

# **An evaluation of business taxes in Canada**

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Businesses in Canada are taxed in a variety of ways. The most important tax on business is the corporate income tax (CIT) but a variety of other taxes are also levied on businesses. There are the personal income tax (PIT) levied on unincorporated businesses, the taxation of corporate dividends and business capital gains under the PIT, federal and provincial taxes on corporate capital and municipal and provincial property taxes on commercial and industrial property.

The employer component of federal and provincial payroll taxes is the second most important set of taxes paid by businesses. In 1995, payroll taxes paid by business actually exceeded corporate income taxes paid. In 2000, total corporate taxes paid were almost \$46 billion, whereas total payroll taxes paid by business were \$28.6 billion. Table 1 presents details on corporate income, capital and payroll taxes.

In this chapter, I evaluate the costs and benefits of the corporate income tax and the issues surrounding the possible integration of the personal and corporate income taxes.<sup>1</sup> In my evaluation of the corporate income tax and the integration of the personal and corporate taxes, I assume that the basic structure of the income tax

**Table 1: Corporate income, capital and payroll taxes (CDN\$ millions), 1971–2000**

	Corporate Income Tax		Capital Tax	Payroll Taxes <sup>c</sup>		
	Federal <sup>a</sup>	Provincial <sup>b</sup>	Provincial	Federal	Provincial	CPP/QPP
1971	2,477	869	104	232	350	414
1972	2,901	1,019	128	305	404	446
1973	3,643	1,436	138	395	503	488
1974	5,012	2,039	166	675	641	603
1975	5,380	2,114	185	854	803	714
1976	5,061	2,067	211	1,083	1,182	827
1977	5,135	2,103	241	1,116	1,319	915
1978	5,737	2,451	349	1,231	1,503	1,022
1979	6,860	3,178	423	1,225	1,638	1,158
1980	8,406	3,672	451	1,367	1,761	1,327
1981	9,323	3,473	651	2,064	2,425	1,489
1982	9,212	2,543	831	2,097	2,891	1,779
1983	9,536	2,784	921	3,070	3,053	1,709
1984	11,319	3,665	976	3,337	3,361	1,929
1985	11,586	3,977	1,172	3,829	3,653	2,139
1986	10,302	4,271	1,280	4,207	4,190	2,342
1987	11,864	5,126	1,387	4,484	4,877	2,674
1988	11,857	5,729	1,490	5,091	5,663	2,976
1989	12,132	6,434	1,885	4,513	6,223	3,300
1990	10,442	6,392	1,917	5,699	8,270	3,794
1991	9,892	5,123	1,863	6,591	8,127	4,068
1992	9,981	4,536	2,089	7,841	8,269	4,359
1993	10,695	5,568	2,387	8,146	8,561	4,578
1994	12,200	7,142	2,611	8,724	9,000	4,849
1995	13,372	8,766	2,810	8,530	9,686	5,421
1996	16,225	10,014	3,162	8,236	9,788	5,535
1997	20,229	12,021	3,430	8,843	9,689	5,850
1998	19,331	11,131	3,743	8,315	9,913	6,855
1999	24,173	12,494	3,860	8,163	10,343	7,875
2000	30,353	15,682	3,987	8,200	10,958	9,480

Source: National Income Accounts and author's calculations. **Note a:** Federal corporate income tax includes the large corporation tax and capital taxes on financial institutions. **Note b:** Provincial corporate income tax includes taxes on mining and logging profits. **Note c:** 58% of EI contributions, 100% of provincial payroll taxes and 50% of CPP/QPP contributions are paid by employers. Following the Mintz Committee (Table 2.1) we assume that  $\frac{3}{4}$  of employer payroll taxes are paid by businesses.

system remains unchanged. In other words, I assume that no radical reforms such as a switch from an income base to a consumption base are undertaken at the same time. This means that I evaluate the corporate income tax within an income-based tax system.

### **Reasons for a separate corporate income tax**

Why tax corporate profits at all? Since these profits are ultimately either distributed as dividends or generate capital gains, both of which are taxed under the personal income tax system, it has been argued that a corporate income tax is redundant and involves an element of double taxation of corporate source income.

In Canada, the issue of double taxation has been dealt with by the partial integration of the PIT and CIT, under which taxpayers are allowed to deduct from taxes due on corporate dividends part of the CIT paid by the corporation. In practice, this integration requires the application of a tax credit to dividend income that has been the “grossed-up”, i.e. taxable dividends are 125% of dividends received. The full integration of the PIT and CIT eliminates all elements of double taxation, though in Canada full integration in this sense has not been achieved (except for small corporations).

I believe that a separate but integrated corporate income tax is required in an income tax system for several reasons. First, taxing corporate income at the corporate level protects the personal income tax base. If there were no corporate income tax, profits could be reinvested rather than distributed. Since the resultant increase in the value of the corporation is taxed only upon realization of capital gains, the reinvestment of corporate earnings would permit the owners of corporations significant opportunities to defer the payment of income taxes. Taxes at the corporate level mitigate or eliminate this problem. Second, taxing corporate income enables Canada to tax profits of foreign-owned enterprises, which otherwise would be taxed only in the home country of the investors. Third, a separate corporate income tax effectively taxes on an accrual basis excess profits or “rents” of corporations, which can be taxed without inducing economic distortions and therefore are highly efficient.<sup>2</sup>

## **Existing corporate income taxes in Canada**

In Canada, corporate profits are taxed by both the federal and provincial governments. Seven of the provinces levy their tax on the federal base and have the federal government collect the tax on their behalf. Three important provinces, Alberta, Ontario, and Quebec, have separate corporate taxes, which allow them to use definitions of taxable income different from that used by the federal government.

Statutory and effective rates of tax vary by industry, by size, by type of asset and by province. Following are some major features of the existing CIT system.

- 1** A preferential rate for manufacturing.
- 2** Special allowances and deductions for certain resource industries.
- 3** A favourable rate for small Canadian controlled private companies (CCPCs). For dividend income, the corporate taxation of these companies is approximately fully integrated with personal taxes.
- 4** Dividends receive a credit under the “gross-up” and credit mechanism, and capital gains are taxed at one half the rate of ordinary income. It is important to note that these measures amount to the partial integration of the CIT and PIT for large companies.

