconcile competing political priorities. It was also reflected in the cautious mating dance of Finance Minister Wilson and his provincial counterparts -- most notably the Treasurers of the two largest provinces, Ontario and Quebec -- as Wilson tried to determine the feasibility of negotiating a joint federal-provincial value-added tax.

Agenda-Setting: The Finance Committee Hearings

Finance Committee Chairman Don Blenkarn wasted little time holding hearings on Wilson's *Guidelines to Tax Reform* proposals. His objective was to build public support for these proposals by involving major national interest groups representing a cross-section of economic and social interests. The Committee held 25 hearings between October 30, 1986 and April 13, 1987, involving the major broadly-based and sectoral business organizations, organized labour, farm, social policy and women's groups, as well as a number of economic experts.

Within the Committee, Blenkarn sought to build a relatively non-partisan consensus among the Committee's members on the need for and broad principles of tax reform. To this end, he summoned a variety of expert witnesses ranging from the Fraser Institute's Michael Walker to Mike McCracken of Infometrica. The Economic Council of Canada, and indeed most expert witnesses, reflecting a growing trend within the economics profession, supported a shift from income-based towards consumption-based taxation. While Finance officials had no intention of moving towards an expenditure-based income tax structure[33], it reinforced their argument in favour of "re-balancing" the tax structure to shift a part of the tax burden from personal income taxes to corporate and sales taxes.[34]

Blenkarn's third objective was to link income and sales tax reform in the public mind as a "win-win" proposal that would use the new Value-Added Tax (VAT) to permit major cuts in personal and corporate tax rates to parallel recent American rate reductions. As a practical politician, he dreaded the prospect of having to sell the castor oil of sales tax reform in the absence of the sweetener provided by major income tax cuts. However, to do this, he would have to persuade both opposition finance critics to abandon their parties' policies and, especially with the New Democrats' Michael Cassidy, years of opposition to higher consumption taxes as contrary to social democratic principles.[35]

While the Business Council on National Issues and the Canadian Manufacturers' Association strongly supported shifting the tax burden and introducing some form of VAT, this hardly qualified as the kind of broadly-based support needed for such a major structural change in the tax system. In fact, hoped-for business support for the Business Transfer Tax turned out to be much weaker than anticipated. A majority of national business groups opposed the concept. While some were willing to consider a federal

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[33] Expenditure-based income tax: income tax system in which savings, investments and the income (e.g. interest, dividends) from them are not recognized as taxable income. For the sake of neutrality, interest and dividend expenses are not deductible from taxable income.

[34] D.A. Dodge, "Economic Objectives of Tax Reform", in J. Mintz & J. Whalley, eds., *The Economic Aspects of Tax Reform*, (Toronto, Canadian Tax Foundation, 1989), 37-41. A shift towards some form of consumption-based taxation was endorsed by the C.D. Howe Institute, the Economic Council of Canada, and the Fraser Institute, as well as many business economists. See Commons Finance Committee, *Minutes and Proceedings*, Issues # 12 (Dec. 2, 1986), 14 (Dec. 8, 1986), 23 (Jan. 26, 1987), and 34 (Feb. 17, 1987).

[35] Interview, Don Blenkarn. Blenkarn finally succeeded in winning all-party support for a BTT in March 1988, following the Committee's trip to New Zealand to inspect its highly successful sales tax reform program. See especially the Committee's Fifteenth and Sixteenth Reports, *Minutes and Proceedings*, Issues # 147, 148, (Ottawa, House of Commons, March 15, 24, 1988). However, this was too late to convince Wilson of the political and administrative viability of introducing the new tax before the 1988 election.

Value-Added Tax exempting food, most advocated a joint federal-provincial sales tax as their preferred reform option.[36] (See Table 12-3.) Labour and social policy groups were almost unanimous in their opposition to sales tax reform and to shifting part of the tax burden from income to consumption taxes.

TABLE 12-3
INTEREST GROUP RESPONSES TO SALES TAX REFORM, BUSINESS TRANSFER TAX: 1986-87

	SUPPORT BTT?	FED.ONLY VAT?	INCLUDE FOOD IN TAX BASE?	REQUIRE VISIBLE TAX?	SUPPORT FED-PROV VAT?
BUSINESS COUNCIL ON ON NATIONAL ISSUES (BCNI)	MAYBE	IF NECESSARY	YES	YES	BEST OPTION
CDN. MANUFACTURERS ASSOCIATION (CMA)	YES	IF NECESSARY	YES	STRONGLY YES	BEST OPTION
CDN. CONSTRUCTION ASSOCIATION (CCA)	NO	NO	N/A	N/A	N/A
CANADIAN FEDERATION OF INDEPENDENT BUSINESS (CFIB)	STRONGLY NO	NO	NO	N/A	LEAST WORST OPTION
CANADIAN ORG. OF SMALL BUSINESS	NO	NO	N/A	STRONGLY YES	BEST OPTION
RETAIL COUNCIL OF CANADA	NO	NO	NO	STRONGLY YES	BEST OPTION
CANADIAN LABOUR CONGRESS (CLC)	NO	NO	NO	N/A	N/A
NATIONAL COUNCIL ON WELFARE	NO	NO	NO	N/A	N/A
NATIONAL ANTI-POVERTY ORG'N.	NO	NO	NO	N/A	N/A
NATIONAL ACTION COMMITTEE ON THE STATUS OF WOMEN	NO	NO	NO	N/A	N/A

SOURCE: Commons' Finance Committee, *Minutes and Proceedings*

[36] Industries dominated by smaller firms loathed the idea of having to administer two separate sales taxes levied on different bases at different rates. However, support for a joint value-added tax was a tactical manoeuver for several groups -- some wanting a federal VAT, but not able to persuade their members to swallow the idea; others not wanting any kind of VAT but hoping to use the prospect of a joint federal-provincial tax as a firewall against the BTT. (Interviews, business association representatives - AE-1, AE-5.)

The strongest and most politically effective business opposition to sales tax reform came from John Bulloch of the Canadian Federation of Independent Business (CFIB). Bulloch, who had led highly visible campaigns against the 1969 and 1981 tax reform proposals, attacked the BTT as a potential tax grab, a hidden tax, and a costly and complex administrative burden on small businesses.[37] Bulloch's arguments resonated strongly with Tory backbenchers, who were worried about their prospects of re-election as government support dropped below 25 percent in published polls. As Mulroney had come to use backbench support as a litmus test for major policy changes, the intensity of caucus opposition was fatal to the early success of sales tax reform. A senior Finance Department official commented that at this time

> the caucus was not behind it. The Prime Minister was not prepared to go ahead without their support. The PM was committed to it (the BTT) but he couldn't go ahead without his caucus behind him.[38]

A senior Mulroney advisor attributes much of the caucus opposition to the influence of small business groups.

> The Tory caucus was a small business caucus. ... [There was] Bulloch saying 'we'll go to war with you' over the BTT. [This created] a pretty difficult balancing act, especially in its impact on caucus. Finance couldn't ignore the political context of caucus.[39]

While a number of business groups, including the BCNI, the CFIB and the Canadian Organization of Small Business, urged Wilson to negotiate a joint sales tax reform package with the provinces, few Finance Department officials held out much hope of a joint federal-provincial sales tax. However, early in 1987, Ontario Treasurer Robert

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[37] Commons Finance Committee, *Minutes and Proceedings*, Issue # 19, (Ottawa, House of Commons, December 16, 1986).

[38] Interview, senior Finance Department official.(D4)

[39] Interview, former PMO official. (PMO-1)

Nixon telephoned Wilson suggesting the possibility of a deal on the subject.[40] When further soundings indicated possible support from Quebec and other provinces,[41] Wilson decided that a delayed sales tax package enjoying provincial support would be a technically superior and politically safer means of achieving sales tax reform.

SALES TAX REFORM DEFERRED: THE WHITE PAPER

After failing again to convince cabinet colleagues to accept the BTT in April 1987, Wilson and his officials decided to separate the two elements of tax reform.[42] Wilson would proceed immediately with Phase I, dealing with changes to the Income Tax system. Phase II, sales tax reform, would follow after the federal election anticipated in late 1988 or early 1989. Several senior government officials give three main reasons for the charge: strong opposition in the Tory caucus, the difficulty of implementing a new federal sales tax, whether visible or hidden, before the election, and the growing hope that provincial support could be achieved for a combined federal-provincial sales tax.[43] Wilson announced the change when he released the two White Papers on June 18, 1987.

> Unlike the changes to the personal and the corporate income tax, sales tax reform will be delayed. The reason is no mystery. Changes to the personal and corporate income tax are changes within the existing system and can be made more easily. But sales tax reform is fundamental change. We will be replacing one system with a totally new one. And that requires adequate time - for consultation with the provinces and with interested

40 Interview, former Finance Department official; Ontario government sources. (F02, PG1).

41 Quebec Finance Minister Gerard D. Levesque was reportedly willing to harmonize sales tax bases with Ottawa in return for control over provincial rates and tax administration. Cathryn Motherwell, "Critics dislike menu for sales tax reform", *The Globe and Mail*, May 11, 1987, B1,13; Interviews, Ontario Ministry of Treasury & Economics.

42 Christopher Waddell, "Tory unease threatens reforms in tax system", *The Globe and Mail*, April 18, 1987, A1,5.

43 Interview, former PMO, Finance Department officials. (FMO-1, D4, FO2)

> Canadians; and to make Canadians familiar with the proposed new system and make a smooth transition to it.[44]

The White Paper offered three options for sales tax reform, all variants of the Value-Added or multi-stage sales tax concept: the Business Transfer Tax, a federal-only Value-Added Tax, calculated on a credit-invoice method, and a single National Sales Tax (NST), to be levied by all federal and provincial governments on virtually all goods and services sold in Canada. The NST had three major selling features: conceptual and administrative simplicity, openness to the public, and the prospect of political delay while federal and provincial governments haggled over the details.

