The Logic, Policy and Politics of Tax Law: An Overview

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1 The Joy of Learning Tax Law ................................................................. 4
1.1 Accounting for the Attraction of Tax Law ...................................... 4
1.2 Personal Benefits ................................................................................. 4
1.3 Pervasiveness of Tax Law in Legal Practice .................................... 4
1.4 Wonderful vantage point to view developments in the law ........... 5
1.5 Intellectual Fascinating ................................................................. 5
    1.5.1 Application of one simple idea ........................................... 5
    1.5.2 Fast game played by dedicated players for high stakes ....... 6
1.6 Every Important Policy Issue Has a Tax Angle .......................... 6
1.7 The Subject of Study by All Disciplines ........................................... 7
1.8 Shot Through With Politics ......................................................... 7
    1.8.1 Centre of political debates currently and historically ......... 7
    1.8.2 Barometer of shifting prevailing ideologies ................... 8
1.9 Centre of Class War ................................................................. 8

2 Objectives of the Basic Course in Tax Law .................................... 10
2.1 No Different Than Other Legal Subjects ....................................... 10
2.2 Explication of Explanatory Frameworks ........................................ 10
2.3 Importance of Theory ................................................................. 10
2.4 Law Is a Process of Decision-Making ............................................. 11
2.5 Importance of Understanding Explanatory Frameworks .............. 11
    2.5.1 To understand the law ....................................................... 12
    2.5.2 To evaluate the law .......................................................... 12
    2.5.3 To improve critical thinking skills and clarify values .......... 12
    2.5.4 To enable deep learning of the law ................................. 13
2.6 The Relative Unimportance of the Details of Tax Law .............. 13

3 Tax Taxonomy: The Definition, Classification and Terminology of Taxes ..... 15
3.1 What Is a Tax? .............................................................................. 15
3.2 Classification of Taxes ................................................................. 19
    3.2.1 The Tax Base ................................................................. 19
    3.2.2 The Rates of Tax ........................................................... 21
    3.2.3 Income Tax Terminology ................................................ 23

4 Methodology of Tax Law and Policy Analysis .................................. 27
4.1 Forms of Reasoning About Tax (or Anything Else) .................... 27
4.2 Analytical Reasoning ................................................................. 28
4.3 Normative Reasoning ................................................................. 30
4.4 Empirical Reasoning ................................................................. 32
4.5 Methodological Pluralism ........................................................... 37

5 Analytical Tools for Tax Analysis ......................................................... 38

5.1 Inflation: Nominal Versus Real Values ........................................... 38
5.2 Tax Deferral and the Time Value of Money ...................................... 39
5.3 Capitalization Effect of Taxes ......................................................... 42
5.4 The Incentive Effect of Taxes: The Income and Substitution Effects ....... 44
5.5 Tax Incidence: Who Pays? ........................................................... 45
5.6 The Deadweight Loss of Taxation ................................................ 48
5.7 General Theory of the Second Best ................................................. 49

6 Normative Justifications for Tax Laws .................................................. 50

6.1 Why We Need Tax Laws? ............................................................... 50
6.2 The Role of the Tax System in Constituting the Marketplace ............... 50
6.3 Achieving an Efficient Allocation of Resources ................................. 51
   6.3.1 Role of the Market ................................................................. 51
   6.3.2 Public goods ......................................................................... 54
   6.3.3 Externalities ........................................................................... 55
6.4 Asymmetric Information ............................................................... 55
   6.4.1 Cognitive Limitations .......................................................... 56
   6.4.2 Incomplete Markets ............................................................. 56
6.5 In Achieving a Morally Acceptable Distribution of Income .................. 58
6.6 The Role of the Tax System in Stabilizing the Economy ...................... 60
6.7 The Role of the Tax System in Increasing the Rate of Economic Growth .... 62

7 Criteria for Evaluating Technical Tax Measures .................................. 64

7.1 Role of Evaluative Criteria ............................................................ 64
7.2 Equity .......................................................................................... 65
7.3 Neutrality ...................................................................................... 69
7.4 Simplicity ....................................................................................... 70

8 Criteria for Evaluating Tax Expenditures ............................................ 71

8.1 Definition of Tax Expenditures ....................................................... 71
8.2 Evaluating Tax Expenditures ........................................................ 72

9 Principles of Statutory Interpretation ................................................ 74

9.1 Importance of Statutory Skills ....................................................... 74
9.2 Approaches to Determining the Usage of Words in a Statute ............... 76
   9.2.1 General ................................................................. 76
   9.2.2 Literal or Strict Approach ................................................... 76
   9.2.3 Plain Meaning Approach .................................................... 77
   9.2.4 The Avoidance of Absurd Results Approach (The “Golden” Rule) ... 78
   9.2.5 The Mischief Rule (Heydon’s Case, 1584) ......................... 79
   9.2.6 The Legislative Intent and History Approach ......................... 79
### 9.2.7 Purposive Approach

- **Page**: 80

### 9.2.8 Pragmatic, Policy Approach

- **Page**: 81

### 9.2.9 Modern Approach (Words-in-Total Context)

- **Page**: 82

### 9.2.10 Use of Conventions of Statutory Interpretation

- **Page**: 83

### 9.2.11 Presumptions of Legislative Intent (Substantive Canons)

- **Page**: 83

### 9.3 Characterizing the Taxpayer’s Transaction

- **Page**: 84
  - 9.3.1 General
  - **Page**: 84
  - 9.3.2 Ineffective Transactions
  - **Page**: 84
  - 9.3.3 Shams
  - **Page**: 84
  - 9.3.4 Mischaracterized legal rights or obligations
  - **Page**: 85
  - 9.3.5 Legal rights and obligations that do not intend to be enforced
  - **Page**: 85
  - 9.3.6 Form and Substance
  - **Page**: 85

### 9.4 Discouraging Tax Avoidance

- **Page**: 85

### 10 Making Sense of Income Tax Laws

- **Page**: 86
1 The Joy of Learning Tax Law

1.1 Accounting for the Attraction of Tax Law

Proving only, some would say, that there is no accounting for taste, a surprisingly large group of students find the study of tax law the most interesting, challenging and fascinating course in law school. Nevertheless, many students approach their first tax law course with trepidation. They anticipate that it will be both tedious and daunting. In this chapter I will reflect on what makes tax law attractive to some students, with the aim of enticing other students to approach it with a more open mind, or at least persuade them of its potential value. Moreover, thinking hard about why you are taking a tax course should serve to reduce your alienation and enable you to plan your approach to the course to maximize its educational value.

1.2 Personal Benefits

Some law students find tax law interesting for obvious practical reasons - both personal and professional. Every individual resident in Canada who owes tax must file a tax return annually. You have just learned your first tax rule in this course. Just to seize the opportunity to give you a taste of the fun that lies in store, subsection 150(1) (which is found in Division I of the Act, headed, helpfully enough, “Returns, Assessments, Payments and Appeals”) of the Income Tax Act (the “Act”) actually provides that “a return of income...shall be filed...for each taxation year of a taxpayer.” “Taxpayer” is defined in subsection 248(1) (the general definition section) as “includes any person whether or not liable to pay tax.” The word “person” is also defined in that subsection. You have to read subparagraph 150(1.1)(b)(i) to discover that this rule does not apply to an individual unless “tax is payable.” Why is there a need for two provisions to make this simple point? Why aren’t the definitions in subsection 248(1) preceded with a paragraph letter for ease of reference? The definition of “taxpayer” provides that it “includes” any person, what else might it include? Should all individuals over the age of, say 18, have to file a tax return whether they owe tax or not? Filing your annual tax return and paying tax is one of the most important obligations of citizenship. Consequently, tax law is of personal interest to almost everyone since knowing a little tax law will make the annual ritual of filing a tax return more understandable, will perhaps make it more profitable, and might even make it a joyful experience.

1.3 Pervasiveness of Tax Law in Legal Practice

For an aspiring lawyer, an even more compelling practical reason to study income tax law is that tax law is pervasive. No matter what area of legal practice you engage in, tax matters are likely to be relevant. Any advice that a lawyer gives a client about such apparently uncomplicated transactions as the sale, lease or encumbrance of property; the dissolution of marriage; the drafting of wills and the administration of estates; the negotiation of employment and other contracts; or the settlement of claims for personal injuries and other losses will be inadequate
unless the tax consequences are considered. More complex commercial and business transactions, from the incorporation of a private business to the capitalization or reorganization of a public company, are permeated, if not dominated, by tax considerations. Obviously, all lawyers do not need a specialized knowledge of tax law, even the tax law relevant to their particular area of practice. They must, however, be sufficiently aware of the potential tax consequences of the transactions to which they commit their clients in order to advise them when to consult a tax specialist. Many practising lawyers go through their careers blissfully ignorant of most of the esoteric rules of private law and cause their clients little grief on that account; however, if lawyers are not sensitive to the possible income tax implications of the transactions upon which they advise their clients they might irrevocably send them on a course of action that results in adverse tax consequences. These will not be happy clients.

1.4 Wonderful vantage point to view developments in the law

As a consequence of its pervasiveness, one of the aspects of tax law that makes it particularly interesting is that it provides a superb vantage point from which to study many related legal subjects, if not the whole fabric of the law. Studying the income taxation consequences of transactions such as sale and leasebacks, weak currency loans, commodity straddles, financial derivatives and corporate mergers is a good way to learn about those transactions themselves. Every new fashion in the capitalization of corporations, corporate reorganizations and most other areas of transactional law must pass before tax lawyers.

1.5 Intellectual Fascinating

1.5.1 Application of one simple idea

Aside from its obvious practical value, the study of income tax law is intellectually fascinating. At its most elemental level, it involves taking one simple idea -- the idea that everyone should pay tax on their income -- and then applying that idea to the full panoramic variety of economic and property relations and transactions that characterize our modern, complex society. To determine each individual’s income the infinite variety of human activity must be classified under this single rubric. Do individuals earn taxable income in the following situations: When they receive an interest-free loan from their parents? When they are awarded a scholarship? When they benefit from the use of the heavily subsidized recreational facilities at university? When they accept a free trip from their law firm in recognition of the hard work they have done as an associate? When they earn frequent flier miles on the value of that trip? When someone discharges a debt they owe? When they exchange their legal services for the roofing services of their neighbour (does the neighbour also receive taxable income from this transaction)? When they sell their university poster collection? When they live in a residence they own? When they look after their own children? When they receive an inheritance?

Even the contributors to this volume are bedevilled with these kinds of questions in their personal lives. For example, the publishers of this volume usually send the contributors an extra free copy.
Should the contributors include the value of this gift in their taxable income? If so, should they include the subjective value of the book to them in their income, or should they include its fair market value (as a new or second-hand book)? Does your answer change if they give it away to a deserving student? If they include its value in their employment income as a benefit they have received by virtue of their employment, can they deduct its value from their business income if they use it to assist them in earning that income? If they give it away should the person who receives it have to include its value in their income? These are straightforward examples drawn from the countless situations in which a person might have to recognize gross income for tax purposes. Now think about the difficulties of determining what expenses individuals should be entitled to deduct from gross income in order to arrive at their net taxable income, or the complex problems of determining at what point in time income should be recognized even in the most straightforward financial transaction, and you will begin to appreciate what an intensely intellectual endeavour studying tax law can be. Incidentally, the answer to the question of which of the above situations should result in gross income is arguably all of them, although the income generated in many of those transactions is in fact not subject to tax under the Act, as you are about to learn.

1.5.2 Fast game played by dedicated players for high stakes

Tax law is also intellectually exciting because it constitutes the rules of a fast game played by dedicated people for high stakes. Bright tax lawyers, accountants and economists in the Department of Finance attempt to implement government policy by drafting provisions of the income tax law. As soon as these provisions are announced, a small army of dedicated and imaginative tax lawyers and accountants -- being paid an indecent amount of money -- begin to apply their minds to how they might advise their clients to find ways around the laws. The courts are called in to resolve disputes. Department of Finance officials respond with proposed amendments to the legislation, in an often vain attempt to preserve the integrity of the government’s initial policy judgements. Wealthy individuals, their representatives, and the business community frantically lobby for relief. The financial press takes sides. Politicians fulminate. Tax teachers pontificate. As tax law students you have front-row seats to this high stakes game. Take time to reflect on it as a disinterested observer before you join in the fray upon graduation.

1.6 Every Important Policy Issue Has a Tax Angle

Tax law is also interesting because almost every social and economic policy has a tax angle. The Act is laden with social and economic legislative judgements that have nothing to do with administering an equitable, efficient and simple technical tax system. Consequently, there are few better vantage points from which to observe the unfolding drama of public policy. The government publishes an account every year of the provisions in the Act that are deliberately used as instruments to further specific social and economic policies. In the most recent annual account of tax expenditures the Department of Finance estimated that the personal income tax legislation alone contains over 100 such provisions in policy areas such as culture and recreation, education, family, health, income maintenance and retirement, general business and investment, and small
business. To give some sense of the importance of these tax expenditures for Canadian economic and social policy, if their individual cost estimates are added together, they amount to over $50 billion of foregone tax revenue. In the past year alone, the public policy debate has included the need for tax breaks for sports stadiums and NHL hockey teams, the need for additional green taxes to protect the environment, the need for tax changes to support traditional family values, the need for more tax breaks for talented workers in the hi-tech industry and other tax concessions to increase the innovative capacity and productivity of the Canadian economy, and the need for more tax breaks for students pursuing higher education.

At a macro level, over the past couple of years many Canadians have been caught up in a debate over whether the level of taxes in Canada is causing a “brain drain” to the United States and generally whether tax levels are reducing work incentives, savings behaviour and investment activity and thus resulting in Canadians falling further behind the standard of living of Americans. As illustrative of the importance of tax in public policy, and of its potential interest, scan the major newspapers on almost any day of the week and mark the references to tax law. During budget season (from the end of February to about the end of April), when the federal and provincial governments are tabling their budgets, announcements of major tax law changes dominate the news. Indeed, the public debate over the federal budget and related tax changes every year is about the closest Canadians get to a national conversation about our collective goals and values.

1.7 The Subject of Study by All Disciplines

Tax laws are such important instruments of economic and social policy that they are the subject of examination by scholars from almost every discipline. Thus the study of tax law is greatly enriched by the fact that tax lawyers share an interest in this subject with accountants, philosophers, economists, political scientists, sociologists, psychologists and historians. No matter what your undergraduate training, you ought to be able to find aspects of tax law to which it is highly relevant.

1.8 Shot Through With Politics

1.8.1 Centre of political debates currently and historically

Finally, tax law holds the attention of many students because it is shot through with politics. Often it is at the centre of politics. Historically, it has been the immediate cause of countless revolutions, including of course the American War of Independence. The refusal to pay taxes is a traditional and still sometimes used form of protest against government policy. In the late 1980s, the introduction of the Goods and Services Tax in Canada gave rise to one of the most divisive political battles in recent history. In the last few years, in what has become referred to as the era of post-deficit politics, the need for tax cuts has become one of the defining issue of Canadian politics. No other public policy issue has been so consistently at the centre of ideological conflict over the proper role, size, and functions of the modern welfare state.
1.8.2 Barometer of shifting prevailing ideologies

Modern political parties really define themselves by their stance on tax issues. This should not be surprising since tax laws are the most visible policy instrument that modern governments use to position themselves along the two fundamental axes upon which political ideologies have traditionally been arrayed: an axis in which political ideologies are ordered from those concerned primarily with individualism to those concerned primarily with collectivism; and, an axis upon which they are arrayed from those concerned with the need for hierarchy or elitism to those concerned primarily with achieving a high degree of social and economic equality. To implement collective decision-making, and thus move from concerns over individualism to concerns about community, taxes are an important policy instrument. Similarly, taxes are normally seen as an important policy instrument in achieving a more egalitarian society. Taxes thus raise fundamental questions not only about public policy but also about morality, including the central question of what is a morally acceptable distribution of the income and wealth that members of a society collectively produce. As such, tax laws are a particularly reliable barometer of shifts in prevailing ideologies. The tax system has been called “a mirror of democracy.”¹ Joseph Schumpeter, a widely admired economic historian, observed that “nothing shows so clearly the character of a society and of a civilization as does the fiscal policy that its political sector adopts.”²

1.9 Centre of Class War

Altogether aside from the rational use of tax laws as an instrument of government policy, taxes are at the centre of political debate because they are so clearly about money. Although money is not everything -- we are told -- it appears that most people think it is not without its advantages. At the end of the day, the debate over taxes is a debate over who will pay. Although it is a rather obvious point that taxes “reflect a continuing struggle among contending interests for the privilege of paying the least,”³ a few of the many frequently repeated quotes provide the flavour of this debate. T. S. Adams, a prominent American economist who worked in the U.S. Treasury when the American income tax was being implemented observed that “modern taxation or tax-making in its most characteristic aspect is a group contest in which powerful interests vigorously


endeavour to rid themselves of present and proposed tax burdens. It is, first of all, a hard game in which he who trusts wholly in economics, reason, and justice, will in the end retire beaten and disillusioned. Class politics is the essence of taxation.”

Louis Eisenstein, a leading American tax lawyer in the 1940s and 1950s, and a tax commentator of uncommon brilliance and originality, in a book that every tax student should read, *The Ideologies of Taxation*, was equally blunt. He stated, “Taxes...are a changing product of earnest efforts to have others pay them. In a society where the few control the many, the efforts are rather simple. Levies are imposed in response to the preferences of the governing groups. Since their well-being is equated with the welfare of the community, they are inclined to burden themselves as lightly as possible. Those who have little say are expected to pay.”

In attempting to account for the attraction of tax law, perhaps the last word should be left to Louis Eisenstein who, after a lifetime of practising, studying, and writing about tax law observed, “Any intelligent thinking on taxes eventually reaches the ultimate purpose of life on this planet as each of us conceives it.”

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5. Supra note 3 at 11.

2 Objectives of the Basic Course in Tax Law

2.1 No Different Than Other Legal Subjects

Some law students express anxiety about taking a tax law course because in numerous respects tax law seems different than other law subjects. It is detailed and complex and contains mathematical formulas and accounting concepts; it appears to be dominated by economic analysis and principles; the policy issues appear unique; it is entirely statutory; and, the politics are largely driven by the concerns of business interests. Hopefully, what this introductory chapter will show is that these characteristics of tax law should not be off-putting, no matter what your background, and that tax law is no different than other legal subjects; indeed, in a tax law course you can learn everything you need to know about the law.

2.2 Explication of Explanatory Frameworks

The purpose of this chapter on the logic, policy and politics of tax law is to provide students with a brief overview of the concepts and vocabulary of tax law, the tools of tax analysis, tax policy principles, and some of the basic frameworks that are essential in understanding and evaluating tax law and policy issues. It may seem somewhat odd to present these frameworks here since -- and this is the point that was made above -- they are the same frameworks that underlie most areas of law. Nevertheless, as they apply to tax law they are sufficiently unique that it seems justifiable to set them out in this context. Moreover, the application of these explanatory frameworks is really all there is that is very difficult to learn in law school and they can be thoroughly mastered only by applying them again and again across the diverse subject areas of the law.

2.3 Importance of Theory

Some law students still seem to resist the idea that it is worthwhile learning what they consider “theory.” They came to law school to learn the practice of law, not to apply theoretical frameworks. It has always been a mystery to many of us who teach law why this feeling still seems to linger among some law students. Where do students get the idea that practical matters can be divorced from so-called theory? Presumably not from ordinary experience. Without a theory you cannot explain why a Panda is not a bear, a whale is not a fish, or a tomato is not a vegetable. Moreover, you have no basis for arguing that professional wrestling is not a sport, that men should not be allowed to compete in synchronized swimming events, or about anything else that matters. Why would anyone suppose that the study of law is any different than these gripping issues? Even if you think that law, or tax law, generally makes no sense, or is simply a set of discrete rules to be memorized, you implicitly hold some view about what does make sense or why tax law is only a set of discrete rules divorced from any context and, therefore, the premises underlying that intuition should be exposed and subject to examination. As someone once said, “there is nothing more practical than a good theory.” As aspiring practising lawyers,
you ought to take this dictum seriously. On the other hand, in the interests of disclosing contrary authorities, as all ethical lawyers would, Yogi Berra is reputed to have said, “In theory there is no difference between theory and practice. In practice there is.”

