CHAPTER VIII

EQUITY AND EFFICIENCY IN TAXATION

The Commission is directed by its terms of reference to examine whether taxation, as at present allocated and imposed in Canada, is as equitable and efficient as can be devised. The examination has been made in Book I\(^1\) and reasons have been given for returning a negative answer to the question thus propounded. The financial plan recommended by the Commission as Plan I has been devised with a view to effecting some important improvements in the Canadian system of taxation and to making possible a thorough reform of that system in respect both of its equity and its efficiency. The purpose of the present chapter is to advance a number of recommendations and suggestions for reform and to show how the adoption of Plan I would make it possible to give effect to them. Equity and efficiency in taxation are closely related and in practice neither can be pursued without regard for the other. It will, however, be convenient to direct discussion in the first place to efficiency in taxation.

EFFICIENCY IN TAXATION

Efficiency in taxation has been defined in Book I\(^2\) as skill in collecting a given amount of revenue with the least possible burden on the national income. Taxation, taken together with the expenditure which it defrays, does not necessarily impair the national income. Indeed, the national income should be enlarged by the influence of the services which governments supply, and, if wise policies are followed, the form which the national income takes as a result of taxation and expenditure will be preferable to that which it would have taken had the functions of government been more restricted. While the present chapter is devoted to equity and efficiency in taxation it must be remembered that it is equally important that governmental expenditures should also be governed by considerations of efficiency and equity. However, as the proportion of the total national income which is taken by governments rises, it becomes only too probable that taxes will be employed which seriously impede the expansion of the national income. In calculating the proportion of the income which is taken by governments their non-tax revenue in the form of licences, liquor store profits and so forth must be included and, if social services are financed by compulsory contributions, these too must be counted.

Inefficiency of Taxation on Costs.—Generally speaking, the national income will be restricted if revenue is raised in ways which lead to an increase in production and business costs. To this general proposition there is an obvious exception in the case of taxes which appear to increase the costs of an industry but which, in so doing, merely operate to drag into the open and impose upon it concealed costs which had previously been borne by the public, e.g., taxes on vehicles which damage the roads, levies to provide compensation for those injured in industrial accidents, or to provide maintenance for those thrown out of employment. In these cases it is true that a marginal firm, or even a marginal industry, may be eliminated, but in the long run its disappearance should be socially beneficial, as it is likely to be replaced by a firm, or an industry, which can pay its way. Taxation which forces an industry to bear its legitimate costs will sometimes operate, just as minimum wage laws may operate, to destroy a substandard industry.

But, except in a special case of this character, it is very undesirable that taxation should eliminate either a firm or an industry by destroying the margin of profit which enables it to remain in operation. This is precisely what taxes which increase costs of production tend to do. Many firms and many industries are, no doubt, able to bear these taxes. But firms which are struggling to survive may find that taxes affecting their costs of production compel them to raise their prices, and that although their competitors also have to raise their prices, their sales fall off because of diminished consumption. In the long run these struggling, or marginal firms, may find that their business has become unprofitable or, worse still, that they can continue in business only at a loss. The result will be that marginal firms will tend to disappear and that other firms which had formerly had a comfortable margin of profit will in their turn become marginal. At the same time

—1 Ch. VIII.
—2 Ibid.
new enterprises will be deterred from entering a business in which costs have been raised by taxation, and consumption restricted by high prices. The result of the tendency of marginal firms to disappear and of the tendency of potential investors to refrain from engaging in new enterprises, is that both labour and capital resources will be thrown out of employment and that the national income will be correspondingly diminished. Out of this diminished national income a larger revenue than before will have to be raised, as the unemployed will have to be maintained at the public cost. If, in order to raise the larger revenue, new taxes are imposed which bear on costs, the vicious circle will be completed.

The alternative to taxes which increase business costs lies in taxes falling on profits or other surpluses. In the long run this means that these taxes should be replaced by an expansion of the personal income tax. As an immediate measure they would presumably be replaced, in the main, by increasing the rate of tax on corporate income. This (which would result almost automatically from the implementation of Plan I) would in itself be a great step forward, for although the corporate income tax partakes of the character of a tax on costs it is paid only by businesses which show a net profit and imposes no burden whatever on enterprises which are unable to bear it. It would, therefore, occasion no diminution of the national income in the way which has been described. Nor should it exercise the same deterrent effect on new investment.

It has been shown in Book I8 that in Canada a larger part of the total revenue of governments than in other comparable countries has been raised by taxes which increase costs, and it has been shown that this harmful taxation is not merely the result of a mistaken policy which can be changed at will, but that it is a practically inevitable consequence of the present allocation of the burdens of government and of the sources of revenue as between the Dominion and the provinces. The financial arrangements which the Commission has proposed in Plan I are designed to go to the root of the evil and to remove the basic obstacle to a sound fiscal policy. By relieving provincial governments of many of the charges which they now have to meet, and transferring these charges to the Dominion, Plan I makes it possible, and necessary, for the provinces to renounce the use of taxes on corporations, personal income taxes and succession duties. The Dominion, as the sole government employing these important forms of taxation, will then be in a position to give effect to substantial reforms, some of which will follow automatically from the unification of taxing authority.