The major shortcomings of the proposed national sales tax were the product of its advantages: the potential political cost when consumers faced a combined sales tax of 12-15 percent on a broad base (instead of provincial sales taxes of 7-11 percent -- none in Alberta -- and the largely invisible FST on a narrower base); and the old jurisdictional questions -- why should the provinces allow Ottawa to invade their tax room, and who should control future changes to the new tax?[45]

The White Paper answered some of the challenges to the original BTT concept, but deferred most of them until after the election. Wilson left the door open for the exclusion of food from the tax base because this had become a precondition of provincial

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[44] Hon. Michael H. Wilson, Speech to Vancouver Board of Trade, (Ottawa, Dept. of Finance, unpublished, June 26, 1987), 7.

[45] Ultimately, the federal-provincial negotiations foundered on these issues. Most provincial governments were reluctant to pay the political price for being associated with the new tax in the public eye, and the federal governmment was unwilling to tie its hands in allowing the provinces to share significant control over future changes to the tax rate and base. Wilson broke off negotiations the week before the 1989 budget, and decided to "go it alone" on sales tax reform. Interviews, Ontario Government sources. [PG1, PG2]

participation in negotiations to harmonize federal and provincial sales taxes.[46] While government, health, educational services and charitable activities of a non-commercial nature would be exempt from the proposed taxes,[47] the overlap between public and private sector activities promised to make this an area of considerable complexity. The White Paper also proposed the taxation of financial institutions, commercial real estate and new residential housing construction.

A number of veteran tax policy practitioners have suggested that Wilson made a major tactical error in separating the BTT from the income tax reform package. From this perspective, one invisible consumption tax would merely have replaced another, and the revenue derived from a more broadly-based sales tax could have financed a major income tax cut for all income groups. Don Blenkarn was the most outspoken public supporter of this view.

> Right now, we have a nice federal hidden tax. We do not get blamed for it by most people; most people do not believe we charge anything. Now you are asking the federal government to get rid of a nice quiet under-the-table tax ... you are asking us to put that up front so that everyone will hate us.[48]

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[46] Wilson agreed to provincial terms at a finance ministers' meeting in mid-December 1987. Ontario Treasurer Robert Nixon had previously announced that Ontario support would be conditional on exemptions for food and federal compensation for higher tax costs in the broader public sector. "Food free of tax - national plan to exempt drugs", *Winnipeg Free Press*, December 11, 1987, A1,4.

[47] Tax exempt status allowed vendors not to collect VAT from exempt goods, but not to obtain refund of VAT paid on related purchases. "Commercial activity: property or service of a type generally supplied by a commercial business." *Tax Reform 1987: Sales Tax Reform*, (Ottawa, Department of Finance, June 18, 1987), 109-10. Wilson bowed to stiff provincial opposition in December 1987 and agreed to compensate provinces for the higher costs arising from higher sales taxes on the broader public sector.

[48] Commons' Finance Committee, *Minutes and Proceedings*, Issue # 28, February 2, 1987, 10.

However, according to government MPs, the government's low standing in the polls prompted Cabinet to reject Wilson's proposal for a sales tax on food, even an invisible one.[49]

In the absence of any broadly-based public or interest group support for sales tax reform, Wilson opted for the path of least resistance: deferred sales tax reform and modest income tax reductions. The hard decisions on how and whether to accommodate the provinces would be put off until after the 1988 elections.

CONCLUSION

The Business Transfer Tax debate took place mainly among the policy elites of the federal sales tax policy community. As with previous efforts at sales tax reform, it was a bureaucratically-driven exercise led by the Department of Finance in response to growing systemic pressures, especially the erosion of the existing sales tax base. While consultation within the broader policy community was much greater -- and came earlier in the process -- than for any previous tax reform initiative, the general public was only involved to the degree that the Department of Finance commissioned opinion surveys on the sales tax system.[50] The technical flaws of the old Federal Sales Tax, while serious in Canada's changing economic environment, did not constitute the fiscal or economic crisis that would have generated widespread public interest in or support for sales tax reform.

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[49] Published polls showed 63 percent of voters opposed to federal sales taxes on food and services. Ferguson, "Don't tax food, services, 63% tell Ottawa", *The Gazette*, Montreal, March 21, 1987, A5; Waddell, "Tory unease ...", op. cit.

[50] Decima Research Ltd., *Nation-wide Survey*, Department of Finance "Decima (1987)", (March 1987); Angus Reid Associates, *Canadians' View of Selected Public Policy Issues: The Results of a National Public Opinion Survey*, "Reid (1988)", (September 1988). Research reports obtained under Access to Information and Protection of Privacy Act. Proposals for sales tax reform received some coverage in the business press. Some business groups, such as the CFIB, took surveys of their memberships.

The potential number of beneficiaries from a value-added tax was too small to convince most interest groups, let alone the general public, of the benefits of the proposed tax. Finance Department surveys revealed a growing tax fatigue, and minimal public trust in the government's promises of economic benefits from the new tax.[51] These factors contributed to institutional resistance to sales tax reform within the federal government -- especially within cabinet and the PC caucus. These critics were fearful that the political fallout from a unilateral effort to introduce sales tax reform would jeopardize their prospects for re-election.

Drawing on the support of senior tax professionals, Wilson and Blenkarn were gradually able to develop an all-party consensus on the need to replace the Federal Sales Tax with a New Zealand-model Goods and Services Tax.[52] However, this consensus came too late to affect the White Paper process. And the defeat of both opposition Finance critics, Raymond Garneau and Michael Cassidy, in the election of 1988 effectively removed the two men who might have helped Wilson to preserve a minimal consensus on the GST in Parliament.

Wilson also faced a no-win decision on the timing of sales tax reform. Major structural change was unavoidable. Some degree of political conflict was inevitable. Wilson may be faulted by political pragmatists for pursuing the "impossible dream" -- a joint federal-provincial sales tax -- or for bargaining away his negotiating position, GST exemptions for food and the broader public sector, in return for minimal political gains between June 1987 and April 1989. However, there is no indication that the federal government could have mobilized significantly more support for unilateral sales tax reform in 1987 than it

[51] Decima 1987. These findings are also reflected in published polls. Ferguson, "Don't tax food, services...".

[52] Commons' Finance Committee, *Fifteenth Report*, "The GST in New Zealand", Minutes and Proceedings, Issue # 147, March 15, 1988; *Sixteenth Report*, "Stage II of Sales Tax Reform", ibid., Issue # 148, March 24, 1988.

did later. Indeed, given the widespread opposition to sales tax reform visible even then, a frontal assault on the government by opponents of the new tax could well have jeopardized both income tax reform and the government's bitterly fought election victory in 1988.[53] As changes to the tax structure involve issues of politics, not just policy, the path of interest accommodation seems to have been the more prudent course to preserve some measure of comprehensive tax reform in 1987-88.

[53] Prime Minister Mulroney reportedly told the P.C. caucus after the 1988 election that, if implemented as scheduled in 1990, the GST would drive the Tories below 20 percent in the opinion polls for two years. [Interview, former senior Finance Department official - D4.] He was right. While the GST backlash was only a secondary factor in the destruction of the Conservative Party in the 1993 federal election, it is improbable that it would not have become a decisive factor in dozens of narrowly fought ridings if Wilson had introduced it before the 1988 election instead.

CHAPTER 13 -- INCOME TAX REFORM: 1986-88

> The central objective [of tax reform] is to get tax rates down. The best incentive for investment, saving, and job creation is to allow all Canadians to keep more of what they earn --- to spend or save as they see fit.
>
> Michael Wilson[1]

The passage of major changes to the federal Income Tax Act in September 1988, Bill C-139, led to a significant restructuring of the personal and corporate income tax systems in Canada. Unlike tax reform in 1981, the changes were relatively uncontroversial and received Parliamentary approval with a minimum of partisan or interest group conflict. This lack of controversy can be traced to a process of careful political management and consensus-building by the Minister and Department of Finance. Finance Minister Michael Wilson avoided direct challenges to entrenched economic interests and sought to minimize the number and extent of tax increases directly associated with tax reform. He also took extensive measures to consult with and conciliate major economic and social interests, and to reinforce the impression of policy continuity arising from his piecemeal tax changes of the mid-1980s.[2]

This chapter will examine the institutional factors underlying tax reform, the political process of consultation and trade-offs which shaped the package, and the strategy and tactics used to market tax reform to the Canadian people and build a political coalition for structural policy changes.

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[1] Hon. Michael H. Wilson, "Managing the Challenge of Tax Reform", *Proceedings of Thirty-Eighth Tax Conference*, (Toronto, Canadian Tax Foundation, 1987), 3.

[2] This is a repeated theme of speeches given by Wilson and his Minister of State, Tom Hockin, around the country in 1987-88. Speeches, unpublished Department of Finance archives.

INSTITUTIONAL FACTORS: Continental Economic Integration, National Reconciliation and Internal Consensus Building

Finance Minister Wilson and his officials initially resisted the idea of comprehensive tax reform because of its potential to disrupt the government's political and economic agenda, and to draw resources away from the pursuit of its other priorities.[3] Wilson's change of heart resulted from two major events: the federal cabinet's rejection of his initial proposals for sales tax reform and the unexpected passage of a comprehensive tax reform bill in the United States during the summer and fall of 1986.[4] The U.S. tax reform bill parallelled similar measures involving base broadening and tax rate reduction in several other industrial countries.[5] Tax reform provided an opportunity to link several separate elements of the government's overall economic strategy in a coherent package that could impose order on an overloaded policy agenda and provide a clear sense of political direction for a government which appeared to be drifting half-way through its electoral mandate.[6]

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[3] Hon. Michael H. Wilson, *Budget Speech*, May 23, 1985, 15; interview, senior Finance Department officials.

[4] Interview, former Deputy Minister. (D4) For a discussion of the U.S. tax reform process, Jeffrey H. Birnbaum and Alan S. Murray, *Showdown at Gucci Gulch*, (New York, Vintage Books, 1988).