Current Canadian statutory rates for corporate taxes are higher than the American rate for non-manufacturing companies and lower than the American rate for manufacturing companies. Other features of the corporate tax like deductions and credits cause the marginal effective tax rate for manufacturing to be about the same in Canada as in the United States. However, Canadian marginal effective tax rates for services are higher than American marginal rates. Sweden, the United Kingdom, and Ireland have lower marginal effective tax rates. Canada has a lower statutory corporate tax rate from small business than the United States.

At the start of the new millennium, Canada began a process of lowering corporate tax rates. Thus, the federal government reduced the general statutory rate by one percentage point on January 1, 2001 and is committed to reducing this rate by six more percentage points

over the following three years. Ontario reduced its general corporate tax rate by 1.5 percentage points in 2001 and is committed to a further reduction of six percentage points over the following five years. Alberta reduced its rate to 13.9% in 2001 and is committed to reducing the rate to 8.0% over the following five years. British Columbia has adopted a three percentage point reduction, effective on January 1, 2002. When these federal and provincial rate reductions are fully implemented in 2006, the average statutory corporate rate for large corporations in Canada will be reduced to 32%. Because of the existing different rates of taxation for different types of corporations in Canada noted above, the new average level represents a decline of 11.3% for large non-manufacturing firms and a decline of 3.0% for large manufacturing firms from levels in 2000.

These large reductions in statutory rates generate significant reductions in marginal effective tax rates (METRs) for most non-manufacturing firms. With the exception of the oil and gas, and mining sectors, large non-manufacturing firms will experience declines in METRs of 3.6 to 7.2 percentage points. The METR for large manufacturers is projected to decline by 2.5 percentage points. These planned rate reductions will put METRs in Canada 2.5 to 3 percentage points below present American rates. The statutory rate for large corporations will be about 7 percentage points below the American rate. Even with these rate reductions, however, corporate taxes for large firms will be higher in Canada than those in the United Kingdom, Sweden and Ireland.

## **Principles for efficient taxation of corporations**

The existing corporate tax system was examined extensively by the Technical Committee on Business Taxation (The “Mintz Committee”). Following other reviews of the corporate income tax, the Mintz Committee argued that the most basic general principle of business taxation should be neutrality. Such neutrality assures that the tax system does not distort business decisions by favouring particular industries, investments, or activities. The Mintz Committee also emphasized that the level of business taxation should be internationally competitive by having tax rates no higher than those of Canada’s major trading partners.

Neutral tax treatment also entails equal marginal effective rates of tax for all asset types and industries. The Committee found, however, that such neutrality did not exist in Canada and that there is substantial room for improvement of Canada's corporate tax structure.

Non-neutral treatment is appropriate where market imperfections affect investment decisions. Such market imperfections exist in the case of investment in Research and Development (R&D), which can generate significant spillovers or externalities that are not captured by the investing firm. While such externalities justify R&D tax incentives under the corporate income tax, the Mintz Committee found that Canada's tax treatment of R&D is so generous that substantial tax credits and deductions presently generate large negative marginal effective tax rates.

Many small businesses have limited access to capital or face prohibitive capital costs because of imperfections in the capital market. Such capital rationing can be mitigated by a lower rate of tax on the retained earnings of small businesses. The existence of capital market imperfections for small businesses provides the most important justification for Canada's generous treatment of small CCPCs. The other justification is the integration of the personal and corporate taxes, which is considered in the next section.

### ***Integration of the corporate and personal taxes***

Ultimately all income and general taxes paid by corporations and businesses are borne by individuals in their capacity as shareholders, investors, consumers, or employees. Some business taxes, like payroll taxes, are primarily shifted back to employees in the form of lower wages. Others, like sales taxes, are shifted forward to consumers through higher product prices. In the case of the corporate income tax, the incidence of the tax is ambiguous. The Technical Committee took an eclectic view, arguing that some portion of the CIT is borne by investors in Canada and some by foreign treasuries.

To the extent that the corporate tax is borne by investors, savings and investment and, therefore, the future rate of growth of potential output are reduced. As a result, the average level and growth of real income of Canadians are diminished. It is, therefore, most important to design a corporate income tax that minimizes these negative effects.

Another issue concerning the efficiency of the corporate tax involves the presently unequal taxation of debt and equity. This inequality is due to the absence of a deduction for the cost of equity and the deductibility of interest costs in the calculation of corporate income-tax obligations. This distortion can be eliminated by the full integration of the CIT and PIT discussed above or, alternatively, by allowing interest deductions only at the PIT level.

The full integration of the CIT and PIT has the further benefit of eliminating another non-neutrality of the existing corporate income tax in Canada, the distortion of incorporation decisions. Without full integration, the combined taxation of corporate source income exceeds the taxation of comparable unincorporated businesses.<sup>3</sup>

The Canadian Tax Reforms of 1971 created a mechanism for integrating the CIT and PIT taxes. Under this mechanism, personal income tax returns allow taxpayers to gross-up their dividend income and then apply a tax credit to adjust the amount of taxes payable. The rates of gross-up and credit were set to achieve the full integration for small businesses. But, since the large business corporate tax rate is higher, the present rates do not result in a full integration for dividend income of corporations.

Since its creation in 1972, the dividend credit as well as statutory corporate tax rates have changed. As a result, in some years there has been over-integration for small business in the sense that the dividend credit was generous enough to reduce the combined tax on dividend income below that on other income. With the provinces levying differential rates of corporate tax on small business, and with federal and provincial surtaxes, the situation has become more complex. At present there is over-integration in some provinces and under-integration in others, though it should be noted that the departures from full integration are not large.

### **Recommendations of the Technical Committee on Business Taxation**

The recommendations of the Technical Committee were constrained by the requirement that the overall package of changes in tax rates and mix had to be “revenue-neutral.” Unless rate reductions were “self-financing” through stimulative effects upon economic activity,

rate reductions had to be financed by base-broadening measures. Furthermore, the requirement for revenue neutrality had to include the cost of any transitional relief provided to industries adversely affected by the proposed changes in tax rates and structure.