2.4 Law Is a Process of Decision-Making

It is a commonplace view that law, as practised by lawyers, is a process of decision-making, not the regurgitation of a discrete set of rules. It does not take three years to train lawyers how to find the black-letter rules that might be relevant to a legal problem. First-year law students are able to find those rules with relative ease. Learning to think like a lawyer involves learning to solve public policy problems, normally at the level of the implementation of the law in judicial and other adjudicative forums, however, not infrequently before administrative and legislative bodies. Like participants in all decision-making processes, in order to practise law well lawyers must be prepared to bring to bear on their work the full variety of approaches, knowledge and disciplines relevant to it. Moreover, they must understand the basic principles, the conceptual frameworks, and the factors that animate the law and the different perspectives from which it can be viewed. That is to say, they must understand the law, and be able to place legal problems, in their widest possible context.

As with all law courses, at the heart of the basic tax law course are issues for which there is no one answer and which require the full range of the skills of a lawyer to determine the preferred outcome. Tax law involves the kind of intellectual work needed for figuring out the best of a number of alternative answers. It is complex and requires sophisticated and careful reasoning and the exercise of thoughtful judgement. That is why competency in law requires so much training and, incidentally, one of the reasons that good lawyers are so well remunerated: not many people are prepared to devote the time required for the formal education and practical experience nor do they not have the aptitude (or inclination) required to develop the skills of perceiving similarities between situations and factors, drawing normative distinctions, and theorizing about and mustering evidence relating to the relationship between legally relevant variables. Parenthetically, the high salaries of some lawyers are also likely accounted for by their innate abilities, personal connections, the government regulation of legal practice, and several market failures in the delivery of legal services. One such failure is the fact that the value of legal services is almost impossible for clients to judge (legal services are a classic illustration of what economists refer to as post-experience goods in which consumers are generally unable to judge the causality between consumption and some of its effects, therefore, markets are unlikely to deliver them efficiently). Another is the fact that the practice of law is increasingly taking the form of a winner-take-all tournament in which marginal differences in skill levels are making huge differences in remuneration. All of these considerations suggest strong normative justifications for the regulation of legal salaries, including progressive income taxation. More on this later.

2.5 Importance of Understanding Explanatory Frameworks
The following brief reviews of the various logics, policies and politics -- or as they might be collectively referred, the explanatory frameworks -- that underlie tax law are somewhat conventional. They very briefly summarize a vast literature, much of which some of you will have covered in great depth in your undergraduate courses. You may not find these frameworks particularly useful, however, you should then attempt to develop your own frameworks, whether drawn from disciplines as diverse as feminist theory or classical economics, so that you can coherently, from your own perspective, grasp the law in action and understand and evaluate its consequences.

2.5.1 To understand the law

You need to develop theories about all aspects of the tax system, for a number of reasons. First, to help you understand tax law. Without an intellectual framework, you will be simply learning what must appear as a bunch of incoherent rules. Perhaps more so than in any other area of law, the details of tax law can only be truly understood if you understand the deeper structures that underlie the income tax. Even though much of tax law is accounted for by the pleadings of special interest groups, the log-rolling of politicians, or even the incompetence of the drafters, you will not be able to identify these rules and make sense out of them without an explanatory framework.

2.5.2 To evaluate the law

Second, although these explanatory frameworks for thinking about legal issues should help you understand the law, they are obviously indispensable in critiquing the law. Aside from your obligations as citizens, as lawyers you bear an increased responsibility for the quality of our laws and their administration. As lawyers we are constantly called upon to react to and evaluate the flow of proposals concerning legal change and the government’s role in the economy more generally. Having a systematic framework for organizing your thoughts about various government programs and laws not only ensures that you will be applying your values consistently, but will also assist you in avoiding the kind of armchair empiricism and ad hoc judgements that lawyers are sometimes accused of engaging in. Moreover, understanding the policies and principles that underlie the law will help you avoid falling into the trap of false necessity, that is, the irresistible temptation to assign a degree of inevitability to existing arrangements and convert “what is” into “what ought to be.”

2.5.3 To improve critical thinking skills and clarify values

A third reason for theorizing about tax law in the basic tax course is that two of the overriding purposes of university education are to further the ability of students to think effectively and to assist them in clarifying their beliefs and values, with the consequence of making the world a better place. The development of these attributes of citizenship is, of course, the reason that there are numerous tax credits for university students and large (but unfortunately) diminishing
government subsidies. Hopefully, thinking about the important public policy issues raised in tax law will contribute in a small way to furthering these important missions of the university.

2.5.4 To enable deep learning of the law

Finally, mapping, or understanding complex conceptual interrelationships, is an important learning strategy. There has been a considerable amount of research into student approaches to learning that reveals that whether you are an abstract or concrete learner or a sequential or network learner, there are important differences between deep and surface approaches to learning. Those students whose learning is most effective appear to have the following characteristics: they focus on what is “signified,” that is, the author or the instructor’s argument or the concepts applicable to understanding the issues under discussion; they relate previous knowledge to new knowledge; they relate knowledge from different courses; they relate theoretical ideas to everyday experience; they relate and distinguish evidence and arguments; and, they organize and structure content into a coherent whole. These explanatory frameworks are intended to assist you to do all of these things as you proceed through the tax course.

The following sections of this introductory chapter briefly describe some of the explanatory frameworks that underlie tax law. By and large, learning the frameworks is presented as an objective of the basic course in tax law, but naturally each instructor will have his or her own objectives for the course (as will students). Nevertheless, normally the objectives of individual instructors (and students) will be embraced within some number of the objectives as stated here, although the emphasis will obviously vary widely. These objectives include learning the following: some of the details of the taxation of individuals, the vocabulary and classification of taxes, the methodology of tax law and policy analysis, some of the important analytical tools for tax analysis, the normative justifications for tax laws, the criteria for evaluating technical tax laws, the criteria for evaluating tax expenditures, the conceptual framework that underlies the income tax laws relating to the taxation of individuals, the fundamentals of tax planning, the principles of statutory interpretation, the political and other determinants of tax laws, and the various perspectives from which tax law can be viewed. Only the most basic outlines of these frameworks are presented here. Students who wish to advance their knowledge of these frameworks beyond the elementary level presented here should consult one of the standard texts in the relevant area. However, your knowledge and skill in applying these frameworks can only be enriched and deepened by using them to assist your thinking about the issues that are raised throughout the course.

2.6 The Relative Unimportance of the Details of Tax Law

One obvious, if not particularly important, purpose of the basic course is to learn some of the details of tax law. At the end of the course, you might not have a working knowledge of income tax law, but you will be aware of the kinds of transactions involving individuals that are likely to have tax consequences, what principles would apply in giving shape to the details that govern the transaction, and where in the conceptual structure of the tax law answers to particular tax problems are likely to be found.
There is no question that tax law is comprised of a formidable quantity of detailed rules. The Act itself is now consolidated in an over 1400 page document. Thousands and thousands of additional pages are needed to embrace the regulations, rulings and other pertinent government documents. It is detailed because the environment of tax law -- the economy -- is complex and sophisticated and tax laws must be drafted to apply to the minutia of the transactions that the economy generates.

However, you should not be overly concerned with learning the details of tax law, and in most basic tax courses little effort is made to survey much of the detail. Although a fair amount of technical detail is covered in most courses -- in fact students are often shocked by how much has been covered come exam day -- covering detail is not an end in itself. The detailed tax law should serve primarily to introduce you to the vocabulary of income tax law and to illustrate and give content to the deeper, conceptual structure of the law. Having said that, however, you should not shy away from the detail. As a lawyer you will often be called upon to learn, categorize, and make sense out of massive details of the law in many areas and, therefore, you should begin to learn to cope with the details of the law. A tax law course is a wonderful vehicle to assist you in learning this skill. Moreover, concentrating on the details in some areas is absolutely essential if you are to learn the skill of reading statutes carefully and for all of their nuances. One of the most important objectives of a basic tax law course is to assist students in learning how to read a complex statute. This often requires concentrating on the precise language used in the Act and an attempt to understand the logic of obscure and arcane refinements to the provisos to the exceptions.

In case you are still feeling tempted to begin memorizing by rote vast chunks of tax law, a few more words of caution. First, in any area where you are familiar with the underlying business, economic or legal context, to be frank, the details of tax law are not all that hard. They are about equivalent to the instructional details one has to understand in assembling IKEA furniture. As someone once quipped -- although it was not a very nice thing to quip -- the details of tax law are so simple to learn that even accountants are expected to learn them. Second, rest assured that no matter how many details of tax law you learn in the basic course, given the voluminous details of the law, you will have probably covered only 1 or 2% of tax law. Could anything possibly turn on whether you have in your head 1.5% as opposed to 1.7% of the tax laws? Third, no area of law is more susceptible to change than income taxation. So even if you remember a few rules, you will be only slightly ahead of the game. They will inevitably change. A major tax amending bill is enacted almost every year. The last one was over 400 pages long. But while the details change, the fundamental structure of the Act, and the fundamental normative principles underlying it, have not changed almost since its inception. Fourth, if all you learn in a tax course are some of the details of tax law you will forget them almost the minute you walk out of the exam. You will have largely wasted your time, and missed an excellent educational opportunity. Fifth, a somewhat more cynical reason for not attempting to memorize the details of tax law is that you can look them up when someone is paying you for it.

One aspect of tax law that contributes to the sense that it is extremely detailed is that tax law is more number-oriented than most law school courses and draws upon concepts in accounting and finance. However, this also should not be a matter of undue concern. In fact, you should see this
as an opportunity. Law students should develop skills in basic numeracy. Some forms of quantitative analysis increasingly are becoming more important skills of lawyers. Moreover, many statutes, including the Act, use arithmetic functions and you should be familiar with how arithmetic functions (especially ratios, which can be tricky) are expressed in statutory language. Tax law, like most business oriented courses, does draw upon corporate, accounting and finance concepts and is laced with the vocabulary of those subject areas. However, there is a surprisingly small number of concepts that are used. If you are unfamiliar with them now is the time to learn them. Their use is becoming increasingly common in all areas of law. Moreover, the computations in tax law, and other areas of law, are only used to illustrate concepts. Normally the concepts are not so difficult that they cannot be expressed and understood verbally -- and you should be able to understand them that way -- however, for some people, at least, an arithmetic function makes the concept more readily understandable. Invariably the arithmetic functions involve simple addition, subtraction, multiplication or division. The math is not difficult. Of course, in some areas such as calculating tax liabilities or alternative tax planning opportunities, the math is not so simple. However, none of these calculations are required in order to understand tax law or even to practice tax law, as opposed to tax accounting. Even if you practice in this area, you will not necessarily need to do the complex math since you will invariably have computer programs (and accountants!) to assist you.

3 Tax Taxonomy: The Definition, Classification and Terminology of Taxes

3.1 What Is a Tax?

Although there is not much question that the income tax is a tax, in order to locate a discussion of the income tax analytically there is some value in thinking about what distinguishes a tax from other methods by which the government might raise revenue and from other government policy instruments more generally. A dictionary definition of a tax would be something like, “a compulsory transfer of money from private individuals or organizations to the government not paid in exchange for some specific good or benefit.” The distinguishing characteristics of taxes are that they are compulsory and unrequited.

It is normally easy to distinguish between a tax paid to the government and an amount paid that would not be classified as a tax. The latter would include fines and penalties imposed by governments to deter or punish unacceptable behaviour; royalty payments imposed to compensate the government for the right to extract oil and gas or to exploit other natural resources from government-owned land or resources; and prices charged by the government for some goods and services that it sells to individuals. However, in some cases one of these types of payments to the government might contain a tax. For example, if the amount paid to the government in return for a particular good or service is not performing the economic function of a price, namely to bring the supply and demand of a good or service into balance, then it should be regarded as a tax.
Is the amount paid for a government-sponsored lottery ticket a price or a tax? One might argue that it is a price because it is voluntary and the purchaser receives a chance to win a prize in exchange. However, an amount can sensibly be treated as a tax even though it can be avoided by not purchasing the good or engaging in the activity to which it attaches. All taxes can be avoided in that sense. Liquor taxes can be avoided by not buying liquor, gas taxes can be avoided by not buying gas, the GST can be avoided by buying only exempt goods and services, and the income tax can be avoided by not working. If one wants to buy a lottery ticket, the full price must be paid, even the portion that far exceeds the government’s cost of the ticket. It is the case that by buying a lottery ticket the purchaser is obtaining a chance to win a prize, however, the government sets the price of lottery tickets far above the expected value of the prizes. About 40% of the price is not returned to winners. Consequently, the payment to the government for a lottery ticket is probably sensibly treated as in part a price and in part a tax. The government’s 40% monopoly profit is equivalent to a tax. One way to think about this is that the government might have sold the ticket for a price that equalled the cost of running the lottery, including the expected value of the prizes, and then imposed an explicit 40% tax and the economic result would have been identical.

What is the significance of classifying an amount as a tax, as in the example of 40% of the cost of lottery tickets? Like many questions in tax law and policy, the question of whether an amount paid to the government should be regarded as a tax or some other type of payment is purely a conceptual question. That is, it is not a question the answer to which can be empirically verified. It is not a question about our sense experience. Also, it is not a question about values. In asking whether a payment represents a tax we are not being asked to assign some value to lotteries whether good or bad, wise or unwise, right or wrong, politically desirable or not. It is a pure question of concept. In order to clarify our thinking about the government’s 40% monopoly profits made from the sale of lottery tickets is it more helpful to think about it as a price, perhaps like tuition fees paid to the government for a university education, or is it more helpful to think about it as a tax, like the income tax? If it is analogous to other taxes, then the normative justifications required in imposing taxes, and the criteria applied in evaluating those taxes, should be applied to this portion of the price of a lottery ticket. Selective sales taxes, also referred to as excise taxes, are normally justified on the grounds that the consumption of the items taxed impose social costs and, therefore, the tax is an attempt to ensure that the price of the good reflects its full cost; both the private costs of producing it and the social costs imposed by its consumption. What cost do purchasers of lottery tickets impose on society? One of the criteria used in evaluating taxes is whether the cost of the tax is fairly distributed across income classes. The empirical evidence suggests that low-income individuals spend a much larger percentage of their income on lottery tickets than high-income individuals. Assuming that the winners announced in the newspapers -- who always seem to be folks down on their luck -- are a random sample of the people who buy lottery tickets, this seems like an obvious point. But then the normative question becomes more urgent, what possible justification is there for this viciously regressive tax?

Another kind of situation in which the decision to label a payment to the government as a tax is contentious is where there is only a loose connection between the amount an individual pays for government goods and services and the value of the goods and services provided. For example, there is an on-going debate in Canadian public policy as to whether the premiums paid for
employment insurance and coverage under the Canada pension plan should be regarded as a price or a tax. Basically, everyone pays a fixed percentage of their income in these premiums, around 6% in both cases (on the assumption that the amount paid by the employer is, in the long run, paid by the employee in the form of lower wages), until their income reaches slightly under $40,000. Then the premiums remain a fixed amount. Consequently, someone earning $100,000 pays a significantly lower percentage of their income in these premiums than someone earning $40,000. If these premiums are regarded as a price this might be unobjectionable since the employment insurance coverage purchased by the high-income individual is about equal to the coverage received by the middle-income individual. Similarly, both will receive about the same amount from the Canada Pension Plan. However, if the premiums bear little relationship to the benefits that different individuals receive then they can fairly be regarded as taxes and the fairness of their incidence, that is who pays them, becomes a matter of concern.

Public finance texts frequently divide government charges into public prices, service fees, specific benefit taxes, taxes in lieu of charges, general benefit taxes, earmarked taxes (and further into pure earmarking, notional earmarking, and effective earmarking), and taxes. However, for the purposes of simply locating taxes analytically within the broader range of government policy instruments that require payments to governments enough has been said. But more generally on this issue about what is a tax, it is important to bear in mind that while in some contexts it is analytically useful to distinguish between a tax and other government policy instruments such as prices, regulation, government subsidies and confiscation, in many respects taxes are no different than these other policy instruments. In particular, a sharp distinction is often drawn between the government’s use of taxes and the government’s use of property and contract laws to achieve particular policy objectives. Unlike property and contract laws, taxes, it is sometimes alleged, are burdensome impositions, reduce freedom, usurp private choices, and are an interference with private property. At one level, whether taxes reduce freedom, for example, is a normative question. Many people would argue that taxes, in fact, greatly enhance the amount of freedom available in a society by redistributing income. By any measure, $1,000 in the hands of someone whose income is otherwise $20,000 increases the options confronting that person by much more than taking $1,000 from a person earning $300,000 could conceivably reduce freedom. Moreover, taxes increase peoples’ freedom by allowing them to pursue their collective aspirations. However, at another level, the extent to which taxes are different from other government policy instruments, including the rules of property and contract law, along any of these dimensions is a purely conceptual question.

Many commentators, particularly those on the right, appear to assume that the rules that govern the marketplace or the private sphere are somehow natural, or at least uncontroversial and perhaps even inevitable, while those that govern the public sphere, including the tax system, are the result of political choices that are imposed on those who disagree with them. But this effort to categorize the background rules governing market-place transactions differently from the rules imposed by legislative or regulatory bodies is conceptually incoherent. What economists often refer to as the self-regulating, neutral and free market-place is, in fact, comprised of legal rights and commercial exchanges that are created and regulated by a seamless web of rules, standards, distinctions and judgements that collectively constitute the rules of property, contract and tort law. None of these rules were ordained by God. None sprang from nature. Even in the nineteenth century, when most of these rules were formulated, they simply represented the value
judgements and policy decisions of common law judges. In part, the judges formulated these rules by considering the same issues of loss distribution and social welfare that are considered by legislators in enacting modern regulatory regimes, including tax laws.

In establishing the incidents of property ownership, property rules significantly affect the value of property rights; in establishing the ground rules for trade and exchanges, rules of contract law significantly affect the relative bargaining strength of the parties. Thus these so-called “neutral” or background rules have decisive and pervasive distributional consequences. They favour those with property and other sources of bargaining power created by the state over others. And if you can believe most legal historians, that was their intent. If an individual violates one of these free market rules, another private party can bring the full coercive power of the state to bear upon that person by initiating a court action. The point of this digression is to make the perhaps obvious point that in terms of being the result of political action, of having significant distributional effects, and of being imposed on some by the force of state action, there is simply no difference between the rules of property and contract law and the rules of tax law.

Just to push this conceptual point a little further, the results of tax law are sometimes described as a “taking” and, therefore, conceptually distinct from the results of many other types of law. This is an odd way to characterize taxes, if the point is to distinguish them from any of the other laws that govern our social or economic lives, including laws of contract and property and even criminal law. Tax laws are no different because they affect the distribution of resources than any other regulatory laws. To take a straightforward example, assume that the majority of citizens democratically decide that because of their own myopia and their concerns about their own ability or willingness to rationally weigh the costs and benefits of fastening a seat belt, and because of their mutual interest in preventing serious injuries, they should require all automobile drivers to have seatbelts available for their use. This judgement could be implemented in one of two ways. All automobile manufacturers could be required by regulation to install them, or the government could impose a tax on automobiles and then subsidize their installation. On the assumption that the cost of installing the seatbelts would be passed on to consumers, the effect on the after-tax income of car-buying individuals is identical. The “taking” inherent in the seatbelt regulation is identical to the “taking” involved in the tax and subsidy program. The same is obviously the case for all laws that regulate, for example, workplace safety, materials, production, and treatment of employees. It is only slightly less obviously the case, although certainly as true, for all laws that create property rights and all laws that determine the rules for negotiating legally enforceable contracts.

To take the most counterintuitive example, in the same sense that tax law is a taking, even criminal law is a taking. The criminal law greatly diminishes the value of the natural advantages of those who are physically strong and have a brutal disposition but perhaps are less conniving and shrewd than those who make money manipulating the rules of property law and contract to their own advantage. The criminal law “takes” from them. Yet, unlike some tax evaders, when physically strong criminals or gifted break and enter artists congregate they generally do not whine about the immorality of the criminal law in an effort to justify their activities.

There are important differences between governing policy instruments such as taxes, subsidies, regulation, credit controls, the rules of contract and property law, government ownership, and
government suasion. However, the differences are much more subtle than they are often made out to be in discussions over tax law and policy.

3.2 Classification of Taxes

All taxes have five components, and they are usually classified by reference to an attribute of one or the other of these components. First, each tax must have a base upon which it is levied. Second, each tax must have a tax-filing unit that is responsible for paying the tax. Third, taxes must have a rate that is to be applied to the base in arriving at the tax owing. Fourth, unless they are imposed on individual transactions, taxes must have a period over which the base is measured and the taxes collected. Fifth, each tax must have a set of administrative arrangements for its collection. Although taxes can be classified by reference to the characteristics of each of these components, only the tax classification schemes relating to the tax base and tax rates will be reviewed here since they are by far the most important.