[5] John Bossons, "International Tax Competition: The Foreign Government Response in Canada and Other Countries", *National Tax Journal* XLI (3), [September 1988], 347-355; Joseph Pechman, ed, *World Tax Reform*, (Washington, DC, Brookings Institution, 1988). Wilson often made this point in his speeches to business audiences during this period, linking tax reform to events elsewhere in the world and the government's agenda of promoting free trade, competitiveness and innovation. (unpublished speeches, Department of Finance archives, 1987).

[6] Interview, senior PMO official. (PMO-1) In mid-1986, there were 386 separate cabinet documents at various stages of the policy process. The Prime Minister had just reshuffled his cabinet. In the words of a senior PMO official, "there was a need for a renewed sense of direction". Wilson himself commented later that "the whole ... government was involved on a whole range of issues. It was a bloody waste of time. We then [after mid-1986] set up a lot of ad hoc committees with only two or three ministers, which allowed us to deal with issues in a lot speedier manner." (Interview, Hon. Michael Wilson).

The biggest policy initiative on the federal government's agenda, the proposed Canada - U.S. Free Trade Agreement, was intended to promote the competitiveness of Canadian industries in an increasingly interdependent continental and global economy. U.S. tax reform, working its way through Congress during the summer of 1986, promised to make major cuts in marginal tax rates for both corporations and individuals. Reliant on U.S. markets for 80 percent of its exports, Canada could not hope to compete for private investment and production facilities if its corporate tax rates were 50 percent higher than American rates. This message was constantly repeated by business groups, led by the Business Council on National Issues, in their meetings with the government.[7]

TABLE 13-1
U.S.- CANADA DIFFERENCES IN MARGINAL EFFECTIVE TAX RATES (METRs) ON CORPORATE INCOME

	METR U.S.	METR CANADA
1975 (all taxpaying companies)	15%	40%
1985 (all taxpaying companies)	19%	26%
1990 (all taxpaying companies)	20%	29%
1990 (loss making firms)	14%	4%
1990 (all firms)	19.2%	18.7%
1990 (U.S. Multinational)	20%	26-31%
1990 (Canadian Multinational)	24%	29%

[SOURCE: Wayne Thirsk, *Fiscal Sovereignty & Tax Competition*, Tables 4, 24.]

However, Wilson had to overcome a series of institutional barriers before introducing his tax reform White Paper. The most serious of these were the need for approval of his cabinet colleagues, that of the Tory caucus, and the general acquiescence of the provinces.

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[7] Task Force on Taxation Policy, *Taxation Policy Reform in Canada*, (Ottawa, Business Council on National Issues, October 1, 1986); Robert D. Brown, "Tax Reform: Can we do better the second time around", in *Report of Proceedings of the Thirty-Eighth Tax Conference, 1986*, (Toronto, Canadian Tax Foundation, 1987), Commons' Finance Committee, Minutes and Proceedings, Issue # 14, (Ottawa, House of Commons, December 8, 1986).

Cabinet and Caucus

The Minister and Department of Finance have traditionally brooked little interference from outsiders on the details of tax policy. The Minister depends on the Prime Minister's political support for the strategic direction of fiscal and economic policies, but usually has a free hand on the details unless his proposals seem likely to provoke a major political backlash against the government.

However, interviews with a number of participants in the 1986-88 tax reform process suggest that Wilson was often constrained by the need to build consensus with his cabinet colleagues on his proposals for tax reform. Wilson himself comments that

> the whole question of collegiality has evolved. ... We couldn't do it like MacEachen did; silence until budget day, except for a few statements to throw the media off track. It meant opening up to cabinet ... and to the general public.[8]

A senior Finance official comments that while Mulroney consistently supported Wilson's policy proposals after the pension deindexing retreat of 1985, the timing and form of these proposals was often dependent on Wilson's capacity to convince and persuade cabinet and caucus colleagues of their soundness.

> On virtually every controversial issue, [Mulroney] wouldn't go ahead unless he was certain he had caucus behind him. ... The details of policy were left to ministers. But caucus was his reality check. Holding the caucus together was the key to Mulroney's political style.[9]

The government's steady decline in the poll• ihroughout 1986 and much of 1987 and the likelihood of an election in 1988 limited cabinet's willingness to take political risks with tax reform. Electoral dynamics clearly shaped the emphasis on personal income tax reductions.

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[8] Interview, Hon. Michael H. Wilson.

[9] Interview, former Deputy Minister of Finance. (D4)

> Mulroney wanted good news, not bad news in the twelve months before the election ... good news and spending. ... He also wanted to get tax rebates out before the 1988 election so that tax reform would be seen as good news.[10]

Unlike some of his predecessors who insisted on complete control of the policy process, Michael Wilson displayed an unusual openness to internal consultation and consensus-building on the broad lines of his tax reform strategy. Part of this approach was inherent to Wilson's political style -- reaching out for political and policy advice and reacting to a wide-ranging personal network inside and outside the government.[11] However, part was also shaped by the overriding importance of electoral concerns during the Mulroney Government's first mandate.[12]

Provincial Governments

"National reconciliation" and "cooperative federalism" were major themes of the Mulroney Government's first term in office.[13] They reflected not only the usual banalities of throne speeches, but an intense reaction against the unilateral changes to federal fiscal and constitutional arrangements which had characterized the Trudeau Government of 1980-84.

Prime Minister Mulroney's desire for federal-provincial cooperation and for the prompt ratification of the Meech Lake constitutional accord imposed several constraints on the Department of Finance. Finance was largely precluded from reducing transfers to the

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[10] Interview, former PMO official. (PMO-1)

[11] Interview, Finance Department official. (F02)

[12] Interview, former cabinet minister (M6); former senior Finance Department official. (D4)

[13] "Speech from the Throne", *Debates*, House of Commons, 2nd session, 38th Parliament, (Ottawa, October 1, 1986), 13-14.

provinces as part of its deficit control program during Mulroney's first term.[14] The influence of energy-producing provinces resulted in the phasing-out of the PGRT in 1986, two years before its scheduled phase-out under the Western Energy Accord. Finally, federal officials were precluded from linking the renegotiation of federal-provincial fiscal arrangements to provincial cooperation and harmonization with proposed federal income tax reductions. While this would have been a standard Finance Department negotiating tactic in the 1970s, a senior Finance Department official comments that it was "contrary to Mulroney's philosophy of federal-provincial relations" during this period.[15]

TABLE 13-2
TRANSFERS TO PROVINCES VS. TOTAL FEDERAL SPENDING: 1985-88

	1985	1986	1987	1988	Average
INCREASES IN FED-PROV. TRANSFERS	9.2%	(3.0%)	7.6%	8.9%	5.7%
INCREASES IN TOTAL FEDERAL SPENDING	7.6%	0.6%	5.4%	6.9%	5.1%
INFLATION (CPI)	3.9%	4.2%	4.4%	4.0%	4.1%

Source: *Economic Reference Tables*, Table 44.1; 54; (Ottawa, Dept. of Finance, August 1992)

International Tax Arrangements

The most visible and immediate cause of tax reform in Canada was the U.S. Tax Reform Act of 1986. Its influence is clearly discernable in the timing, strategy and technical

14 "There was tremendous pressure on us in budgets not to cut federal-provincial transfers." Former Deputy Minister, Department of Finance. (D4) This policy changed significantly after the 1988 election.

15 Interview, Former Deputy Minister, Department of Finance. (D4) While Ottawa unilaterally imposed reductions in the rate of growth of federal EPF transfers to the provinces after 1986, these were quite modest. Rather than reductions in the real or nominal level of transfer payments, transfer growth was limited to 2 percent below the rate of GDP growth in each province. Federal per capita transfers were not frozen until 1990. George E. Carter, "Federal Restraints on the Growth of Transfer Payments to the Provinces Since 1986-87: An Assessment", *Canadian Tax Journal* 42(6), [1994], 1504-32.

content of Canadian tax reform. The vast array of tax preferences in the U.S. tax system, often including special tax breaks created for individual companies, gave the Treasury and Congress greater scope to reduce marginal rates than in Canada -- where tax preferences were not as extensive and more generalized in application.

Canada followed the U.S. in several important areas. It financed a portion of its personal tax reductions by shifting part of the personal tax burden to corporations -- mainly large firms. The inclusion rate on capital gains was increased from 50 percent to 75 percent. Together with the $ 100,000 lifetime capital gains exemption on most investments, this still appeared generous compared with Congress' decision to tax 100 percent of nominal capital gains. Wilson also followed the U.S. example in providing for the partial taxation of business travel and entertainment expenses, lower capital cost allowances for business, lower depletion rates for resource industries, and other measures which, under other circumstances, would doubtless have provoked savage criticism from business interests.

U.S. tax reform also set the limits of international influence in broadening the tax base. Despite the proposal of the Commons' Finance Committee that Canada copy the British Advance Corporations Tax (ACT) which provides for tax-free dividends to shareholders only upon income on which corporate income tax has already been paid,[16] Finance Department officials rejected the idea -- citing administrative and possible compliance

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[16] Under Canadian tax laws, companies in a financial or tax loss position are permitted to pay dividends to shareholders, who may then claim the dividend tax credit on "grossed up" dividend income. This policy is intended to provide equal treatment to shareholders of Canadian private companies, for whom personal and corporate income are taxed equally, and publicly-traded companies.

problems for the large number of American controlled corporations resident in Canada[17] and significant tax benefits for non-resident shareholders of firms operating in Canada.[18]

However, unlike the tax reform debates of 1971 and 1981, the U.S. tax reforms of 1986 set clear limits on the ability of Canadian corporate and financial interests to block major policy changes by pointing to their potential impact on Canadian competitiveness. This allowed Michael Wilson to market tax reform as a positive-sum game for the average taxpayer by combining it with tax reduction for most income groups.