Since the committee was established in 1996, at a time when deficit reduction dominated the fiscal policy agenda, this revenue neutral requirement was an understandable constraint. Now that Canada is achieving fiscal surpluses and the debate is about allocating the future “fiscal dividend,” this revenue-neutral constraint should no longer be binding. There should be room to provide transitional relief to industries that face increased tax burdens through proposed reforms that involve base-broadening measures.

The key base-broadening recommendations made by the Committee include:

- reduction of Capital Cost Allowance (CCA) rates for certain classes of investment;
- phasing out of the 100% write-off of R&D Capital Assets and reduction of R&D credits;
- restructuring of the resource allowance so that it applies to resource revenues net of all deductions—to be undertaken in consultation with the Provinces;
- reduction of the rate of write-off of development costs from 30% to 25%;
- replacement of the present immediate write-off of development expenses in mining by a 25% deduction on a declining balance basis—to be put into effect five years after its announcement;
- various limitations on the deductibility of interest expenses for investment in foreign affiliates and other measures to tighten the taxation of international investment income;
- phasing out of the Atlantic Investment Credit;
- harmonization of the capital tax bases of the federal and provincial governments, together with the elimination of the deductibility of provincial capital taxes.



The Committee's estimates of the revenues to be gained by these base-broadening measures are summarized in table 2, which shows that these recommended corporate tax measures would have generated about \$2 billion in revenue in 1997.

The Mintz Committee also addressed the issue of integration and the taxation of capital gains. It supported the continuation of the gross-up and credit system for dividends. However, it was concerned that the credit was too generous in cases where corporate income tax paid was less than the amount credited. Such conditions arise when dividends are distributed from corporate income that has been sheltered by deductions or credits.

The Mintz Committee also proposed a dividend distribution tax of 25% payable by corporations. Federal and provincial taxes on corporate profits would be fully creditable against this dividend distribution tax. Therefore, the dividend distribution tax would mainly affect corporations not paying taxes and, to a lesser extent, CCPCs in provinces where there is over-integration of dividend income. The Committee estimated that this measure would generate a revenue increase of \$525 million, of which \$350 million would accrue to the federal government and \$175 million to the provinces.

The taxation of capital gains represents another component of a system that integrates the CIT and PIT. Thus, when capital gains

**Table 2: Revenue Impacts (CDN\$millions)  
of Proposed Corporate Tax Measures**

	Federal	Provincial	Total
Reduced CCA Allowances	105	60	165
Reduced R&D Deduction & Credits	200	10	210
Resource Allowances & Deductions	215	130	345
International Income Measures	400	250	650
Eliminating Atlantic Investment Credit	95	—	95
Non-deductibility of Capital Taxes	375	200	575
<b>Total</b>	<b>1,390</b>	<b>650</b>	<b>2,040</b>

Source: *Report of the Technical Committee*, Table 1.1.

are taxed at the same rate as dividends under the PIT, dividends and retained earnings are subject to the same degree of integration. The Committee reviewed the argument for taxing capital gains at rates below the rate on other income and concluded that the inclusion rate of 75% of the value of the capital gains in effect in 1996 was appropriate. I question this conclusion, since the effective rate of tax on capital gains was higher than the effective rate on tax on dividends for top-bracket taxpayers. Instead, the appropriate inclusion rate is two thirds to achieve the the desired equality in the rate of taxation of capital gains and other sources of income. By this reasoning, the 50% inclusion rate in effect since 2001 distorts this neutrality and favours capital gains

The Committee also recommended that the current \$500,000 lifetime capital-gains exemption for farmers and owners of shares of CCPCs should be eliminated and that it should be replaced with enhanced RRSP contributions that would treat such capital gains as equivalent to earned income on a lifetime basis. The Committee estimated that this measure would generate an additional \$450 million of revenue, of which \$275 million would accrue to the federal government and \$175 million to the provinces.

The Committee estimated that the increased revenue from the corporate tax changes, the implementation of the dividend distribution tax and the changed treatment of capital gains would generate about two billion dollars to the federal government and one billion dollars to the provincial governments. These higher revenues were estimated to be sufficient to finance the revenue losses resulting from the Committee's recommendation that the general federal corporate tax rate be reduced to 20% and the provincial rate to 13%.

The Committee also studied the contributions to the Employment Insurance (EI) system made by employers, which is the only federal payroll tax. This payroll tax represents 58% of the total EI premiums collected by the government. The rest is paid directly by employees. Employer payments by business represent 75% of all EI premiums paid, the rest is contributed by governments and non-profit institutions. The Committee recognized that in the long run payroll taxes are largely, but not completely, shifted back to workers. However, the Committee also recognized that in the short run increases in the employer contribution rate raise labour costs with adverse effects on employment and economic growth.

The Committee was mainly concerned with the distribution of the costs and benefits of EI payments among different industries. A small number of industries have very high ratios of benefits received by their workers over contributions made by the employers and the workers. In effect, these industries are subsidized by payroll taxes paid by other industries. To deal with the inequity and inefficiencies implicit in the different ratios of benefits and costs of some industries, the Committee recommended that an experience rating system for employers be gradually phased in. Such a policy was to be financed out of the large surplus in the EI "Account" and implemented by granting greater reductions in contribution rates to industries for which the ratio of benefits to costs is below one and smaller reductions (or, zero reductions) to industries for which the ratio is greater than one. Because governments have a ratio smaller than one, the implementation of experience rating would have reduced government payroll tax costs by almost \$300 million.

The Committee also expressed the view that the federal government should reduce average EI premiums over time in order to bring revenues down to the long-run cost of the program. However, no explicit rate targets were recommended and, therefore, no estimates of revenue impacts were provided.