In another chapter4 a list is given of the various taxes which provinces impose on corporations in addition to those which an individual or partnership carrying on the same business would have to bear. Many of these are taxes which increase the costs of production because they have to be paid even if no net income is earned by the corporation. In practice, it is service corporations—banks, finance companies, chain stores, investment companies, trust companies and loan companies—which have suffered most from taxes based on their capital stock, or on some other index which bears no necessary relation to their earnings. In their turn the chief victims have been the white-collared workers whom these companies would have employed if they had not been forced to close this or that office, or if they had been disposed to expand their operations. And unemployment cannot develop in any section of the highly integrated Canadian economy without tending to spread, by reason of the reduced consumption of the unemployed, to other sections of the economy.

The Dominion is in a far better position than the provinces, and than the Dominion and the provinces together, to sweep away all these objectionable taxes and replace them by increasing the rate of taxation on the net incomes of corporations. As has already been suggested this reform, while it would be important, should only be preparatory to a more radical change which would shift the burden of these taxes to the personal incomes derived from business (and, of course, from other sources too). Other taxes which increase costs, of which the sales tax is the leading example, could be gradually replaced by revenue derived from the two main instruments of progressive taxation—the personal income tax and the succession duties—if, as Plan I provides, these were employed by the Dominion alone. The same use cannot, in practice, be made of these taxes if both the Dominion and the provinces use them, for the imposition of a high rate of tax in one province makes it difficult for the Dominion to increase its own rates without causing great hardship to taxpayers in that province, even though there may be much to be said for higher rates of federal taxation so far as the other provinces are concerned.

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8 ibid.

4 Pp. 110ff
cerned. The importance of reforms which would replace taxes on costs by taxes on surpluses can hardly be over-emphasized, for it is largely through the avoidance of burdens on what have been described as marginal enterprises that more sustained employment of the nation's manpower and of the nation's capital can be achieved.

Inefficiency incidental to other repressive taxes. —Avoidance of burdensome taxes on costs with their repressive effects on employment is not the only objective at which an efficient tax policy should aim. It should seek to avoid other deterrents to desirable economic behaviour and, when possible, should provide incentives to desirable behaviour. The Commission has had occasion to point out how succession duties, as at present imposed by the provinces, operate to distort investment throughout Canada in a way which is economically undesirable. Uniform succession duties which would completely eliminate the evil of double taxation of the same property, and which would minimize the possibility of evading the tax, would make it possible to derive the maximum revenue from this source with the least harm to the national income. It is theoretically conceivable that this result might be obtained by a complicated interprovincial agreement coupled with appropriate Dominion legislation, but experience shows that close voluntary co-operation of this character is extremely improbable. Even if an agreement were made it might, in addition to its beneficial consequences, have the undesirable effect of making it difficult to adjust the details of the tax from time to time to suit changing conditions. Plan I, as has been shown, would both ensure complete uniformity and afford full opportunity to modify the structure of the succession duties as experience might show to be necessary for equity as between taxpayers and for efficiency in administration.

What has been said of succession duties has its counterpart in respect of the personal income tax. In this case, however, the imposition of the same tax by both Dominion and provinces (and even by some municipalities) is not a mere possibility but an accomplished fact. The freedom of action of the Dominion is seriously cramped when it has to find taxes which will operate without causing undue hardship either in provinces which have or in those which have not their own income tax.

When the same citizen has to pay income taxes to two authorities which have different definitions of taxable income, or which allow different exemptions, or which adopt different systems of progression, or between which there is dispute as to priority in assessment, he is likely to be a more than usually unwilling taxpayer. He feels that two different taxes cannot both be right, that they cannot both be the most equitable that can be devised. Almost certainly he will think of the one less unfavourable to himself as the more equitable. Uniformity in income tax structure is conceivable as a matter of agreement, but it is improbable. Under Plan I uniformity is automatic, since there will be only one personal income tax in all Canada, and the field will be clear for perfecting the tax.

From the point of view of efficiency in taxation (as well as from that of equity which will be considered later) it is important that the tax should be perfected. It has already been suggested that the aim should be to make the personal income tax take the place of the corporate income tax which partakes of the character of a tax on business costs. These two income taxes, as they are employed today, have as one of their results that investment income in the form of dividends is taxed twice while all other income (including investment income in the form of bond interest) is taxed once only. The two taxes as now imposed make the income from corporate enterprise less vulnerable to taxation if the capital structure of the enterprise is largely composed of bonded debt. Yet this type of capital structure is hardly deserving of the encouragement which the Canadian taxation system extends to it, for the heavy fixed charges which it involves import a rigidity into the national economy which may be dangerous in times of depression. Nor is it expedient to penalize (as at present) corporate organizations as contrasted with partnerships, individual enterprises, and publicly-owned enterprises. It might be found practicable to obtain, by taxing income generally at a higher rate than at present, enough revenue to replace the revenue which would be forgone if dividends as an item in personal incomes were exempted to the extent of the tax paid upon them at the source as net corporate income.

This device, namely the retention of the corporate income tax coupled with an exemption in respect of the personal income from dividends, would put

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* As a matter of equity there is no clear reason why bond interest should have been accorded this favoured position; and as between two recipients of dividends the combined effect of the two income taxes is somewhat regressive in comparison to the alternative type of taxation.
the individual taxpayer in the same position as if he had received the dividends free from taxation as corporate income but had been required to pay personal income tax in respect of them just as on all other items in his personal income. It appears preferable for several reasons to the complete abolition of the corporate income tax. In the first place the retention of the corporate income tax is convenient if Plan I is adopted and the Dominion undertakes to hand over to the province concerned an amount equal to 10 per cent of the profits arising from the exploitation of its mineral wealth. In the second place the corporate income tax is useful in ensuring that non-residents of Canada do not escape a rate of tax appropriate to direct investment. These non-residents may be Canadians living abroad, or may be foreigners who have invested in Canada. In either case it will be for the income tax authority of their place of residence to consider whether or not their personal income taxes should be arranged so as to avoid double taxation of the portion received from Canadian dividends. In the third place the corporation tax has the advantage from the standpoint of the Government of being payable when the income is earned by the corporation without the delay incidental to its distribution to the shareholders. It would, therefore, act as a tax on undistributed profits without, however, penalizing the shareholder in the long run.