MARKETING TAX REFORM: THE PUBLIC PROCESS

Tax reform in 1987-88 was packaged as a simple, coherent message: "tax reform equals lower taxes". While the objectives of tax reform usually favour the creation of a more homogeneous tax system and the reduction of preferences for special interests, Wilson's major objective in tax reform was to ensure that a majority of taxpayers in every politically significant group would be either better off or no worse off than before. Those groups facing higher taxes -- mainly large corporations -- were promised prompt action on sales tax reform by way of compensation.

Wilson's ability to combine tax reform with tax reduction was partly the result of his decisions to impose major personal and corporate tax increases, including the partial de-indexing of personal income taxes, between 1985 and 1987. Tax reform became a means of refunding a portion of these tax increases to Canadians just before a federal election.[19]

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[17] Standing Committee on Finance, Trade and Economic Affairs, *Report on the White Paper on Tax Reform* (Stage 1), Issue # 125, (Ottawa, House of Commons, November 3, 1987.], 7; Interviews: Don Blenkarn, MP, senior Finance Department official.

[18] Interview, senior tax professional. (P7)

[19] Allan M. Maslove, *Tax Reform in Canada*, (Montreal, Institute for Research on Public Policy, 1989); supra f. 10.

However, Wilson was also fortunate that his tax reform plans coincided with rapid economic growth in 1987-88 which generated higher than expected growth in federal tax revenues.[20]

The process of consensus-building relied on an unprecedented program of public and private consultation to ensure that the details of tax reform were consistent with the program's proclaimed objectives. This process was essential in legitimizing both the goals and details of tax reform.[21]

The marketing of the new tax reform strategy began in July 1986 with Wilson's statement to the House on "options for tax reform". This was followed by a *Guidelines for Tax Reform* discussion paper in October 1986, spelling out at least nine policy objectives to be reconciled as part of the reform process.

> Fairness ... the fair sharing of the tax burden among taxpayers; simplicity and ease of voluntary compliance; balance ... reduced reliance on personal income tax revenues; stability and certainty of government revenues; revenue neutrality; international competitiveness; encouraging economic efficiency and growth; recognition of special regional needs; appropriate transition provisions; and broad consultation prior to introduction of final legislative proposals.[22]

This range of objectives was broad enough to provide something for almost everyone. The *Guidelines* were followed by detailed consultations prior to the February 1987

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[20] Wilson later conceded that the political considerations of tax reform may have taken precedence over the conventions of fiscal policy in using these "surplus" revenues to finance tax cuts rather than reducing the deficit in 1987-88. Eric Beauchene, "Wilson admits he erred with tax reform in '88", *London Free Press*, March 2, 1991, A1.

[21] The first set of hearings, between October 1986 and April 1987, gauged public reaction to Wilson's statement of general principles, *Guidelines to Tax Reform*. The second set, between June and November 1987, provided for expert and public response to Wilson's *White Paper -- Income Tax Reform*. These were supplemented with a number of informal meetings with tax professionals. Finally, the Committee held public hearings on Draft Legislation and Bill C-139 in May, June and August, 1988, involving detailed cross-examination of senior Finance Department officials.

[22] *Guidelines for Tax Reform in Canada*, October 23, 1986.

budget, the release of separate White Papers on Income Tax and Sales Tax Reform in June 1987, public hearings on the White Paper by the Commons' Finance Committee, and further meetings between Finance Department officials and members of the broader tax policy community, culminating in the tabling of Draft Legislation in the Commons on December 16, 1987, to take effect in January 1989.[23]

The government took a "two-tier" approach to marketing its proposals. Wilson presented tax reform to the general public as a populist measure that would reduce taxes for 80 percent of Canadians, increase the "fairness" of the tax system, and increase taxes for corporations.[24] Discussion of technical issues was limited, as usual, to the broader tax policy community of tax professionals and interest groups.

The design and promotion of tax reform was carefully located within existing tax concepts and values of taxation. Early in the reform process, Finance Department officials rejected calls of certain economists and business people for a shift to a flat-rate or expenditure based tax which would have introduced unsettling innovations to the tax system.

> The existing basic system was seen as viable as providing a sound means of raising major amounts of revenue, and as having wide public support. ... These radical reform possibilities for the income tax, which would have involved pushing into uncharted territory as far as the taxpaying public is concerned, did not really occupy us for very long. We did not think they made sense in terms of good tax administration or public acceptance.[25]

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[23] House of Commons, *Debates*, July 18, 1986; Department of Finance, *Options for Tax Reform*, (Ottawa, The Department, July 18, 1986); Wilson, *Guidelines for Tax Reform in Canada*, October 23, 1986; *Budget Speech*, Feb. 18, 1987; *Tax Reform 1987*, Speech delivered in the House of Commons, June 18, 1987; "Speech on Tabling of Notice of Ways and Means Motion", House of Commons, December 16, 1987.

[24] Hon. Michael H. Wilson, "Speech to Order of Chartered Accountants of Quebec, Rimouski, Que.", (Dept. of Finance, unpublished, June 20, 1987), "Speech, Sherbrooke Chamber of Commerce", (Dept. of Finance, unpublished, Feb. 16, 1988).

[25] D.A. Dodge, "The Economic Impact of Tax Reform", in Mintz and Whalley, *The Economic Impacts of Tax Reform*, (Toronto, Canadian Tax Foundation, 1989), 39,41.

Proposed changes were intended to increase tax relief for lower-income taxpayers, shift the benefits of several major tax preferences from upper to lower-income taxpayers, and reduce the number of tax benefits and tax shelters available to upper-income individuals and profitable corporations without interfering with normal business practices. This had the effect of increasing the progressivity of the income tax system for all but the very top income earners,[26] helping to insulate Wilson against criticism that he had helped the rich at the expense of lower and lower-middle income taxpayers. Maslove's analysis of the economic impacts of tax reform suggested that "comparing the post-reform system to status quo 1988, virtually all families benefit".

> Effective average tax rates declined for the lowest 20 percent of families [by income group] between 1984 and SQ [status quo] 1988, and between 1984 and PR [post-reform] 1988. The top 1 percent of families experienced an increase in average tax rates between 1984 and SQ 1988, but an even larger decrease in moving to PR 1988. Over the entire period, tax changes were progressive for the lowest 70 percent of families (up to about $ 36,000 in income in 1984) and regressive for the upper 30 percent.[27]

It was vital to Wilson and his officials that the substance of tax reform lived up to its slogan: *"tax reform equals lower taxes"*. The most time-consuming element in designing the White Paper was the effort by senior officials to craft the package so that the government could demonstrate that up to 80 percent of taxpayers -- and a majority of every major social and income group -- would be better off under the new tax system than under the old one.[28] Central to this theme was the conversion of a series of personal tax

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[26] Frank W. Vermaeten, Irwin Gillespie, and Arndt Vermaeten, "Tax Incidence in Canada", *Canadian Tax Journal* 42(2), [1994], 348-416. The data in this study, based on 1988 tax and income figures, is based on an economic analysis including all federal and provincial taxes and a broad economic definition of income. However, it confirms that the effective PIT rates as a percentage of market income is slightly progressive for all income groups.

[27] Allan M. Maslove, "The Distributional Impacts of Personal Income Tax Reform: 1984 to 1988", in *Tax Reform in Canada: the process and impact,* 52-53.

[28] Interview, senior Finance Department official. (D1)

deductions, whose value increased with the marginal tax rate of the taxpayer, into credits. These included the basic personal deduction, deductions for dependent family members, Canada Pension Plan and Unemployment Insurance premiums, education and tuition, medical expenses and charitable deductions.[29] Rather than lowering the *income* subject to tax, the White Paper sought to *equalize* the value of tax preferences to individual taxpayers above the basic tax collection threshold. As the tax benefit of these deductions, with the exception of charitable contributions, would be calculated on the value of the lowest (17 percent) PIT rate rather than increasing with marginal tax rates, the government could use the added revenues to reduce tax rates for all income groups.

> The overall balance of tax reform can be summed up in a nutshell. People will pay less; corporations will pay more. Most low-income people will pay less; many upper-income will pay more. People at similar income levels will pay more similar amounts of tax. And all of us will pay taxes through a system that supports and complements economic growth and social priorities.[30]

Other major changes to the personal income tax structure in the White Paper included the lowering and compression of the rate structure. The number of tax brackets was reduced from ten to three: 17 percent for Canadians with taxable incomes below $ 27,500, a 26 percent marginal rate on incomes between $ 27,500 and $ 55,000, and a top 29 percent rate for incomes over $ 55,000. This would mean a reduction in the top federal-provincial marginal rate from about 50 percent to about 44 percent.[31] Revenue losses from rate reductions were offset by a number of base broadening measures. Some

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29 Hon. Michael Wilson, *The White Paper - Income Tax Reform,* (Ottawa, Department of Finance, June 18, 1987), 29-32. The charitable donation credit was to be applied at the top 29 percent rate for contributions over $ 250. While this was intended to protect the voluntary sector against a potential loss of donations, it was one of the most bitterly resisted changes to the tax system. [Interviews, Don Blenkarn, MP, senior Finance Department official (D1).]

30 Hon. Michael Wilson, Speech to Financial Post Conference on Tax Reform, Toronto, (Ottawa, Dept. of Finance, unpublished, June 25, 1987), 3.

31 Wilson, *The White Paper: Tax Reform 1987,* (Ottawa, Dept. of Finance, June 18, 1987), 26-28.

of these deductions were widely used, notably the $ 1,000 interest and dividend income deduction, the $ 500 employment expense deduction and write-offs of personal automobiles used for business purposes.[32] Others were deductions used primarily by investors and the self-employed: strict limits on home office expenses, reduced deductions for business and entertainment expenses, and special write-offs for Canadian film corporations and MURBS.[33]

Corporate income tax changes were intended to reduce tax deferrals and to bring the taxable profits of corporations more closely into line with profits reported in financial statements. White Paper measures brought corporate tax rates closer to post-reform levels in the United States, while reducing capital cost allowances for several sectors, and limiting the preferred tax status of resource industries and financial institutions.[34]

TABLE 13-3
TAX REFORM 1987 -- PROPOSED
FEDERAL CORPORATE INCOME TAX RATES

	Current statutory rates	New rates, effective July 1 1988	1989	1990	1991
General Business	36	28	28	28	28
Manufacturing Business	30	26	25	24	23
General Small Business	15	12	12	12	12
Small Manufacturing Business	10	12	12	12	12

[SOURCE: *The White Paper, Income Tax Reform*, (Ottawa, Department of Finance, June 18, 1987), 98.]