## **What has happened since the report of the Technical Committee?**

### ***Key federal tax measures since 1997***

The federal government did not act immediately to implement any of the Committee's recommendations. The federal budget of 1998 provided some reductions in personal income tax targeted to low- to middle-income taxpayers. The basic contribution rates for EI were reduced by \$0.20 and \$0.28 for employees and employers, respectively.<sup>4</sup> Otherwise, no significant changes to business taxes were introduced.

Prior to the 1999 budget, EI premia were again reduced by \$0.15 for employees and BY \$0.21 for employers. The 1999 budget expanded PIT relief to include middle- to higher-income taxpayers. In the field of business taxation, the 1999 budget introduced a measure that reduced effective tax rates for companies generating

electricity by extending the Manufacturing and Processing credit to these firms. This measure was phased in over four years and will reduce the statutory federal corporate rate by 7 percentage points when fully implemented in 2002. While specific to the electrical generation industry, this measure can be viewed as a small initial step towards the more general corporate rate reductions recommended by the Technical Committee.

The federal budget of 2000 finally made a major commitment to reduce corporate income taxes by one percentage point in 2001 and by six additional percentage points within five years. Importantly, these rate reductions were targeted to those firms that were paying the highest statutory and effective rates. This means that there were no rate reductions for firms in the manufacturing and processing, mining, and oil and gas sectors. The budget did not reduce tax rates for small businesses with profits below \$200 thousand but it reduced the statutory rate on profits between \$200 and \$300 thousand to 21% in 2001.<sup>5</sup> Two months before the budget, EI premiums were again reduced, by \$0.15 for employees and \$0.21 for employers. The 2000 budget also reduced the capital gains inclusion rate from 75% to 66.6%. This measure brought the top marginal rate applicable to these gains in line with the top marginal rate applicable to dividends.<sup>6</sup>

Although the corporate rate reductions announced in the 2000 budget represented an important step towards improved international competitiveness and inter-industry rebalancing, there was a great deal of uncertainty about the timing of the tax cuts. This uncertainty was substantially reduced by the *Economic Statement and Budget Update*, October 18, 2000 (hereafter "October 2000 Statement"). This statement lays out a timetable of successive cuts in the corporate rate of two percentage points, which will bring the general federal corporate tax rate down to 21% by 2004.<sup>7</sup> The October 2000 Statement also accelerated and enhanced the PIT reductions laid out in Budget 2000. The "high income" surtax was eliminated, the low-bracket rate was reduced to 16%, the middle-bracket rate was reduced to 22%, and a new upper-middle bracket was created with a rate of 26%. The threshold for the top marginal rate was raised and the brackets themselves were indexed to inflation.<sup>8</sup>

The October 2000 Statement also lowered the capital gains inclusion rate from  $\frac{2}{3}$  to  $\frac{1}{2}$ . With the top federal marginal rate

on capital gains reduced to 14.5% and reduced tax rates in many provinces, tax rates on capital gains in Canada are competitive with tax rates on long term capital gains in the United States. Without changes to the dividend credit, however, the tax rate on capital gains is now below the tax rate on dividends for top bracket taxpayers. This raises the prospect of “surplus stripping” and administrative countermeasures, which would increase tax complexity. I address this issue in the section on recommendations below.

### ***Key provincial tax measures since 1997***

In 1998 British Columbia, Alberta, Saskatchewan, and Manitoba introduced personal income tax reductions, while Ontario continued to implement its multi-year PIT tax reduction. The corporate tax rate for small businesses was reduced to 8.5% in British Columbia and Ontario. Several provinces introduced tax incentives for R&D and specified investments such as film production.<sup>9</sup>

In 1999, several provinces announced reductions in personal income tax rates. The corporate rate for small business was reduced to 5.5% in British Columbia. In Ontario, the phased reduction in corporate tax rates for small business continued, with the rate dropping to 8%.<sup>10</sup>

In the year 2000, nine of the 10 provinces switched from a system under which they imposed their tax on the basis of the federal tax obligation to a tax on income, where income is defined by the provincial code. The tax-on-income system will permit greater flexibility in the design of provincial personal income tax systems. In 2000, personal income taxes were also reduced in several provinces. Alberta adopted a single rate for its PIT, set originally at 11% and then lowered to 10.5%. At the same time, Alberta increased personal exemptions substantially. Corporate tax rates for small business were reduced by 4.75% in British Columbia and Manitoba and to 6.5% in Ontario and 4.5% in New Brunswick. In Ontario, the rate for large corporations was reduced to 12% for manufacturers and 14% for other firms. Ontario also announced a number of incentives for specific activities involving film, publishing, and other media.<sup>11</sup>

In 2001, all provinces and territories adopted the tax on income as the basis for personal income taxes. In British Columbia, the new government adopted a major reduction in personal

income taxes. Small reductions in PIT were implemented in other provinces, partly through matching the changes to brackets and indexing adopted by the federal government in 2000. Corporate tax rates were reduced in British Columbia to 13.5%. Alberta announced a plan to reduce all corporate tax rates: by 2004, for large corporations the rate will be 8% and for small corporations, 3%. Saskatchewan reduced its corporate rate for small business to 6%. Manitoba reduced its rate for small business to 5%, and announced a phased reduction in general corporate rates of 0.5% per year over four years. Ontario announced a plan to reduce corporate taxes over four years so that, by 2005, for large corporations the rate will be 8% and for small corporations, 4%. New Brunswick reduced its general corporate rate to 16% and its small business rate to 4%.<sup>12</sup>

### **Overview of statutory corporate tax rates**

Tables 3 and 4 summarize recent changes in general corporate income tax rates for large corporations and small businesses as well as those planned in the future. Table 3 shows that one of the major recommendations of the Mintz Committee is being implemented. By the year 2006, combined federal and provincial statutory tax rates for large firms in Alberta and Ontario will be lowered to 30% and in Quebec to 31%. Given the importance of these three provinces, the weighted average combined statutory rate for Canada as a whole will be reduced to 32%. This level represents a decline of 11 percentage points relative to 1997. The weighted average level of the combined rate of tax for all provinces will in fact be one percentage point lower than the 33% recommended by the Technical Committee although the Federal statutory rate would be about two percentage points higher.

