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Tax Policy for a Rent-Rich Economy

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Dans cet article, j'avance qu'une partie significative du revenu est constituée de gains ou de rentes exceptionnels. Les rentes profitent aux entreprises et à leurs propriétaires, de même qu'aux détenteurs d'actifs. Elles profitent également aux gens ayant un revenu, étant donné les changements exceptionnels des salaires et les occasions de recherche de rentes, et les gens ayant un revenu élevé obtiennent une part disproportionnée des rentes. J'explore les effets de ce phénomène sur les politiques fiscales canadiennes. Parmi les propositions de réforme fiscale, je souligne l'adoption d'un régime fiscal des entreprises avec déduction pour fonds propres d'une société, l'abolition du crédit d'impôt pour dividendes et le traitement préférentiel des gains en capital, la limitation de l'utilisation des comptes d'épargne libres d'impôt, l'augmentation de la progressivité de l'imposition des revenus et la mise en place d'un revenu de base garanti.

Mots clés : politiques fiscales, rentes, inégalités, redistribution

I argue that a significant amount of income consists of windfall gains or rents. Rents accrue to firms and their owners, as well as to asset owners. They also accrue to income earners due to windfall changes in wage rates and rent-seeking opportunities. High-income persons obtain a disproportionate share of rents, and I investigate the consequences of that for Canadian tax policy. Some tax reforms suggested include adopting an allowance for corporate equity business tax system, abolishing the dividend tax credit and preferential treatment of capital gains, limiting the use of tax-free savings accounts, increasing the progressivity of income taxation, and adopting a guaranteed basic income.

Keywords: tax policy, rents, inequality, redistribution

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Introduction

This article is concerned with the suitability of the Canadian tax system in light of new directions in tax policy elsewhere and recent findings about income and wealth inequality. I focus on two main issues. First, what principles should inform tax policy, and how have those principles evolved over time? In particular, how well do they adapt to changing circumstances? Second, how well does the Canadian tax system accord with accepted principles?

With respect to the first question, I argue that the current dominant approach to normative tax design—the so-called optimal tax approach—is inadequate given recent events, and must be supplemented by other approaches. Such approaches should recognize the importance of rents as elements of the rewards obtained in an evolving market economy. Rents are returns from an economic activity over and above the opportunity cost of undertaking the activity, and are sometimes referred to as windfall gains or economic surplus. Examples include excess profits associated with a monopoly; the value of a natural resource above the costs of exploring, extracting, and processing the resource; and windfall gains from unexpected price increases, such as the extra income received by any kind of worker, from an employee to a corporate executive, when social or technological factors increase her/his wage. Rents are of particular interest from a taxation perspective because, in principle, taxing rents can obtain revenue without any "deadweight loss" reduction of the social value of existing economic activity. Indeed taxing rents could potentially curtail unproductive "rent-seeking" activity, for example a firm's efforts to influence government to

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obtain inefficient tariff protection or a manager's efforts to try to influence her/his board to improve her/his salary.

Regarding the second question, the Canadian tax system has evolved from one based on outdated principles, and some key elements of the system no longer make sense. This is a consequence of the fact that tax reform in Canada has been piecemeal, and while there have been many good innovations, the system as a whole has not been subject to periodic evaluation of the sort undertaken elsewhere in the world.

Interest in tax policy around the world has surged in recent years as indicated by several observations and events. The publication of the landmark Mirrlees Review (Mirrlees et al. 2011) represented a watershed in drawing innovative tax policy recommendations explicitly from theoretical and empirical optimal tax analysis. Although it was written with the UK tax system in mind, its analysis and proposals are universal and some of its ideas are highly relevant for Canada. At the same time, as discussed later, some conceptual issues have been raised by influential public finance economists about the relevance of relying on a particular model of optimal income taxation—the so-called Mirrlees model—to drive policy advice. This model, although widely adopted in the academic literature, relies on some debatable assumptions.

Next, various pieces of evidence on the growth in inequality and the volatility of earnings, income and wealth have recently been published, including by the OECD (2008, 2011, 2015), by Piketty, Atkinson, and various co-authors (Atkinson and Piketty 2007; Atkinson, Piketty, and Saez 2011; Piketty 2013), and in Canada by Veall (2012), Fortin et al. (2012), and Corak (2013), among others. Of particular importance, one finds a shift in the distribution of wage rates in favour of high earners, which leads to earnings increasing much more for higher-income persons than middle- and low-income persons. In addition, wealth inequality (including housing) has been rising, which according to Piketty results from the return to capital being higher for wealthier persons and remaining high relative to the growth of earnings despite the growth in the capital-output ratio. To the extent that these outcomes are unanticipated, they lead to rents or windfall incomes. More generally, rents are an inevitable consequence of a constantly changing economy, and part of my purpose is to contemplate the implications of that for tax policy.

Finally, the economic collapse of 2008 revealed a potential weakness in the financial system, to which tax policy might have contributed. Interest deductibility in the corporate tax system encourages firms to take on leverage, and the preferential tax treatment of housing, especially in the US, encourages households to take on mortgage debt. The proclivity of the financial sector to take on risky debt was the immediate source of the financial collapse, but tax reform has a role to play in discouraging undesirable risky behaviour.

These observations raise the issue of the suitability of current normative tax theory, which is based on static assumptions, and of the current tax system for dealing with a changing world, particularly one in which rents are more important than usually recognized. What implications, if any, does the change in the wage distribution have for the design of the tax-transfer system? How should capital income be taxed at the personal and corporate level? How progressive should the tax on earnings be? How should housing be treated? These are issues I take up in this article, albeit largely speculatively.