It is only fair to note two considerations which affect the equity of this change in the character of the corporate income tax which appears so important from the point of view of efficiency. The first is that the corporate income tax tends (just like the real property tax which is discussed elsewhere)\(^8\) to be capitalized and to diminish the market value of the security by the capitalized value of the existing tax. Inequitable as the tax itself may have been in its inception, its removal would produce a further inequity—namely the enrichment of holders of securities who have purchased them since the tax has been in operation. This second inequity need not, however, be a compelling reason for retaining in perpetuity a tax which is undesirable from the point of view of efficiency. It would be possible to take the bold course of exacting a tax on the windfall gain which would accrue to the holder of a security if the corporate income tax were removed (or, as has been suggested, counterbalanced by an exemption in respect of the personal income tax). Or the removal (or counterbalancing) might take place gradually. The essential thing is that new corporate enterprises should not be discouraged by the prospect of the tax. The second consideration is that the device of exemption from personal income tax does not readily meet the case of small incomes in respect of which the rate of personal income tax payable on the highest bracket of the taxable income is less than the rate at which the corporate income tax is imposed. To take an extreme example, an income too small to be taxable may consist entirely of dividends. In this case equity would demand that the holder of the income should be entitled to claim a refund of the corporate income tax, while efficiency might make it seem inexpedient to invite such claims.

There are, of course, many other ways in which the personal income tax might be improved and some of these will be discussed when equity in taxation is considered. It would, however, be beyond the scope of the Commission's instructions, and of its competence, to draw up an elaborate scheme of reform. It will suffice, at this point, to discuss the type of graduation which should be used in designing a progressive income tax. If, as at present, the successive brackets within which the income falls are taxed at progressively higher rates, the rate applicable to the highest bracket may become very high while the total income tax expressed as a percentage of the total taxable income is much lower. The effect of applying a very high rate of taxation to any increment of a large income is, of course, not entirely predictable.\(^9\) There are various possibilities. An indomitably acquisitive taxpayer might behave exactly as if no tax were imposed unless the rate on the highest bracket of his income rose to 100 per cent. A taxpayer who was mathematically inclined might work out the odds which he might reasonably accept in investing for capital appreciation rather than for an income of which governments would receive the lion's share. An altruistic taxpayer might, at little sacrifice to himself, make donations to charity within the limits allowed as exemptions for purposes of the income tax. An astute taxpayer might think of ways in which he could share his income with those who would otherwise be his dependents. It is a matter of conjecture which of these consequences would be most likely—but it is a matter which should be studied. It is only by systematic research that a taxing authority can make sure

\(^8\)P. 144.

\(^9\)In some provinces the rate on the highest bracket of a very large income would exceed 100 per cent if Dominion and provincial taxes are combined. If any very rich men lived in these provinces their behaviour might be observed.
that the indirect effects of the taxation which it imposes are not highly injurious to the national income. The ultimate consequences of taxation may be so obscure that it is quite futile to rely on the taxpayers themselves making known through their parliamentary representatives the full effects of the tax. But consequences which are obscure are not, for that reason, unimportant, and taxation offers a most fruitful field for research. It is a matter of policy whether or not the probable consequences would be desirable or undesirable. If they were considered undesirable they might be avoided by applying lower rates, than those now applied to the highest brackets of taxable incomes, to the totality of the taxable income. A typical large income might pay the same amount as at present and yet its possessor might not be subjected to the same economic incentives as at present.

Inefficiency arising from high cost of tax compliance.—In another chapter the Commission has discussed the economies which can be made in the cost of tax collection through cordial and intelligent co-operation between governments.10 Under Plan I most of these economies would be secured automatically since, in respect of three important taxes, one taxing authority would be substituted for many. There remains to be considered the important question of the cost to the taxpayer of complying with the laws which impose taxation upon him.

Representations from business organizations placed such emphasis on the cost of tax-compliance that the Commission attempted to secure some measure of this burden. Through the facilities of the Canadian Manufacturers’ Association, a questionnaire was circulated among about 100 Canadian firms constituting a representative cross-section of Canadian industry. In the hope of obtaining fuller and framer information than might otherwise have been supplied, the firms were not asked to make their identities known to the Commission. The replies were received by the Canadian Manufacturers’ Association and a code number affixed. Copies of the information were then forwarded to the Commission’s office at Ottawa. About seventy replies were received. The information came from firms ranging in size from those whose office staff consists of one person only to some of the giant corporations of the Dominion. The information thus secured included not only the costs of tax-compliance but also costs on industry arising from compliance with government inspection, audits, statistical returns, etc. The answers to the ques-

10 Sect. C, Ch. II.
to the replacement of the numerous taxes on corporations by a single tax on net corporate incomes.

In the second place, there is the cost to business of the audits designed to test the accuracy of the returns. Governments, to keep their own costs of collection low, are apt to require audits at times inconvenient to business and sometimes long in arrear. The proposals of Plan I would, if adopted, lead to a reduction in the number of audits, since there would be no further occasion for audits by provincial governments which would withdraw from the taxation of corporate income. A single taxing authority would be in a better position than ten potential taxing authorities for arranging audits in a convenient and inexpensive form and for endeavouring to avoid the evil, of which the Commission received complaint, of reopening assessments years after the event and demanding financial readjustments in cases in which there was no accusation of fraud. Some of the hardships complained of may have been incidental to the elaboration of a new form of taxation. A single taxing authority is in the best position to apply quickly and intelligently the lessons of experience.