Table 4 shows that the small business federal statutory tax rate will not change by 2006 but that many provincial rates had been reduced by 2001 and, in Alberta, Ontario and Saskatchewan, further rate cuts are planned. When fully implemented, the combined statutory rates for small corporations will be only 16.1% in Alberta, and 17.1% in Ontario.

It is important to note that these low rates of corporate income tax for small businesses mean over-integration of the corporate and personal taxes in all provinces and territories except for Prince Edward Island and Quebec.<sup>13</sup>

**Table 3: General<sup>a</sup> Corporate Income Tax Rates**

	1988	1995	2001	2006
Newfoundland	16.0	14.0	14.0	14.0
Prince Edward Island	15.0	15.0	16.0	16.0
Nova Scotia	15.0	16.0	16.0	16.0
New Brunswick	16.0	17.0	16.0	16.0
Quebec	13.9	16.3	9.0	8.9
Ontario	15.5	15.5	14.0	8.0
Manitoba	17.0	17.0	17.0	15.0
Saskatchewan	17.0	17.0	17.0	17.0
Alberta	15.0	15.5	13.9	8.0
British Columbia <sup>b</sup>	14.0	16.5	16.5	13.5
Northwest Territories	10.0	14.0	14.0	14.0
Nunavut	10.0	14.0	14.0	14.0
Yukon	10.0	15.0	15.0	15.0
Federal (inc. surtax)	32.5	29.1	28.1	22.1

Note a: These are rates applicable to large firms outside the manufacturing, mining, and oil and gas sectors. Note b: The rate for BC for 2006 is from a BC Ministry of Finance News Release, *Tax Relief, Sound Fiscal Management to Boost the Economy* (July 30, 2001).

**Table 4: Corporate Income Tax Rates for Small Business**

	1988	1995	2001	2006
Newfoundland	10.0	5.0	5.0	5.0
Prince Edward Island	10.0	7.5	7.5	7.5
Nova Scotia	10.0	5.0	5.0	5.0
New Brunswick	5.0	7.0	4.0	4.0
Quebec	3.2	5.8	9.0	8.9
Ontario	10.0	9.5	6.5	4.0
Manitoba	10.0	9.0	6.0	5.0
Saskatchewan	10.0	8.0	7.0	6.0
Alberta	5.0	6.0	5.3	3.0
British Columbia	10.0	10.0	4.5	4.5
Northwest Territories	10.0	5.0	5.0	5.0
Nunavut	10.0	5.0	5.0	5.0
Yukon	5.0	6.0	6.0	6.0
Federal (inc. surtax)	13.4	13.1	13.1	13.1

Source for Tables 3 & 4: Canadian Tax Foundation, *Canadian Tax Highlights* 9, 5 (May 2001).

### ***Broadening the tax base and other recommended measures***

With the exception of certain measures designed to tighten the taxation of international investment income and business profits of foreign-owned corporations, the corporate base-broadening recommendations of the Technical Committee have so far been ignored. This means that the federal corporate rate reductions have largely been financed from the “fiscal dividend.” The upside of this situation is that potential revenues from broadening the tax base remain to finance other desirable tax changes.

The recommendations of the Committee to implement a dividend distribution tax and to replace the \$500,000 capital gains tax exemption have also so far been ignored. Finally, the Committee’s recommendation for the gradual implementation of experience rating for the EI contributions of businesses has not been acted upon. However, as noted above, EI contribution rates have been reduced each year.

At the provincial level, we have witnessed the implementation of a variety of corporate tax measures that provide favourable tax treatment to designated activities. By and large, these represent deviations from the principle of tax neutrality endorsed by the Technical Committee.

### **An evaluation of the effects of reductions in the corporate rate and other measures<sup>14</sup>**

Most economic studies have suggested that the most distortionary revenue sources in Canada are related to business taxes, particularly the corporate income tax. Effective tax rates on capital vary by industry, type of asset, size of firm, and business organization. The business tax system is not only distortionary but also quite complicated. Some studies have suggested that each additional dollar of corporate income tax levied causes the Canadian economy to lose nearly one dollar in economic output.<sup>15</sup> Therefore, the total cost of raising one dollar of corporate income tax revenue can be about two dollars, once these distortionary effects of the tax are taken into account.

An ideal business tax system would be neutral with respect to different industries, asset types, and different degrees of risk. Any



non-neutralities in the system should be used to mitigate the effects of market imperfections. Examples of corrective non-neutralities in the tax system include favourable treatment of small business to offset capital-market rationing and incentives for research and development in recognition of the positive spillovers generated by an increase in knowledge or know-how.

In today's world, not only should business taxes be neutral but they should also be levied at rates that are competitive internationally. This is especially important for the corporate income tax. Given the relative ease with which corporations can shift income from countries with high taxes to those with low taxes without changing real economic activity, a country with a high corporate income tax rate could find its tax base eroded significantly. Recent studies have shown that as corporate income tax rates are increased, the gain in revenues is anywhere from 8% to 20% less than what would be expected if the tax base did not change.<sup>16</sup>

High effective marginal corporate rates deter investment and variations in the effective rates for different industries and different assets distort the allocation of capital. Consequently, a reduction in the level of marginal effective tax rates and a reduction in their variance are high priorities from the standpoints of growth and efficiency.

### ***Effects of Budget 2000***

With the 2000 Budget and the October 2000 Statement, the federal government committed itself to a reduction of one percentage point in corporate income tax rates for the broad service sector<sup>17</sup> in 2001, followed by four cuts of two percentage points each. The government indicated that it would reduce the corporate income tax rate from 28 points to 21 points by the year 2004/2005 for active business income in sectors other than the resource and manufacturing sectors. It also increased capital-cost write-offs for railway assets, utility equipment, and manufacturing equipment subject to obsolescence. The government also introduced a few tightening provisions: tighter thin-capitalization rules for debt owed to related non-residents, the abolition of the election to be treated as non-resident owned investment corporations and adjustments for research and development expense deductions for provincial deductions in lieu of investment tax credit programs.