Tax Policy Innovations in Canada and Elsewhere

To provide further context, it is worth summarizing some tax policy innovations and experiments that have been implemented around the world. Some have been in response to new ideas emanating from the literature, and others in response to the changing world. Many have reflected advances in tax policy administration. Perhaps the most momentous reform has been the widespread adoption of value-added taxes (VATs), which has solidified the use of consumption as a tax base. Various reforms in personal taxation have included increased sheltering of capital income, the flattening of the rate schedule, and the important innovation of refundable tax credits that information technology has enabled. There has been a general reduction in the use of wealth or wealth transfer taxes. All of these changes have led to tax systems that are less progressive and more focused on consumption relative to income than before. In addition, there has been some experimentation with new forms of rent-based business taxation, notably the Allowance for Corporate Equity (ACE) and the Resource Rent Tax (RRT). These various changes will be relevant for my discussion.

Canadian taxation has not been immune to reform; our tax system has been evolving, albeit in a gradual and piecemeal fashion. At the same time, our benchmark for tax policy thinking remains faithful to some of the guiding principles set out long ago in the Carter Report (Royal Commission on Taxation 1966). In particular, the norm to which our personal tax base pays lip service is comprehensive income taxation—that is, earnings plus income from all assets—deviations from which are formally considered to be tax expenditures by the government (Finance Canada 2015). Notable deviations include Registered Pension Plans (RPPs), Registered Retirement Savings Plans (RRSPs), Tax-Free Savings Accounts (TFSAs), Registered Education Savings Plans

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(RESPs), and housing. As elsewhere, Canada has largely moved to a VAT system for sales taxes, specifically the federal goods and services tax (GST), provincial harmonized sales taxes (HST), and the Québec sales tax (QST). As well, refundable tax credits have been introduced for redistributive purposes, including the GST Credit, Canada Child Tax Benefit (CCTB), and the Working Income Tax Benefit (WITB).

Complementing the personal income tax (PIT), the corporate income tax (CIT) is designed as a withholding tax to prevent shareholders from sheltering their income indefinitely within the corporation, and most recent business tax reform proposals aim at perfecting that role (e.g., Technical Committee on Business Taxation 1997). The practical consequence is that the base of the CIT is essentially shareholder income, and the CIT is crudely integrated with the PIT via the dividend tax credit at a given rate on dividends from Canadian corporations and the taxation of 50 percent of capital gains.

Viewing the PIT from the comprehensive income perspective belies the fact that, except for those with high incomes, Canadian taxpayers can potentially avoid taxation of most capital income by taking advantage of tax-sheltering devices (even before the 2015 proposed increase in TFSA limits).[1] Thus, we are very close to a consumption tax system for most of the population. It also belies some consequences of the CIT, which is based on shareholder income that equals a combination of risk-adjusted normal returns to shareholders and above-normal profits, or rents. Given Canada's integration into international capital markets, the risk-adjusted return is largely shifted away from shareholders to labour, so there is no argument for providing credit for corporate taxes paid. At most, integration could be provided for the tax paid on above-normal corporate profits, though that would be infeasible. Moreover, there is no point in the CIT applying to normal shareholder returns given that they largely escape taxation at the personal level. The fact that it does so is the source of inefficiency of the CIT.

As elsewhere, the Canadian tax system has become less progressive with the flattening of the rate structure, although that has been to some extent offset by the institution of refundable tax credits. The latter have also been integrated with the income tax system, resulting in the beginnings of a negative income tax system. Progressivity is also limited by the absence of an inheritance tax, which was gradually abolished by the provinces in the 1970s and 80s. (It is noteworthy that the Carter Report considered inheritances and gifts received as part of comprehensive income, but that was never enacted in Canada.)

This leads me to ask what Canada could learn from taking a fresh look at tax policy. I begin with a brief summary of the Mirrlees Review, which has recommendations that are immediately relevant to my concerns.

The Mirrlees Review: The Main Message

The Mirrlees Review was prepared for the Institute of Fiscal Studies (IFS) in the UK by a committee chaired by Nobel Laureate Sir James Mirrlees to commemorate the 30th Anniversary of the famous Meade Report (Report of a Committee Chaired by Professor James Meade 1978), which was also sponsored by the IFS and was written by a committee chaired by an earlier Nobel Laureate, Sir James Meade. It consisted of two massive volumes. The first was written by a cadre of international public economics scholars, supported by microeconometric household behaviour analysis, and covered all the main tax types. The second was a report written by the committee of largely British scholars that drew on the research studies, but was not bound by them. The committee constrained itself to policies that were roughly distribution-neutral, revenue-neutral, and politically feasible; in other words, policies that could improve the efficiency of raising revenues. It made no attempt to consider the consequences of growing inequality for the progressivity of the tax-transfer system.

What emerged was remarkably similar to the Meade Report. The Meade Report had three main recommendations: progressive personal consumption taxation, cash-flow corporate taxation, and progressive taxation of lifetime inheritances. The Mirrlees Review also recommended versions of these three things. Despite this similarity, the Meade Report was not driven by optimal tax theory and its emphasis on utilitarianism. Its argument for consumption taxation had its genesis in Kaldor's famous dictum that people should be taxed based on what they took from society rather than what they contributed to it (Kaldor 1955).