In the third place, there is what might be termed the cost of tax avoidance. No one wishes to pay more than the law requires. Taxation statutes are often drawn in great detail but their effect is not always crystal clear. Sometimes the amount which a business is required to pay can be substantially reduced by the exercise of care in its accounting practices and by the arrangement of details of the business. From the point of view of the business the cost of obtaining skilled advice and making the adjustments indicated is part of its tax burden since it is an expense which would not be necessary but for the imposition of the tax. From the point of view of the government imposing the tax these expenses may at times appear as incidental to an effort to escape from a legitimate burden. But from any point of view it is regrettable that there should be occasion for them. The proposals in Plan I, by reducing the number and complexity of taxing statutes, should do something to reduce these expenses, although it is impossible to eliminate them altogether.\(^\text{11}\)

In the fourth place, governments demand a great deal of information from businesses which is not concerned directly, or even at all, with taxation. In the survey conducted by the Commission little distinction was made by businesses between returns required for purposes of taxation and returns incidental to other matters. It seems probable that business men treat both types of return as but different species of the same genus, namely governmental interference. This attitude is the easier to take because there seems to be widespread scepticism as to the value of much of the statistical information which governments collect. Yet much of the information is necessary for governmental purposes and useful for industry as a whole.\(^\text{12}\) The Commission suggests that a special effort should be made by statistical branches to place before the industries concerned, at the time when information is requested, the value of the compilations which will be made possible by their co-operation—a co-operation which does involve a certain expense to business. It is always possible that in the course of preparing a justification for a return it may be found that it is no longer of practical importance, in which case the contemplated demand on business need not be made.

It will be seen that the major reductions in the cost of tax compliance are dependent on the adoption of Plan I and are not possible either under present conditions or under Plan II. It is, therefore, necessary for the Commission to add that, if Plan I is not adopted, there should be close voluntary co-operation between Dominion and provinces with a view to using common returns and common audits wherever this is practicable and to combining returns so as to minimize the cost to industry.

**Equity in Taxation**

It must be the wish of every thoughtful citizen that as far as is humanly possible the burden of government should be justly distributed and that every citizen should realize that he is making a just contribution—no more and no less—to the common expenditures. Taxation moreover cannot be efficient if it is grossly unfair and if two citizens, similarly situated, are called on for grossly unequal contributions to the cost of government. From the standpoint of the efficient tax-gatherer the less heavily taxed of the two might be required to pay more. From the standpoint of the taxpayer the more heavily taxed of the two is being victimized. Taxpayers are most willing to pay when they can see that they are getting value for their taxes. In so far as they are contributing to the deadweight costs of governments, taxpayers are most willing to pay if they believe that they are being asked for

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\(^{11}\) For complaints as to number of taxing statutes see Ex. 88, Brief of Canadian Manufacturers’ Association, Ev. p. 2315.

\(^{12}\) E.g., trade statistics, accident statistics.
no more than their fair share of a common expenditure. It is, therefore, essential to efficiency in taxation that taxpayers should be convinced that the taxes exacted from them are taxes which it is fair that they should pay and which it would be unreasonable for them to grudge. But it is hard to find a canon of taxation which would be generally acceptable and it would be hard to apply any canon to the intricate mass of taxation which exists in Canada today. Any individual tax can be criticized on the ground of equity only if it operates unequally as between two citizens in substantially similar positions. When the system of taxation is considered as a whole it would, no doubt, be significant if it could be related to the income of each citizen so as to show what percentage of his income each man pays. But our taxes are very complicated and the incidence of many of them is likely to shift, so that the person who pays a tax in the first instance may not be the one who eventually bears its weight. It is, therefore, impossible to say with confidence what weight of taxation any one taxpayer bears. Nor is it possible to compute what his net income would have been had the tax system been different from what it is.

It may simplify our treatment if we exclude from our discussion of equity those taxes which are in substance a price which the taxpayer pays for specific benefits which he receives and which he is free to forgo. No problem of equity arises here (so long as the price is not exorbitant) for the taxpayer gets value for his money and his income is not diminished. Other taxes may be disregarded because they are linked to some specific benefit which the taxpayer will receive although he is given no choice in the matter. Other taxes, too, can be divorced from any consideration of equity as between taxpayers because they are designed to penalize certain forms of behaviour in the interests of society. Just as the difference between a price and a tax is a matter of degree so is that between a fine and a tax. The taxation of liquor, for instance, may in the interests of temperance be made something of a deterrent and in this case the consumer, though he may complain of intolerance, cannot well complain that he is iniquitably taxed in comparison with citizens of simpler tastes. A large, though indeterminate, part of the revenue from the tariff may be treated in this way, as being a deterrent imposed to discourage the purchase of foreign goods.