The changes in business taxes in the 2000 Budget took many observers by surprise. The cut in corporate income tax rates, although small in the first year, are significant when fully implemented. The rate cuts, moreover, would be focussed on the broad service sector, thereby reducing inter-industry distortions. Tax rates on manufacturing and processing income as well as on resource profits would remain unchanged.

The impact of the 2000 budget changes and of planned provincial corporate rate reductions can be seen in table 5. The small changes introduced for the year 2001 have little impact on effective tax rates on capital. Significant variation in effective tax rates would remain across all sectors. When the proposed corporate rate reduc-

**Table 5: Marginal Effective Tax Rates: Large-sized Tax-paying Firms Only**

	2000	2001	2006
Forestry	32.5%	31.3%	26.0%
Mining	12.5%	12.1%	11.1%
Oil & Gas	4.7%	4.3%	3.2%
Manufacturing	24.2%	23.5%	21.0%
Construction	37.3%	35.9%	28.7%
Transportation <sup>a</sup>	28.2%	27.1%	21.7%
Communications	28.5%	27.8%	21.9%
Public Utilities <sup>b</sup>	26.1%	25.0%	21.4%
Wholesale Trade	34.8%	33.2%	27.0%
Retail Trade	34.0%	32.5%	26.5%
Services	28.9%	28.4%	21.9%

*Note a:* Estimate for the transportation sector reflects the higher CCA rate for railway equipment (i.e., 15% instead of 10%). *Note b:* The estimate is made by assuming that 50% of the public utility sector are in the power generating business, which started phasing in the M&P tax credit from year 2000 and may benefit from the higher tax allowance for CCA class 1 (i.e., 8% instead of 4%).

Source: Mintz and Wilson (2001): 102, table 1.

tions are fully in effect in 2004/2005, however, they have a much more dramatic impact. Most industries, except for mining, oil and gas, and manufacturing, would experience a sharp decline in the effective tax rate—over 4 percentage points. Although this tax reform takes us in the right direction, it still leaves considerable variation in effective tax rates on capital across industries and, in some cases, rates remain too high, thereby discouraging investment.

### **International comparisons and international competitiveness**

In an open economy, the business tax structure must be designed with an eye to the likely response of multi-national corporations (MNCs) as well as to its longer term effects on international competitiveness. Attention should be paid to both statutory and effective marginal rates. Statutory rate differentials may provide incentives for MNCs to shift expenses to, and income away from, high tax jurisdictions through transfer pricing and debt management practices. Statutory rates differences may also influence location decisions.

Current and projected corporate statutory rates for OECD countries are presented in table 6. The corporate statutory rate for large manufacturers in Canada lies in the middle of this group of countries but the statutory rate for large non-manufacturing firms is currently above all the other countries (except for Germany and Japan). Projected rates for 2006 indicate that the Canadian corporate tax rate will be below the level of that in the United States, Japan, Germany, and France but will remain higher than many other countries.

In order to prevent substantial erosion of revenue, statutory rates should not be higher than rates typically found in other industrialized countries where investments by MNCs take place. In order to stimulate investment and provide economic growth, effective tax rates on capital should be lower than in other competing jurisdictions.

The implementation of reductions in the statutory corporate rates would establish Canada's rates at the OECD average and well below American statutory rates, thereby eliminating the principal sources of revenue erosion via debt shifting and transfer pricing.

**Table 6: Statutory Corporate Income Tax Rates (%)  
in Selected OECD Countries<sup>a</sup>**

	July 31, 1996	January 1, 1999	Change	Intentions (year)
Australia	36	36.0	—	30.0 (2000)
Canada <sup>b</sup>	34.9/43.2	35.0/43.3	—	32.0 (2006) <sup>c</sup>
Denmark	34	32.0	↓	
France	41.7	36.7/40.0 <sup>d</sup>	↓	37.8 (2000)
Germany	56.1	51.9 <sup>e</sup>	↓	35.0–38.0 (2001) <sup>f</sup>
Ireland	10.0/38.0	10.0/28.0	↓	12.5 (2003)
Italy	53.2	31.3–41.3 <sup>g</sup>	↓	
Japan	52.2	48.0	↓	41.0 (2000)
Netherlands	37.0/35.0	35.0	↓	
Norway	28.0	28.0	—	
Poland	40.0	34.0	↓	22 (2004)
Sweden	28.0	28.0	—	
Switzerland	35.5	25.1	↓	
Turkey	44.0	33	↓	
United Kingdom	33.0	30.0 <sup>h</sup>	↓	
United States <sup>i</sup>	39.2	39.2	—	

A reduction in the combined general corporate income tax rate to 30% instead of 32% accompanied by broadening of the base would reduce typical marginal effective tax rates for non-resource firms by about 1 to 1½ points. The lower statutory rate would also make Canada more attractive relative to other countries, providing added deterrence to debt shifting and transfer pricing by MNEs.

Because a reduction in corporate statutory rates would stimulate an increase in the tax base, the revenue costs are attenuated to some extent. The Technical Committee estimates that the elasticity of the corporate tax base with respect to a reduction in tax rates is about 0.15. Based on this elasticity, in 1998 for example, a 2% point reduction in all corporate tax rates would involve a revenue