The Mirrlees Review's main elements for my purposes included first a modified personal consumption tax system using three separate asset treatments labelled by their own acronyms:[2] (a) TEE, which is the analogue of TFSAs, applicable to low-risk assets (bonds) and housing; (b) EET, the analogue of RRSPs, applicable to retirement saving; and (c) TtE, an innovative hybrid approach applicable mainly to shares, which is like TEE except that returns on risky assets (shares) above a normal rate-of-return allowance are taxed. Earnings would be subject to a progressive rate structure (though not too progressive), using refundable participation tax credits and harmonized with pension income to encourage labour market participation by the elderly and parents of school-age children (two groups estimated to have large participation elasticities). Transfers and taxes would be better harmonized to avoid excessive marginal tax rates. Business income would be taxed using the ACE

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system for both corporations and personal businesses, which is a rent-based business tax system. This differs from the standard CIT on shareholder income by allowing firms to deduct a cost of equity finance based on a risk-free cost of funds. As discussed later, it is roughly equivalent to Meade's cash-flow tax in present-value terms. The Mirrlees Review recommended continuing integration of CIT and PIT, presumably to avoid double taxation of rents. The report also recommended that the VAT be broadened to eliminate the special treatment of necessity goods, based on some recent important innovations in optimal tax theory (Laroque 2005; Kaplow 2006). As with the Meade Report, the Mirrlees Review recommended a progressive lifetime inheritance tax, based on equality of opportunity arguments.

The elements of the Mirrlees Review that are most relevant for me are the taxation of above-normal returns on shares despite capital income otherwise being sheltered and a business tax system based on rents. The maintenance of the status quo on tax progressivity is also notable, perhaps reflecting the fact that the report was done before concerns over earnings and wealth inequality trends were emerging in the mainstream media. We should also remind ourselves of elements of the Canadian tax system that parallel the Mirrlees recommendation. We have a modified personal consumption tax system with two of the three asset treatments. RPPs and RRSPs correspond with EET treatment, while TFSAs, housing, and to some extent RESPs correspond with TEE. There is no analogue with TtE treatment, although as I shall argue RRSPs accomplish much the same thing by implicitly taxing above-normal returns. Our CIT is based on shareholder income rather than rents as in the ACE, so it includes both rents and risk-adjusted returns to shareholder equity. The HST/QST system is fairly broad based, and as mentioned refundable transfers are integrated with the income tax system. In addition, although we no longer have a tax on inheritances, we do require deemed realization of capital gains on death (although not for housing).

Critiques of the Mirrlees Approach

The Mirrlees Review reflected state-of the-art optimal income tax thinking of the kind predominant in the academic literature. It was based on a *consequentialist utilitarian* view of the world where the government is presumed to use the tax-transfer system to pursue equality in after-tax "utility" or well-being, but is precluded from doing so by behaviour-induced inefficiency and imperfect information giving rise to an equity-efficiency trade-off. In the standard Mirrlees model that informs the review, households are endowed with productive skills that lead to different individual outcomes, and the role of the tax-transfer system is to equalize those outcomes. The model is static in the sense that the productivity/wage distribution is fixed.

This can be contrasted with the Carter Report view of the world where what is important is a taxpayer's ability-to-pay, taken to be captured by comprehensive income, and a tax structure that equalizes sacrifice. One can think of this as akin to an equality of opportunity approach, where resources at one's disposal are the benchmark, and where equal sacrifice means that one's initial position is relevant as well as where one ends up. Of interest is that, unlike the Mirrlees approach, information and incentives do not play a central role: progressivity is determined by equal sacrifice rather than an equity-efficiency trade-off. In fact, the Carter Report considered a reasonable upper bound for the marginal income tax rate to be 50 percent, a number that today has a ring of familiarity.

Despite being the dominant academic consensus to tax policy, the Mirrlees approach is viewed by some as unsatisfactory for various reasons, two of which were recently highlighted by Atkinson (2012) and Feldstein (2012). Feldstein argued that the utilitarian optimal tax methodology was unacceptable because it implicitly assumed that skills of individuals could be treated like common property and their fruits redistributed at will. To put it in other terms, consequential utilitarianism ignores horizontal equity, or equal sacrifice, since it puts no weight on the starting point, or on the ownership of one's human skills. This highlights an important contrast between two widely differing approaches to social equity. At one extreme is the Rawls (1971) social contract idea that human talent is public property and the fruits of it can be freely redistributed to achieve utilitarian ends: initial positions do not matter. At the other extreme is the Nozick (1974) libertarian idea of individuals' ownership of talent where all redistribution is akin to theft: initial positions mean everything. The intermediate case proposed by Mill (1871) is the equal-sacrifice doctrine, where both initial and final positions matter. Note that consequentialism is not necessarily the culprit. An alternative to the utilitarian consequentialist approach is the equality of opportunity approach of Fleurbaey and Maniquet (2011) that stresses equalizing resources persons have at their disposal. It too is subject to the property rights critique.

Normative objectives in the end should conform to what society finds acceptable. Recent survey evidence of Weinzierl (2014) finds public support for the logic of utilitarianism, but constrained by equal-sacrifice. As he argues, what is at stake is the progressivity of the income tax: equal-sacrifice leads to less progression than utilitarianism. Later I suggest that rents attributable to luck and power weaken the equal-sacrifice argument, and lend support to tax policies that tax returns from luck and power.

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Atkinson (2012) pointed out that the Mirrlees Review ignored non-competitive behaviour, including but not limited to monopoly rents. In the Mirrleesian world, there are no production rents: production is linear and taxation redistributes solely according to household rents, that is, consumer surplus arising from one's initial endowments. In fact, Atkinson overstated this absence of monopoly rents in the Mirrlees Review: the idea of the ACE business tax and the taxation of above-normal rates of return at the personal level are predicated on there being producer rents. But his point was that the review was based on a model in which such rents did not exist. They appeared in the policy recommendations as an unexplained add-on.