Equities as between Individuals.—Subject to such reservation as may have to be made on these grounds of public policy, it is arguable that the tax burden should be so apportioned that every citizen will contribute according to his ability. This doctrine may be understood in various ways. It may mean that each citizen should contribute a uniform percentage of his income; or that he should contribute a uniform percentage of his income after deducting the minimum cost of his maintenance and of that of his dependents; or that he should contribute a higher proportion of this surplus if it is large than if it is small. The third version of the doctrine embodies the principle of progression. It is in accordance with the idea that equality of sacrifice is what should be sought, and not far removed from the idea that the necessary revenue should be raised with the least aggregate sacrifice to the citizens. Even among those who agree that progression is desirable there is no agreement as to the optimum rate of progression.

In practice no system of taxation can claim to conform to these exalted principles, the strict application of which would condemn any form of taxation (unless partaking of the character of a price or of a fine) which fell upon incomes so low that they provide a bare subsistence for those dependent on them for support. But principles which cannot be rigidly applied may, nevertheless, serve as a guide.

As far as possible no taxation should be imposed on the necessary minimum expenditures of low income groups. If, as was contended in some of the submissions, all citizens should be made tax conscious in order that a sense of civic responsibility might be fostered, this result can best be achieved by taxes on minor luxuries such as tobacco. In Canada there are some consumption taxes which do fall on low income groups and if these groups are in the future required to pay social insurance premiums it will be important that the taxes which they now bear should be reduced or removed. In the meantime these taxes may be regarded to some extent as a means of payment for essential services rendered to these groups by the state and, therefore, as being, in a broad sense, a price paid for necessaries. This argument is the only possible justification for municipal taxes which increase the cost of the minimum of shelter, though it must be conceded that it is not clear that if taxes on cheap

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\[ \text{\footnotesize \#13 E.g. postage, water rates.} \]

\[ \text{\footnotesize \#14 E.g. local improvement taxes, premiums payable under social insurance plans so long as these do not exceed the value of the coverage.} \]

\[ \text{\footnotesize \#15 A similar argument could be used if universal non-contributory old age pensions were financed by a sales tax, the incidence of which appeared to be highly regressive.} \]
housing were removed the benefit would be immediately passed on in the form of lower rents any more than it is clear that increases in existing taxation would be passed on in the form of higher rents. In theory, however, this would be the case and it is reasonable to expect that, in the long run, there will be a dominant tendency in this direction. Some municipalities do make an attempt to exempt minimum housing requirements from the full burden of the taxation of real estate and further moves in this direction would appear desirable.

Very few taxes lend themselves readily to systematic progression and, if it is desired that the total weight of taxation should progress at a given rate, these taxes will have to progress at a much greater rate. In Canadian practice the two main progressive taxes—the personal income tax and succession duties—are imposed at very high rates on very large incomes and very large estates and exact far less from medium incomes and medium estates than do similar taxes in Great Britain, Australia, and New Zealand. The result is that while Canadian taxation is probably progressive as between medium and large incomes it is possibly regressive as between small and medium incomes. From the standpoint of equity this distribution of taxation seems objectionable and the two taxes which are under consideration could easily be adapted so as to readjust it. But a discussion based on equity and efficiency in the narrow sense would be incomplete if it did not indicate that other considerations may enter into the determination of a tax policy. For instance, large incomes and large estates may be considered as undesirable in themselves and may be taxed accordingly. Heavy taxation may, in this case, be treated as something which will have a stabilizing and democratizing effect on the community, while similar taxation of the preponderantly important class which enjoys medium incomes might be thought of as socially dangerous. Or it may be considered that the taxation of large incomes and large estates may (without being unjust) be so high as to harm the national income by discouraging both exertion and investment. In either of these cases considerations of equity would normally be modified in the interests of over-riding considerations of public policy.

Inequities as between different regions of Canada.—With these general considerations in mind the more serious inequities of Canadian taxation, as at present allocated and imposed, can be considered. The most glaring inequity is territorial. If the taxes which the citizens of each province pay (including taxes paid to the Dominion, taxes paid to the province, and taxes paid to municipalities and other taxing authorities created by the province) are expressed as a percentage of the total income of the area concerned, it has been shown in Book I that this percentage differs greatly as between provinces and that it is highest in the least wealthy provinces. The differences are even greater if the total taxes paid in each province are expressed as a percentage, not of the total, but of the surplus income of the province, i.e., of the total income less the cost of subsistence of the inhabitants. The whole structure of Plan I is designed to reduce (though Plan I will not eliminate) this inequality. Under the Plan each provincial government would be in a position to provide, either directly or through its municipalities and other agencies, normal educational, social, and developmental services for its people without having recourse to exceptionally heavy taxation. Differences in taxation might well continue but they would correspond to differences in the services provided. To realize this result as between provinces it is essential that the two taxes which lend themselves most readily to progression should be entrusted to the Dominion Government alone and should be made uniform throughout Canada. It is in this way only that money can be found for the National Adjustment Grants, payable to the provinces whose need is great, without resort to types of taxation which would nullify the very purpose of the grants. Just as in the discussion of efficiency in taxation questions of equity arose, so this arrangement, which conforms to standards of equity, has marked advantages from the point of view of efficiency. The maintenance of the national income of Canada requires that every government in Canada should provide adequate developmental, educational, and social services for its people. This is not reasonably possible today. Plan I would make it possible. But Plan I cannot produce these consequences unless the provinces proceed to effect, as between various areas within the province, the same sort of equalization that Plan I would produce as between the provinces. At present neighbouring municipalities performing similar services for their citizens frequently have very different rates of taxation and it is very inequitable that these

10 Book I, Ch. VIII.

17 Ibid.
differences should persist. If Plan I is implemented, provincial governments will be financially able to deal with this situation.