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32 Ibid., 34-35. The treatment of automobile expenses was one of the most bitterly contested provisions of the White Paper. It received several major revisions, before a largely truncated version was passed by the Commons' Finance Committee in August 1988.

33 MURBS: Multiple Urban Residential Buildings (rental housing), ibid.

34 Hon. Michael H. Wilson, *Tax Reform 1987: Income Tax Reform*, (Ottawa, Dept. of Finance, June 18, 1987, 98-126; *Supplementary Information Relating to Tax Reform Measures*, (Ottawa, Department of Finance, December 16, 1987), 51-97.

Wilson made a major effort after the tabling of the White Paper to sell his tax reform proposals to the business community and to Canadians as a whole. In the three weeks after the release of the White Paper, he toured the country making at least 10 speeches to showcase his tax reform proposals before a series of national and regional audiences. Wilson presented tax reform as a majoritarian, non-ideological package, consistent with the economic and social objectives of his audience. He stressed competitiveness and balance to business audiences, fairness to social policy groups, and regional concerns outside of Ontario.[35]

Unlike 1981, when the Department of Finance had been inadequately prepared to assist Members of Parliament to answer constituents' questions and concerns about tax reform, the Department's Communications Branch churned out hundreds of thousands of pamphlets targeted at the concerns of seniors, women, small businesses, parents, and other easily identifiable groups. While it is unlikely that these materials had a major impact on public opinion, they provided the superficial impression that the government had thought about these concerns before introducing its proposals.[36]

Following the negotiation of the Canada-U.S. Free Trade Agreement in September 1987, the public spotlight shifted away from tax reform. However, by then, Wilson had

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[35] "Minister's Speeches", Department of Finance archives: Order of Chartered Accountants, Rimouski, PQ, June 20, 1987; Canadian and Empire Clubs, Toronto, June 24, 1987; Financial Post Conference on Tax Reform, Toronto, June 25, 1987; Vancouver Board of Trade, June 26, 1987; Edmonton Board of Trade, June 28, 1987; Montreal Board of Trade, June 29, 1987; Halifax Board of Trade, July 2, 1987; St. John's Chamber of Commerce, July 3, 1987; Spruce Grove, Alta., July 8, 1987; Yukon Territory Chamber of Commerce, July 11, 1987; Kinsmen National Convention, Windsor, ON, August 19, 1987; Kiwanis Club of West Toronto, Aug. 24, 1987. Wilson was almost as active on the rubber chicken circuit in the four months before the release of the White Paper.

[36] Interviews, Department of Finance official. [ADM-6] A similar strategy was employed during the GST debate of 1989-90. The Department of Finance again distributed a blizzard of pamphlets targeted at various groups. In the face of highly publicized public and interest group opposition, they did little to counter the public backlash.

established control of the policy agenda. Discussion was largely confined to questions of detail. The details of tax reform were clearly targeted to the concerns of the interest groups and tax practitioners which dominate the broader tax policy community.

This strategy allowed Wilson the luxury of building a constituency for tax reform on a sector-by-sector basis, rather than facing an angry coalition of aggrieved interests. The prospect of free trade and the imminence of sales tax reform largely neutralized potential opposition from the corporate sector, which had reacted with outrage to the MacEachen budget of 1981. Free trade and the rollback of the National Energy Program did much the same for the energy sector. The rhetoric of fairness, the approaching reality of the Minimum Tax, and the promise to convert many Income Tax deductions to credits won the acquiescence of the social policy community, if only as a "second-best" strategy.[37] While the left dismissed Wilson's attack on "tax expenditures" as minimal, he easily brushed off its calls for a minimum corporate tax.

> There are those who say we should have gone further -- that what is needed in a corporate minimum tax. It's the kind of easy answer we have heard before -- easy, simple and wrong. Because what they are really saying is that we should tax companies regardless of circumstances, for example, showing a profit after years of heavy losses.[38]

The investment and financial community, though concerned with many technical details and the prospect of higher capital gains taxes, was tranquillized by comprehensive consultations followed by several changes to legislation far too technical to engage public

[37] Evert A. Lindquist, "Improving the Scrutiny of Tax Expenditures in Ontario: Comparative Perspectives and Recommendations", in Allan M. Maslove, ed., *Taxing and Spending: Issues of Process*, (Toronto, University of Toronto Press, 1994), 72-73; G. Bruce Doern, "Tax Expenditure Decisions and the Budgetary Decision Process", in K.A. Graham, *How Ottawa Spends 1989-90: The Buck Stops Where?*, (Ottawa, Carleton Univ. Press, 1989), 91-92.

[38] Hon. Michael H. Wilson, Speech to Canadian and Empire Clubs, Toronto, Release # 87-106, (Ottawa, Department of Finance, June 24, 1987), 6. After the 1988 election, Wilson imposed a Large Corporations Tax to limit the pyramiding of tax preferences. However, it maintained the existing carry forward of business losses against future tax liabilities.

attention, let alone understanding.[39] Farmers and small businesses, the most volatile and broadly-based of the producer groups which had reacted with outrage to MacEachen in 1981, were threatened with few major changes in their tax bases -- and wooed with significant offsets.[40]

CONSULTATIONS AND TRADE-OFFS: Internal and External

The consultation process, combining both private Finance Department consultations and public hearings of the Commons' Finance Committee provided a safety valve for public concerns. Consultations were carried on at three levels. Wilson personally consulted with provincial counterparts, senior tax professionals and business executives.

> A lot of time was spent massaging tax professionals ... to make sure they wouldn't come out swinging because of a tax gaffe that would interfere with the economy.[41]

Department officials consulted widely among tax professionals, meeting with senior tax lawyers and accountants in major regional centers before the release of the White Paper, and retaining several senior practitioners to assist in the legislative drafting of Bill C-139. Corporate tax policy specialists actually visited a cross-section of large and small companies in several sectors to "field-test" the assumptions underlying planned changes.[42]

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[39] These related primarily to government attempts to tax the insurance industry. Changes to the Part XII tax were abandoned after 1989 because of excessive complexity and failure to collect any significant revenues.

[40] These included full access to the lifetime $ 500,000 capital gains exemption which had been capped at $ 100,000 for other investors, increased RRSP contribution limits, tax simplification and for farmers, the continuation of massive federal subsidies.

[41] Interview, former Ministerial staff. (F02)

[42] Interview, former Department officials. (F07)

The Commons' Finance Committee

However, the most visible element of the consultation process were the hearings of the Commons Finance Committee under its astute and iconoclastic chairman, Don Blenkarn. The Finance Committee was the most visible and dynamic Parliamentary Committee to emerge from the 1985 reforms of the rules and structure of the House of Commons.[43] Blenkarn combined a high level of personal competence and a flair for timely publicity. He built an independent power-base unusual for a back-bench Member of Parliament using many of the same tactics that had enabled the Senate Banking Committee and its Chairman, Salter Hayden, to play an effective role in critiquing tax legislation for many years. These included the leadership of a strong Chairman, the effective support of professional experts, an emphasis on consensus-building within the Committee and a general avoidance of partisan attacks on the government.

Blenkarn began by retaining David Weyman as the Committee's principal consultant. Weyman, a senior partner of a major national accounting firm, had just completed a two-year stint as Assistant Deputy Minister, Tax Policy and Legislation, in the Department of Finance. While committed to the general outline of Finance's agenda, he provided Blenkarn with the expertise necessary to challenge Finance's autonomy, if necessary. Weyman and other professional advisors briefed the Committee on the technical details of government proposals in order to bring members "up to speed" on the economic and technical context of each stage of the goverment's proposals.

Blenkarn brought opposition MPs into the policy-making process to a degree fairly unusual at the time. While Wilson and his officials looked to the Committee to remove obstacles to their objectives, Blenkarn tried to make the atmosphere of the Committee as

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43 These rule changes were implemented in the wake of the McGrath Committee report of 1985.

non-partisan as possible. He sought to accommodate the concerns of the Liberals' Raymond Garneau and the NDP's Michael Cassidy over perceived abuses of the tax system into Committee discussions and its initial reports, in effect offering them a degree of influence over technical details in return for opposition support of the broad outlines of tax reform. Blenkarn's success in consensus-building increased the Committee's leverage in dealing with Finance on both the White Paper and the final stages of Wilson's tax reform legislation.

The Committee's first set of hearings, which began shortly after the release of the *Guidelines*[44] paper in October 1986, was designed to gauge the response of key professional and interest groups to the general direction of tax reform. For most of these groups, the first stage of Committee hearings was an opportunity to insert their particular goals on the public agenda, or alternately to point out the potential dangers of tax reform to be avoided in preparing the White Paper. A few groups, such the Business Council on National Issues, suggested strategic road maps for tax reform.[45] Most responded to Wilson's statement of general principles in kind, while identifying specific objectives to be achieved or protected.

While most business groups expressed support for a rate reduction exercise comparable to the recent U.S. tax reforms, response to Wilson's informal proposals for a Business Transfer Tax were decidedly mixed. Social policy groups, while calling for a major reduction in tax expenditures, emphasized the desirability of converting a number of tax

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44 Wilson, *Guidelines to Tax Reform*, October 23, 1986, op. cit.