Two further anomalies in the Mirrlees Review are worth noting. First, apart from the taxation of super-normal share income, capital income would go untaxed. This is at odds with what was recommended in the background research papers. Banks and Diamond (2010) recommended continued taxation of capital income, albeit at concessionary rates. This would resemble the dual income tax system adopted first in the Nordic countries, and later in other EU countries, including the UK.[3] In addition, established results in the dynamic optimal income tax literature call for fairly substantial capital income taxation (Conesa, Kitao, and Krueger 2009) especially at the upper end of the income distribution (Banks and Diamond 2010). Second, while the core of the Mirrlees Review was based on utilitarian logic, the recommendation for a progressive lifetime inheritance tax was based on equality of opportunity. This recommendation was aimed at large inheritances, since there would be a high exemption level. It is consistent with the idea of taxing windfalls or above-normal profits that are found elsewhere in the Mirrlees Review.

The Abundance of Rents

Atkinson's critique has a point. Sources of rents in production are not hard to find, and include the following: natural resources, both renewable and non-renewable; market power in financial institutions, infrastructure firms, and natural monopolies like telecommunications, cable, and transportation; differences in productivity of firms in competitive industries; and knowledge advantages in pharmaceuticals, information technology, and patents. In attempting to tax productive rents, it is important to distinguish rents from quasi-rents, that is, rents generated from previous investments, and also rents from returns to risk. It is not always possible to make these distinctions.

The prevalence of rents goes beyond traditional monopoly rents. It can be argued that a significant component of the growth in inequality can be viewed as attributable to changes in rents both positive and negative—that is, windfall gains and losses reflecting luck—so the tax treatment of rents will play a central role. There are several aspects to this. One is that changes in earnings inequality, which has been the source of much of the growth in income inequality, are in large part a consequence of changes in factor prices, as opposed to changes in behaviour or the supply of skills. If, say, high-skilled persons find that their wage rate has increased because of technological progress, this creates significant producer surplus that dwarfs the effect of any behavioural response. This can be regarded as a matter of luck, and taxing that surplus may be less open to the equal-sacrifice critique of the optimal tax approach. Some of this increase in producer surplus appears as capital income at higher income levels because of the use of tax-planning techniques like stock options as forms of payment.

Related to this, Stiglitz (2012) has argued that much of the growth in inequality documented by Piketty can be attributable to rent-seeking opportunities created by globalization of markets, information, lax credit market regulation, and market power, for example, in financial services. The phenomenon of super-managers is an instance of this. However, if the rent-seeking takes the form of innovation, what might appear to be rents are returns to innovation, and the case for taxing them is considerably diminished. Piketty (2013) also documented a correlation between rates of return to savings on the one hand and portfolio sizes on the other, which can be interpreted as conflicting with the competitive view of capital markets. While his data drew on large foundations in the US, it is conceivable that the same correlation applies more broadly.

More generally, Ray (2015) has argued that in the process of economic development, countries go through alternating cycles of increasing and decreasing inequality, analogous to Kuznet's Inverted-U Hypothesis (Kuznets 1955). That is, when new innovations or opportunities arise, those with the financial and human wealth endowments and entrepreneurs are able to take advantage of them, increasing inequality. Over time, the economy adjusts and the benefits are passed to workers and others, reducing inequality. Thus, rents are temporarily created and then eliminated. This process repeats itself and applies at a sectoral level as well as economy-wide.

Recent work by Piketty, Saez, and Stantcheva (2014) has attributed some of the growth in executive pay to better bargaining outcomes induced in part by low marginal tax rates at the top, which increase the bargaining strength of CEOs. These lower rates have diverted more corporate rents to executives by increasing the gain from bargaining for higher rewards, and this is compounded by the ability to take executive pay in forms that are lightly taxed. This is reinforced by the recent suggestive

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evidence presented by Lemieux and Riddell (2015) that is based on Canadian census data. They find that high-income earners in finance, business services, and oil and gas contribute disproportionately to the growth on incomes of the top 1 percent (relative to occupational groups like doctors, engineers, and computer scientists). They attribute this to the ability of executives and other individuals to extract rents in these sectors.

Finally, increases in housing prices in certain locations have contributed disproportionately to measured wealth inequality. Whether this represents rents or luck as opposed to return to risk is an open question. Note that saving in housing is essentially the same as TFSA saving since imputed rents and capital gains on housing are not taxed.

Some might argue that what I am calling windfall rents from, say, changes in the distribution of wages are really better thought of as risky returns, given that wage rates are stochastic to begin with. It is doubtful that is fully true. Given the difficulty economists have in explaining changes in relative wage rates, it is hard to imagine individuals anticipating the distributions of future wages they face.

It is interesting to recall that there was some recognition given by the Mirrlees Review to the prevalence of rents, or what they called *super-normal returns*, on private assets. As mentioned, the review advocated that the tax treatment of saving in business shares should follow what we can think of as a modified TFSA approach: instead of returns to these assets being tax-free, any above-normal returns should be taxed. Although this is highly unworkable from a tax-compliance point of view, it at least signified that the Mirrlees Review authors thought there could be rents or super-normal returns at the personal level. Undoubtedly this was largely driven by the importance of the financial sector to the UK economy. Other rent-like elements of the Mirrlees Review tax package included proposals for rent-based corporate taxation, for land value property taxation, and for taxation of inheritances (including housing).