3.2.1 The Tax Base

The most common way for classifying taxes is by reference to their base, that is, the amount, transaction or property upon which the tax is levied. The concept of the “tax base” is an important part of the specialized terminology of tax. There are three obvious bases upon which a broad-based tax might be levied: the amount that an individual earns (income), the amount that an individual spends (consumption); or, the amount represented by an individual’s property (wealth). The base of most taxes is expressed in monetary terms. The dollar value of income earned, goods consumed, or of property held. The tax is calculated simply by applying the rate of tax, almost always expressed as a percentage, to this base.

An income tax is, of course, a tax in which the base is income. A good deal of the basic course in income tax law is taken up with learning how this base is defined in the Act. In the Act income is defined, by and large, by reference to the sources side of the household budget as the net amount an individual earns from sources such as employment, property and business. However, income can also be defined on the uses side of the household budget; the value of the individual’s personal consumption plus the increase in their net wealth. The equivalence between defining income on the sources and uses side of the household budget is easy to see. If an individual earns income from some sources they can either use it to purchase consumption goods and services or save it and thus increase their net wealth.

In addition to taxing income comprehensively, a government might impose a tax on only some aspect of income, such as wages and salaries. These taxes are commonly referred to as payroll taxes and are primarily used to finance social insurance schemes. In Canada, federal payroll taxes consist of premiums for employment insurance and Canada/Quebec pension plan contributions. Provincial payroll taxes include workers compensation premiums and, in some provinces, taxes on payrolls to help finance health care.
Consumption is potentially another comprehensive tax base. Recall that the definition of income, on the uses side of the household budget, is consumption plus increase in net wealth. Hence a consumption tax is essentially equivalent to an income tax that exempts the value of the taxpayer’s savings from tax. If consumption is the desired tax base, there are numerous ways the tax can be imposed and collected. The federal Goods and Service Tax (GST) is a value-added tax in which the tax rate is applied to the value added to goods and services at each stage of their production. By contrast, the provincial retail sales taxes are single-stage taxes that are collected by retailers when goods and services are sold to consumers. Over the years, there has been an extended debate over which form of sales tax is to be preferred, however, the multi-stage sales tax appears to have emerged triumphant and is now used around the world. Generally, it appears easier to extend to all goods and services, easier to remove from production goods, and more difficult to evade than a single-stage sales tax.

In addition to a tax on sales transactions, a broad-based consumption tax could take the form of a personal expenditure tax. For example, if individuals calculated all of their income and then deducted their savings at the end of the year presumably the balance would be the value of the goods and services they consumed in the year. Some economists argue that a personal consumption tax would be more equitable, efficient and administratively simple than an income tax, but no country has yet implemented one.

Consumption taxes that are only imposed on selected goods and services are commonly referred to as excise taxes. In Canada, excise taxes are imposed both by the federal government and the provinces on products such as gasoline, cigarettes, alcoholic beverages, lotteries, automobile air conditioners, and a few luxury goods. The normative justification for most of these excise taxes is that the consumption of these goods creates social costs so that the tax is necessary in order to ensure that the price of the good reflects these social costs.

In addition to income and consumption, an individual’s wealth is a third possible comprehensive tax base. Wealth taxes can take many forms. Some European countries impose an annual tax on the net wealth of individuals. More commonly, countries impose a tax on the value of a person’s wealth when they transfer it to some other person either by way of gift or upon death. Wealth transfer taxes are referred to, depending upon their form, as estate or inheritance taxes, or more prosaically as death taxes. The justifications for wealth taxes include the need to achieve a more equitable distribution of wealth, to increase the progressivity of the tax system, to act as a backdrop to the income tax system, and generally to increase the efficiency of the tax system. Not surprisingly, all of these arguments are contentious. Nevertheless, Canada remains only one of three industrialized countries in the world that does not have a general tax on wealth. Canada does, however, have substantial partial wealth taxes. All provinces or local governments in Canada impose a tax on real property.

This brief review of possible tax bases does not exhaust the list of taxes. Taxes can be levied on any base and in most countries there are a number of miscellaneous taxes that are levied on bases such as business activities, corporate capital, gross receipts, and the use of natural resources. In addition to taxes, governments also generate revenue by selling goods and services, earning investment income and from other sources.
The following statistics provide a sense of the importance of these various tax bases and sources of revenue to Canadian governments. In 1997, the revenues of all governments in Canada was $352 billion. This was composed of the following amounts (in billion of dollars): income taxes - $143 (41%); general consumption taxes - $42 (12%); property taxes - $37 (11%); payroll taxes - $32 (9%); excise taxes - $26 (7%); miscellaneous taxes - $14 (4%); the sale of goods and services - $28 billion (8%); investment income $26 (7%); and other $3 (1%). From the point of view of students enrolled in a basic course in income tax, the most salient statistic is that income tax accounts for by far the largest percentage of government revenue.

In the public finance literature there is heated debate over what is the proper mix of taxes in a country. Generally, left-wing commentators argue for more reliance on income and wealth taxes because they are progressive; right-wing analysts call for more reliance on consumption taxes because they exempt income from capital from tax. The latter argue that taxing income from capital creates economic distortions that impair the rate of growth in the economy and that this problem has become more serious in the new globalized economy in which capital is almost completely mobile. The owners of capital, multinationals and high net wealth individuals are free to move their capital across the world seeking those jurisdictions in which it can earn the highest after-tax rate of return.

3.2.2 The Rates of Tax

In addition to their base, the other major way that taxes are classified is by reference to their rates. Here, only the concepts that apply to the rates of an income tax will be considered. In considering both the progressivity and the economic effects of income taxes, it is important to distinguish between several concepts of tax rates, most notably, statutory, marginal, average and effective rates.

The statutory rate structure is straightforward and is set out in section 117 of the Act. Although this is not evident from the rate scale established in section 117, the Act provides for a personal tax credit that offsets the tax liability on a taxpayer’s first $7,231 of income (in year 2000). (The tax credit is expressed as 17% of $7,231 in section 118(1)(c). Since the rate of tax on this income is 17% the credit completely offsets the tax liability.) Once the amount sheltered by the personal tax credit is exceeded the statutory rates apply. The tax-schedule in section 117 contains three tax brackets: 17% on taxable income up to $30,004; 25% on additional taxable income up to $60,010; and 29% above $60,010 (the dollar amount of these brackets is for year 2000). Parenthetically, these rates are, of course, only the rates of tax in the federal Act. All of the provinces also impose an income tax which, as of year 2001, they will impose on the taxpayer’s federal taxable income. The federal government collects the provincial income taxes (in all provinces except Quebec) and remits them to the provinces. Thus taxpayers only have to file one tax return. The provincial rates vary considerable, but simply by way of example, the Manitoba rates for 2001, which are somewhat typical, are 10.9%, 16.2% and 17.5% and they apply to the federal rate brackets. Thus in Manitoba the top combined marginal tax rate (ignoring surtaxes) will be 46.5% (29% + 17.5%).
In tax terminology, the rate of tax that applies to an additional dollar a taxpayer earns within each income bracket is called the marginal rate of tax, while the rate that is applicable to the taxpayer’s income as a whole, that is the fraction of total income that is paid in taxes, is called the average rate. The percentage figures in the statutory rate schedules are clearly marginal rates; average rates are not set out in the statute. An individual with $80,000 of taxable income, for example, is subject to a rate of 17% on income from $7,231 to $30,004; a rate of 25% on the next $30,005 ($30,004 to $60,010); and a rate of 29% on the last $19,990 ($60,010 to $80,000). Thus although the individual’s marginal rate of tax is 29% - that is what they will pay on their next dollar earned - their average rate of tax is only 21% ($17,169/$80,000). Notice that when taxpayers earn an additional dollar, even though it might cause them to be moved into a higher marginal tax bracket, it cannot affect the amount of tax they pay on their other income. Thus the popular expression, “I cannot afford to earn more money because it will throw me into a higher bracket,” if it is taken to imply that the taxpayer might actually sustain an after-tax loss if they earn more money because they will be paying more tax on their income earned up to that point, rests upon a misunderstanding of marginal tax rates.

The expression “effective tax rate” is similar to the expression average tax rate except that it is usually computed by reference to some broader measure of the taxpayer’s income than taxable income. In the example above, the taxpayer with taxable income of $80,000 had an average rate of tax of 21%. But suppose that the taxpayer had also earned $10,000 of income that was exempted from tax and had claimed a $10,000 deduction because he made a tax-preferred investment. The taxpayer’s real income thus exceeded taxable income by $20,000. The individual’s effective tax would be only 17% ($17,169/$100,000). The concept of effective rate of tax can be used to illustrate the effect of exemptions, deductions and tax credits on tax liabilities.

Most commonly, taxes are classified, in relation to their rates, as either being progressive, proportional or regressive. A progressive tax is one that takes an increasing proportion of income as income rises, a proportional tax takes a constant proportion of income, and a regressive tax takes a declining proportion of income. Note that progressive taxation does not simply mean that the rich pay more than the poor. This is true even in the case of the regressive tax. A progressive tax is one where the proportion of income paid in taxes rises with income.

Whether a tax is progressive, proportional or regressive cannot be determined by examining only who legally pays the tax, their taxable income and the rate scale of the tax. These terms are usually used to refer to the reduction in an individual’s actual income because of a tax (that is after taking into account the economic incidence of a tax) and are based upon a broad measure of the individual’s income. Consequently, whether a particular tax is progressive, proportional or regressive depends upon such things as who really pays the tax, how broadly their income is defined, over what period of time their income is measured, and who is assumed to benefit from exemptions, deductions and credits in the tax base.

Over the years several studies have examined the incidence of the taxes imposed in Canada and whether they are progressive, proportional or regressive. Generally, the studies find that all taxes in Canada are regressive except the income tax. This should occasion no surprise. Consumption taxes tend to be regressive, even though the rate of tax is constant, for example 7% for the GST,
because high-income individuals do not consume all of their income. They save a good portion of it. One study\textsuperscript{7} found that in 1988 individuals earning under $10,000 spend about 14.6\% of their income on commodity taxes, while individuals earning between $100,000 and $150,000 spent only 7\% of their income on commodity taxes. On the assumption that renters paid the property taxes levied on apartment buildings, even the property tax was found to be regressive. Individuals earning under $10,000 paid 7\% of their income in property taxes, while individuals with incomes between $100,000 and $150,000 paid only 2.8\% of their income in property taxes. Even the individual income tax turned regressive over high income ranges. Thus while individuals earning between $20,000 and $30,000 paid 7.6\% of their broad income in income taxes and individuals earning between $100,000 and $150,000 paid 15.5\%, those earning over $300,000 paid only 14.5\%. The reason for this is that very high income individuals disproportionately earn sources of income that receive favourable tax treatment, such as capital gains. The authors of this study found that overall the Canadian tax system was about proportional. Everyone, regardless of their income, paid between 30\% and 35\% of their income broadly defined in taxes. The progressivity of the income tax was completely offset by the regressivity of the other taxes in the Canadian tax system.

3.2.3 Income Tax Terminology

It is difficult to understand any part of the income tax law, or any specific provision in the \textit{Act}, without knowing something about the whole structure and where the particular piece being studied fits into the overall puzzle. Although this problem of the interrelatedness of the law applies in all areas of the law it might be slightly more serious in tax law because the income tax law is embedded in a statutory scheme that few can grasp by the exercise of pure intuition. Therefore, you should take time to study the logic of the scheme of the \textit{Act} and be sure to locate any specific provision that you are examining within the larger structure of the \textit{Act}. A very condensed version of that structure will be presented here for the purpose of defining some of the key terms used in the \textit{Act}.

In calculating their tax liability, taxpayers first determine their net income for tax purposes. The rules for calculating net income are contained in Division B of Part I of the \textit{Act}. Although there is no formal definition of gross or net income, section 3 provides a formula for calculating net income for tax purposes. Although most of the major ideas you need for understanding the Division B calculation of net income are embedded in section 3, very basically, it contemplates the following steps. First, the taxpayer “determines the total of all amounts each of which is the taxpayer’s income for the year...[other than capital gains] from a source inside or outside Canada, including, without restricting the generality of the foregoing, the taxpayer’s income for the year from each office, employment, business and property.” Second, they add their net taxable capital gains. Third, they subtract the deductions permitted in subdivision e. Fourth, they subtract any losses from employment, business, and property.

Even though this formula for the determination of income appears to be relatively comprehensive, a number of items that clearly increase a taxpayer’s ability to pay are exempt from tax either because the courts have held that they do not fit within the concept of income as used in section 3 or because the Act specifically exempts them from tax. Strike pay is an example of the former. The Supreme Court of Canada (the “Supreme Court”) has held that strike pay is exempt from tax since it is not “income from a source.” Other exempt items that might be thought to be income but which have been held or accepted not to be included in section 3 include gambling gains, gifts and inheritances, windfalls, and personal injury awards. The Act explicitly exempts from income one-third of any capital gains realized by a taxpayer. Section 81 exempts a number of other very particular types of income from tax including income from the office of the Governor General of Canada, certain allowances paid to elected officials, and various types of compensation such as that paid by the Federal Republic of Germany to victims of Nazi persecution.

This is not the place to review all the exemptions from tax, but simply to make the definitional point that an item exempted from tax simply does not enter the computation of income. It is important to note that the benefit to an individual taxpayer of having an amount exempted from income for tax purposes depends upon her marginal tax rate, which in turn will depend upon the amount of her taxable income. Suppose that a taxpayer sells a publicly-traded share and earns $1,000 of capital gains, that is, she sells the share for $1,000 more than she paid for it. What is the value to the taxpayer of the fact that one-third of this gain is exempt from tax? It depends upon the taxpayer’s marginal tax rate. If the taxpayer’s income is so low that the taxpayer owes no tax then obviously the exclusion is of no value to her whatsoever. She would not have paid any tax on it even if it were included in her income for tax purposes. If the taxpayer’s income is $25,000, and her combined marginal tax rate is 25%, then the value of being able to exclude $333 from income is 25% of $333 or $84. For a taxpayer whose income is say $80,000, and who is in the 50% combined marginal tax bracket, the value of being able to exclude $333 from income is 50% of $333 or $167. That is, if the tax rates are progressive, exempting amounts from income has much greater value to high-income taxpayers than low-income taxpayers.

In arriving at income for tax purposes, section 3 contemplates that taxpayers earning business or property income will be able to deduct all the business expenses which represent the cost of earning business or property income, such as wages paid to employees, depreciation on business investments, and fees paid to investment advisors. All expenses of earning income should be deductible to arrive at the taxpayer’s ability to pay. But in addition to business expenses, in subdivision e of Division B, taxpayers are able to deduct numerous expenses that are clearly personal expenses or investments, that is, expenses that were not incurred in order to earn income but that are in the nature of personal consumption expenses or personal savings. These personal deductions include deductions for such things as contributions to Registered Retirement Savings Plans, expenses for spousal support, moving expenses, and childcare expenses. Like business expenses, these personal expenses are allowed as deductions, that is as offsets against the taxpayer’s income before applying the tax rates. As a matter of tax arithmetic, the value of a deduction for personal expenses is the same as that of an exclusion. Thus, if a taxpayer who has no tax liability incurs child care expenses of $2,000 they receive no benefit from the tax deduction. If they are in the 25% marginal tax bracket and incur the same expense, the value of the deduction to them is $500. If they are a high-income taxpayer and in the 50% tax bracket the
value of being able to deduct $2,000 of child care expenses is $1,000. This result is sometimes referred to as the upside down effect of personal tax deductions.

Once taxpayers have arrived at what is sometimes referred to as net income for tax purposes, or Division B income, they then turn to Division C of Part I in order to calculate their “taxable income.” Division C allows for the deduction of a few additional amounts. They include the following: a deduction of one-third of the employment income realized on the exercise of employee stock options; a deduction for business and other allowable losses that have been carried forward from prior years or back from subsequent years; payments such as worker’s compensation and social assistance that are required to be included in the taxpayer’s net income under Division B; the equivalent of an interest free $25,000 employee home relocation loan; and certain deductions for individuals residing in certain prescribed northern and isolated areas.

For many taxpayers, their net income for tax purposes will be the same as their taxable income; they will not be entitled to claim any of the deductions in Division C. However, if taxpayers qualify for any of the deductions in Division C then obviously their taxable income will be less than their net income. Why does the Act distinguish between net income and taxable income? That is to say, why aren’t the deductions in Division C found in Division B? The reason is that the drafters wanted a concept of income in the Act that corresponded more closely to the taxpayer’s economic income than does taxable income since some of the tax expenditures in the Act are conditioned on the taxpayer’s income. For example, in one-earner families, the income earning spouse can claim a tax credit of $1,229 (in 2000) if they support a spouse working at home. However, if the spouse working at home has “income” of over $614 this credit is reduced dollar for dollar. The drafters wanted a concept of income for the purposes of determining when the spousal credit should be reduced that corresponded as closely as possible to economic income. Similarly, the GST tax credit of $205 (in 2000) is reduced by 5% of the amount that a taxpayer’s family income exceeds $26,284. Eligibility for these credits, and several others in the Act, are dependent upon the spouse or taxpayer’s net income as determined under the Act, not their taxable income. The need to have a concept of income that corresponds somewhat closely to the taxpayer’s economic income leads to the odd result that taxpayers receiving worker’s compensation payments will include the payment in their income under Division B but then subtract it under Division C. Thus, although these amounts are not taxable, they must be included in the taxpayer’s income so that, for example, individuals receiving them cannot also claim the full GST credit if their income, including these payments, exceeds $26,284. In addition to conditioning some of the provisions in the Act, people using tax statistics in tax and economic policy analysis find the concept of net income more useful for many purposes than taxable income since it corresponds more closely to economic income. It is arguable that some of the deductions for personal expenses, including the deduction for contributions to RRSPs, that are now found in Division B of the Act, should be moved to Division C since they do not reduce a taxpayer’s economic income.

Once taxpayers determine their taxable income, they then turn to Division E of Part I to calculate their basic federal tax payable. In calculating this amount, taxpayers first apply the rate schedule in section 117. Then once they have determined their federal tax payable by applying the rate schedule they can deduct from this amount a number of tax credits. Tax credits are amounts that are offset directly against the taxpayer’s tax liability, thus unlike tax deductions their value does
not depend upon the taxpayer’s marginal tax rate. They have the same value for all taxpayers, at least all taxpayers who owe tax in excess of their eligible credits.

Like deductions, credits are divided into two categories. Most are deductible in arriving at the taxpayer’s basic federal tax payable. However, some are deductible after this amount has been determined. The reason for the distinction is that the provinces used to calculate their income tax by applying their income tax rates to taxpayers’ basic federal tax payable. Consequently, any federal tax credit that was deducted in arriving at basic federal tax payable also gave rise to an implicit provincial tax credit. For example, the personal tax credit is subtracted in arriving at basic federal tax payable. As provincial taxes payable were calculated by multiplying the provincial tax rate times this reduced figure, there was effectively a provincial personal tax credit equal to the federal personal tax credit multiplied by the provincial tax rate.

The federal tax credits that are deducted from tax payable in arriving at basic federal tax payable, and thus that had an implicit companion provincial credit, include the basic, married, equivalent-to-married, and dependent tax credits; the caregiver tax credit; age credit; employment insurance credit; Canadian (Quebec) pension plan credit; disability credit; tuition fee credit; education credit; interest on student loan credit; transfer of tuition fee and education credits; transfer of spouse’s credits; medical expense credit; charitable donations credit; and dividend tax credit. Additional federal tax credits are available to reduce the total federal tax payable, however, these additional credits do not directly affect provincial taxes as they are deducted after the determination of basic federal tax. Even so, many provinces have enacted explicit credits analogous to these. These credits include the foreign tax credits, federal political contributions tax credit, investment tax credit, employee and partner GST rebate, and labour sponsored funds tax credit.

All the tax credits listed above are nonrefundable. This means that if the taxpayer’s tax credits exceed the tax that is otherwise owed, the government does not make a payment to the taxpayer. The value of the credit is simply lost to the taxpayer. Tax credits can be made refundable. Refundable means that if a tax credit exceeds the tax that is otherwise payable, the government makes a payment to the taxpayer, creating in effect a negative tax. The Act contains three refundable credits: the GST credit, the child tax benefit, and the medical expense credit for taxpayers eligible for the mental or physical impairment credit who have income from employment or business of at least $2,500.

In addition to being refundable, tax credits might also be designed to be vanishing by being income-tested. This targets them on low- and middle-income taxpayers. All three of the refundable tax credits in the Act, as well as the age credit, are vanishing. For example, as mentioned above, the GST tax credit of $205 (in 2000) is reduced by 5% of the amount that a taxpayer’s family income exceeds $26,284.