45 Business Council on National Issues, Task Force on Taxation Policy, *Taxation Policy Reform in Canada*.

deductions into tax credits which would convey the same economic benefit regardless of income.[46]

TABLE 13-4
COMMONS' FINANCE COMMITTEE HEARINGS ON TAX REFORM

	Part I General Principles Oct. 1986 - April 1987	Part II White Paper Hearings June-Nov. 1987	Part III Sales Tax Changes Jan.- June 1988	Part IV Draft Bill & C-139 May-Aug. 1988
# of HEARINGS	25	41	15+	13
# of WITNESSES	25	174	20	2
FINANCE/REVENUE OFFICIALS	5 (hearings)	12 (hearings)	2 (hearings)	12 (hearings)
OTHER GOVERNMENT (Broad Public Sector)	--	8		
COMMITTEE CONSULTANTS			5 (hearings)	
BUSINESS ASSOCIATIONS	13	63	10	
INDIVIDUAL BUSINESSES	--	30	4	
AGRICULTURAL GROUPS	1	14	--	
PROFESSIONALS/ ECONOMISTS	6	14	4	1
LABOUR UNIONS	--	9	--	
WOMENS, SENIORS SOCIAL POLICY GROUPS	3	18	--	
CULTURAL GROUPS	1	5	--	
VOLUNTARY SECTOR	--	4	--	
INDIVIDUALS	--	4	--	

+Includes January 1988 hearings on idea of National Sales Tax, March 9 on sales tax changes included in 1988 budget, Hearings Apr.26-May 11,1988 on 1988 sales tax changes. Does not include meetings from Finance Committee's Feb. 1988 trip to New Zealand.

(SOURCE: Standing Committee on Finance, Trade and Economic Affairs, *Minutes and Proceedings*, (Ottawa, House of Commons, 2nd Session, 33rd Parliament, 1986-88.)

46 See comments of Ken Battle, National Council on Welfare, *Minutes and Proceedings*, Commons' Finance Committee Issue # 15, December 9, 1986; Havi Echenberg, National Anti-Poverty Organization, ibid., Issue # 43, March 23, 1983.

Following Wilson's tabling of the White Paper on June 18, 1987, the Committee held another, more intensive series of hearings. It heard 174 witnesses in 41 hearings, several in major cities across Canada.[47] The make-up of witnesses in the hearings provide a fair assessment of the character of the broader tax policy community and the depth of institutional involvement with the tax system. More than half the witnesses represented business associations and individual firms -- 93 in total. Eighteen represented a range of women's, seniors' and social policy groups; fourteen spoke for various elements of the farm sector; nine for public and private sector unions; fourteen were tax professionals or economists. (See Table 13-4.)

One major purpose of the Committee hearings was to defend the broad thrust of the White Paper proposals while identifying potential problem areas in which they might create serious political controversy or undue economic disruption. In November 1987, the Committee tabled a 168-page report with 81 recommendations making a number of "fine-tuning" suggestions to the White Paper. Although both opposition parties tabled dissenting reports, Blenkarn succeeded in maintaining consensus on a majority of recommendations. The details of many of these proposed changes were negotiated in private meetings between Blenkarn, Wilson and senior officials of the Department.[48]

The final stage of the Committee's hearings involved detailed discussions with senior Departmental officials on the technical details of draft legislation in May-June 1988 and on Bill C-139 itself following second reading in August. While most major issues had been resolved at this stage, the Committee dug in its heels on a few items of historic or

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[47] Commons Finance Committee, *Report on the White Paper on Tax Reform,* Stage 1, (Ottawa, House of Commons, November 1987), 141-144.

[48] See Proceedings # 164, 165, 166, 168 & 170 of Commons' Committee on Finance and Economic Affairs, May-June 1988, for hearings on wide range of technical issues; the Committee's Report (Proceedings # 177, Sept. 18, 1988) is summarized in "Checklist", *Canadian Tax Journal* 33(5), 1337-39.

TABLE 13-5
COMMONS' FINANCE COMMITTEE
RECOMMENDATIONS FOR CHANGES TO WHITE PAPER (Excerpts)

Conversion of Deductions to Credits

» allow full, not partial deductibility of CPP/UIC premiums paid by employees

Child benefits

» minor increases in size of child benefit for large families
» parent with higher income required to include family allowances in income (more progressive clawback)

Capital Gains Taxation

» increase inclusion rate on capital gains from 1/2 to 2/3 as transition arrangement (88-89)
» full inclusion of capital gains in income (NOT ADOPTED)
» introduce five-year active business use rule for farms or small businesses to qualify for capital gains exemption (NOT ADOPTED)

Automobile Taxation

» allow deduction of car expenses proportional to business mileage, less $ 500.

Corporate Taxation

» introduce "comprehensive Advance Corporations Tax" payable on dividends (NOT ADOPTED)
» increase proposed CCA on manufacturing & processing equipment from 25% to 30%. (NOT ADOPTED)
» phase-out of flow-through shares in resource sector

Financial Institutions

» introduce "alternative minimum margin tax" on Canadian earnings of financial institutions (adopted in alt. form)
» eliminate proposed "investment income tax" on life insurance companies

Sales Tax Reform

» eliminate proposed shift of Federal Sales Tax to wholesale level on marketing companies associated with manufacturers.

[SOURCE: Standing Committee on Finance and Economic Affairs Report on the White Paper on Tax Reform (Stage 1), Issue # 125, (Ottawa, House of Commons, November 3, 1987.]

symbolic importance to members, most notably, definitions of farm income, the deductibility of R&D expenses and, that hardy perennial, the deductibility of automobile expenses.[49]

The Finance Committee served as a major instrument for the legitimation of tax reform. It provided a vehicle for consensus-building and the constructive involvement of both government and opposition members in the design of legislation. Blenkarn and the Opposition critics, Liberal Raymond Garneau and New Democrat Michael Cassidy, demonstrated that a parliamentary committee could transcend much of the normal partisanship of the House of Commons to improve a major government initiative. The Committee also provided a forum for a broad range of interest groups to make their case, and to demonstrate that tax reform could pass the test of organized public opinion.

CONCLUSION

The income tax reforms of 1987-88 were the first attempt at large-scale tax reform in forty-years to achieve a broad, if grudging consensus, broadly acceptable to tax professionals, the business community, the news media and the general public.[50] They represented a more-or-less consensual effort on the part of the federal government, the Parliamentary opposition, major interest groups and the tax community to lower marginal tax rates and broaden the tax base in the wake of similar reforms in the United States. They led to a closer integration of tax preferences and income transfer programs for lower

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[49] Commons' Finance Committee, *Minutes and Proceedings*, Issue # 177, 34-66.

[50] The last one was the Income Tax Act of 1949, arising out of the work of the Ives Royal Commission on Taxation. Les MacDonald, *Taxing Comprehensive Income: Power and Participation in Canadian Politics 1962-1972*, Unpublished Ph.D. Dissertation, (Carleton University, 1985).

and middle income taxpayers. They also led to a more even distribution of corporate tax burdens, even while lowering corporate tax rates.

By avoiding the bitter political battles that had characterized attempts at tax reform in 1967-71 and 1981-82, Wilson's tax reforms of 1987-88 were a political success. While debate on tax issues in the election of 1988 was largely drowned out by the popular focus on free trade with the United States, the failure of any political party to make tax reform a major election issue indicates the political skill with which it had been handled in the previous two years.

While often dismissed by critics as politically naive, Wilson helped to create the conditions for his own political success by deliberately avoiding major challenges to entrenched political and constitutional interests. This is consistent with the pragmatic, broadly non-ideological approach to tax policy pursued by Wilson during his first term as Minister of Finance. Given the Mulroney government's weak political standing in 1987, the process of consensus-building depended on the perception that his reforms did not threaten the vital fiscal or economic interests of the provinces, the competitive position of large corporations or small businesses, or the income security of lower and middle income taxpayers. By taking a systematic approach to consultation, he was able to ensure that by the time the White Paper was introduced in June 1987, virtually all the ideas contained in it had become familiar and relatively unthreatening not just to business interests and tax professionals but to social policy groups as well. Finally, he was able to take advantage of external circumstances. Most tax innovations in 1987-88 followed those of Canada's major trading partners rather than attempting to lead them or to challenge international economic relationships. While external conditions made some form of tax reform unavoidable, the government's own growing unpopularity forced Wilson to minimize the political risks associated with those changes.

Wilson's political caution resulted in the deferral or avoidance of several major issues which could have shattered the fragile consensus on which tax reform was built. Faced with quiet but persistent opposition from cabinet, caucus and small business interests, he postponed his stated goal of restructuring the sales tax system at the same time as income tax reform. Unlike Allan MacEachen in 1981, he did not attempt to link tax reform to his larger deficit reduction goals, thus avoiding challenges to tax reform as a zero-sum or negative-sum game. Instead, he increased taxes in 1985, 1986, and 1989. Thus, income tax reform can be seen as a temporary rebate against a larger backdrop of rising taxes.

Wilson's final "fudge" on tax reform was equally important. The federal promise that tax reform would mean lower taxes was largely dependent on provincial governments exercising self-restraint by harmonizing their tax policies with those of the federal government. If the provinces took advantage of added revenues from federal base broadening without matching federal rate reductions -- or even raised their tax rates, this would undercut the political and economic logic of Wilson's tax simplification plan. However, since he would have to depend on provincial goodwill to sell the idea of a National Sales Tax, he refused to link tax harmonization to the one major fiscal policy lever at his disposal: the maintenance of federal transfers to the provinces. Thus, a series of provincial tax increases between 1989 and 1993, most notably in Ontario, made the benefits of Wilson's rate reductions rather short-lived in most parts of the country.

Some risks, however, could not be deferred indefinitely. Unable to win provincial support for Sales Tax Reform, Wilson acted unilaterally in 1989-90 to introduce the Goods and Services Tax. Without the sweetener of income tax reductions which had already been offset by provincial tax increases, the federal government's popularity plummeted from 43 percent at the election of 1988 to below 20 percent throughout most of 1991 and 1992. Arguably, the introduction of a Business Transfer Tax in 1987 would have shattered the fragile Tory coalition which won the 1988 election. However, attempting to force through changes to both the economic constitution (the GST and free trade) and the political constitution (The Meech Lake and Charlottetown Accords), despite widespread public opposition, aroused enough voter resentment to shatter the Conservative Party in the 1993 federal elections.