Rents are incredibly difficult to measure. For example, it is difficult to distinguish rents from returns to risk. Nonetheless, there is some evidence that rents in the production sector can be substantial. To see this, note that corporate taxable income comprises three elements: normal returns to investment, returns to risk, and rents. Recently, de Mooij (2011) considered the consequences for corporate tax revenues of moving from a CIT based on shareholder income to an ACE tax system by allowing as a deduction the risk-free interest rate times the amount of equity finance. He calculated that in the case of Canada, such a reform would reduce corporate income tax revenues by 20 percent, which implies that 80 percent of corporate income consists of returns to risk plus rent. This can be confirmed by an alternative back-of-the-envelope calculation.[4] The Statistics Canada *National Balance Sheet Accounts* for 2012 reported $2.1 trillion in assets versus $1.2 trillion in loans, leaving $900 billion equity-financed investment. An ACE deduction using 4.3 percent (the long-term government bond rate) would reduce the corporate tax base by $.043 \times \$900$ billion $= \$39$ billion, which is equivalent to $6 billion in tax revenues. Since total federal corporate tax revenues in 2012 were $33 billion, this represents a decline of 19 percent. Thus, moving from the current income-based CIT to an ACE rent-based CIT would reduce tax revenues by less than 20 percent, confirming that about 80 percent of corporate income consists of rents and returns to risk. Even if the risk premium were equal to the risk-free interest rate, rents would still be 40 percent of corporate income, and presumably this is an underestimate. Of course, rents would vary by sector, but the point is that if the CIT were designed to be a tax on rents rather than on all shareholders' returns, revenues would fall by only 20 percent. Moreover, the tax would be less distortionary, so investment could rise and a higher tax rate could be tolerated.

The upshot of this discussion can be summarized as follows. Optimal tax theory that informs much tax policy discussion has significant limitations. It is based on static assumptions and is ill-equipped to provide guidance to economies faced with exogenous shocks. Its philosophical underpinnings—especially its consequentialist approach—is suspect, and it differs considerably with classical approaches, such as equal sacrifice, that take account of initial positions, and for which there is apparently some public support. There are other shortcomings that have been prominent in recent academic literature, such as how to deal with the fact that persons have different preferences, and how to take into account social preferences or norms for redistribution. These lead to different, more cautious, views about optimal redistribution, some of which are based not on equalizing ex post utility but on equalizing access to resources and not penalizing persons based on how they use resources. I have suggested that an important issue affecting tax design that is not captured in standard models is the prevalence of rents, including rents accruing to producers, rents on earnings arising from shocks to the wage structure, and rents that appear in asset income, especially at upper income levels. In turn, there are various elements of the tax system that apply to rents, such as the CIT, the personal taxation of asset income, and the taxation of earnings.

The quantitative importance of rents remains an open question. To the extent that high asset returns and increased earnings rates are random returns that are anticipated, some of what we suppose are rents could

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be returns to risk. The case for taxing them away on the grounds that they are due to luck is then compromised. However, the arguments for rents being substantial are compelling. This is especially true in the case of rents to market power and informational advantage. It is equally compelling for temporary rents created by the ebb and flow of market evolution. Similarly, it is hard to believe that changes in labour earnings could be anticipated by workers. To the extent that high returns to labour or capital reflect good random outcomes, taxing them arguably does relatively little harm, provided good returns and bad ones are treated symmetrically. Indeed, as Domar and Musgrave (1944) show, if negative returns are treated symmetrically by the tax system as positive ones, taxing returns to risk need neither discourage risk nor reduce expected utility substantially since the government is effectively sharing the risk.

Implications for Tax Reform in Canada

The earlier discussion of the importance of production rents and of windfall gains of earnings and capital income leads me to some preliminary proposals for tax reform in Canada. Some of these parallel what one finds in the Mirrlees Review, and others are similar to what has recently been proposed in Canada by Milligan (2014). They draw on some proposals in Boadway and Tremblay (2014) and in Boadway (2014). They also draw on tax reform experience in other countries. While the reform proposals represent a reorientation in the basis for tax policy, they can be implemented with relatively little transitional anxiety. There are several components.

Taxation of Rents at Source

The rationale for designing the CIT as a withholding device for personal income tax is no longer relevant. The key reform here is to move the CIT from a tax based on shareholder income to one based more closely on rents. The current CIT already applies in part to rents, but since it includes normal shareholder income in its base, it is unnecessarily distorting: it encourages excessive leverage, discourages investment, and is prone to tax competition.

Taxing rents directly would not be feasible since rents are difficult to measure as they accrue. But it is straightforward to tax them indirectly and approximately by using a cash-flow or cash-flow equivalent corporate tax. That is because under certain circumstances (especially the absence of risk aversion), the present value of cash-flows equals the present value of rents (Auerbach 1979). I use the term *approximately* because it is practically impossible to apply a cash-flow type tax to rents that does not also include the return to risk in its sights. I return to this shortly.

There are many cash-flow equivalent taxes, and a number have been applied in various countries. Cash-flow taxation itself is used in the Norwegian offshore petroleum industry. The RRT was used in the Australian mining industry, and versions of it are used in some Canadian provinces, including Alberta, British Columbia, and Newfoundland and Labrador. An RRT is essentially a cash-flow tax except that negative cash flows are not honoured immediately, but are carried forward at a risk-free rate of interest, referred to as the *uplift rate.*

Of more relevance is the ACE tax that various European countries have used and that the Mirrlees Review advocated. It has the advantage of being a relatively simple revision to the current CIT. Its essential feature, though by no means the only one, is to allow firms a deduction for the cost of equity finance equal to the risk-free corporate interest rate times the book value of equity-financed investment. In other words, both the cost of debt and the cost of equity would be deductible. The book value of equity-financed investment is based on the depreciation rate used for tax purposes. The key point about both the ACE and RRT is that they differ from pure cash-flow taxation only in postponing some deductions from the tax base. In the case of the ACE, these are deductions for investment costs. These are carried forward at the risk-free rate on the presumption that there is no risk that the government will not honour them in the future.