A final concept that should be briefly defined here is the tax expenditure concept. It has already been referred to a number of times in this chapter. The income tax law is composed of two analytically distinct provisions, technical tax provisions and tax expenditures. The technical tax provisions establish and define the basic structural elements of the tax system: the base, the taxfiling unit, the accounting period, the rates and the administrative apparatus. These rules are
necessary so that the tax system can achieve its principal objectives of raising revenue and redistributing income and they are evaluated using the traditional tax policy criteria of equity, neutrality and simplicity. However, the Act contains over 100 provisions that have nothing to do with achieving the principal objectives of the tax system or defining one of its essential elements. Instead, their purpose is to provide implicit subsidies to taxpayers to encourage them to engage in particular types of activities or to provide particular taxpayers with a transfer payment. These provisions are now widely referred to as tax expenditures. The federal government publishes an annual account of these implicit spending provisions in which it identifies them, briefly describes them, and estimates the cost of each to the federal government. Tax expenditures are defined in this account as “an alternative to direct spending for achieving government policy objectives. They are defined as deviations from a benchmark tax system. Typically, they take the form of income exclusions, deductions, credits, or tax deferrals that are available to select groups of individuals or types of activities.” All the personal deductions and tax credits mentioned above are classified as tax expenditures by the government.

The fact that tax expenditures are economically equivalent to direct government spending is easy to see. If the government decides to subsidize 50% of the cost of taxpayers’ child care expenses, it has two basic ways of doing so. On the one hand, it could invite taxpayers to submit their child care receipts at the end of the year and simply write them a cheque for 50% of the cost. On the other hand, assuming that the taxpayers were in the combined 50% marginal tax bracket, the government could allow taxpayers to claim their child care expenses as deductions from their income for tax purposes. By being allowed to deduct their child care expenses taxpayers would be able to reduce their tax liability by 50% of their child care expenses. In effect, by providing the subsidy through the tax system, instead of writing taxpayers a cheque directly the government simply allows them to offset their subsidy cheque against their tax liability. There is an ongoing debate about whether or when tax expenditures are a preferred method for delivering government subsidies.

4 Methodology of Tax Law and Policy Analysis

4.1 Forms of Reasoning About Tax (or Anything Else)

The term methodology is normally used to refer to philosophy of science issues in the social sciences: the study of how, in practice, economists, sociologists, historians, and political scientists go about their work; how they conduct investigations and assess evidence; and, how they decide what is true and false, or whether they can. In the past, lawyers sometimes assumed that they did not have to be bothered with issues of methodology. They assumed that finding and applying tax law, for example, or thinking like a lawyer more generally, involved quite a different reasoning process than that involved in other social sciences and was mainly deductive and largely learned by doing. Almost no one believes this any longer. It is now widely accepted that legal reasoning, even statutory interpretation, is essentially policy-making and is not all that different than policy-making in any other context. Like all policy-making, determining the tax law to apply in some contentious area involves postulating a range of plausible, alternative options; a consideration of the consequences of each in terms (in the case of tax law issues) of
tax fairness, the neutrality of the tax system, administrative practicality and other relevant evaluative criteria; and a choice of the preferred option. Like all important decisions in which the consequences are serious -- as invariably they are in deciding what the tax law is -- all relevant principles, theories and tools of analysis should be brought to bear on the decision-making process. Of course, this methodology is no different than that followed when we make important decisions in our personal lives, although few of us do it systematically. But the more important the decision, even in our everyday lives, the more likely we will think about it carefully and follow this kind of reasoning process. So why not in tax law analysis?

To assist students to engage seriously in an analytical approach to tax law, this section reviews the three different forms of reasoning commonly used in all policy analysis. Whether undertaken in law offices, government departments, Parliament, or the courts, all reasoning involves the explication of issues that can be usefully classified as analytical, normative or empirical. Analytical issues involve reasoning about concepts; normative issues involve reasoning about values; and, empirical issues involve reasoning about facts. Naturally, like all attempts to classify phenomena, this classification can easily be deconstructed, no great trick to that. The world does not come in nice identifiable chunks. Along with other reasons, the distinction cannot be absolute because, on the one hand, normative theories make empirical assumptions about the kind of social order that will result if certain principles are acted upon; while, on the other hand, explanatory theories always rest upon judgements about which phenomena are significant enough to warrant our attempts to explain them. Nevertheless, this classification of issues is frequently useful in clarifying thinking and advancing debates. As an example, the question of whether some type of activity amounts to tax evasion would in most cases be usefully classified as a conceptual question; the question of the appropriate treatment of tax evaders as a normative question; and the question of what causes tax evasion as an empirical question.

Practitioners from almost every social science discipline have tackled issues relating to tax law. The interdisciplinary literature in tax is broad and deep. Thus, the other reason for reviewing the distinction between these forms of policy reasons here is that like all well educated lawyers, tax lawyers need to be aware of, and appreciate the range and validity of, the different forms of research across a broad range of disciplines and methodologies that bear on their work. No one expects tax lawyers to become social scientists, but they necessarily must be critical consumers of the work of social scientists. Many students will have an extensive background in various social sciences; this brief review of how some of that work bears on tax law is meant only to be suggestive. However, it will assist in alerting students as they proceed throughout the study of tax law to the types of arguments that must be made in particular contexts and the acceptable forms of reasoning in resolving those issues.

4.2 Analytical Reasoning

Analytical reasoning does not involve an inquiry into values or facts, but instead it is an inquiry into the methods by which we search for such values or facts, the basis on which we assert them, and the concepts we use in formulating them. In effect, it is thinking about what is thinking. It aims to clarify. The pursuit of analytical knowledge is, of course, the domain of philosophy.
However, practitioners in all disciplines must engage in conceptual analysis. Indeed, because of their professional training and practice lawyers are characteristically good at conceptual analysis. At some level, determining and applying the law often simply involves classifying situations with similar facts together, or being able to distinguish between particular fact patterns depending upon the context in which they arise.

Although analytical reasoning involves several methodologies, one that everyone is familiar with, at least superficially, is the methodology of logic. Logic is the study of the validity or invalidity of what follows from what. Developing a facility with the logical assessment of arguments traditionally involves becoming familiar with the recurrent patterns of reasoning and their common pathologies. Even though no one believes any longer that legal reasoning can be reduced to formal logic, it clearly has logical qualities. Therefore, as in every area of law, in engaging in tax law and policy analysis students should be alert to the common fallacies and errors in personal inquiry such as over-generalizing, begging the question, the proneness to see things in terms of extremes, the fallacy of composition (the assumption that what is true for a part will be true for the whole, or the reverse), the fact that correlation does not imply causation, and the fallacy of the transplanted category.

As you begin the study of each new area of tax law, or begin to construct an argument about an important issue in tax analysis, you should attempt to ensure that you understand the definition of the terms, are able to articulate and apply the basic principles, and that you understand the underlying logical structures of the area. A good deal of tax law involves simply conceptual reasoning. Indeed, many of the most important advances in tax analysis, such as the development of the Haig-Simons definition of income and the tax expenditure concept, have been due largely to increased conceptual clarity.

The most distinctive form of legal logic is that of analogy: of comparing and contrasting similar and dissimilar examples. Analogical reasoning is frequently used in tax law for the same reason it is used in other areas of law, to ensure consistency, equal treatment and continuity. For example, the tax law provides that individuals resident in Canada are subject to tax on their worldwide income. The concept of “residency” is used in this context to implement the principle that if an individual has sufficiently strong social and economic ties with Canada, and is benefiting from Canadian government services and organized social and economic life in Canada, as a normative matter they can be justifiably taxed on their worldwide income. In most cases it will be obvious whether this principle applies to particular individuals, for example, if they have been physically present in Canada and have lived here most of their lives. However, in some cases, where an individual perhaps does not live in Canada year-round and has only tenuous social and economic connections, whether the general principle underlying the concept of residency applies will be less obvious. The case will have to be decided simply by arguing by analogy to similar previously decided cases. Is the case more like those previous cases in which the individual was held to be resident or more like those in which the individual was held not to be resident? But once again, even though it is traditionally regarded as a distinctive form of legal reasoning, in fact, analogical reasoning is frequently used in everyday life and in many policy-making contexts. It is by no means unique to the law.
4.3 Normative Reasoning

This type of reasoning involves making moral, ethical or value judgements. It deals with what ought to be. There is a great dispute about the nature of normative knowledge and, in particular, about whether moral judgements are any different than just feelings and thus can have no status as knowledge. However, for purposes of briefly explaining the types of normative arguments usually made in tax law and policy analysis that debate can be set aside.

Most social science disciplines have both an empirical and a normative branch and in most disciplines practitioners can be divided into those who concern themselves primarily with normative issues and those who concern themselves primarily with empirical issues. This distinction is perhaps drawn most sharply in economics. Positive economics, which is the primary concern of most economists, deals with the explanations and predictions of decisions made by consumers and producers. In the policy context, these economists make assertions that take the form, if policy X is followed outcome Y will result. Many economists confine themselves to positive analysis. They seem to think they have a comparative advantage over other social scientists and nonspecialists in the description of the economy if they confine themselves to positive analysis but no such advantage in the production of normative or value judgements. So they confine themselves to questions such as what effect an increase in taxes might have on labour supply and savings behaviour and do not deal with the question of whether taxes are too low or high in terms of the goals and values of society.

Even though most economists purport to engage in positive economics, there is an important branch of economics that deals exclusively with normative issues relating to government action. This normative branch of economics is referred to as welfare economics. It should not be confused with government welfare programs. Basically, it provides a normative framework for assessing all of the government’s activities and, therefore, is the normative framework that is most frequently invoked in tax policy analysis. It provides a framework for thinking about questions such as should the tax system provide tax concessions for research and development, tuition fees, child care expenses, principle residences, charitable contributions and almost every other tax rule that might influence individual behaviour. It is hard to make any normative sense out of much of the tax system without having a basic understanding of welfare economics and therefore it is briefly examined in the next section.

The study of politics can also be divided into a branch that is descriptive, often referred to as political science, and a branch that is normative and concerned with the characteristics of political values, often referred to as political theory. Empirical studies in political science have become increasingly separate fields of inquiry: the study of government, of public administration, of international relations, and of political behaviour and public policy analysis. Although political scientists have examined numerous empirical issues relating to taxation much of their work has concentrated on attempting to provide political and other explanations for the details and design of the tax system.

Normative political theory is directly concerned with the justification of political institutions and policies. It aims to lay down principles of authority, liberty, justice, equality and so forth and then to specify what kind of social order would most adequately fulfil these principles. There is
of course a broad range of opinions about taxation held by political theorists. Libertarians who
are sceptical of the ability of democratic governments to pursue public ends argue that most
social ordering should be left to the market economy. The more extreme proponents of this
political theory argue that tax is not only an illegitimate exercise of government power but that it
is equivalent to forced labour. Many liberal political philosophers, however, see an important
role for taxation in ordering the good society. Prominent here have been various versions of
contractarian political theory. Contractarian theorists hold that there is a set of basic political
principles which all rational people would agree to given appropriate conditions. The most
influential example has been John Rawl’s theory of justice, which understands justice as the
principles that rational individuals would choose to be governed by in an “original position” in
which they were ignorant of their personal characteristics, their ideals of a good life, and their
social position. He argues that in this “original position” alongside the familiar liberal principles
of equal liberty and equality of opportunity, people would choose the difference principle, which
permits social and economic inequalities only to the extent that they benefit the least advantaged
members of society. Most would agree that if the state’s normative role is to see that its least
fortunate members have the best life it is possible to provide to them there is a large role for the
tax system.

Moving to the left on the political philosophy spectrum, some left liberals claim that the state is
responsible for guaranteeing the preconditions for effective choice and even that freedom must
be distributed equally to everyone. Again, tax laws would presumably play a large role in
ordering such a society. Of course on the far left, political philosophers view most major
economic and social problems as being deeply rooted in the structure of basic capitalist
institutions and therefore they see little role for the tax system as an instrument of social
transformation. Karl Marx was scornful of attempts to achieve equality by taxation: “Tax reform
is the hobby-horse of every radical bourgeois, the specific element in all bourgeois economic
reforms. From the earliest medieval philistines to the modern English free-thinkers, the main
struggle has revolved around taxation. The further it slips from his grasp in practice, the more
keenly does the bourgeois pursue the chimerical ideal of equal distribution of taxation.... The
reduction of taxes, their more equitable distribution, etc., ... is banal bourgeois reform.”

There is a range of liberal-democratic values employed in policy arguments: equality, fairness,
efficiency, freedom, autonomy, community, participation, authority, tolerance and order. Clearly
they frequently clash with one another and must be reconciled. Although there is no form of
argument that is widely accepted among policy analysts for resolving the clash of values, at the
very least normative arguments should be subject to the common standards of rationality. Thus,
at the most basic level, any normative claim should be accompanied by reasons; the argument
should be clear, that is, steps in reasoning should not be left out, words used should be
unambiguous, and the arguments should be systematically presented and complete; the
arguments should be consistent and free of contradiction, that is, the claim should follow
logically from the reasons, and the claims should be consistent with each other; the argument
should be complete, that is, it should address all of the important values involved with the policy;
and, to the extent the argument rests upon empirical claims, they should be true.

But assuming the argument satisfies these criteria, it then must be judged simply upon a direct
appeal to our intuition of what is just. In testing our intuition about value judgements there are a
number of common techniques. We can apply the principle to a number of particular cases and examine the implications of each of those against our intuition. We can abstract the principle to a higher level of generality and examine its consistency with other more fundamental principles that are perhaps more widely held. We can use heuristics like the Rawlsian original position to see whether we think that the principle would have reasonably been chosen by people who were unable to consider their own self-interest. Once these strategies are exhausted, we must simply accept that individuals with different perspectives hold different values and ensure that we have in place a fair procedure for taking action whether in relation to the tax system or any other area of public policy.

4.4 Empirical Reasoning

Many of the most contentious issues in tax law involve empirical questions. What effect do tax laws have on the decision of individuals to work, save and invest? What effect do they have on who performs household labour and the formation of families? What effect do they have on compensation packages, the financial structure of firms, and the legal forms in which businesses are conducted? Are taxes a drag on the economy? These are only a sampling of the countless empirical questions that will confront you in a basic tax course, therefore, it is important to understand the logic and methods of empirical research, or the way that trained social scientists go about answering these questions.

What all empirical or scientific research is about is finding and explaining causal relationships: “if A occurs, does B occur, and why?” All empirical or scientific knowledge is knowledge of relationships. The basic idea is straightforward. Only a difference or change can explain another difference or change: only variables can explain variables. So the language of variables is the language of science. In biology, scientists explain the causal relationships between biological phenomena; in astronomy, they explain the relationships between celestial phenomena. In the social sciences, scientists attempt to explain a variation in human behaviour by discovering some related variation. Of course, the idea of causality is complex and debating causality is what makes science so endlessly fascinating.

In investigating causal relationships, the variable that the investigator wishes to explain is referred to as the dependent variable (this variable depends on the action of another variable), and the hypothesized explanation is referred to as the independent variable (this variable is defined by the experimenter and hence is independent or outside the experimental situation). The most salient characteristic that distinguishes the different disciplines in the social sciences is simply the independent variables they usually invoke in order to explain whatever it is that needs explanation (the dependent variable). Within disciplines, what distinguishes different perspectives is, again, most often the nature of the independent variables they study.

In studying the relationship between two variables, a social scientist will inevitably begin with a theory about why and how the variables might be related. Naturally, that theory will usually be derived from the conventional wisdom about human behaviour that informs the social scientist’s particular discipline. Thus, the choice about what independent variables to study in large part rests upon different theories of human behaviour that each social science discipline by and large
assumes. In addition to studying different independent variables in attempting to explain changes in behaviour, the different disciplines have also developed different scientific procedures for testing causal relationships, based upon their relative expertise.

The characteristics and tools of empirical research, as they are applied to tax policy issues, could be illustrated by reference to any one of the dozens and dozens of empirical questions that bedevil tax analysts. In recent years one of the most contentious issues in tax policy has been the effect of income tax rates on labour supply, savings, investment, and tax evasion. Therefore, one of these issues, the effect of tax rates on evasion behaviour, will be used to illustrate the different approaches that the social sciences use to answer this empirical question. Posing the question more broadly, the phenomenon that interests social scientists in this context is why some people comply with tax laws and others do not. What explains this variation in behaviour, or, in the language of variables, what independent variable or variables explains the dependent variable of whether or not individuals evade the payment of taxes?

Economists approaching the question of why people choose not to comply with the tax laws generally begin by constructing a theory based upon the assumption about human behaviour that underlies all of economics, namely, that individuals generally act rationally in evaluating the costs and benefits of any chosen activity. Consequently, in modelling the choice confronting individuals who are deciding whether to engage in tax evasion, their basic model assumes that people would commit evasion when the expected utility of their criminal act exceeds its expected disutility. Therefore, the independent variables they examine include all phenomena that affect this rational calculus, most notably the tax rate, since that determines the benefits of evading paying tax on a given amount of income; the penalty structure, since that is part of the expected cost of evading; and, the probability of being caught and sanctioned, since that is also relevant in determining the expected disutility of evading.

Naturally, economists have developed various theoretical models of taxpayer evasion behaviour that are considerably more complex than a simple model that assumes that taxpayers optimize their conduct in reacting passively to whatever tax rules are in force. For example, since in reality there is a high degree of interaction between taxpayers and revenue departments, a number of economists have attempted to model the tax evasion decision in terms of game theory. Also, some economists have used partial and general equilibrium models to take account of factors such as the degree of substitutability in the consumption of goods and services produced in the evasion and non-evasion sectors that are ignored in standard theories of choice under risk models.

Once a social scientist has constructed a theoretical model to explain what variables might be related to a taxpayer’s choice to engage in tax evasion, he or she then, of course, must test this model empirically to determine if it has any explanatory force in the real world. Because economists are familiar with aggregate economic variables, and because they have developed highly sophisticated techniques for statistically controlling variables, most economists use actual data and statistical methods to attempt to scientifically estimate the casual relationship between variables. Thus, for example, as a first cut, if they wanted to know whether high tax rates cause individuals to evade tax, they might compare the amount of tax evaded at different income levels. Since in a progressive income tax system marginal income tax rates increase as income increases,
if high-income taxpayers are more likely to evade taxes than low-income taxpayers one might infer that high rates cause evasion. Of course, the problem with this simple kind of correlational study is that it does not control for confounding variables. Even if it were found that high-income taxpayers cheated more than low-income taxpayers there might be explanations for this that are equally plausible as the higher marginal tax rates these individuals faced; for example, maybe high-income taxpayers have more opportunity to cheat because of the types of income they earn, or maybe high-income people are generally more dishonest than low-income people, indeed, maybe that is how many people get rich, by cheating.

To ensure that a correlation between income and tax evasion is not just an effect of some variable associated with income other than tax rates, in comparing evasion between high-income and low-income taxpayers the economist would have to attempt to control for all other plausible explanations. They might do this by finding two jurisdictions with different tax rates, and undertake what is called a cross-sectional study. In comparing the tax evasion behaviour of individuals in the same income class in the two jurisdictions they would attempt to statistically control for all other plausible independent variables (type of income, marital status and so on). If, having controlled for all other variables, it is found that high-income individuals in the high-tax jurisdiction engage in more tax evasion behaviour than high-income individuals in the low-tax jurisdiction, the difference might be reasonably attributable to the effect of high tax rates. Another common method used by economists to control for extraneous variables is a longitudinal study. The tax evasion of high-income individuals is examined before and after a reduction in their tax rates, for example. There have been countless studies of this type, empirically testing for the various variables that economists predict would influence a taxpayer’s decision to evade.

Psychologists would begin to approach the question of why people evade taxes in the same way that economists do, that is, by postulating a theory of human behaviour that would explain this particular type of behaviour. However, psychologists tend to view the model of human behaviour used by economists as too simplistic. Although, like economists, psychologists tend to explain human behaviour in terms of variables that relate to individuals, they model human behaviour in much more complex terms than economists. Unlike economists, for example, they would not think of modelling taxpayers, in this context, as perfectly amoral, risk-averse utility-maximizers. Instead, they might be interested, as key independent variables in the tax evasion decision, in factors such as the individual’s views about the moral acceptability of tax evasion. That is, unlike economists, psychologists tend to assume that individuals are moral beings with ideas and values of their own and that legal commands and their own impulses filter through and are affected by this moral screen. Furthermore, they would note that variables such as tax rates, the probability of detection, and the size of fines are mediated through individual attitudes and perceptions.