Evaluating Tax Reform -- A Policy Perspective

While Wilson's tax reforms of 1987-88 were a political success at the time, what was their long-term policy impact? Some observers have criticized his reforms as half-measures which failed to address what they view as the fundamental inequities of the tax system, and are thus undeserving of the label of "real" tax reform.[51] A fairer assessment of the effectiveness of tax reform can be based on the durability of Wilson's own proclaimed objectives: base broadening, a flattened rate structure and the promise of "lower taxes", in the fast- changing economic environment of the 1990s.

Unlike previous tax reform programs, the 1987-88 reforms have not been followed by a serious erosion of the tax base as Finance Ministers subsequently scrambled to appease aggrieved business and voter interests. Post-reform policy changes introduced by Wilson himself, his immediate successor, Don Mazankowski (1991-93), and Liberal Paul Martin (1993-) have generally followed the broad outlines of policies introduced between 1985 and 1988. These changes include the imposition of a Large Corporations Tax integrated with the corporate income tax (1989), the consolidation of most family-related transfers and tax preferences into a more generous tax credit targeted exclusively to lower and middle-income families (1991), and the gradual phasing out of the capital gains exemption for all taxpayers except farmers and small business owners (1992-94). On this

[51] Linda McQuaig, *Behind Closed Doors: how the rich won control of Canada's tax system and ended up richer*, (Toronto, Viking/Penguin, 1987).

level, Wilson can claim to have left his successors both a stable tax base and the least hospitable political climate for special interest pleading on tax issues in many years.

The federal income tax rate structure has also proven relatively stable in the years since 1988. While federal rates have risen slightly, the largest change both to overall tax rates and the progressivity of the tax structure has come from increases in provincial income taxes and surtaxes. This is mainly due to fiscal competition between Ottawa and the provinces -- sometimes characterized as "deficit offloading". Most provinces declined to curb the rapid growth in their spending to accommodate the modest tax reductions contained in federal tax reforms. (See Table 13-6.)

TABLE 13-6
FEDERAL AND PROVINCIAL PROGRAM SPENDING AND FEDERAL-PROVINCIAL TRANSFERS

	Per capita program spending growth 1984-85 - 1989-90	Per capita program spending growth 1989-90 - 1994-95
Federal	11.3%	9.6%
Federal cash transfers to provinces	18.0%	0.1%*
Provincial average	32.3%	14.0%

* Federal per capita transfers increased 10.8% between 1989-90 and 1992-93, subsequently declining to 1989-90 levels between 1992-93 and 1994-95.

SOURCES: Canadian Tax Notes, (Toronto, Canadian Tax Foundation, July 18, 1995), 51; Fiscal and Economic Reference Tables, Sept. 1994; Hon. Paul Martin, Budget Speech, (Ottawa, Dept. of Finance, Feb. 1995).

They opted instead to levy comparable or higher tax rates on the new, broader federal tax base, thus increasing total provincial revenues. When Wilson retaliated in 1990 by freezing per capita transfers to the provinces, several provinces opted for further tax increases, sometimes by levying substantial surtaxes on middle and upper-income taxpayers.

As a result, the personal income tax structure has become more steeply progressive in four provinces -- Ontario, Nova Scotia, Saskatchewan and British Columbia.[52] (See Table 13-7.)

TABLE 13-7
PROVINCIAL PERSONAL INCOME TAX RATES AS PERCENTAGE OF BASIC FEDERAL TAX: 1988-94

	1988	1994	Top fed.-prov.rate 1994	Surtax(es) /threshold	
Nfld.	60%	69%	51.3%	n/a	
P.E.I.	56%	59.5%	50.3%	10%	$ 92,734
N.S.	56.5%	59.5%	53.8%	20%	$ 60,862
				30%	$ 81.137
N.B.	60%	64%	51.4%	8%	$ 93,034
Quebec	n.a.	n.a.	52.9%	5%	$ 33,488
				10%	$ 55,210
Ontario	51%	58%	53.2%	20%	$ 52,279
				30%	$ 67,855
Manitoba	54%	52%	50.4%	2%	$ 30,001
Saskatchewan	50%	50%	51.9%	15%	$ 40,361
Alberta	46.5%	45.5%	46.1%	8%	$ 45,390
B.C.	51.5%	52.5%	54.2%	20%	$ 54,632
				30%	$ 79,406

SOURCE: *The National Finances, 1994*, Tables 7.9, 7.14, 7.15, (Toronto, Canadian Tax Foundation, 1994).

While this does not necessarily reflect on the "success" of federal income tax reforms in creating a more stable environment for tax policy, it underlines the essential futility of attempting to solve all tax problems as part of a single comprehensive tax reform strategy.

The concluding chapter will attempt to summarize the lessons of tax reform in the 1980s and assess a political theory of tax reform for the 1990s.

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52 *The National Finances*, (Toronto, Canadian Tax Foundation, 1994), 7:12-22. Not surprisingly, three of these provinces had NDP governments in the early 1990s.

CHAPTER 14 -- CONCLUSION

This study has examined the nature of the Canadian tax system as a reflection of competing ideas, institutions and interests, and how they have interacted since the 1970s to influence the timing, nature and direction of tax reform. It has found that rather than conforming to any single theoretical framework, the Canadian tax structure reflects a pragmatic balance of competing interests, values and policy priorities -- each with well-entrenched defender within government and the political system. As such, it has largely defied the attempts of Finance Ministers, tax theorists or ideologues to subordinate it to a single, overarching strategy for comprehensive tax reform. From this study, we may draw the following theoretical and practical conclusions about the tax system as a quasi-constitutional structure and about the conditions necessary for successful tax reform.

1. **The tax system is part of an economic constitution which is as durable and pervasive in its impact as the political constitution which defines and limits the powers of the state and the rights of individuals.**

The functions of the modern state -- and its demands for revenue -- are so extensive that the tax system has become deeply embedded in the economic and social lives and expectations of Canadians. While widespread public acceptance of the tax system as an instrument of economic and social policy gives governments substantial power to influence the behaviour and choices of Canadians, it also limits the autonomy of Finance Ministers, particularly their capacity to introduce major structural policy changes without a broad consensus among societal interests. Thus, the tax system has become, in effect, part of an economic constitution that may evolve over time but which is as resistant to large-scale change as Canada's political constitution.

The timing, extent and political effectiveness of tax reform depend on the institutional capacity of the federal government, especially the Department of Finance, to design an alternative tax system that will achieve its fiscal and other policy objectives without excessive political and economic disruption. To do this, the Department must be able to design a tax reform package that will combine respect for existing economic and social relationships with adequate provisions to facilitate the transition to the new system.

2. **The major elements of the tax structure reflect a political consensus on a nation's basic social and economic institutions, values and priorities. For many groups in society, certain aspects of the tax structure have taken on the character of entrenched "property rights" through long usage and broad political acceptance of their legitimacy.**

Some aspects of the structure and administration of tax laws are constitutionalized either as a product of the federal division of powers, intergovernmental agreements or the accumulation of legal precedents. These include the federal-provincial tax collection agreements and the right of taxpayers to minimize their taxes within the law. Others, including security against retrospective taxation, the tax treatment of retirement savings, small businesses and the capital gains exemption on principal residences, achieve the normative status of an "economic right" through the passage of time or long-standing legitimization through the political process. When proposed tax reforms are seen to threaten those rights and entitlements, (even when they are presented as "rational" in the context of comprehensive tax reform or other policy objectives), they are likely to provoke a backlash which can threaten their political viability.

3. **A viable political theory of tax reform must begin with the tax system as it is -- not as we might wish it to be in the best of all possible worlds.**

The range and diversity of objectives, interests and ideologies which have been accommodated within the tax structure over time strongly suggest that governments which must pursue structural changes to the tax system to achieve major policy objectives should do so in a piecemeal, sometimes even incremental fashion -- dealing with one major aspect of the tax structure at a time.

The more overloaded the agenda for structural policy change, the greater the likelihood that a government will inflict unintended damage on enough interests to form the basis for a countervailing political coalition that will wreck the consensus necessary for politically effective tax reform.

Two fatal flaws of the 1981 tax reform budget were its failure to provide for adequate transitional measures for industries affected by the budget and a more general perception that, in its pursuit of the theoretical benefits of tax reform, the government had not anticipated the practical effects of its proposals on the lives and economic well-being of its citizens in the short-term. Paradoxically, the economic crisis of 1980-82 that made tax reform politically feasible turned these technical missteps into major blunders which destroyed the budget's political credibility. Avoiding the political errors of 1981-82 became a major preoccupation of the Minister and Department of Finance in designing and marketing their tax reform proposals of the late 1980s. By deferring the challenge of sales tax reform in 1987, Michael Wilson succeeded in passing a limited, but durable income tax reform package where Allan MacEachen had failed in 1981.

The 1981 income tax reforms, coming in the wake of a series of highly confrontational policy changes, including constitutional patriation and the National Energy Program, invited ideological polarization. So, too, did the introduction of the Goods and Services Tax, which came on the heels of the bitter Free Trade election of 1988, the controversial interest and exchange rate policies of the Bank of Canada and the growing conflict over Meech Lake and constitutional reform.

4. **The introduction of substantive changes to the principles and objectives of the tax structure requires a significant shift in the intellectual framework or policy paradigm guiding national economic policies.**

The Department of Finance enjoys considerable autonomy in making tax policy as long as it is successful in communicating proposals for change as logical extensions of existing policies, usually as responses to specific policy problems -- in other words, as incremental changes within the existing social and political consensus.