The ACE could apply both to corporations and to personal businesses. It could apply to all sectors of the economy, including finance and resource industries, and it could be applied by both levels of government. Rates could be chosen with less constraint compared with the current tax system, since a rent tax would be partly immune from tax competition. This would permit the ACE to be introduced in a revenue-neutral way if desired, though that is not necessary.[5] Some special measures might be needed to deal with rents from intellectual property, which is highly mobile across countries. For example, the profit from intellectual property that is exploited in Canada could be afforded special tax treatment, as recently suggested by Pantaleo, Poschmann, and Wilkie (2013). Other countries deploy similar preferences for intellectual property. Loss-offsetting should be as complete as possible, with any carry-forward of tax losses bearing a risk-free interest rate. The main detraction from full loss-offsetting is the difficulty giving refundability of accumulated losses to firms that wind-up or go bankrupt. (Almost no countries do this, an exception being Norwegian offshore petroleum taxation.) Since most of these will be small businesses, a preferential small business tax rate should be maintained given their extra riskiness and chances of bankruptcy.

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Since the CIT would no longer be designed to withhold against shareholder income, the case for integration of the CIT and PIT largely disappears. The term *largely* is used because while a substantial part of capital income, including rents, would not be taxed at the personal level, some would. Where rents are taxed, for example, by high-income persons who have exhausted sheltering possibilities, or persons who hold RRPSs or RPPs that tax rents ex post, it would be practically impossible for integration to target the rent taxes paid at the corporate level on their behalf. The implication is that the dividend tax credit and the one-half taxation of capital gains would disappear. This would affect largely higher-income taxpayers. Eliminating the half-taxation of capital gains in particular would reduce much wasteful tax planning, especially if the tax treatment of stock options were also changed to eliminate the tax advantages for executives to take their income in this form of stock options. (Gains from the exercise of stock options are not explicitly treated as capital gains for income tax purposes, but recipients can claim a 50 percent deduction that is comparable to capital gains tax treatment. The benefit of this preferential treatment is muted by the fact the corporations cannot deduct stock options granted from their taxable income.)

A key problem facing a CIT based on rents, and one that also applies to the existing corporate tax system, is that it cannot avoid taxing returns to risk. This is an unavoidable by-product of taxing rents, at least as long as corporations are risk-averse so risk premiums are positive. While cash-flow or rent taxes, like RRSPs at the personal level, fully shelter the risk-free return on investments, they include in their base both above-normal returns and stochastic returns to risk. The fact that a rent tax taxes the return to risk is not necessarily bad. As mentioned, as long as full loss-offsetting applies, the taxation of risk generally encourages risk-taking since the government is sharing in the risk. The only issue is whether too much risk is encouraged.

One final caution should be noted about rent taxation, which also applies to the existing corporate tax system. To the extent that economic progress follows a Schumpeterian creative destruction process, temporary rents are a necessary part of that process. To the extent that Schumpeterian innovators capture rents of their innovations, taxing them might discourage technological investment aimed at creating an advantage over one's rivals. However, Schumpeterian investment might be viewed as simply another form of risk-taking, in which case a rent tax might favour it. In other words, despite the strong case in principle for the CIT to tax rents, in practice this is a difficult thing to do. Nonetheless, reforming the CIT from a tax on shareholder income to a cash-flow equivalent tax will, by removing normal returns to equity from the tax base, bring the tax closer to a neutral rent tax and if anything encourage risk-taking.

The federal-provincial dimension of designing the CIT as a rent tax is also worth noting. Were the provinces to adopt the tax reform, the corporate Tax Collection Agreements could and should continue to apply, and provinces could choose to allow the Canada Revenue Agency (CRA) to collect the CIT on their behalf. Of more significance, a rent tax would be very similar to an ideal tax on natural resources, both renewable and non-renewable. Since a rent-based CIT would not selectively target the resource industries, it would not violate the provincial right to levy dedicated resource taxes. Indeed, the current CIT already taxes natural resource rents, albeit inefficiently. However, to the extent that the CIT and resource taxes applied to the same base, the possibility would open up to harmonize resource taxes across provinces, and harmonize them with the CIT in a way that improves the efficiency of the business tax system as a whole. The CIT would no longer favour resource firms, nor would there be any need to deduct provincial resource taxes from the CIT as under the current system. The provinces would retain the right to choose their own CIT rates as well as their resource tax rates.

Personal Taxation of Asset Income

The accumulation of reforms to the Canadian tax system has resulted in a high proportion of capital income being sheltered from taxation. Sheltered income includes savings in *ex ante sheltering devices*, like RPPs, RRSPs, and human capital investment, and *ex post sheltering devices*, like TFSAs, primary-residence housing and to some extent RESPs.[6] The fact that the tax mix includes consumption taxes (GST/HST/PST) and payroll taxes further contributes to capital income sheltering. The HST functions essentially like an ex ante sheltering scheme, while payroll taxes are like ex post sheltering schemes.

Most unsheltered capital income consists of (a) that accruing to high-income earners who have exhausted their contribution limits, (b) earnings of high-income persons that masquerade as capital income for tax planning purposes, and (c) capital income of low-income earners who have neglected to maximize their use of tax-sheltering devices. The recent federal budget measure to increase TFSA limits to $10,000 would move the system very close to a consumption tax system of the sort recommended by the Meade Report by allowing high-income persons to shelter much of their savings.