In addition, psychologists would likely be troubled by the fact that economic theories of compliance are premised on the assumption that noncompliance is the result of considered and conscious decisions by taxpayers. The assumption overlooks the considerable force of habit in accounting for behaviour. In many situations compliance or noncompliance may be simply the result of habit, doing what is easiest, or indifference. So in studying compliance psychologists would want to explore the factors that might affect the movement of taxpayers from inertia to active decision-making and back to inertia again. How do tax issues become salient? What
causes people to begin thinking about changing their behaviour? How do people form habits? They would also likely note that the assumption that taxpayers make a rational calculus of the costs and benefits of evasion overlooks the fact that decision-making is inevitably a process. Likely, most people do not approach taxpaying in terms of simply making a decision at one point in time of whether to comply or not. Rather, they undertake or fail to undertake a series of actions whose cumulative result is compliance or noncompliance, for example, keeping track of all income, maintaining records, padding a particular expense, making a guess at what the law is. These are discrete actions and decisions that people may confront and make without reference to an overarching decision to comply or not to comply. Finally, psychologists would want to consider the subjective framing of tax decisions. As an example, there is now an extensive body of empirical research suggesting that decision-makers typically frame their choices in terms of gains or losses from some initial or neutral reference point rather than in terms of net assets after an action.

Since they are primarily interested in variables related to the individual, psychologists frequently use simulations and laboratory experiments to test the explanatory power of their chosen independent variables. By way of illustration, simulations undertaken by psychologists in testing their hypothesis about tax evasion have often involved small-scale experiments, in which subjects might be paid a monthly salary. Subjects might then be given tax tables and asked to assess their tax liability and pay tax under a hypothetical tax system in which evasion will be penalized and audits will be conducted at varying frequencies. Subjects are informed that it is a game and that the winner will be the persons with the largest amount of net earnings after-tax at the end of the simulation. To determine their effects on tax compliance independent variables such the fairness of the game, tax rates and penalties would be varied in separate conditions. These simulations are highly artificial and that often makes it difficult to generalize the results to actual tax evasion behaviour, however, they can make an important contribution to the accumulation of knowledge about tax evasion.

Sociologists tend to see the cause of variation in human behaviour in the structure of the social system. Thus they explain people’s actions by examining the forces that impinge on the positions that individuals occupy within the system. Among other things, this means that they extend the basic economic model of crime control by making the point that law is not the only source of punishments and rewards. Taxpayers live and work in society. They have families, friends, and co-workers who are sources of rewards and punishments. These social forces shape behaviour just as effectively as the rewards and punishments administered by the state. Given their basic assumptions about human behaviour, sociologists are also likely to look at independent variables such as attitudes toward government, views relating to the enforcement of tax laws, views about the fairness of the tax system, contact with the tax department, and demographic characteristics.

In testing their hypotheses, sociologists frequently use so-called soft methods of research, such as participant-observer research, but they also attempt to test for structural explanations of behaviour using randomized controlled field experiments and social surveys. One of the most famous randomized controlled field experiments undertaken in the area of tax evasion was
conducted in the early 1960s by Schwartz and Orleans.\textsuperscript{8} The study has since become somewhat of a classic in social experimentation. A homogeneous sample of taxpayers was selected and randomly assigned to either one of two experimental groups or a control group. Members of the experimental groups were interviewed about one month before filing their returns on 1961 income. During the interview they were subjected to comments by the interviewers. To one experimental group the interviewers stressed the severity of government sanctions against tax evasion. To the other, they stressed the obligations of citizens to the government and the importance of personal integrity. After the subjects’ tax returns were filed, the IRS supplied the investigators with data relating to the adjusted gross income, tax deductions, and tax payment data, for the groups interviewed as a whole for both 1961 and 1962. Based on comparisons of the change in reported adjusted gross income and tax payment figures for the two experimental subgroups and the control group, which received no communication, Schwartz and Orleans concluded that both threats of sanctions and appeals to conscience encouraged compliance, but moral appeals were more effective than threats.

Sociologists have also conducted a large number of surveys relating to tax evasion. Basically, based on the surveyed population’s answers to a number of questions, researchers have attempted to divide the sampled population into evaders and non-evaders and then have attempted to determine the salient differences between the two populations. Assuming that the dependent variable can be accurately operationalized, any number of possible independent variables can be examined: perceived likelihood of apprehension, perceived severity of legal sanctions, perceived disapproval from others, perception of evasion by others, moral acceptability of tax evasion, views on enforcement of tax laws, views on the fairness of tax system, and demographic characteristics.

The point of this brief review of the empirical research related to tax evasion was not to determine what has been learned about the causes of tax evasion, but simply to examine the various approaches that social scientists take to such questions. Empirical questions will arise throughout the basic tax course. Students cannot be expected, of course, to set about collecting and evaluating the empirical research that relates to these questions. However, you should carefully identify such questions; conceptualize them as an issue involving the relationship between variables; attempt to operationalize the dependent variable and hypothesize relevant independent variables; search for a theory of human behaviour that might explain why a given independent variable might be expected to cause the dependent variable; and examine your own experience and your knowledge of widely accepted social or economic facts for evidence that might constitute empirical grounds confirming your hypothesis.

4.5 Methodological Pluralism

Tax policy analysis seldom involves pure analytical, normative or empirical questions. The resolution of those questions is the domain of philosophers and social scientists. Instead, tax policy analysis is concerned with identifying and defining problems in the tax system, specifying ends to be achieved, evaluating alternatives and selecting options. At one level it involves simply the application of clear thinking. In trying to reach decisions as rationally as possible we should formulate the issues as analytically as possible and we should make our values and empirical assumptions explicit. But even though it is essentially an instrumental exercise, since it involves the resolution of important questions with serious consequences, it should draw upon all the relevant principles, theories and tools of analysis helpful in reaching an informed decision.

As mentioned above, no one believes that even the most routine court decisions are uniquely determined by pre-existing legal rules and that courts either do or should reach their decisions by logical deduction from a conjunction of a statement of the relevant legal rule or statutory provision and a statement of the facts of the case. When judges decide cases they are making policy decisions and, therefore, judges and the lawyers who argue before them should engage in the full range of techniques of policy analysis.

In tax classes the discussions can become heated since the policy issues often deal with such fundamental questions about the nature of our collective lives together and our moral responsibilities toward one another. Even those who believe most strongly in the rationality of normative reasoning and the verifiability of empirical reasoning usually concede that there is no
one true answer to every question. Therefore, like all policy analysts, it is important that tax analysts remain sceptical and cautious about all claims, that they attempt to achieve clarity and civility, and that they respect the importance of perspective in addressing any issue.

5 Analytical Tools for Tax Analysis

An understanding of a few accounting, financial and economic concepts will greatly clarify a number of tax policy and tax planning issues. The ones discussed here are most important in terms of influencing the design of the tax laws and are the primary tools of positive tax analysis.

5.1 Inflation: Nominal Versus Real Values

Inflation is the persistent rise in the general price level. Assume that in 1999 you earned $40,000 and in 2000 you earned $44,000. The money or nominal value of your wages increased by 10% from 1999 to 2000. Your experience will suggest, however, that the purchasing power or real value, of your income did not increase by 10% because the price of goods and services that you have to purchase also increased. Indeed, if prices increased by 10%, it would require $44,000 in 2000 to purchase what $40,000 purchased in 1999. In this case, although the nominal value of your income rose, the real value remained unchanged. “Nominal” refers to the value of a concept measured in terms of current dollars; “real” refers to the value of a concept measured in terms of the number of units of goods and services that can be purchased.

In any given year the nominal and real value of money will be the same. However, the nominal value of money earned in a prior year (or any dollar figure) must be adjusted for the rate of inflation to arrive at its real value in the current year. The rate of inflation is the percentage change in the price level from period to period. A widely used measure of the average price of goods and services is the consumer price index (CPI). It measures the average cost of the goods and services bought by a typical consumer. The percentage change in the consumer price index is the key measure of the inflation rate. In the early 1980s, the inflation rate was over 10% a year. In recent years, it has been between 1% and 3% and, therefore, not of as great concern. Nevertheless, any amount of inflation affects the real value of money over time.

Inflation gives rise to at least three problems for the tax system. First, it means that if the dollar figures used in the Act to express the value of deductions and credits and to establish the income level at which tax rates increase (the tax brackets) are not adjusted for inflation they will lose their real value over time. This means that inflation will generate increasingly larger amounts of government revenue without any change in the dollar amount of tax deductions and credits or any change in the tax brackets or rates. In 1974 tax brackets and deductions and credits were fully indexed for inflation. In 1986, however, in order to raise increasingly more revenue every year and in order to reduce the deficit without explicitly increasing tax rates, the federal government adopted a system of partial indexation. Indexing adjustments were only to be made for annual increases in the CPI in excess of 3%. Over the years this resulted in billions of dollars of additional tax revenues for Canadian governments. Finally, after much pressure from
numerous constituencies and from the popular press, the federal government restored full indexing in its February, 2000 Budget.

A second way in which inflation may affect the tax system, if it is not taken into account by those who write the tax laws, is that it will result in the taxation of the nominal value of income from capital instead of its real value. Since the Canadian income tax system takes no account of the declining real value of capital due to inflation, it imposes a hidden and in some cases quite substantial additional tax on some taxpayers’ income from capital. Although the failure to index the cost of capital affects all forms of capital, an illustration using capital property will serve to make the point. Suppose in 1980 you used some of your savings to buy stock in a company for $10. In 2000 you sell the stock for $30. You would have to recognize $20 of capital gains for tax purposes. But suppose the overall price level doubled from 1980 to 2000. In this case, the $10 you invested in 1980 is equivalent (in terms of purchasing power) to $20 in 2000. When you sell your stock for $30 you have a real gain (an increase in purchasing power) of only $10. Yet the tax system treats your gain as being $20, namely the full amount of your nominal gain. Capital gains have always been given preferential tax treatment. Under the present Act you only have to include 2/3 of your capital gains in your income for tax purposes. In part, this preferential treatment is designed to be a crude proxy for indexing. However, for this purpose it is clearly too generous in many cases and not sufficiently generous in others. Furthermore, the taxation of all forms of income from capital is distorted by not properly accounting for the real value of capital. Thus a fully indexed tax system would allow for the indexation of interest income, inventories and depreciable property.

Finally, whenever a dollar amount is carried forward or backward under the Act, it is the nominal dollar value and not the real value that is used. For example, taxpayers who realize a $10,000 loss in one year, if they have no other income to offset this amount, can carry the amount forward and deduct it from income the next year. The Act contains a complicated set of rules for the carryforward and carryback of losses. But clearly in principle it is the real value of the loss that should be carried forward, that is the loss adjusted for inflation, and not its nominal value. By not allowing taxpayers to carryforward the real value of their losses the tax system is, in effect, only allowing them to carry forward part of their loss.

5.2 Tax Deferral and the Time Value of Money

Questions relating to the time value of money, and the correct period for reporting income or claiming deductions, present some of the most critical and vexing issues in the design of an income tax. They are the key to understanding the taxation of financial instruments, installment sales, prepaid income and expenses, compensation arrangements, and important aspects of international and corporate tax. Tax legislators have only relatively recently recognized the importance of time-value analysis. This recognition has resulted in numerous tax amendments and it will undoubtedly continue to inform a broad range of tax issues. Tax planners continue to structure transactions to exploit gaps in the tax system’s treatment of transactions taking place in different years. The importance of time-value analysis is that it neutralizes the time dimension so that transactions occurring at different times can be compared. Students sometimes misleadingly think that the important issues in tax are whether an item is included in or deducted from income
and that questions of timing could not be all that important. In fact, in tax, timing is almost everything. A few of the foundational concepts that are important in understanding basic income tax laws are reviewed here.

**Future value.** The fundamental idea underlying the time value of money is that the value of capital increases over time because it can be used to earn additional income. Therefore, $100 received this year is worth less than $100 received last year and more than $100 to be received next year. This is not a very difficult concept. If someone offered you $100 today or $100 next year which would you take? Naturally, you would take the $100 today since you could invest it and earn say a 10% rate of return and have $110 next year (instead of the $100 that was otherwise offered). If you invested it in an Internet stock, and got lucky, you might be able to double it to $200 in one year. The point is that because of the time value of money $100 today is worth more than $100 next year. This assumes, of course, that you earn a rate of return greater than the rate of inflation. To keep the math simple, these examples assume that there is no inflation.

How much more is $100 worth if it is received this year instead of next year? The future value of an amount is the amount that it will grow over the period. Normally in calculating the future value of an amount, the amount that it will grow is assumed to be the rate of interest on relatively risk-free investments. If we assume that the interest rate is 10%, which is greater than it is in fact these days, but assuming this keeps the calculations simple, then the value of $100 one year from now is $110. In the example above, unless the person offered you more than $110 one year from now, you would be wise to take the $100 now.

Often we want to know the future value of $100 for a period of greater than one year. What is the future value of $100 twenty years from now? If an investor only earned simple interest on the $100, that is, if they were paid the interest the $100 earned each year than, assuming the rate of interest were 10%, at the end of 20 years the investor would have the $100 principal plus $200 of interest ($10 of interest each year for 20 years). So the value of $100 in 20 years would seem to be $300. But in doing these kinds of future value calculations it is normally assumed that the interest earned at the end of every year is not paid to the investor, but instead is reinvested. That is, it is assumed that the interest earned each year is, in effect, loaned to the borrower which itself will earn interest, and so on. The earning of interest on interest is called “compounding.” When interest is compounding there is a simple formula for deriving future amounts (the compound interest formula) which need not be set out here. However, as anyone who has heard a sales pitch by a banker knows, the effect of compounding is “magic.” For example, in the simple example above, over 20 years simple interest yields an amount of $300 while compound interest (at the same rate of interest and over the same period) yields $673. Quite a difference. The difference becomes even greater over longer periods of time. Thus at the end of 30 years simple interest in the example would yield $400 while compound interest would yield $1,745; at the end of 40 years, simple interest would yield $500 while compound interest would yield $4,526.

What accounts for the dramatic difference between simple interest and compound interest? The reason is that accumulating interest, which is available to earn further interest, grows exponentially. Calculators or tables are frequently used in calculating the future value of amounts. However, the “rule of 72” is a straightforward method of arriving at an approximate
amount. This rules states that money will approximately double at a given rate of interest over the number of years obtained by dividing 72 by the interest rate. For instance, money doubles approximately every 6 years at a 12% rate of compounding interest and approximately every 8 years at 9%.

There are countless examples in the literature on investing in RRSPs that illustrate the importance of investing early in your career because of the “magic” of compounding; here is one. Assume A gets a job right after high school and invests $10,000 a year in an RRSP from 1953 to 1958 and then stops investing and goes off for the rest of his life. B goes to law school and therefore does not start investing in an RRSP until 1961. She works and invests $10,000 for the next 38 years and earns 10% interest. In 1999 how much do each have in their RRSP? B will have about $3 million, A will have $4.3 million!9

Present Value. Future value analysis neutralizes the time factor by taking a current year amount and converting it to a future year amount. Thus $100 this year is the same as $110 next year, assuming a 10% rate of interest. The alternative means of neutralizing the time factor is the exact reverse of the future value method, namely, the present-value method, which converts future values into present values for purposes of comparison. We know that $110 one year from now is worth $100 this year, assuming the interest rate is 10%, what is $100 one year from now worth today? Again, there is a relatively straightforward formula for discounting a future payment to its present value and it is easy to determine with a calculator or a present-value table. However, the concept is all that is important here. The answer you could guess at; it is approximately $91. Present value computations are important and have many applications in both tax policy analysis and in tax planning.

Asset valuation. The processing of calculating the present value of a future amount is, of course, the key tool in the valuation of assets. Conceptually, the value of an asset is simply the sum of the present values of all future returns that will be generated by the investment, regardless of whether such future returns take the form of interest, dividends, or capital gains.

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**Value of Tax Deferral.** Often people assert that the ability to contribute $10,000 to an RRSP (or make any other tax shelter investment) is not such a great tax break since it only defers tax and does not result in an exemption of tax. Taxpayers who contribute to an RRSP pay no tax on the income they contribute to the plan (they can deduct it from their income for tax purposes) and they pay no tax on the investment income earned in the plan. However, both the principle contributed and the investment income earned is taxed with they are withdrawn from the plan. However, compounding interest on the tax that is deferred explains the benefits of deferral and it can be huge. In the above example, if taxpayers in the 50% tax bracket pay tax on the $10,000 and then invest after-tax amount of $5,000 and earn 10% interest upon which they pay tax, after 20 years they will have only $13,260. If they invest in an RRSP and are able to defer paying tax on the $10,000 and the earned interest until they withdraw it after 20 years they will have $33,363 after-tax. If the period of saving is extended to 30 or 40 years the benefits of deferral become even greater because of the effect of compounding.

There are many ways to describe the tax benefits of deferral. One way is to say that the tax deferred (which in the above example above would be $5,000 in the initial year, assuming the taxpayer was in the 50% marginal tax bracket, and the tax that would otherwise be payable each year on the earned interest) is essentially an interest-free loan from the government to the taxpayer without collateral and without a definite time for repayment of the loan. The higher the taxpayer’s tax bracket, the larger the interest-free loan.

Another way of expressing the advantages of deferral in the above example is that it is equivalent to the government completely exempting the taxpayer’s after-tax income from tax. That is, deferral is equivalent to exemption of the yield on the amount deferred. To see this conceptual point, think of the above example this way. If the taxpayer had been taxed on the $10,000 of earned income she would have only had $5,000 left to invest after-tax. In effect, because she was able to deduct this amount from her taxes in that year, she put $5,000 of her own money in the RRSP and the government gave her an interest-free loan of $5,000 to put in as well. When the principal and earned interest is withdrawn the government will recover, in effect, its interest-free loan and, again assuming the tax rate is 50% it will recover one-half the earned interest. The other one-half of the interest, which conceptually one might say was earned on the taxpayer’s $5,000, will never be subject to tax. Among other assumptions, this equivalence between deferral and exempting the return on after-tax income only holds if the tax rate is the same in all relevant years. In fact, in most cases the taxpayer’s marginal tax rate will be higher in the year that she contributes to the RRSP than when she withdraws it. Therefore, tax advantages of RRSPs, and other forms of tax deferral, are likely to be greater than exempting the yield on after-tax income from tax.

As you read through the materials in this casebook the importance of the time value of money will become clearer to you not only in tax planning but also in tax policy analysis. Many of the provisions in the present Act do not fully account for the relationships between present and future value and consequently provide unintended tax breaks for taxpayers.

### 5.3 Capitalization Effect of Taxes
To the extent that the tax system favours one type of investment over another the demand for, and supply of, particular investments will be affected. Money and other resources will be shifted from the unfavoured type of investment to the tax-favoured type of investment and in response the relative prices of the investments will change. For example, if a tax is imposed or increased on income from a particular type of asset, the value of that asset will likely fall as investors sell it off. Conversely, if a tax is removed or reduced on income from an asset, the value of the asset will likely rise as investors increase their demand for the investment. The fall or rise in the price of assets due to the imposition or removal of a tax is referred to as the capitalization effect of a tax. The effect is simply an application of the obvious proposition that the world does not stand still when taxes (or anything else) change.

A simple, and simplified, example can be used to illustrate tax capitalization. Assume a bond that has a value of $100 pays $10 interest annually, which is taxed at a rate of 50%, for an after-tax return of $5. Now suppose that the government decides, for whatever reason, to remove the tax from the income of this type of bond. What should happen to the price of the bond? It would likely rise to $200. Since investors will now be able to earn $10 after-tax from this type of bond, presumably they would be willing to pay twice as much for it as they would for bonds from which they could only earn $5 after-tax.

Although analysts disagree about the extent of tax capitalization, and whether the price of assets in most markets ever rise to completely discount the tax benefits, as assumed in the above example, there is no question that tax capitalization is a wide-spread phenomenon in the economy and an absolutely essential concept to take into account in tax policy analysis, tax reform, tax planning and in interpreting the Act. A few implications of the concept can be drawn from the example above. First, when the tax on the bond is removed, notice that all existing holders of this type of bond receive a windfall. The value of their bond increases from $100 to $200. The more general point is: that whenever taxes are changed there will be windfall gains and losses to some taxpayers. The random and undeserved effect of these gains or losses is the concern that gave rise to the old adage “an old tax is a good tax.”