Major structural changes to the tax system require a substantial and ongoing shift in the consensus among social and political actors with regard to the objectives of the tax system and the most effective means of achieving those objectives. They also frequently involve the subordination or displacement of policy objectives which may have been central to the previous policy consensus. This shift is conditional upon several major factors, including the failure of existing economic ideas and policies to answer persistent policy questions facing senior policy makers, the threat posed by such failures to the legitimacy of major political or economic institutions, the emergence of a credible alternative policy paradigm, and the acceptance of this paradigm by political and bureaucratic actors within the institutions which control national economic and tax policies.

The possibility of success in introducing new ideas as guiding concepts for tax reform can be greatly increased if a Finance Minister can point to their successful implementation in another major industrial country. Successful tax reform programs in Britain and the United States created viable precedents for Michael Wilson's income tax reforms in the mid-1980s. However, New Zealand's success in implementing a new Goods and Services Tax in 1986-87 proved to be too remote a precedent (in too controversial a context) to be politically helpful when Wilson introduced his GST in Canada.

The existence of an economic crisis, by itself, does not guarantee the political success or durability of tax reform. Obviously, those groups in society whose interests are subordinated or discarded as part of the reform process will resist tax reform unless they are compensated for the costs of change -- and thus included within the new consensus -- or unless they are pushed to the margins of political influence. The competitive nature of partisan politics and the unstable character of voter support for political parties, however, leads us to conclude that few groups are permanently excluded from a share of power, and that groups seriously disadvantaged as a result of tax reform are generally capable of organizing politically to mitigate or roll back these changes.

This is precisely what happened in the tax reform cycles of 1971-82 and 1982-88. Large segments of the business community and the middle class refused to accept the stated principles of tax reform when faced with the prospect of significantly higher taxes for themselves. This undermined support for the governing political party, and encouraged its competitors to promise wholesale revisions to the tax system following the next election. (The same pattern occurred in 1993 when both the Liberals and the Reform Party ran successful campaigns based in part on promises to replace the Goods and Services Tax.)

5. **Changes to the economic constitution require the support or acquiescence of a broad consensus of state and societal actors, including those stakeholders most directly affected by the proposed changes -- just as amendments to the political constitution require a "constitutional majority" to take effect. The political legitimacy and durability of tax reform depends in large measure on the federal government's ability to build a coalition in support of its proposals among the tax professionals and interest groups which make up the broad tax policy community.**

The political success of tax reform depends on the ability of the Minister of Finance to build a consensus on the objectives and contents of reform among three distinct groups: tax policy experts, major interest group stakeholders and the general public. However, active support from the latter is vital only when the first two groups, which form the broad tax policy community, are in serious conflict. Provincial governments must also be willing to accommodate major changes in federal tax policy, particularly in areas of taxation where federal and provincial taxes overlap.

In practical terms, the political success of tax reform in Canada has been conditional on the ability of the Department of Finance to market it as a "positive-sum game" yielding economic benefits or minimal costs for most major economic and social groups -- not just for the economy as a whole. While this may contribute to a small-scale redistribution of income, it effectively precludes the use of tax reform as an instrument for deficit reduction or the redistribution of wealth or income on a large scale.

Allan MacEachen failed to meet these requirements in 1981. He made little or no effort to build widespread popular or interest group support for his budget before its introduction or to ease the path of change through consultations and the development of adequate transitional measures. His crude rhetoric of redistribution confirmed the worst suspicions of the business community and upper-income Canadians that the budget was an ill-disguised instrument of class warfare and a power grab by the federal government at the expense of the private sector.

Revenue neutrality, or an overall reduction in the level of taxation, is a central element in building political support for tax reform. The average taxpayer cares far less about the structures or theories of taxation than about their practical impact on his existing economic obligations and opportunities. In practice, this means that during times of relative fiscal austerity, an astute Minister of Finance must separate measures requiring tax increases or spending reduction from the process of tax reform in order to preserve the political saleability of the latter. After three years of tax increases and relatively buoyant economic growth in 1985-87, Michael Wilson introduced tax reform in 1987-88 as part of a "good news budget" of personal income tax reductions for most taxpayers.

Wilson's emphasis on deficit reduction in his budgets of 1989-90, along with the concessions he had already made to win provincial support for a national value-added tax, limited his ability to purchase the consent of voters and aggrieved interests with further tax reductions when he introduced the Goods and Services Tax in 1990. This problem was aggravated by the inability of Tory strategists to decide whether to sell the GST as a fairer, more efficient and revenue neutral version of the old Federal Sales Tax or a necessary part of the government's program of deficit reduction.

6. **Building consensus on the objectives and details of tax reform depends in large measure on the use of a meaningful consultation process to allow policy stakeholders to "buy into" proposed changes and to identify and overcome potential political and institutional roadblocks.**

The Minister and Department of Finance face significant institutional constraints in navigating large scale changes to the tax system through the political process. Political leaders must be able to navigate proposed reforms through the bureaucracy, cabinet and Parliament, and must be able to overcome institutional constraints inside and outside government. In practical terms, the Minister of Finance must build sufficient credibility among stakeholder groups and the general public that cabinet colleagues, Parliament and opinion makers, including the media, are persuaded that the benefits of tax reform outweigh its political and economic risks. A well-managed consultation process is essential to mobilizing elite and public consent to policy changes that may significantly affect their economic rights and entitlements.

The consultative process for income tax reform and the initial stages of sales tax reform in 1987-88 emphasized the need for consensus-building and the accommodation of both existing business interests and social commitments within the revised tax structure. While this may have been a by-product of the Mulroney Government's political weakness at the time, it was possible because Wilson's income tax reforms were the logical result of consultations and incremental policy changes which had been taking place since the new government's election in 1984.

As a fundamentally different approach to consumption taxation, the Goods and Services Tax did not lend itself to this kind of accommodation -- in spite of some of the most extensive consultations in Canadian tax history. The government failed to convince the vast majority of Canadians, including most of the 1.8 million individuals and businesses required to collect federal sales taxes for the first time, either that it was necessary to replace the old Federal Sales Tax, that the idea of fairness (horizontal equity) required the FST's extension to a vast range of previously untaxed services, or that the much broader tax base would not result in a significant tax increase for the average Canadian. As a result, the Mulroney government suffered the political penalty for having asked Canadians for their views and then having ignored the response -- virtual annihilation in the 1993 federal election.[1]

7. **Tax reform proposals should be consistent with broad trends in international taxation in order to maintain the competitiveness of the Canadian economy with those of its major trading partners.**

The history of tax reform in the 1980s suggests that Canadian governments, political parties and organized interests are more likely to adopt new policy ideas when they have been implemented with reasonable success somewhere else. This demonstration effect was noticeably absent in 1981-82, when Allan MacEachen attempted to use tax reform as a vehicle to raise personal and corporate taxes at the same time as Ronald Reagan was cutting them in the United States. By contrast, the course of U.S. tax reform after 1986 and the prospect of free trade with the United States created both a visible example of tax

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[1] Public support for the GST dropped from 26 percent in early 1989 to 12 percent in the fall of 1990. Gallup Canada, "72% believe tax system is less fair", *Toronto Star*, December 10, 1990, A15.

reform for Michael Wilson to imitate and a ready-made coalition of interests ready to support a parallel tax reform plan in Canada. Wilson was thus able to argue convincingly that a failure to follow the Americans in lowering marginal and effective tax rates would place Canada at a serious competitive disadvantage with its largest trading partner in both trade and capital markets.

8. **A key element in building consensus and diffusing opposition to tax reform is to offer compensation to groups whose interests may be threatened by proposed reforms, thus reducing their incentive to organize a countervailing coalition.**

Finance Ministers attempting to build a consensus in support of tax reforms are often compelled to compensate aggrieved interests not only through "grandfathering" provisions and other transitional measures, but also through substantive changes in other tax provisions. Such trade-offs include Edgar Benson's decision to phase out federal inheritance taxes after 1971 as compensation for the introduction of the capital gains tax, Michael Wilson's promise of sales tax reform to diffuse big business opposition to the higher corporate taxes contained in his income tax reforms, and the introduction and expansion of sales tax credits to offset the impact of sales tax reform on lower- and middle-income families. Compensation packages have become a tradition in Canadian politics to ease the economic pain associated with a wide range of structural policy changes, from the phasing out of freight-rate subsidies to the reduction of support programs for agricultural producers and the fishery.

This lends credence to Allan Maslove's suggestion that the trade-offs necessary to achieve political support for one round of tax reform create conditions which, left to themselves, will normally result in higher tax rates, the progressive erosion of the tax base, and the renewal of pressures for tax reform.[2]

At the time of writing, there are several proposals for major structural changes to the tax system under consideration. These include major changes to the Unemployment Insurance system, a review of Canada's system of tax-funded pensions, and the beginnings of debate over the possible introduction of a flat rate income tax system.

These proposals are potentially as sweeping in scope as the fundamental changes proposed by the Carter Royal Commission in 1967. In particular, some proposals for a flat rate tax system go beyond the elimination of the progressive rate structure to a complete redefinition of the concept of income and the objectives of taxation.[3] As it is unlikely that provincial governments would accept a unilateral redesign of their tax structures by the federal government, the implementation of such a system would, of necessity, involve a redesign of the entire structure of Canadian fiscal federalism as well.

While economic theorists can debate the potential costs and benefits of such proposals, the principal lesson of this study is that tax reform is a political question -- not just an economic one -- that must be addressed with the same care and commitment to building a national consensus as the reform of a country's basic constitutional structures. Failure to do so leads either to massive political failure -- or to the introduction of a tax system with so little political legitimacy that it contains the seeds of its own destruction.

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[2] Allan Maslove, *Tax Reform in Canada*, (Montreal, Institute for Research on Public Policy, 1989).

[3] Robert E. Hall and Alvin Rabushka, *The Flat Tax*, Second Edition, (Stanford, CA, Hoover Institution Press, 1995), Rep. Dick Armey and Sen. Richard Shelby, "The Freedom and Fairness Restoration Act", (mimeo, July 1995). Similar proposals are under consideration by Canada's federal opposition parties.

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