The case for taxation of capital income at upper-income levels is compelling. The optimal tax literature has emphasized that capital income is correlated with skills for various reasons, and it is also correlated with inherited wealth. Evidence suggests that the propensity

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to save rises with skills (or equivalently the utility discount factor falls with skills). As mentioned, asset returns are higher for wealthier persons, indicating that they are able to earn above-normal profits or rents. Also, high-income persons hold a higher proportion of their assets as shares, which obtain windfall benefits from the low-interest rate monetary policy of recent years. In addition, the dynamic macro public finance literature has emphasized the case for capital income taxation based on uncertainty of future wage rates and liquidity constraints. A provocative article by Conesa, Kitao, and Krueger (2009) based on such a model calibrated to the US economy argued for a 35 percent capital income tax rate. At the same time, there are good reasons for sheltering capital income at lower income levels, not just on redistributive grounds, but also to encourage saving for retirement and to smooth tax liabilities over the life cycle.

In thinking of tax policy alternatives, a key difference between ex ante sheltering devices (like RPPs and RRSPs) and ex post sheltering devices (like TFSAs and primary-residence housing) should be understood and borne in mind. While RPPs and RRSPs shelter normal capital income from tax, they do not shelter super-normal returns or returns to risk. The latter are included in the tax base when the accumulated value of sheltered assets are drawn down and subject to taxation. Human capital accumulation is treated similarly to RRSPs, so super-normal returns and returns to risk are captured. The same can be said for the HST since consumption taxation is analogous to RRSP treatment that taxes consumption financed from super-normal returns.

In contrast, TFSAs exempt all asset income from tax, including above-normal returns, which accrue disproportionately to high-income taxpayers. The same is true for primary-residence housing. Not only is imputed rent sheltered from tax, but so is any accrued capital gain. Moreover, there is no limit to sheltering asset income in housing, making it especially attractive to high-income persons. The Mirrlees Review partly addressed this concern about ex post sheltering devices by proposing their hybrid tax treatment of share income. Share income would be sheltered ex post, except for returns above a normal rate-of-return allowance, which would by fully taxed. This seems to be an unworkable system from a tax administration point of view. A preferred alternative to the Mirrlees system is simply to restrict the use of ex post sheltering devices like TFSAs. From this point of view, increasing the limits of TFSA contribution from $5,500 to $10,000 is ill-advised: it allows more rents of high-income taxpayers to escape taxation.

A more serious issue applies with the accumulation of primary-residence housing equity, where no limit applies. While it would be politically challenging, a case could be made for a limit to the exemption of housing returns, particularly capital gains, on primary residences. Some countries, such as the UK, partly address this concern through their inheritance tax systems, which include primary residence housing in the base. The sizeable threshold ensures that this affects only persons who have accumulated large estates. While we have no inheritance tax system, the Canadian tax system requires deemed realization of capital gains on death, which essentially prevents indefinite postponement of capital gains taxation. Although this currently does not apply to primary residence housing, it would be possible to limit the value of houses eligible for capital gains exemption. A strong a priori case can be made for a progressive inheritance tax that includes housing in the base, with a sufficiently high threshold level. We did have a tax on estates in Canada into the 1980s, but it disappeared not long after turning it over to the provinces. It would take a relatively major initiative to re-introduce inheritance taxation, despite its merits.

Finally, recall that I have proposed eliminating CIT/PIT integration measures, particularly the dividend tax credit and the 50 percent exemption of realized capital gains that apply on unsheltered capital income. Unsheltered capital income would be fully taxed, but at what rate? My preferred alternative is to aggregate capital income with earnings, and to apply a single comprehensive rate structure to it. The alternative is to adopt a dual income tax structure such as that used in the Nordic countries where a lower rate is applied to capital income than earnings. The argument against a dual income tax system is that it invites tax planning as private firms seek to report labour income as capital income—for example, using stock options—to reduce their tax liabilities. Moreover, given that most capital income can already be potentially sheltered by all but the upper-income classes, the main rationale for a dual income tax does not apply. Combining limits on TFSAs (and ideally on the ex post sheltering of primary residence housing) and the full taxation of unsheltered capital income, both the taxing capital income of high-income persons and the taxation of above-normal returns would be achieved.

Taxation of Earnings

The taxation of earnings accounts for the largest share of tax revenues and also raises the most difficult issues. In the standard optimal income tax literature, lack of consensus about the desired progressivity of the tax comes from several sources, including the perceived equity–efficiency trade-off; the relevance of equal sacrifice as a principle of taxation; the role of luck versus choice when individuals have different preferences for work, leisure, and saving; and constraints allegedly imposed

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by political economy considerations. I have stressed in the earlier discussion the element of rent or windfall income resulting from exogenous shifts in the distribution of wage rates, which translates into changes in the earnings distribution. To the extent that these are unforeseen, they constitute windfall effects that undermine standard efficiency or property rights arguments against redistribution, or more accurately against social insurance delivered through the income tax system.

Roughly speaking, these changes in wage rates have tended to steepen the wage profile. Over a long period, labour markets might adjust by individuals making education, training, and occupational choices, but in the medium term, changes in the income distribution reflect to some extent windfall changes in income to existing workers. Much discussion in the literature and the press has focused on the consequences of this for tax rates at the upper end of the income distribution. From that perspective, a good case can be made for creating an additional tax bracket at the top. Opposition to this has often centred on the incentive effects of increasing top marginal tax rates, not so much because of real behaviour changes, but because of tax planning and perhaps tax evasion. This is mitigated to the extent that options for tax planning are reduced, such as by taxing capital income and earnings at the same rate, and by eliminating the preferential treatment of stock options. There is evidence from Denmark that more comprehensive tax bases can reduce the elasticity of taxable income considerably (Kleven 2014). There is even some suggestion that increasing the marginal tax rate will mitigate bargaining outcomes between executives and corporations based on standard bargaining theory (Piketty et al. 2014). In addition, devoting more resources to the CRA to detect tax evasion would presumably help, although that is no doubt easier said than done. But in the end, most tax compliance is essentially voluntary, and there is no easy way to improve what the literature calls *tax morale* (e.g., Luttmer and Singhal 2014). Working on improving trust in government would be a good place to start.