**Questions of Equity and Efficiency relating to Particular Taxes.**—In the course of the public hearings many representations were made to the Commission concerning the inequity or inefficiency of particular taxes as at present imposed, and some further suggestions have occurred in the course of the Commission's work. In this connection specific recommendations do not appear appropriate as many conflicting considerations are involved, some of which the Commission is not in a position to appraise. Discussion of a general character may serve two purposes: it may call attention to a number of grievances; and it may indicate the need for constant vigilance in adapting taxes to changing conditions.

In connection with the personal income tax it is frequently contended that it is unfair, or even unjust, to tax an individual on that part of his income which he has already paid by way of income tax to another taxing authority. This is what happens in the Western Provinces and on large incomes is a very important factor. The following table shows the percentage of the gross income taken by the provincial income tax in British Columbia and Alberta, where the income tax paid to the Dominion is not allowed as an exemption, and, in contrast, the proportion taken in Ontario, where the provincial rate is half the Dominion rate, but where the income tax paid to the Dominion is allowed as an exemption:

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<th>Income</th>
<th>British Columbia</th>
<th>Alberta</th>
<th>Ontario</th>
</tr>
</thead>
<tbody>
<tr>
<td>3</td>
<td>23%</td>
<td>26%</td>
<td>7.4%</td>
</tr>
<tr>
<td>100,000</td>
<td>27%</td>
<td>30%</td>
<td>7.7%</td>
</tr>
</tbody>
</table>

This grievance results from the existence of Dominion and provincial income taxes neither of which concedes priority to the other. It would disappear automatically if Plan I were adopted. At present some provinces complain that they must perforce concede priority to the Dominion income tax and, if they do so, the taxpayer's grievance does not arise. In practice neither the grievance of the individual nor that of the province is much alleviated by pointing out that a careful readjustment of the rates of tax could raise the same revenue from the same people without taxing anyone on income which he had already paid in income tax. If Plan I is not adopted there is, however, much to be said for making some such readjustment. As between a Canadian and a foreign jurisdiction the question of priorities is an appropriate subject for international agreement—and the scope of such an agreement can be wider if the Dominion is the sole authority levying an income tax, or if all provinces accept the Dominion's definition of taxable income.

Various suggestions were made as to the exemptions which should be accorded under the Dominion income tax law. The Ontario Brief, for instance, suggested an exemption for children attending universities. The same relief to parents of university students could probably be more equitably given by a reduction in university fees which would benefit rich and poor alike, whereas an income tax exemption would mean far more to high than to low income groups. The same sort of objection applies to the proposal for exempting life insurance premiums from personal income tax. In both cases the objection would be greatly modified if the income tax exemption were replaced by a tax rebate of a fixed sum equal to the tax at a low rate on the income to be exempted. There is much to be said for such an exemption in the case of life insurance as an incentive to prudent behaviour. Yet, it could easily be made to appear harsh and heartless to tax the equally praiseworthy investments of those who by reason of some disability are uninsurable or of those who prefer to provide for their future in other ways. A further suggestion was that the Dominion, which charges interest on underpayments of income tax, should pay interest on overpayments made in error. The point may appear to be a small one, but the fact that such a grievance should have been deemed worthy of inclusion in a provincial brief suggests that it is worth while to make a small financial sacrifice in order to make an equitable adjustment and to remove the danger of creating a "victimization" psychology in taxpayers.

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20 Ibid., Pt. II.
21 This idea is developed later. An exemption for moderate insurance premiums is allowed under the British Columbia income tax.
22 Ibid., Pt. II.
The Dominion income tax at present treats all royalties as investment income and taxes them at the rate applicable to that income, although the royalties received by authors are the reward of exertion, differing from wages only in that they are deferred and hazardous, and differing in all but name from the royalties received in respect of coal or oil. This is a minor matter but it seems worth mentioning as an illustration of the possibility of constant perfectionment of an instrument of taxation in the light of experience.

It has been suggested that the taxation of investment income paid to non-residents provides a suitable way of raising a revenue with no burden to the Canadian taxpayer. This is, of course, true only if no further foreign borrowing is contemplated either by public or private bodies, and if immunity from this type of taxation (as contrasted with normal taxation of an enterprise in which a foreigner may have invested) is not considered to have been a tacit condition in past borrowing. The Commission is not in a position to appraise either of these two conditions, but it may be pointed out that the taxation of income payments to non-residents is a suitable matter for international agreement. Some such agreements have already been made, and it will be easier to make them if the Dominion is the sole authority levying a personal income tax. While Canada as a debtor nation might gain on balance today by taxing foreign investors, forbearance may be a quid pro quo in other arrangements. And Canada may not be forever a debtor country.

In connection with the corporate income tax it has been suggested that provision should be made, by way of incentive as well as on grounds of equity, to exempt for obsolescence of plant and equipment as well as for normal depreciation. The Commission notes that some action in this direction has already been taken and looks on this as yet another instance of perfecting a novel instrument of taxation in the light of experience.