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**Note a:** The 1996 rates are based on the former Coopers & Lybrand, 1997 *International Tax Summaries* and the 1999 rates are adopted from the KPMG *Corporate Tax Rates Survey*, January 1999, unless otherwise specified. **Note b:** The rate is a combination of the federal CIT rate (22.1% and 29.1% respectively for manufacturing and others) and the average of provincial CIT rates that is weighted by the provincial GDP by industry. The minor difference between the two years reflects some changes in provincial CIT rates. **Note c:** This is a weighted average of all industries. Note that the current general CIT rate of 43% will still be applicable to the resources sector, which also enjoys various preferential tax treatments unavailable to any non-resource sectors. **Note d:** The rate is a combination of the corporate income tax rate of 33 ⅓% and the surtax of 10% and 20% respectively. The lower surtax is applied to smaller-scaled firms that are mainly owned by individuals. For year 2000 and later, the lower rate will apply to all firms (see Ernst & Young, 1999 *Worldwide Corporate Tax Guide*, for details). **Note e:** Our estimate based on to Ernst & Young, 2000 *Worldwide Corporate Tax Guide*. It includes a corporate income tax rate of 40%, an average trade tax of 16.75% (ranging from 13% to 20.5%), which is deductible for CIT purposes, and a surcharge of 5.5% on CIT payable. **Note f:** Refer to *Tax Notes International* 20, 4 (January 24, 2000). **Note g:** The higher rate (41.3%) includes a general corporate income tax rate of 37% and a regional tax of 4.25%. The latter is levied on the Italian-source income from productive activities, which includes interest payments and cost of labour. The general CIT rate may be reduced to 19% for qualifying taxable income corresponding to the ordinary remuneration (currently 7%) of the net equity increase. However, the average corporate income tax rate for a company may not fall below 27%, which, combined with the regional tax rate of 4.25%, resulted in the lower aggregated income tax rate of 31.3%. **Note h:** Effective as of April 1, 1999. **Note i:** Our estimate based on an average state corporate income tax rate of 6.5% (ranging from 1% to 12%).

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loss of about \$1.3 billion of federal corporate tax revenue (representing about 7% of federal corporate tax revenues).<sup>18</sup> In future years, moreover, this relative revenue loss would be further attenuated, as the lower corporate tax rates lead to higher investment, a higher capital stock, and hence increased labour productivity and real output.

Differences in marginal effective tax rates provide incentives for MNCs to adjust their real capital stocks, increasing investment in countries with relatively low effective marginal rates relative to other countries. Table 7 presents current and prospective marginal effective tax rates (METRs) for Canada and eight other countries.

**Table 7: Marginal Effective Tax Rates (METRs) for Domestic**

	Canada	United States	United Kingdom	Germany
<b>Manufacturing</b>				
1996	23.5%	23.8%	19.4%	38.0%
2000	23.5%	23.6%	17.2%	34.4%
2001	23.4%	23.6%	17.2%	21.1%
Intention in 2006	21.0%			
<b>Services</b>				
1996	29.0%	25.0%	19.2%	37.5%
2000	29.0%	24.8%	17.2%	34.0%
2001	28.3%	24.8%	17.2%	20.8%
Intention in 2006	21.9%			

**Source:** Mintz and Wilson 2001: 102–3, table 2.

**Note 1:** To single out the tax impact, we assumed that the interest rate was 6.8% and the inflation rate, 1.4% across countries and periods. **Note 2:** The Canadian METR for the service sector in 2001 corresponds to the federal CIT rate of 28.12% (including the 4% sur-tax) combined with the weighted average provincial CIT rate of 14.15%. **Note 3:** The German METR for 2001 reflects the federal CIT reduction from the current 40% to 25%, starting in January 2001. The municipal trade tax (16.66% on average) and the solidarity surcharge (5.5%) will still apply.

In 1996, Canada's effective tax rate on capital invested in manufacturing was comparable to the United States, lower than that found in Germany, France, Italy, and Japan and higher than rates in the United Kingdom, Sweden and Ireland. The broad service sector was more highly taxed in Canada compared especially to the United States and to most countries, except Germany, Italy and Japan.

Since the Technical Committee's Report was released, developments abroad have made further lowering of effective corporate tax rates in Canada more important (Mintz 2001). Within the G7, Japan, Germany and Italy have all reduced effective marginal rates substantially. The United Kingdom, which previously had the lowest effective marginal rate, also reduced its rate by two percentage

**Firms in G-7 Countries, 1996, 2000 and 2001**

France	Italy	Japan	Sweden	Ireland (1)	Ireland (2)	Ireland (3)
25.3%	31.6%	31.6%	14.4%	4.2%		
23.2%	18.1%	22.6%	14.4%	4.2%		
23.2%	18.1%	22.6%	14.4%	4.2%		
27.9%	35.5%	33.1%	14.2%	4.2%	8.7%	16.2%
25.8%	21.4%	24.0%	14.2%	4.2%	5.6%	11.3%
25.8%	21.4%	24.0%	14.2%	4.2%	4.3%	9.1%

**Note 4:** The general CIT rate in Ireland was 32% in 1996, 24% in 2000 and 20% in 2001. A lower rate of 10% is applicable for manufacturing and the international tradable service sector (i.e., financial service sector), to which a corresponding METR of 4.2% is shown in Case (1). Case (2) is for hotel services that are subject to the general CIT rate but enjoy a higher tax depreciation rate of 15% for hotel buildings. Case (3) is for other services subject to the general CIT rate and tax depreciation allowance. In 2004, Ireland's statutory corporate rate will be 12.5% for all three sectors and the corresponding METR, 5.3%.

points. As a result, Canada has become an outlier, with the highest effective marginal rates of any of the G7 countries (except Japan).

Recent reforms in Scandinavia have resulted in companies being taxed at corporate income tax rates below 30% in Finland, Sweden and Norway, and 32% in Denmark. However, the aggressive business tax policies of Ireland are the most important case in point, since Ireland is the fastest growing OECD country of the past decade, virtually doubling its per-capita GDP in 10 years. While Ireland has reduced tax rates on manufacturing and financial service income to 10%,<sup>19</sup> it also eliminated a number of special ineffective preferences for investments. After pressure from the European Union, Ireland is implementing a corporate income tax rate of

12.5% by the year 2004 that will apply to all businesses. As shown later, Ireland and Sweden have a far more favourable tax treatment of investments compared to Canada.

Over the past five years, Canada's competitive position has eroded as a result of reforms in many countries. In 2000, Canada's effective tax rate in manufacturing, while still comparable to that of the United States, was only lower than that of Germany. However, in 2001, Germany's substantial reform of its system put its effective tax rate well below Canada's. For services, in the year 2001 Canada's effective tax rate was well above that of most countries.

With prospective reductions in federal and provincial statutory corporate tax rates, by 2006 Canada's effective tax rate on capital will be competitive with that of the United States but still above those of the United Kingdom, Sweden, and Ireland. However, it is likely that many of these countries will undertake further changes to their corporate income tax systems and it can be expected that in five years many countries will have reduced corporate income tax rates while broadening their tax bases.