Second, once the tax change is made, and at some time in the future, most holders of the tax-favoured bonds will be investors who bought them for $200. It will appear as if they are receiving a tax concession since the income on their bonds is not being taxed. But in fact they are no better off than investors holding the taxable bonds. Both sets of investors are earning a rate of return of 5% after-tax. Consequently, although economic inefficiencies have been created by increasing the demand for the particular bonds by exempting their income from tax (assuming that the exemption was not correcting a market failure), once the change has been made there are arguably no tax inequities - both investors in the unfavoured and the tax-favoured bonds are in the same after-tax position. Incidentally, as another illustration of the adage “an old tax is a good tax” notice how arguably unfair it would be to remove the tax concession. All those investors who purchased the tax-favoured bond for $200 would suffer an immediate $100 windfall loss. Would that be unfair?

Third, if you were a tax planner would you advise your clients to buy the tax-favoured bond simply because it was tax favoured? Presumably not. It bears an implicit tax in the form of a reduced rate of return. In deciding on the best investment for a client both explicit and implicit
taxes have to be considered. Does the tax effect of capitalization mean that in fact because of the forces of demand and supply it is pointless to invest in tax-favoured investments?

Fourth, it is sometimes difficult to determine who benefits from the capitalization effect of taxes. For example, years ago when the government introduced a tax-sheltering scheme for investors in multiple-unit residential buildings in order to increase the stock of rental units and hopefully reduce rents, some analysts suggested that the only large winners from the scheme were those speculators who owned urban land upon which such units could be build. Such land was in short supply and when the scheme was announced, since these speculators could see that the tax concession was going to reduce the cost to developers of building such units, they simply raised the price of their land and captured a good chunk of the expected tax savings.

5.4 The Incentive Effect of Taxes: The Income and Substitution Effects

Taxes affect human behaviour in two ways, first, by reducing people’s income and, second, by increasing the relative prices of the activities, transactions and goods and services upon which they fall. Although hardly any human behaviour escapes the effect of taxes, the most important effects, from the point of view of the economy, are the effects of taxes on people’s work and savings behaviour and the effects of taxes on the investment decisions of businesses. Social scientists in most disciplines have examined the effects of taxes (or related phenomena) on human behaviour, however, the issues raised by this concern have been studied most extensively by economists. Standard consumer demand theory in economics notes that when the price of a good changes, it has two effects on consumer’s behaviour: an income effect and a substitution effect. The importance of these effects can be illustrated by attempting to answer a straightforward question: Will people work more or fewer hours a week if the income tax they have to pay for each hour worked is increased?

A simple example might help in thinking about this question. Assume that A earns $60,000 a year (she earns $40 an hour and works 1,500 hours a year) as an employee in a firm. The income tax rate is a flat 25%, with no exemptions. Consequently, she pays $12,500 a year in tax and is left with $47,500 of disposable income. How is she likely to vary the number of hours she works if the tax rate is increased to 30% with the result that her taxes are increased by $2,500 and her disposable income reduced to $45,000? In attempting to answer this question, economists would assume that A is a rational individual seeking to maximize her utility (seeking to make herself as well off as possible), given her disposable income. In deciding whether to increase or decrease the number of hours she worked, she would feel the influence of two competing pressures, a substitution and an income effect.

On the other hand, she might decide to work fewer hours because of the tax increase. She might reduce her hours of work so that her disposable income is, say, only $42,500 instead of $45,000. Why might she work fewer hours after the tax increase? Since the tax increase means that she is only earning $28 after-tax for every hour she works, instead of $30 which she earned before the tax increase, she might decide that it is not worthwhile to work so hard. She might decide that at this lower after-tax wage she would rather be wind-surfing or listening to Holly Cole albums a few more hours a week instead of working. The way that economists talk about this effect is to
say that the effect of a tax increase is to reduce the cost of leisure and, therefore, people will consume more of it, that is, they will substitute leisure for work. Before the tax increase the opportunity cost of her leisure was $30; after the tax increase it was only $28. When the price of a good goes down economists predict that consumers will consume more of it by substituting it for other goods. Hence the term, the substitution effect. The force of this effect is what presumably lies behind people’s intuition when they predict that tax increases will cause workers to work less. However, this theorizing ignores the income effect of taxes.

The tax increase reduced A’s disposable income by $2,500; therefore, in theory, she might decide to work additional hours in order to restore the level of her disposable income. This effect is called the income effect for the obvious reason that it results from the fall in the taxpayer’s real income. “A” may enjoy foreign travel and with the fall in her income would not be able to afford her annual trip abroad, therefore, she may rationally decide to work more hours after the tax increase.

The relative size of the income and substitution effect is likely to differ for different types of people. Given these two effects what types of persons, or persons in what situations, do you think would work more if taxes are increased, and who would work less? In theory, the income effect is likely to prevail if taxpayers have fixed income commitments such as family obligations, mortgages or if they have large incomes and therefore an increase in tax represents a substantial cut in income. In theory, the substitution effect is likely to prevail if taxpayers have a weak commitment to the labour force because they have a good deal of discretionary income. The important point is if we assume that individuals act rationally in deciding how many hours to work, a fall in the after-tax wage rate because of a tax increase does not lead to an unambiguous prediction about the quantity of work effort supplied. Economic theory is silent on which of these two opposing effects will dominate. Therefore, the case for one prediction or the other can only be made with empirical evidence. Nevertheless, although they may sound abstract, the income and substitution effects are useful tools in thinking about a number of tax law and policy issues.

The income effect is largely determined by the average tax rate (since it depends upon the effect of the tax on the taxpayer’s total disposable income), while the substitution effect is largely determined by the marginal tax rate (since it depends upon the effect of the tax on the taxpayer’s next increment of income). This observation has lead some economists concerned about the effect of the tax system on economic growth to support a tax system with high average tax rates and low marginal tax rates. In practice, the easiest way to achieve a tax system where average rates are high and marginal rates are low is to make the tax base as comprehensive as possible.

5.5 Tax Incidence: Who Pays?

The notion of tax incidence is indispensable in tax analysis. While it is one of the most important topics in tax analysis it is also one of the most intractable. Basically, the question that tax incidence seeks to answer is: when a tax is imposed (or changed) whose real income is reduced by the tax? A few things can be said reasonably confidently about tax incidence: (1) It is always some individual’s income that is reduced. Corporations or other legal constructs cannot
themselves bear the incidence of taxes. (2) It is not necessarily the person who actually writes the tax cheque to the government or who is legally obliged to pay it, since some part of taxes are almost inevitably shifted backward and forward from the payer. (3) The more difficult it is for the person who is taxed to substitute other goods or activities for the taxed goods or activity the more likely it is that they will bear the tax. (4) The incidence of tax is likely to vary between the short-term and the long-term. The last three points require a slight elaboration.

The proposition that the formal incidence of a tax, that is who is legally obliged to pay it, is largely irrelevant to its effective incidence is so well established that it has a name: the invariance of incidence proposition. The reason that the formal incidence of a tax tells you very little about who in fact pays it is that the incidence of a tax is ultimately determined not by legal formalities but by the forces of supply and demand operating through the economy. Take a straightforward example. If a new tax were introduced on the sale of televisions and required to be paid by television retailers it is unlikely the retailers would bear the tax, or much of it. On the one hand, if consumer demand for televisions was fairly inelastic, that is if consumers simply had to have televisions and were unable to substitute other products for them, then very likely retailers would simply add the cost of the tax on to the price of television. Tax analysts would say that the tax has been shifted forward. Forward shifting takes place if the tax falls on the user, rather than the supplier of the commodity or service in question. On the other hand, if consumers could easily substitute other products for televisions (by buying computers, for example) then their demand for televisions would decline if its price were increased and it is likely that the cost of the tax would be shifted backward to those engaged in producing televisions through lower wages and salaries, lower prices for raw materials, or a lower return on borrowed money. Or, the tax might not be shifted at all and reduce the net income of the owner of the business. The point is that since the incidence of tax is determined by the forces of demand and supply its legal incidence is irrelevant. There is no reason for believing that the person whose real income is reduced if a tax is imposed on televisions would vary depending upon whether the tax was imposed on manufacturers, retailers, or directly on consumers.

Another well accepted proposition about tax incidence is that the harder it is for people to substitute other things for the taxed activity, the greater the proportion of the incidence they are likely to bear. In the above example, if there are no substitutes for televisions, and every consumer demands a television, it seems reasonably certain that consumers of televisions will bear the incidence of the tax no matter who it is legally imposed upon.

Finally, in determining the incidence of taxes it is sometimes necessary to distinguish between the short-term and the long-term. In the short-term the individual who is legally obliged to pay the tax might not be able to shift it forward or backward. However, in the long run, as the economy adjusts to the tax, it is likely shared between several parties.

Simply to illustrate the application of these propositions, one can ask who likely bears the incidence of the payroll tax. In Canada, the employee’s contribution rate to employment insurance is 2.55%, the employer’s rate is 3.57%. Whose real income is likely reduced if a tax is imposed on televisions would vary depending upon whether the tax was imposed on manufacturers, retailers, or directly on consumers.
after-tax take home pay. Neither of these considerations would suggest that in the long run it should matter who bears the formal incidence of the tax. Is it likely that workers can avoid the tax by substituting some other activity for working? Not likely. Empirical studies on labour supply in Canada suggest that for most of the workforce the elasticity of labour supply is close to zero. This would suggest that in the long run the payroll tax in Canada is probably borne by workers.

What is the likely incidence of the tax on corporate profits? In a perfectly competitive economy, if the tax is not shifted it must be paid out of profits and thus it reduces the real income of shareholders. If this is its incidence the tax is extremely progressive since shareholders tend to be high-income individuals. However, some analysts contend that corporations in many industries are able to treat the tax as simply a cost of doing business and, therefore, they are able to add it to the price of the goods and services that they sell. In this case it would be borne by consumers. In effect, it acts as a disguised sales tax. Others suggest that firms are unlikely to be able to add the tax to prices since their products have to compete against the products of foreign corporations which do not bear the tax and, therefore, it likely falls on the most immobile factor of production, namely workers. Unfortunately, empirical studies have been unable to lend much certainty to the theoretical ambiguity about who pays the corporate tax.

Incidence analysis can be applied not just to overall tax changes, but also to changes in specific tax laws. For example, what would be the incidence of increasing the tax on business meal and entertainment expenses by making them completely nondeductible? (At present, business people can deduct 50% of the cost of business meals and entertainment.)

Although useful things can be said about the incidence of a tax change based upon an application of the theoretical propositions mentioned above, in fact, the effective incidence of any tax change is almost impossible to determine. There are at least two reasons for this. First, in deciding what the incidence of a particular tax change is it is necessary to make a judgement about what would happen if the change were not made. That is, there is always an implicit counterfactual hypothesis underlying the judgement about the incidence of a tax change. In the theoretical literature on tax incidence economists have developed several different concepts of incidence to attempt to account for different ways that the revenue might be raised if, for example, the tax under examination were not enacted. Second, the examples above might be generously described as an illustration of partial equilibrium analysis. We concentrated on the market of the tax product and ignored other markets. But in a market economy the introduction or change in a tax starts a series of adjustments that ripple through the entire economy. Ultimately, the price of totally unrelated products might be affected. Economists use general equilibrium theory to attempt to identify and incorporate economy-wide repercussions and implications of taxation. However, although general equilibrium models can sometimes be usefully applied to policy problems, including questions of tax incidence, limitations in data and problems of tractability usually lead economists to evaluate policies in one market at a time.

Several studies have been done on the overall incidence of taxes in Canada. Using various assumptions about the incidence of the taxes levied in Canada, most studies have concluded that the overall tax burden in Canada is about proportional. That is, that regardless of your income (broadly defined) you will pay about 35% of it in tax.
5.6 The Deadweight Loss of Taxation

The cost of taxes to taxpayers includes the amount they have to pay to government. This amount concerns some economists since they think that individuals can make better choices about how to spend their income and increase their well-being than governments. Nevertheless, assuming that the government is spending the tax revenues raised wisely, most would agree we are likely better off paying at least some taxes and receiving government services since, altogether aside from issues relating to the fair distribution of income, there are many services that the market cannot provide efficiently. At the very least, the public services that individuals receive as a result of the taxes they pay are presumably worth something to them. But in addition to the cost to taxpayers of actually paying a tax, there is an additional cost of taxes that no one benefits from, this cost is variously described as the deadweight loss of taxation or the excess burden of taxation (the burden in excess of the amounts actually paid). It arises because when a tax is imposed on a particular good or activity it causes some people to avoid the tax by substituting a less valued good or activity for the taxed good or activity. As a result of this substitution of valued for less valued goods, the individual’s welfare will be diminished because of the tax, even though they do not pay it.

Consider a simple example. Suppose that a pizza slice costs $4. “A” would pay $7 for a slice of pizza, he values it so highly. When he buys the pizza he has $3 of what economists call consumer surplus, which is the difference between the maximum amount a person is willing to pay for a good and its current market price. “B,” on the other hand, would only pay $5 for a slice of pizza. She still buys the pizza for $4, but she has only $1 of consumer surplus. Notice that when A and B buy a slice of pizza $4 of individual welfare is created in the form of consumer surplus. That is, after the exchange of their money for pizza, A and B are in total $4 better off. The pizza salesperson is likely better off as well, but in this simple example we will ignore the producer’s surplus. Of course, increasing individual welfare, or the social surplus, is what voluntary exchanges are all about.

Now look what happens if the government imposes a $2 tax on a pizza slice. “A” will continue to buy pizza slices, but will now pay $6, leaving him with only $1 of consumer surplus. “B,” on the other hand, will not buy the pizza for $6 and will forgo the $1 of consumer surplus such a purchase brought when she only had to pay $4. What is the effect of the tax? The consumer surplus, or the well-being of the two parties, has been reduced by $3, from $4 to $1. Of this $3 in reduced welfare, $2 has been paid to the government and we assume that the parties will benefit from it in some way. But that still leaves a $1 loss of consumer surplus that is unaccounted for. Thus in addition to the $2 of revenue that it raises the tax causes a $1 deadweight loss. It is called a deadweight loss since no one benefits from it. Notice that the deadweight loss arises only because B changed her behavior because of the tax and thus lost the consumer surplus that buying a pizza at the pre-tax price of $4 provided her. If individuals do not change their behavior because of a tax there is no deadweight loss. Economists are prepared to assume that they derived an equal benefit from the tax they paid. Since as a normative matter, economists are primarily interested in increasing the social surplus through voluntary exchanges, the deadweight loss of taxes is of great concern to them.
The concept of deadweight loss is usually explained in microeconomic textbooks much more thoroughly, with the aid of diagrams and algebraic formulae. However, the basic idea behind the concept is straightforward, taxes -- like any form of legal regulation -- can reduce individual welfare by preventing individuals from achieving some of the gains to be realized through voluntary exchanges. Taxes should be designed, most economists argue, to minimize deadweight loss.

5.7 General Theory of the Second Best

In one of the most frequently quoted passages in economic policy literature, R.G. Lipsey and K. Lancaster assert, “The general theorem for the second best optimum states that if there is introduced into a general equilibrium system a constraint which prevents the attainment of one of the Paretian conditions, the other Paretian conditions, although still attainable, are, in general, no longer desirable.”

At the most general level, what this theorem appears to suggest is that once the economy has deviated from the ideal of perfect competition, piecemeal tax (or any other) reforms to improve the allocation of resources might make things worse off, not better off. This might suggest that all reform efforts to achieve efficiency are hopeless. To prevent complete paralysis of action, in tax policy analysis the policy prescription suggested by the theorem has been applied loosely to simply act as a caution that the tax system, or any individual part of it, does not operate in a vacuum. When making a change to one tax law, the whole system must be considered as well as other government policies. For example, the theory posits that removing a preference from that tax system that appears to induce behaviour that might not otherwise occur cannot be assumed to improve the efficiency of the economy because there might exist some other government policy, or tax provision, that the tax preference is counterbalancing. Although efficiency would be promoted if both measures were repealed, if the other government intervention cannot be changed the tax provision might be acting as a “second best” alternative in promoting economic neutrality. All tax changes have to be evaluated in the context of other tax provisions as well as non-tax government policies. Put another way, a tax provision that distorts behaviour might actually be desirable when other distortions exist in the economy. As you proceed throughout the course, see if you can identify measures that can be justified by the use of second best analysis.

When a measure is referred to as a second best it is a way of drawing attention to the fact that there is a first-best policy but it cannot be achieved because of resource, technological or institutional constraints. Obviously all economic policy is likely second best in this sense, however generally, the context does not call for the point to be made or the term used. It is well known, for example, that the first-best tax system, that is one that would not effect people’s behaviour, is a “lump-sum” tax; a tax that is a fixed amount for each individual regardless of their income, consumption or any other attribute that might relate to their behaviour. This is the first-best solution. On moral grounds, no one argues that government should be financed with a lump-sum tax. But in this sense our present mix of taxes is clearly second-best. However, when

the term first-best is applied to the income tax, for example, it is normally taken to mean an income tax with a comprehensive tax base. In some cases, policy decisions have so many constraints that they are referred to as “third best” or “seventh best.”

6 Normative Justifications for Tax Laws

6.1 Why We Need Tax Laws?

The short twofold answer to the question of why we need tax laws is to raise revenue to finance government spending and to redistribute income. These are not bad answers. However, in thinking about tax laws in Canada, or any other market economy for that matter, it makes sense to start at the beginning. At the most basic level, we have taxes because we have governments. Collecting taxes is simply one of the ways that the government has to achieve its broad social and economic objectives. Consequently, the question of why we have taxes can be reduced to the question of why we have governments. Although examining normative theories of government might appear far removed from the study of tax law, because tax laws are so deeply embedded in the structure of government, and are such a pervasive instrument of government policy, at least a superficial understanding of the normative theory of government is required to make sense out of tax laws. A discussion of the normative justifications for government, or stated more broadly, a discussion of the principles that should guide the selection of forms of social organization to coordinate social life, could quickly become mired in competing versions of libertarian, liberal and collectivist theory. What follows is a brief account of the conventional way of thinking about normative justifications for government for the purpose of tax policy analysis.

Although there are much richer normative theories of government than that provided by economists, because welfare and public finance economists have developed the most highly articulated and arguably the most explanatory theory of government, that discipline’s conceptual framework is the one emphasized here. This normative model of government is the one most frequently used in discussions of tax law and policy and the one that has driven the structural economic reforms, including tax reforms, in western industrial countries over the past twenty years.

Public finance economists divide the functions of government in a market economy into three categories: the allocation, distribution and stabilization functions. In addition to these functions, this section will briefly discuss the government’s role in constituting the marketplace and encouraging economic growth.

6.2 The Role of the Tax System in Constituting the Marketplace

In identifying the functions of government, economists often begin by assuming that a marketplace exists in which individuals exchange goods and services. They then identify “market failures” that require government intervention. This might seem like a harmless
convention, however, conceptually it is wrong and failing to adequately recognize how markets are constituted can lead to a misconception of the nature of tax laws and mistaken public policies.

There is no such thing as a free, neutral and self-regulating marketplace in which exchanges between individuals take place. As any first-year law student knows only too well, what economists refer to as the marketplace is in fact a domain of economic activity that is regulated by countless detailed and complex rules of property, contract, tort and even criminal law. In the eighteenth and nineteenth century many of these rules were developed by judges deciding the concrete cases that formed the common law. As such, they represented the value judgements and policy decisions of those judges. Since the writings of the legal realists, it has not been disputed that in formulating these common law rules judges considered issues of loss distribution and social welfare. At present, most of these areas of law are shot through with legislative enactments and regulations and are thus even more obviously subject to the same political forces as rules in any other area of law. The rules that govern the marketplace are every bit as socially and politically constructed as the tax system and other government policy instruments. There is nothing inevitable or natural about these rules. Moreover, they have distributional consequences in the same way that taxes do and they are as coercive.

Once the government’s role in constituting the marketplace is recognized a number of consequences follow; in particular, such recognition renders incoherent a good deal of rhetoric comparing private market rules to regulatory rules such as taxes. However, perhaps most importantly, there is no neutral position in thinking about public policy issues. That is, in discussions over the relative merits of the market or taxes and public provision there is no default position. Both are forms of government intervention and both require justification.

One purpose of taxation is to assist in constituting the marketplace. The revenues raised through taxation are required to fund the elaborate public infrastructure -- such as law reform bodies, the judicial system, the police and the prison system -- that is needed to develop and enforce the private law rules regulating markets. There could be no property without taxation.