Of more relevance is what to do at the bottom of the income distribution. While much attention has been focused on the plight of the middle class and how they have benefitted relatively little from recent productivity growth, the plight of those at the bottom is worse. They get very little relief from the income tax-transfer system. Instead, they rely on a variety of programs—many administered by the provinces outside the income tax system—and a substantial proportion of them fall well below conventionally measured poverty levels. To be more explicit, think of the many categories of low-income persons: the working poor, the elderly, children in low-income families, welfare recipients, the long-term unemployed, the disabled, and a large proportion of the aboriginal population. Of these, arguably only the elderly and children have been well served by the tax-transfer system, mainly at the federal level. Welfare and disability recipients have been left to the provinces and their real incomes have fallen considerably since the early 1990s. The plight of aboriginals is well-known.

An approach for dealing with this embarrassing state of affairs is to use the income tax system to create a proper targeted Guaranteed Basic Income system. A mechanism for doing so is the refundable tax credit, which has been used to good effect in the GST Credit, the CCTB, and the WITB. Refundable tax credits are one of the main innovations of tax policy in the past 25 years. They are flexible and administratively relatively simple. Unlike a classical flat rate negative income tax system, refundable tax credits can be clawed back progressively at any chosen rates: the more rapid the clawback, the higher can the basic income guarantee be. A good starting point would be to make all non-refundable tax credits refundable and income contingent. The federal government would have to be actively involved in this, perhaps with the agreement of the provinces. Ultimately, a Guaranteed Basic Income system could replace provincial welfare and disability assistance programs.

One final, and important, reform would recognize the volatility of household earnings, including that arising from precarious employment and destruction of human capital through structural unemployment. That would be to revisit a system of general income-averaging such as we had in the early 1980s. Income-averaging was originally conceived as a way to achieve horizontal equity between those with stable incomes and those with fluctuating incomes because of the effects of a progressive tax system. Some would argue that income-averaging is less relevant nowadays since there are significantly fewer tax brackets and the rate structure is much flatter. In addition, there are certain administrative complications associated with income-averaging, although these can presumably be overcome given the extent of electronic record-keeping at the CRA. There are also incentive-related issues, such as how to deal with persons who voluntarily leave the job market or those who choose to remain in college or university. But at the same time, earnings and employment volatility have apparently increased. There are some mechanisms for responding to that volatility, such as Employment Insurance (EI) and self-averaging using RRSPs and TFSAs, and self-insurance. As well, a Guaranteed Basic Income would provide income insurance for low-income persons. However, even these measures may not be adequate for dealing with the kind of involuntary earnings volatility faced by many Canadians.

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Conclusions

This article has been exploratory. I have mentioned some problems with using existing normative tax theory as a basis for policy recommendations. These include philosophical issues about the utilitarian approach that—unlike the equal sacrifice approaches of the Carter Report—ignores initial positions. More important, standard normative theories are based on static assumptions and cannot take into account the fact that economic development can create opportunities for some segments of the population to obtain rents or windfall returns. I have suggested, with limited empirical support, that significant rents accrue in production and in the first instance are claimed by firms. As well, rents attributable to windfall wage rate changes favour high-income persons, and those available from asset ownership favour those with more asset wealth. A prima facie case can be made for targeting rents in the tax system, even under equal sacrifice approaches. Rents are essentially lucky returns that involve no effort by those receiving them.

I have offered several minimal, or even timid, reforms to the Canadian tax system aimed at taxing rents, recognizing that rents cannot be selectively taxed without at the same time taxing returns to risk-taking. More ambitious tax reforms, such as taxing large inheritances or wealth holdings (along the lines suggested by Piketty) could be contemplated, but would be more difficult to achieve.

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Notes

1 Milligan (2012) and Finance Canada (2013) both provide estimates that when the TFSA system is mature, well over 90 percent of Canadians will be able to shelter all their asset income from the PIT if they choose.
2 The three letters in the acronyms refer to the taxation of saving and the returns to saving (a) when the saving occurs, (b) while it is accumulating, and (c) when the cumulated asset value is sold. Thus, EET means saving is tax deductible (that is *exempt* from taxation), saving returns are *exempt* from taxation as they accumulate, but when the asset is sold the proceeds are fully *taxed*.
3 Under the dual income tax system, earnings are subject to a progressive rate structure while capital income is taxed at a uniform rate corresponding to the earnings tax rate in the lowest bracket.
4 This was suggested to me by Erin Weir.
5 Following standard international practice, an ACE would be levied on a territorial (or source) basis so would apply to income generated in the taxing jurisdiction. Devereux and de la Feria (2014) have proposed a destination-based CIT that would exempt exports and tax imports. They argue that this avoids the incentive for firms to locate in the lowest-tax country, but it would preclude a country from taxing rents in export industries.
6 Ex ante sheltering devices correspond with EET in the Mirrlees Review, while ex post ones correspond with TEE. Emphasizing the ex ante versus ex post distinction is useful because it highlights the fact discussed in this article that under the former rents and returns to risk are not sheltered from tax, unlike the latter.

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