## **Recommendations for corporate taxes**

- 1** Implement the seven-percentage-point reduction in the general corporate rate in Budget 2000 on a timely basis, as laid out in the October 2000 Statement. The one-percentage-point rate reduction of January 1, 2001 and two-percentage-point rate reduction of January 1, 2002 should be followed by two annual reductions of two percentage points over the next two years.
- 2** Implement the base broadening and other recommendations of the Report of the Technical Committee (including the elimination of the 4% corporate surtax). This will permit additional reductions of federal and provincial statutory rates, bringing the combined rate close to 30%.
- 3** Provide selective investment credits that provide transitional relief for industries adversely affected by these reforms.



## **Recommendations for integrating corporate and personal income taxes**

As noted above, amid growing concern that high tax rates affect Canada's international competitive position, the federal government has recently moved to lower taxes on capital gains substantially, and plans to reduce corporate tax rates significantly over the next 4 years. Some provinces have recently reduced these taxes, and others plan future reductions.

While these reductions in effective marginal rates on capital income are welcome, the reduction in capital gains taxes has created a differential between taxes on these gains and taxes on dividends, thereby providing an incentive for conversion of dividends into capital gains. Resolving this issue is now more difficult, because all provinces have moved to a tax on income basis. In this section I consider alternative ways of dealing with this problem.

There are several features of the existing income tax system that prevent the establishment of equal effective marginal tax rates on capital gains, dividends and other income. There is no full integration of the corporate and personal income tax system. While the system has been designed to approximately integrate corporate and personal taxes for small CCPCs, for all other corporations, integration is only partial. Since the rate of corporate tax for small CCPCs differs from that of other corporations, a common dividend credit rate alone cannot achieve perfect integration for both types of firms. Finally, the existence of the \$500K capital gains exemption for shares of qualifying CCPCs prevents equalization of taxes on the three categories of income derived from such companies.

Since a major tax reform to equalize corporate rates, provide full integration and abolish the special capital gains exemption is not in the cards, what is the "second best" solution? As the differential treatment of small CCPCs lies at the heart of the problem, we first consider the appropriate tax rates on dividends for these firms, and then consider the tax treatment of other companies. For many small CCPCs the special capital gains exemption reduces the effective rate of tax on capital gains to zero. The existence of this exemption has necessitated the implementation of many rules to determine how firms may qualify for the exemption. These rules

effectively prevent the generation of capital gains through either dividend strips or the accumulation of financial assets.

For small CCPCs, the most important issue is, therefore, the equalization of taxes on dividends and on other income paid by these firms (wages and salaries, bonuses, etc.) This can be accomplished by setting federal and provincial net dividend credit rates so as to achieve perfect integration of taxes on dividend income for these firms. One way of doing this is to implement dividend distribution taxes on dividends paid from income eligible for the small business deduction.

For other companies (public corporations, large CCPCs and other private corporations) the most important issue is the equalization of taxes on dividends and capital gains for top bracket tax payers. If the rate of tax on dividends is higher than the rate of tax on capital gains, these firms would have an incentive to convert dividends into capital gains through share buybacks and other financial arrangements.

How do we implement these recommendations? For all corporations except small CCPCs, I propose that the dividend gross-up and credit system be changed to equalize marginal rates on dividends and capital gains for individuals in the highest marginal rate bracket. Specifically, I recommend that the dividend gross-up factor be increased to one third, and the federal dividend credit be increased to set the top marginal federal tax rate on dividends at 14.5%, equal to the top marginal federal tax rate on realized capital gains.

I assume that participating provinces will accept the federal definition of taxable income, so that the 50% capital gains inclusion rate and the one-third dividend gross-up enter the provincial income tax base. Each province should then set its dividend credit so as to equalize its top marginal rate on dividends with its top marginal rate on capital gains.

At current corporate tax rates, this system will not provide complete integration for large corporations. However, the degree of integration will increase as planned future corporate rate reductions are put into effect.

## **Notes**

- 1** For a discussion of the allocational and incentive effects of business payroll taxes, see Mintz and Wilson 2001 and Dungan 1998.
- 2** Boadway and Kitchen 1999: 220–21.
- 3** It is for this reason that the United States modifies its classical CIT through the use of sub chapter “S” corporations, which are taxable in the same way as partnerships.
- 4** As usual, these EI contribution rate changes were put into effect prior to the budget on January 1, 1998.
- 5** Other corporate changes included liberalization of capital cost allowance for certain assets, tightening of the thin capitalization rules for foreign owned corporations, repeal of non-resident investment corporation elections, and restrictions on “weak currency” borrowing.
- 6** Other measures permit deferral of tax on the exercise of employee stock options and the establishment of rollover provisions for certain small- and medium-sized business investments.
- 7** This would bring the general corporate rate down to the rate for manufacturers and processors. Note that the general federal rate for mining and oil and gas is to remain at 28%.
- 8** This income bracket is from \$60,000 (indexed after 2000) to \$100,000 (indexed after 2001).
- 9** See Perry 1998: 626–44.
- 10** Source is Ort and Perry 1999: 1194–213.
- 11** Source is Ort and Perry 2000: 710–33.
- 12** Source is Ort and Perry 2001: 674–707.

- 13** For perfect integration under the existing gross-up and credit for dividends, the combined corporate rate should be 20%. Rates above 20% indicate under-integration and rates below 20% indicate over-integration. The resolution of this problem will be discussed in the section on recommendations below.
- 14** This section draws upon Mintz and Wilson 2001: 95–133.
- 15** See Whalley 1997.
- 16** See Dungan, Murphy, and Wilson 1997 and Jog and Tang 1997.
- 17** The broad service sector includes all industries except manufacturing and processing and the resource sectors.
- 18** This revenue loss is less than the fiscal cost estimate derived from Finance, *The Economic and Fiscal Update*, Nov. 2, 1999 p. 113.
- 19** This rate is substantially below the 30% rate for other industries, resulting in less favourably taxed industries growing less quickly.

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