### 6.3 Achieving an Efficient Allocation of Resources

#### 6.3.1 Role of the Market

The efficient allocation of resources, and thus the maximization of social welfare, is the normative government objective that preoccupies economists. The term efficiency in ordinary usage refers to the absence of waste or an effective (efficient) strategy for achieving a particular objective. The technical economic usage of the term includes this notion of carrying on a given activity at least cost, however, the term is used in a much wider sense in normative economics. In welfare economics the economy is said to be efficient not only if goods and services are produced with the least amount of waste but also if they are distributed among members of society in such a way that no redistribution could take place among them that benefits some without harming others. This state of affairs is referred to as Pareto efficient, or Pareto optimal, after the Italian economist and sociologist Vilfredo Pareto (1848-1923) who developed the concept.
In thinking about the role of government, and therefore the objectives of the tax system, economists begin by demonstrating that private markets are generally capable of achieving an efficient allocation of resources without government intervention and, thus, without taxation. They claim that so long as economic markets are competitive (and a limited number of other assumptions are made), the actions of individuals pursuing their self interest can alone solve the three major coordinating tasks that must be accomplished in any society: exchange efficiency, goods will be allocated to those individuals who value them most; production efficiency, the given output of goods will be produced with the fewest possible inputs; and product mix efficiency, those goods produced will correspond with those desired by consumers. Basically, the claim is that competitive markets will ensure that all potential gains from trade will be exhausted so that no additional exchange of goods could make anybody better off without making someone worse off. In this idealized world not only are taxes unnecessary but they will almost invariably have the undesirable effect of reducing the efficiency of the economy. For example, if taxes increase the price of labour, then less labour will be devoted to producing goods that others value, and the economy will be less efficient. If taxes increase the price of some consumer goods relative to others, then people will buy less of the taxed goods and more of other goods even though at prices set in the market they would have preferred the former. By distorting people’s behaviour taxes destroy social welfare.

A simply story can be told to show the intuition that lies behind the claim that competitive markets alone can result in an efficient allocation of resources. In a competitive marketplace, individual consumers will presumably purchase those goods that will maximize their own satisfaction, given their budget. In selecting between goods and services in pursuit of their own well-being, consumers have no need for governments. How could a government bureaucrat possibly know more about what individuals should consume in order to satisfy their wants than those individuals themselves? Business people, the people in society who produce the goods and services individuals consume, will try to make as much profits as they can, but they cannot exploit consumers. If they produce shoddy goods, produce inefficiently, or try to profiteer, consumers will turn to the goods produced by other business people. Workers will try to get the best pay and conditions of employment they can, but they cannot get more than the value of their labour or it would profit their employer to sack them. They cannot be required to accept less than the value of what they produce for then it would pay another capitalist to employ them at a slightly higher wage rate. Investors will always invest their financial capital in businesses they think will yield them the highest rate of return; therefore, by attempting to maximize their own wealth, they will be ensuring that capital is always allocated to its highest use, to the benefit of society. Exchanges will always be fair in competitive markets because each party to a transaction must benefit, whether buying or selling goods or services, or else he or she would refuse to deal.

Although one might gain a sense from this description of the operation of markets about how the self-interested actions of individuals exchanging with one another might lead to an efficient allocation of resources, economists make two very strong claims about the virtues of markets that to most people are counterintuitive. First, they allege that no matter how large and complicated the economy, if all markets are competitive, an equilibrium point will be reached at which all markets will be cleared: individual prices will be established for all goods and services so that the
demand for all these goods and services will be met. Second, at this equilibrium point social welfare will be as great as it can be: the total benefits that consumers derive from consuming the goods and services produced, minus the cost of producing them, will be maximized. That is, the allocation of resources will be Pareto efficient. The proofs for these points are boring and complicated, but are given in simplified form in any basic microeconomic textbook. Nevertheless, it is important to be clear about this virtue of markets since it is the reason that most economists so passionately support markets and often express so much concern about the effect of taxes. Taxes almost invariably distort prices set by the market forces of supply and demand and thus impair the efficient operation of the economy, resulting in reduced consumer or producer surplus and thus reduced welfare.

I do not mean to belabour the concept of efficiency, however, the concept of social surplus, or gains from trade, or social welfare (hence “welfare” economics), is so important in understanding the virtues of markets and the concern that economists have with taxes (or any other government policy instruments that interferes with markets) that a simple illustration might firm up the point. Assume that I stop to buy a cup of coffee at my favourite coffee shop. It is early in the morning, and I would pay $1.20 for a cup of coffee. It costs the owners of the coffee shop only 80 cents to serve a cup of coffee to go. They sell it for $1. When I agree to pay $1 for the coffee, it is clear that this exchange has made both I and the coffee shop owner better off. I am 20 cents better off. The coffee was worth 20 cents more to me than I had to pay. This is referred to as my consumer surplus. The coffee shop is also 20 cents better off. The amount they received for the coffee exceeded their cost by 20 cents. This is referred to as their producer surplus. It is easy to see that after this simple exchange -- my $1 for a cup of coffee -- there has been a social gain, or welfare gain, of 40 cents due to the existence of this market. And, of course, the remarkable thing about gains from trade is that while both the consumer and producer have both gained, no one has lost. The process of trade creates welfare gains that simply did not exist before the trade took place. It is important to realize it is the exchange that created the wealth not the production of the coffee. That is, if the coffee was produced but no one valued it no wealth would be created. Or, if I stepped outside the coffee shop with my coffee and someone else who at that moment valued a coffee at $1.40 offered me that amount for my coffee (because the shop had closed), upon this exchange the wealth of society would increase by another 20 cents. A good that was only valued at $1.20 (by me) was now in the hands of someone who assigned a value of $1.40 to it.

Since it is exchanges that create welfare in society, economists argue that to increase social welfare we ought to generate as many markets as we can to allow people to trade freely. To repeat the claim made by welfare economists, in a competitive equilibrium, the sum of all the gains to all the market participants is as large as possible, without making anyone worse off. Thus one can see why neo-classical economists attach such a strong normative value to regimes of private exchange and private ordering.

The concept of efficiency, as understood by welfare economists, might appear to be uncontentious as a normative standard. Basically, it says that if two (or any number of) people are made better off in their own estimation by exchanging goods and services, and no one is harmed, then society is better off if we allow people to exchange. The principle does, however, rest upon a number of ethical judgments all of which could be challenged, for example, that the most important goal of public policy is the maximization of social welfare as opposed to the
achievement of other values such as fairness, justice, or economic security; it assumes that when responding to marketplace forces, individuals are always the best judge of their own welfare; it assumes that an individual’s welfare does not depend upon the welfare of others; and, it assumes that a dollar to each individual should be given the same weight in measuring social welfare regardless of whether the person is poor or rich. Nevertheless, setting aside the possible ethical objections to the principle of efficiency, markets will only achieve an efficient allocation of resources if certain conditions are met. When one of these conditions is not met in a particular market there is a normative justification for some form of government action.

Economists refer to the types of situations in which individual behaviour will not lead to an efficient allocation of resources as market failures. Market failures have been studied, refined, and disputed endlessly in the literature. Right-wing economists have difficulty seeing them; left-wing economists find market failures everywhere they look. The following is a brief list of some of the major market failures. They can be discussed with almost unimaginable degrees of complexity, however, the point of this brief list is simply to illustrate the types of normative arguments that are made to justify tax laws on the grounds of promoting efficiency. Governments attempt to correct many of these market failures by subsidizing or directly providing goods and services that will not be supplied or will be under-supplied in markets. Obviously, governments must raise taxes in order to do this. Also, the great majority of tax expenditures are justified on the grounds that they are necessary in order to correct a market failure. Hence you need to know something about market failures not only to understand why tax laws are required generally, but also in order to make any sense out of most of the over 100 tax expenditures in the Act.

6.3.2 Public goods.

The market will only allocate resources efficiently if goods consumed by one person cannot be consumed by someone else (the good has the characteristic of rivalry in consumption); if those who do not pay for a good can be excluded from its consumption (the good has the characteristic of excludability in ownership and use); and, if individuals can decide whether or not to purchase the good. There is a long list of goods that do not meet these criteria to some degree. They are referred to as public goods. The classic example is national defence. There is no way that one person, by themselves, could purchase national defence. But even assuming that they could, if they were able to protect themselves and their home from a missile attack at least all of their immediate neighbours would be protected without having to purchase the good and there is no way that the consumer could exclude them from the benefits of the good. Other familiar examples of public goods include law and order, public parks, and public infrastructure like street lighting and highways. The only way that people can provide themselves with these goods, all of which presumably promote their well-being, is by paying taxes and providing them publicly for everyone. Notice that it would not do to simply ask for donations for the purchase of these goods. Some individuals would not contribute and “free-ride” on other individuals’ contributions. One purpose of taxes is to prevent “free-riders.”
6.3.3 Externalities.

The market will only allocate resources efficiently if all the costs and benefits of the production and consumption of a good are borne and enjoyed exclusively by the producers and consumers of that good. But both the production and consumption of all sorts of goods generate negative and positive externalities (or as they are variously called spillover effects, social costs and benefits, or neighbourhood effects). The standard example of a negative production externality is pollution. Smoke from a local factory will impose medical, cleaning and other costs on households that do not use the factory’s output. Governments may regulate, impose taxes (emission taxes), issue tradeable emission permits, or use some other policy instrument in an attempt to deal with these negative production externalities. They may even subsidize the businesses causing pollution in order to encourage them to internalize these externalities. Thus, the Act contains fast write-off provisions for investments in pollution control equipment.

Education is an example of a good that generates positive consumption externalities. Why does the government provide free public education and generous tax credits, as well as subsidies, for individuals who attend institutions of higher education? One reason is that we assume that society generally benefits if its citizens are well educated. Therefore, since there are social benefits to education, in addition to private benefits, in order to ensure that individuals consume the efficient amount of education it must be subsidized. Again, taxes are obviously required to pay for the social benefits of education as well as many other goods that generate social benefits. Notice that this argument for taxes is made simply on the grounds that they are required to ensure that resources in the economy are allocated efficiently. That is, it accepts as its premise the normative standard of welfare economics. Naturally, a case can also be made for the public provision of education and other goods on the grounds of social justice.

6.4 Asymmetric Information.

Markets can only achieve an efficient result -- that is a result in which both parties are made better off -- if both parties have access to all relevant information. Yet in many markets one party knows more about the product or service to be traded than the other and therefore there is a market failure. The most obvious way to attempt to correct this market failure is for the government to mandate consumer and investor disclosure requirements or product standards. However, in addition to the availability of information, for markets to operate efficiently, individuals have to be prepared to inform themselves about their exchanges. Yet fully informing oneself and making choices is not costless, in fact it is often burdensome. For this reason, it is reasonable that for some complex but essential products or services individuals would favour taxes and government designed and provided services over prices and market-provided services. For example, with respect to retirement pensions, government pensions can provide much greater security than private pensions and thus alleviate the anxieties of choosing among often insecure private alternatives. Moreover, the time and costs involved in requiring each individual to make an informed judgment about issues relating to private pension design and investment policies is enormous. It is a curious kind of person who enjoys the literature of pension and life insurance companies. Many people would presumably rather be reading Robertson Davies.
6.4.1 Cognitive Limitations.

Markets will only achieve an efficient result not only if individuals have all the relevant information to make an informed choice but also if people are able to make rational judgments on the basis of the information they receive. Yet, psychologists have documented dozens and dozens of types of situations in which people consistently make errors of judgment. One of countless examples that might be given to illustrate this market failure is the notorious difficulty that people have in making rational intertemporal choices, particularly if the costs of those choices have to be borne immediately and the benefits will not be realized until sometime in the distant future. So, for example, one of the most compelling normative arguments supporting the tax deduction for contributions to RRSPs is that if the government did not bias peoples’ choices about whether to spend all of their money now or save some for retirement, many people would make the wrong choice, even in terms of their own best interest, and not save for retirement. The RRSP deduction is designed, in part, to correct this market failure.

6.4.2 Incomplete Markets.

In order for markets to allocate resources efficiently there must be markets for everything for which consumers are prepared to pay a price that covers their production costs. However, in some instances, even where this is the case, no market will emerge. This is particularly the case in markets for insurance because of problems of moral hazard and adverse selection. For example, even though consumers might demand employment insurance it is unlikely that a private market for employment insurance would develop since insurance companies would be concerned that the presence of insurance would cause more individuals to become unemployed (the moral hazard problem) and that only individuals who were likely to lose their jobs would purchase the insurance policy (adverse selection). Therefore, if individuals think that employment insurance would increase their well-being, the only way it can be provided is if they pay taxes to cover its cost and administer it through government agencies. Other obvious cases of incomplete markets include capital markets for loans to students, loans to small businesses, and loans to companies engaged in international trade. In all of these areas the government has stepped in, in some cases with tax measures.

This list of market failures could go on at length; the need for taxation even on grounds of economic efficiency is much more pervasive than most people seem to realize. However, the main point to be made here is simply that one important purpose of taxes is to allow for the correction of market failures and thus further the efficient allocation of resources and the maximization of social welfare. As you proceed through the study of tax law attempt to discern the normative justification for tax expenditures by identifying the market failure they were designed to correct. Of course not all tax expenditures are designed to correct market failures, some can be justified as instruments to achieve other government objectives.

Before turning to other normative justifications of tax, by way of clarifying the role of taxes in correcting market failures a few further points might be made. Once a market failure has been identified the government does not, of course, necessarily have to invoke taxes in order to correct it. The government has a broad range of policy instruments at its disposal including the
reformulation of rules of property and contract law, regulation, the criminal law, minimum standards, enhanced private remedies, direct subsidies, public ownership and moral suasion. For example, assume that the government decides that the marketplace left to itself will not result in the optimal amount of indigenous cultural activity because there are positive externalities to such activities including the provision of public creative ideas and aesthetic standards; the development of national feeling, pride and identity; and, the social improvement of the participants in such cultural activities. Having made this normative judgement the government must then make an instrumental judgement about which is the best policy instrument to achieve this end. It could directly provide such activities through public ownership, such as the Canadian Broadcasting Corporation and the National Film Board; it could provide direct grants to non-profit organizations involved in such activities; it could impose Canadian-content regulation on the media; or, it could provide tax expenditures in the form of tax credits or fast write-offs for businesses engaged in the sale of Canadian cultural activities. The point is that once the government decides that as a normative matter a particular activity should be encouraged (or discouraged) in an attempt to correct for a market failure an equally difficult task involves selecting the appropriate instrument to achieve that end. Tax laws are only one such instrument.

In recent years, reflecting the rise of neo-liberalism, there has been much discussion about the general inadequacy or inappropriateness of the use of rule-bound forms of policy instruments and the advantages of flexible market-based instruments. Hence, the generally accepted preferred government intervention to reduce pollution externalities has shifted from so-called command and control regulations, to taxes, to tradeable emission permits.

Simply because a market failure is identified that does not justify taxation or some other form of government intervention. Market failures are a necessary condition for government action but not a sufficient condition. Governments also fail. Even though the market might fail to produce an efficient result that does not mean that governments can do any better. Again, reflecting the shift in prevailing ideologies, economists who used to spend most of their time examining market failures are these days preoccupied with studying government failures. There is now a branch of economics, public choice theory, devoted exclusively to this study. These economists point out the tendency of politicians to make decisions that provide short-run obvious benefits at the expense of long-run hidden costs; the numerous incentives for politicians to support special interest groups; the fact that majority voting does not always lead to what is in the public interest because of the problem of the oppressive majority (in some situations, the majority will benefit but not by as much as the minority will lose); the voting paradox (in which majority voting leads to no clear winner); and the fact that politicians frequently engage in log rolling (in which one politician votes for a policy supported by another because that politician will return the favour); and other strategic forms of behaviour. Also, they point to all the problems of bureaucracies, including the difficulty of controlling and evaluating a department’s performance and the tendency for government agencies and their budgets to expand. As is well known, based in part on these trends in public sector economics, governments have increasingly reduced the role of monetary policy, privatized government services, deregulated private industries, reduced social security programs, reduced taxes, and have moved to impose legislative limits on what democratically elected governments can do in the field of economic policy, and constrained their own ability to collect taxes.
Finally, in concluding this discussion of market failures, it should be noted that maximizing welfare is not the only virtue that some economists and political philosophers claim for markets. Some defend markets largely on epistemological grounds. They argue that the limitations of human knowledge make rational planning impossible and that markets allow for the influence of tacit knowledge that is embedded in practices and institutions. Others defend markets largely on the ethical grounds that they promote individual freedom, choice and autonomy. Others defend them on the political grounds that they diffuse power and act as a shield against coercion by others and by a tyrannous state. Others defend them on the practical grounds that they provide incentives for action and for dynamic growth. The role of government and taxes become less clear cut if one of these other justifications for markets is accepted.

6.5 In Achieving a Morally Acceptable Distribution of Income

While many people are prepared to defend private markets on the grounds that they maximize social welfare or individual freedom of choice, only a few defend the market’s ability to achieve a just distribution of income. Therefore, most people are prepared to assign some role to the government in achieving a socially acceptable distribution of income and wealth, that is, in redistributing resources from the rich to the poor. (There have been few serious claims that the market, absent government intervention, generates too much income equality.)

The government’s distributive function might embrace one or both of two different conceptions. Stated in the form of questions, they are: First, to what extent should government raise the living standards of low-income individuals? Second, to what extent should the government attempt to increase the equality of the distribution of income throughout society by reducing the income and wealth of the rich? Even though there are different views about the justification for assisting the poor, the fact that the government should do so is seldom in dispute. The question of to what extent the state should attempt to equalize incomes has been much more contentious.

There are several contending theories of distributive justice. At one end of the spectrum are theories based upon notions of entitlement in a market economy. Some theorists apply a principle of entitlement without qualification; individuals are entitled to keep whatever they earn in the market. Only a small number of political philosophers hold this view, however, it appears to be surprisingly widely held among the general population, particularly among business people and others who have done well in the marketplace. Other theorists who espouse entitlement-based arguments normally qualify them in some way: individuals are only entitled to keep what they earn in markets that are competitive, or only in markets in which everyone was given an equal starting position. At the other end of the spectrum are theorists who apply some form of egalitarian criteria in making judgements about the just distribution of income. At the extreme, strict egalitarians call for perfect equality in the distribution of economic resources. Others argue for a distribution of income in which the welfare of the lowest group is maximized.

Most theories of distributive justice clearly contemplate that, if implemented, some people will be made better off and others worse off than they would be in an economy that sought solely to maximize social welfare, as that term is understood by economists. Some economists, reluctant to rest the case for redistribution on strong value judgements, have posited two bases for
redistribution that might actually make it Pareto efficient; that is, they have posited circumstances under which after redistribution all individuals might be at least as well off as under the status quo. First, redistribution might be Pareto efficient if individuals have interdependent preferences. If individuals derive utility from making gifts to the less fortunate, then both the rich donor and the poor donee are better off after the transfer. While this would only argue for voluntary redistribution, if it is the overall distribution of income that affects the utility of the rich, and not just the income of specific individual poor people, then distribution has the characteristics of a public good. Unless the government intervenes and redistributes through taxation there will be a sub-optimal amount of transfers because of the free-rider problem.

A second set of circumstances under which self-interested individuals might consent to income redistribution is if they are risk-averse and uncertain about their economic futures. In these circumstances, progressive income tax and means-tested transfers can be justified as a form of social insurance: it is a way for individuals to spread the risks of income variation. Collective provision of this form of insurance can be justified because of problems of moral hazard in analogous private insurance plans and imperfections in capital markets.

This is not the place to review critically, or even summarize, the many hundreds of years of debate over the most appropriate theory of distributive justice. However, simply because the view that it is departures from the market distribution of income -- through taxation for example -- that require justification appears so widespread, it seems worthwhile to note a few of the many problems with the intuitions underlying the justness of the market distribution of income. There would appear to be two such intuitions.

First, one intuition that suggests the market distribution of income is just rests upon the assumption that people’s earnings are a measure of the value of their contribution to social welfare and therefore their personal desert. However, to be at all persuasive there are a number of obvious problems such a theory would have to overcome, to list just a few: the value of individual contributions to social welfare are impossible to determine since all contributions are of an intrinsically social nature and all income is cooperatively generated, therefore, the rules of property and contract cannot sensibly distinguish between individual contributions in the production of goods and services; the demand side of the labour market does not reward skills that are socially valuable but skills that individuals with money demand; in the same way, the supply side of the market does not reward skills that are valuable or admirable but skills that are scarce; large earnings are often the result of morally irrelevant factors because the contributor has no control over them, such as the accident of being born into a family of wealth, the chance event of being raised in a wealthy country, the good fortune of remaining able-bodied and working for a firm that remains profitable and in Canada, the good luck of investing in the right stock, or the fortuity of being born with an inherited talent that is in scarce supply; and finally, even if an individual’s contributions were morally relevant in determining the amount to which they should have a moral claim, in real markets, factors such as social conventions, discrimination, monopoly power, and government regulation are much more likely than productivity to determine the size distribution of income.
A second intuition that appears to underlie the notion that the market distribution of earnings is presumptively just rests upon the judgement that the process by which earnings are distributed appears to be fair. However, this process-claim arbitrarily assumes that the initial distribution of income and wealth is just; that people only have property and not broader social rights; that the marketplace in which people trade is free (that is, that people’s choices are always fully informed and non-coerced) and neutral (that is, that the rules that define the marketplace do not favour some over others); and, that individuals only have entitlements to goods and services allocated through markets but not to those allocated by other social forms of organization. None of these assumptions are easy to support.