A contention by the electrical industry presents very great theoretical difficulties. It is said that it is unfair to those consumers of electricity who are supplied by privately-owned utilities, if the rates they pay must include provision for taxation, while other consumers of electricity, who are supplied by publicly-owned utilities, may have their rates lowered to the extent of eliminating profits. Whether the rates charged to consumers are, in fact, raised by taxation of the profits of privately-owned utilities, at a rate applied to profit from all other forms of corporate investment, is open to doubt. But it is clear that a province or municipality which chooses to supply electricity at cost can charge lower rates than an enterprise which operates for profit, assuming that both enterprises are more or less equally efficient. If the publicly-owned utilities had been taxed on the profits which would have been earned had such a policy not been pursued, it is said that in 1936 a revenue of upwards of $7,700,000 might have been raised. The simplest practical method of removing this inequity would seem to lie in the replacement of the corporate income tax (and of all other taxes peculiar to corporations) by an expansion of the personal income tax, or by the more expedient way of obtaining this result, namely, the exemption of dividends from personal income tax to the extent to which they have already been taxed as corporate income. If taxes on costs, e.g., on the electricity supplied, had been substituted for taxes on profits, this additional revenue might have been obtained at the expense of those who have, it is said, virtually received an untaxed distribution of the profits of publicly-owned utilities. A similar result would have been achieved by taxing publicly-owned utilities on the assumption that they should have charged higher prices. The Commission is not prepared to recommend either of these two courses, and considers that, in the circumstances, the consumers of electricity purchased from publicly-owned utilities must be allowed to retain such advantages as they now enjoy. Nor would it be easy to say what should be done if a publicly-owned utility paid dividends to a province or municipality. Should its earnings be subjected to the corporate income tax or not? The exemption which, in one way or another, is accorded to publicly-owned enterprises may, of course, be considered as the use of an incentive to drive provincial governments to socialism, for if all enterprises were publicly-owned the income of a province might be freed from the burden of the corporate income tax, much as it was contended in one of the submissions that a province escapes this burden if its businesses are conducted by individuals or partnerships. If this larger issue is raised the answer seems to lie in the exemption for the purposes of the personal income tax of dividends, to the extent to which they have already been taxed as corporate income.

23 Ex. 109, Brief of Canadian Electrical Ass'n, Inc.

24 Ibid., p. 8.

25 The general case for this course of action has been stated ante, p. 162.

26 Ev. Senator Farris, p. 5029.
It is necessary to consider complaints made with respect to the corporate income tax because, although it has been suggested that this tax is objectionable as being a tax on profits, its retention has been recommended (subject to a counter-balancing exemption). It has been contended that it is inequitable that a corporate income, in which profitable and unprofitable years occur, should be taxed on the profits of the profitable years and receive no consideration for losses in the unprofitable years. A corporation which has a net profit every year will pay the same tax over a prolonged period whether it is assessed year by year, or permitted to average several years' income in computing the tax to be paid. But if net income alternates with losses, a corporation will pay less if it is allowed to average its net income over several years than if it is taxed on the full net income in every year in which there is a net income. Put differently, two corporations with the same net income in the course of a long period may be very unequally taxed in respect of this income if they both pay on the full net income in the years in which there is a net income. The corporation which has occasional losses is relatively overtaxed to the extent of the tax payable on income equal to the losses. The Commission considers that, if the system can be conveniently introduced, it is fairer to tax corporations on the basis of their average income over, say, a three-year period. There would be some loss to the national revenue (unless rates were raised slightly to compensate for it) but there would be a certain advantage in stabilizing the yield of the corporate income tax, since the taxable income would be less variable from year to year. 

Averaging might also have a place in connection with the personal income tax, although its purpose would be different. It is less likely than in the case of corporations that losses would alternate with net incomes, but the rate of tax varies greatly with the size of the income so that a taxpayer with an exceptionally high income in some one year would gain substantially if he might average his income over a three-year period. This consideration would be of very great importance if capital gains were treated as income and capital losses were deductible. However, the administrative difficulties would probably be greater in averaging personal incomes than in averaging corporate incomes.

The question whether or not capital gains should be assessed and taxed as income, and capital losses allowed as a deduction, arises both in respect of personal and corporate incomes. It is a difficult question. It is hardly practicable to assess the whole of a taxpayer's property annually to determine how much he has been enriched or impoverished within the year, and the usual suggestion is that only realized cash profits should be treated as income. The problem is a very complicated one in which questions of equity and efficiency are both involved. It is not inequitable that capital gains should be taxed, provided that an allowance is made for losses and that there is averaging of net income over a period of years. But it is not everyone who counts capital gains as if they were components in his annual income. The return to the taxing authority becomes more variable from year to year as gains and losses are included in computing taxable income. The technical administration of the tax becomes complicated, and a complication which is worth while when substantial sums are involved becomes wasteful when the gains and losses on capital account are small. The effect of various plans for taxing capital gains on the investment policy of taxpayers—on their reluctance to sell securities whose value has risen within the year, or their eagerness to sell those whose value has fallen—is difficult to appraise. With the means at the command of the Commission it is impossible to appraise. Devices designed to reduce this effect on investment policy involve complications in administration and give rise to various possible inequities. The whole question deserves careful study. The Commission's offhand opinion is that capital gains are best taxed through the succession duties and that (except perhaps in the case of taxpayers whose income is mainly derived from buying and selling) they cannot advantageously be classed as income.

If it is desired to make the income tax somewhat more productive this result might be achieved by replacing the exemption of that part of the income necessary for the taxpayer's maintenance and that of his dependents, and such exemptions as might be accorded in respect of other reasonable expenditures, by a reduction of the tax payable by a fixed and equal amount which would be equal to the tax payable on the sum of these exemptions if each constituted the sole taxable income of the taxpayer. No great inequity would be involved, for the purpose of these exemptions is to make sure that the requirements of a decent subsistence are exempted from taxation. At present any one exemption operates with far greater benefit to the
rich than to the poor and frequently relief is given where none is needed. The same considerations do not apply to exemptions for charitable donations whose purpose is to promote munificence or at least to protect charities against the indirect consequence of high rates of income tax on those who sustain them.

The effect of such a change on the tax payable by a married man with two dependents, and a gross income of $10,000 annually, is illustrated in the following table:

**DOMINION INCOME TAX PAYABLE**
(pre September 1939 war budget increase of 20%)

<table>
<thead>
<tr>
<th>Taxable income less exemptions</th>
<th>I</th>
<th>II</th>
</tr>
</thead>
<tbody>
<tr>
<td>$10,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$2,800</td>
<td>7,200</td>
<td>10,000</td>
</tr>
<tr>
<td>462.00</td>
<td>787.50</td>
<td></td>
</tr>
<tr>
<td>84.00</td>
<td>703.50</td>
<td></td>
</tr>
</tbody>
</table>

In the case of succession duties it is often argued that the tax should progress rather in proportion to the total wealth of the beneficiary than according to that of the decedent. It is obvious that there would be great administrative difficulty in assessing the estate of every recipient of a legacy as at the moment of its receipt. His taxable income of the preceding year would be readily ascertainable but would not be a thoroughly satisfactory basis for assessment. However, something might be done to lower the rate of duty in the case of a decedent who makes provision for a large number of dependents or whose estate is divided on intestacy among a number of children. Usually a transmission to children is taxed at a lower rate than a transmission to more remote relatives or to strangers. It would be in keeping with this universal practice to extend some concession to large families. This point would be of particular importance if Plan I is adopted and a uniform succession duty made applicable to the whole of Canada.

Various aspects of the sales tax were brought under discussion in the public hearings. There is a strong case for the progressive elimination of this tax partly because it is a tax on costs, partly because (except in the case of very low incomes) it is regressive, partly because, if social insurance premiums are collected from very low income groups, those who pay the premiums can hardly be expected to pay the sales tax as well. The sales tax is open to the further objection that the tax is pyramided because, if it is collected from the manufacturer, each subsequent dealer in the commodity taxed calculates his profit on the price which he pays—a price which includes the tax. The effect is that the tax, which collects for the government a given percentage (today 8 per cent) of the manufacturer's price, takes from the ultimate taxpayer approximately the same percentage of the retail price. A number of points of detail were mentioned in the public hearings, objecting to the tax being levied on prices of materials which included freight charges, claiming relief in the case of payment of the tax on sale of goods to a purchaser who became bankrupt and never paid for them, and asking for frequent and final audits. These are not questions with which the Commission feels competent to deal, but they are points on which experience should be continually used as a guide in making further improvements.

In spite of its many defects the sales tax is one which many governments may be driven to use. The Province of Saskatchewan and the City of Montreal already use it. The Provinces of Nova Scotia and British Columbia asked for an extension of provincial taxing powers which would validate a retail sales tax. The School Trustees of British Columbia advocated a provincial sales tax earmarked for education. So did the Vancouver Real Estate Exchange. The Calgary Board of Trade made similar representations as did the Home Builders' Association of Toronto. But many briefs either expressed dislike of the existing sales tax on grounds which have already been indicated, or opposed its extension to the provinces. The Quebec Hospital tax on meals was

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28 Book I, Ch. VIII.
29 Brief of N.S., p. 33; Brief of B.C., p. 352; Ev. p. 4840.
30 Ev. p. 3348.
31 Ex. 190.
32 Ex. 249.
33 Ex. 258.
34 Ex. 491, Brief of Communist Party; see also Ex. 91, Brief of Canadian Manufacturers' Ass'n and Ev. p. 2449; Ex. 250, Brief of Canadian Importers and Traders Ass'n, Inc.
35 Ex. 296, Brief of Provincial Council of Women, B.C.; Ex. 236, Brief of Edmonton Chamber of Commerce; Ev. p. 3129 (Trades and Labor Congress).
denounced for similar reasons. The upshot of this discussion is that a sales tax does raise revenue and if levied at the source excites no great opposition from those who pay it. Its incidence, however, when it is traced out, does not make it a desirable component in a tax system. Its indirect costs are high. Its rating on considerations of equity and efficiency must, therefore, be low. In particular circumstances it may well appear to be the least of several evils. The Commission appreciates the full strength of the argument against the tax and hopes that its general recommendations are of such a character as to remove any demand for its imposition except by the Dominion.

In connection with excise taxes a question of jurisdiction was raised. Provinces are obliged to frame their taxes on such things as fuel oil or gasoline so as to conform to the courts' definition of direct taxes. It is claimed that in some cases the result is inefficiency and expense in collection. It would be in keeping with the general

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36 Ex. 342, Brief of Montreal Board of Trade, Ev. p. 3149.
37 Ex. 34, Brief of Sask., p. 123; see also Ev. pp. 4163-4 re Nova Scotia.
38 Pp. 144f.