If any role is assigned to the government to distribute earnings, on whatever ethical basis, most commentators are of the view that the taxation system is an important policy instrument to achieve that objective. Even libertarians have traditionally preferred that redistribution be achieved through the tax system as opposed to other forms of government intervention because the tax system preserves the basic processes of free exchange. A reasonable level of taxes poses little threat to either producer or consumer sovereignty. Even with a tax on income, individuals are still free to make whatever career or investment choices they wish, and free to choose whatever goods and services they wish to consume. The only liberty seriously infringed by an income tax is the liberty to retain all the income one is able to gain by entering into profitable market transactions. But, since prices continue to be determined largely by supply and demand, and since the effect of the tax on income would be known before individuals made the choices they thought would maximize their well-being, it is hard to imagine that this loss of liberty is serious at all. Indeed, unless one assumes that economic freedom needs absolutely no instrumental justification, it would appear to be hardly affected at all.

Of course, the tax system itself, even if it were extremely progressive, is unlikely to be able to seriously affect the distribution of income, or turn back the rising tide of inequality now being experienced in most industrialized countries, including Canada. Concerted action on almost every front would be necessary to achieve the distribution of income that most political philosophers would regard as just including the enrichment of early childhood education, providing increased economic security and bargaining power for workers, and glutting high-skill labour markets with university graduates. Those on the far left, if there are any remaining, would argue that no redistributional policy can be effective without changing fundamentally the economic system of production.

6.6 The Role of the Tax System in Stabilizing the Economy

For the past fifty years, the prevailing economic wisdom has been that full employment and stable prices did not come about automatically in a market economy even if the government corrected for the misallocation of resources and inequalities in the distribution of income. In the absence of public policy guidance, market economies tended to be subject to substantial fluctuations, and could suffer from sustained periods of unemployment, inflation or both.

The overall level of employment and prices depends upon the level of aggregate demand for consumer and investment goods relative to potential output in the economy at prevailing prices. The level of aggregate demand depends, in turn, upon the spending decisions of individuals,
consumers and investors. In the nineteenth century, classical economists argued that market economies would tend to move toward full employment. However, the performance of western economies after World War I and, in particular, the prolonged depression of the 1930s, threw the assumption of inherent stability of free market economies into question. John Maynard Keynes, in his classic text, *The General Theory of Employment, Interest and Money*, argued that aggregate demand, which is the chief determinant of the level of economic activity, might stabilize the economy at points other than full employment. He suggested, therefore, that government intervention in the economy was important in order to manage aggregate demand, and to ensure the economy was operating near its potential output.

Keynes argued that government fiscal instruments -- spending and tax policies -- were the most effective tool for demand management. In order to increase aggregate demand in periods of economic downturns, for example, the government should increase its spending on public works, provide more money for social assistance, offer loans and other forms of relief to small businesses hurt by a decline in demand for their goods and services, and cut taxes for people who tend to consume most of their incomes, namely those in low-income brackets. Keynes suggested that monetary instruments to control the money supply, such as bank reserve requirements, discount rates, open market policies, and selective credit controls, might also be used to achieve the government’s stabilization policy, but these instruments were not as important, or as effective, as fiscal instruments.

“Keynesianism,” the term that came to be applied to government policies aimed at reducing the severity and duration of downturns in the business cycle, became widely accepted among industrialized countries. By the late 1960s, many economists were predicting the prudent use of fiscal policy to manage aggregate demand would ensure that business cycles were a thing of the past.

To make a long story short, with the advent of stagflation (a sharp rise in both the rate of inflation and unemployment coupled with declining output) in the 1970s, there was a sharp retreat from Keynesianism at every level. The economic doctrine of monetarism, which questions the effectiveness of any stabilization role for government, not only began dominating economic studies but also was adopted by many industrialized countries as part of their general drift towards neo-liberal policies. In Canada, the triumph of monetarism has been almost complete; the federal government appears to have abandoned any meaningful stabilization function. In the early 1990s, during one of Canada’s most severe recessions, the government not only refused to implement any special counter-cyclical measures, but instead reduced spending and increased taxes on middle-income Canadians. They attributed this stance to the persistent high deficits and high public debt.

Rightly or wrongly, macro-economic stabilization policy, or efforts to fine-tune the economy through the use of fiscal instruments including the tax system, now occupy little attention of economists or the government. As one indication of this, stabilization policy used to constitute almost one-third of most public finance textbooks, now it is frequently relegated to a short chapter. In any event, it seems reasonably clear that in the immediate future the structure of the tax system will not be influenced by a concern over its potential use as an instrument of economic stabilization.

### 6.7 The Role of the Tax System in Increasing the Rate of Economic Growth

In recent years, the most contentious debate over the role of the tax system has been its role in assisting or hindering economic growth. From the mid-1970s until only fairly recently, there was a dramatic slowdown in economic growth and in particular productivity. Although there is some dispute about the cause of this slowdown, many economists and business persons blame it squarely on structural impediments in the economy caused by excessive government intervention, and most importantly, excessive taxation. They argue that reducing taxes will usher in a new ear of unconstrained prosperity.
The precise behavioural mechanisms through which lower taxes are supposed to unleash unbridled economic growth are sometimes difficult to discern from the arguments of those who support the reduction of taxes, however, they appear to include the following. If high-income individuals face lower marginal tax rates they will work more hours per week, more weeks per year, and more years per lifetime since the amount they can earn after-tax from working will have increased; they will save more because the government will be taking less of the interest, dividends and capital gains they can earn on their savings; and, rich and talented Canadians will be more likely to remain in Canada and contribute to the economy instead of emigrating to more tax-hospitable countries. If taxes are lowered generally, and in particular are lowered on the profits earned buying and selling corporate shares or cashing in employee stock options then more individuals will be encouraged to become entrepreneurs or otherwise make risky investments since they will be allowed to keep more of the resulting profits. Reduced taxes on high-income individuals will also signal to international business that Canada is friendly to business and, therefore, encourage them to locate their plant and head office here. Reduced corporate taxes will allow Canadian firms to retain more of their profits to invest back in their business and attract more international investment.

These arguments were popularized by the so-called “supply-siders” during the Reagan administration in the United States. As briefly described above, according to traditional Keynesian doctrine, employment and economic growth are determined by aggregate demand. Unemployment and low rates of economic growth are caused by insufficient spending. During the late 1970s, when many western economies were suffering from stagflation, supply-side economists stepped in and argued that the preoccupation of Keynesians with demand had blinded them to the need for analyzing the effect of changing tax rates on productivity, investment and incentives to work. They argued that instead of concentrating on demand, governments should concentrate on increasing the supply of goods and services. Although supply-side economics addresses all aspects of aggregate supply, it focuses in particular on the appropriate role of government in encouraging growth through its taxation policies.

No one doubts the existence of the kind of incentive effects supply-side economics teaches, incentive effects of this kind are the stuff of *Econ 101*, however, the question is how important they are within a range of reasonable tax rates. Although it seems to be almost an article of faith among the converted that high taxes have significant adverse effects on economic growth, many others take the view that this proposition is not obvious in theory, nor is it supported by the weight of empirical evidence.

The debate over the role of taxes in encouraging economic growth cannot be resolved here, at some time you may want to turn your mind to it, but the important point for the purpose of understanding the foundations of individual income tax law is that the concern over the effect of taxes on economic growth is reflected throughout the *Act*. Unlike stabilization policy, which no longer appears to be a matter of concern in structuring the tax system, the role of the tax system in promoting economic growth is a central preoccupation of the tax drafters. However, precisely how this concern becomes reflected in the tax laws will naturally depend upon which model of what makes the economy productive the government is basing its policies on. The model for increasing productivity that underlies supply-side economics and the resulting tax design were suggested above. But there is another model for increasing productivity and international
competitiveness in which the public sector and taxes play a substantial role. This model rests on the premise that an economy will be productive if there is a highly trained, well paid, secure, and cooperative labour force that is willing and able to adapt to changing technologies and innovations, a well developed public infrastructure including high quality health, education and transportation systems; a professional public sector that is capable of taking the lead in the process of gathering information, targeting potential high-growth areas of the economy, and allocating public resources; and a society in which equality is actively promoted.

7 Criteria for Evaluating Technical Tax Measures

7.1 Role of Evaluative Criteria

A good income tax system is one that functions as an effective instrument for achieving its assigned government goals. In broad terms, this means that it should be designed so that it can be used to assist in raising the revenue required to finance government spending, in stabilizing the economy, in achieving a socially acceptable distribution of income, and in pursuing the appropriate rate of economic growth. However, as well as being designed to ensure that it is an effective instrument in achieving the goals the government wishes to pursue through its use, the tax system must be designed so that it satisfies the criteria that are used in evaluating all policy instruments. These criteria arise from the value judgments and assumptions underlying a country’s basic social and economic institutions. In tax law they are traditionally classified under the headings of equity, neutrality and simplicity. In recent years, because of the increasing internationalization of domestic economies, a further criteria has been added, international harmonization or competitiveness. Indeed, those on the right argue that in this age of globalization the most important consideration in designing a tax system is ensuring that a country’s system does not differ greatly from those of other countries, particularly major trading partners, and particularly as it affects income from capital and high-income, mobile taxpayers.

A few general comments will provide some context for examining each of these criteria. First, it is conceptually important to distinguish these evaluative criteria from the purposes of the tax system itself. Tax systems are not enacted to ensure that equally situated individuals are treated the same, or to leave the choices of individuals unaffected, or to make life simpler for people. The fairest, most neutral, and simplest tax system would be no tax system at all. The purpose of the tax system is to assist the government in achieving its broad objectives. However, once it is conceded that a tax system is required for these purposes, then it clearly should be designed in a way that satisfies the familiar criteria of equity, neutrality, and simplicity.

Second, although these criteria appear to be relied upon more explicitly in understanding and evaluating tax law, they are no different than the criteria used for good policy analysis in every area of law. In legal analysis generally, most of the policy arguments that are made can be categorized as fairness arguments, arguments about the incentive effects of the law, and arguments about whether the law can be administered. Every policy question in law -- which means every legal question -- requires you to consider the fairness of competing outcomes. In tax law these considerations are discussed under the heading, sensibly enough, of equity. Every
legal policy question requires you to consider what effect the proposed rule will have on people’s
behaviour and thus on the economy and society generally. In tax law these considerations are
usually somewhat misleadingly discussed under the heading of neutrality. Finally, policy
questions in every area of law can only be sensibly answered after a thorough consideration of
the administrative practicality of alternative solutions. How will the legal rules actually be
administered? Will they be convenient to comply with? Will they lead to too much uncertainty?
Will they be enforceable? Often the answer to these questions will require the familiar rehearsal
of the pros and cons of implementing a bright-line test as opposed to a more flexible standard.
All these considerations are referred to compendiously in tax policy analysis as considerations
relating to simplicity.

Third, in tax law there is an ongoing debate about whether, based upon these criteria, the base of
our most comprehensive tax should be income or consumption. Many economists argue that a
personal consumption tax would be more equitable, more economically neutral and simpler than
the present personal income tax base. This debate will not be pursued in these introductory
materials. However, as you with your study of tax law you might consider how different a
personal consumption tax base would be from the income tax base that you are studying and
whether it in fact would be more equitable, neutral and simple.

Fourth, an obvious point, no element of the tax system can be designed in a way that simply
follows deductively from some general overriding principle. Inevitably difficult trade-offs
between these three criteria have to be made. For example, one reason for the complexity of the
tax system is the frequent attempts to fine tune the rules to ensure that an equitable result is
reached in most cases. Some commentators argue that more inequities should be tolerated in
order to have a simpler tax system.

Fifth, the importance of learning to apply these criteria can be underlined by noting that they
have never changed. The details of the law change constantly; yet the norms underlying the Act
and the basic structure of the Act have remained essentially unchanged because they reflect a
balancing of these criteria. By understanding the application of these criteria you can spot rules
that conflict with them and, therefore, are possible candidates for revision.

Finally, these criteria only apply to the elements of the technical tax system. That is, you apply
them in attempting to understand the design of the technical tax base, the definition of the tax
units and the attribution of income to them, the rules relating to the period of income
measurement, the tax rates, and the rules of administration. These tax criteria do not apply to an
evaluation of tax expenditures. It is a common mistake among students taking the basic tax
course (and judges) to apply these criteria to all provisions in the Act. Tax expenditures are
implicit government spending programs and, therefore, they should be evaluated using budgetary
criteria not tax criteria.

7.2 Equity

One of the most fundamental axioms of social justice is that people in the same circumstances
should be treated the same. In tax policy analysis this evaluative criteria is referred to as
horizontal equity: people who are “similarly situated” should pay the same amount of tax.
Vertical equity refers to the ethical requirement that unequals be treated appropriately differently. Arguably, equity is the most important criterion with which to evaluate a tax system. If the government was not concerned about horizontal equity, it could raise revenue simply by confiscating resources or by printing money. What distinguishes a tax from other methods of reducing private consumption is that a tax is premised on some notion of equity or fairness. The difficult question is: in determining whether two people are similarly circumstanced or have the same ability to pay, and, therefore, should bear the same tax burden, which of their personal circumstances should be considered?

Although the criteria of horizontal and vertical equity are routinely used in tax analysis, they in fact have no normative content. They are simply used as devices for alerting analysts to potential normative issues. With respect to horizontal equity, since individuals are always alike in some respects and different in others, the difficult question is what personal circumstances are to be counted in determining whether two persons are equal for tax purposes. A normative theory is required in order to determine the relevancy of various personal characteristics. Similarly, with respect to vertical equity, a normative theory is required to judge what degree of differentiation between dissimilar persons is appropriate. For example, if one believes the fairest manner of raising revenue to finance public goods is to require individuals to make an equal sacrifice, and that income is an appropriate and manageable proxy for sacrifice, then horizontal equity simply requires that those with the same income pay the same amount of tax. Vertical equity requires that the rate structure be set so that those with different incomes pay an amount that requires them to make the same sacrifice. That is to say, basically, these criteria simply require that once a normative theory of a fair tax system has been chosen, it ought to be applied across taxpayers as consistently as possible. Or to put this another way, if we say that not allowing individuals to deduct their child care expenses, or any other expenses, violates horizontal equity all we are really saying is that given our normative definition of income individuals should not have to pay tax on income spent for child care. While the concept of horizontal equity might be used to indicate there is a problem here, obviously the real issue is whether or not our normative definition of income should include amounts spent on child care. Horizontal equity is simply a way of referring to the consistency with which the normative theory underlying the tax base is implemented.

How should income be defined in an equitable income tax system? There have been numerous suggestions of precisely how to define income in order to arrive at the most equitable tax base. The most commonly accepted theory of tax fairness equates a fair tax system with one based upon a taxpayer’s ability to pay. The rationale of the ability-to-pay approach is that the payment of taxes involves the individual in a loss of utility, a sacrifice. A fair system of taxation based on the ability-to-pay approach is defined as one in which the sacrifices of utility by all taxpayers are equal. In the public finance literature at the turn of the century there was considerable discussion of precisely what ultimately should amount to a sacrifice of utility, both in the sense of treating taxpayers with the same ability to pay the same (horizontal equity) and ensuring that those with greater ability to pay were required to make the same subjective sacrifice as those with less ability to pay (vertical equity).

Some commentators assumed that a taxpayer’s ability to pay should be measured by reference to the flow of psychic satisfactions to an individual. However, since a tax base must be measurable, even in theory, this definition makes no sense. There is no known scale or metric that allows the
satisfaction experienced by one person to be compared with that experienced by another. Other commentators assumed, and some economists still do, that a taxpayer’s ability to pay should be measured ideally by reference to his or her “full income”; that is, basically, the amount he or she could earn if they realized their full earning potential. Full income is obviously an unobtainable ideal. Most people never reveal their earnings potential and if it were taxed they would of course have even less incentive to do so. Thus there is no administrative way of taxing it. Moreover, most commentators concede that, in Rawlsian terms, a tax on full income would violate the liberty principle. It would require highly endowed individuals to adopt a life plan that would provide them with the funds to pay the tax on their full income, notwithstanding a preference they might have for a different life plan. Nevertheless, many commentators still view the concept of income that should be implemented in the income tax as being a proxy for a taxpayer’s ability to pay as understood by the sacrifice and earning potential theory.

In 1938, Henry Simons launched a blistering attack on these theories of tax fairness in his classic text, *Personal Income Taxation.* He scornfully dismissed them as “pseudo-scientific” and noted that the concepts upon which theories of ability to pay were based -- “sacrifice” and “faculty” -- were incapable of measurement. In their place, he argued that income should be defined as in essence the power to consume: “Personal income connotes, broadly, the exercise of control over the use of society’s scarce resources.” Simons is often accused of not being clear about the normative principle underlying his proposed definition of income. However, his definition is derived not from any principle of tax fairness, but followed from his strongly held view that the only justification for a progressive income tax was the redistribution of income. Simons is frequently quoted as favouring redistribution on “the ethical or aesthetic judgment that the prevailing distribution of wealth and income reveals a degree (and/or kind) of inequality which is distinctly evil or unlovely.” But Simons’ strong commitment to progressive taxation reflected more than a mere aesthetic judgment; he believed that progressive taxes were a vital step in the creation of a more stable and non-monopolistic capitalism. He felt that not only was an excessive inequality of economic power “unlovely,” but more significantly, it seriously threatened the legitimacy of the capitalist economy. Reflecting, in part, the pragmatic public philosophy accepted by most social scientists during the 1930s, most economists almost immediately adopted Simons’ line, or a variant of it, as the justification for progressive taxation.

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13. Ibid. at 49.

Although most contemporary commentators accept Simons’ concept of income there is still wide disagreement over precisely what it means. In recent years, largely in the context of attempting to justify the treatment of personal expenses in a fair tax system, such as the treatment of medical expenses and charitable contributions, a number of different normative theories justifying the income tax have been proposed, each leading to a slightly different concept of income. However, the primary debate has been between those who think that income should be defined by reference to the economic resources that taxpayers benefit from (often referred to as the standard-of-living concept of income) and those who think that income should be defined by the economic resources that individuals control (often referred to as the ability-to-pay concept of income).

Whether income is defined by reference to the benefit theory or the control theory has implications throughout the tax system, however, the importance of the debate might be illustrated by reference to the question of whether the individual or the family should be the basic taxpaying unit. Under the Canadian tax system, the individual is the basic unit of taxation. However, some commentators and political constituencies argue that the family should be the basic unit of taxation. They use the following example to give force to their argument. Under the present tax system a family in which one spouse earns $100,000 and the other works in the home pays much more tax than a family in which both spouses work outside the home and earn $50,000 each. Under our progressive tax system an individual earning $100,000 will pay about $36,000 in income tax, while an individual earning $50,000 will only pay about $13,000. Hence, the one-earner family will pay about $10,000 more tax in this example than the two-earner family. Those who support family-unit taxation argue that in a fair tax system two families with the same income should pay the same amount of tax regardless of how that income is earned by the individual spouses. What do you think?

As a conceptual matter, the debate is not really over whether the family or the individual is the correct unit of account. Few people claim that the household is the natural unit to which utility -- or anything else that matters for tax purposes -- accrues. Instead, the individual is the proper focus of fairness in any social institution; therefore, the proper question is, in determining an individual’s tax liability, should that individual’s marital status, or other personal relationships, be relevant? Those who argue for family-unit taxation argue that income should be defined by reference to the economic resources that an individual benefits from and, therefore, if an individual has a sharing relationship with another the economic resources provided by that person, and from which the individual benefits, should be included in his or her income. On the assumption that married couples share all their economic resources, this reasoning leads to the conclusion that the earned and other taxable income of both spouses should be totalled and then divided equally between them in determining their individual tax liabilities. Those who argue for individual taxation presumably take a different view of the definition of income. Individuals should be taxed on the income they control whether they share it with another or not. Thus taxpayers’ conjugal, or any other sharing relationships, should be ignored in assessing their tax liability.

Which leads to a fairer tax base, the benefit theory or the control theory of income? This is clearly a normative question. The benefit theory obviously has some intuitive appeal. It would seem just that two individuals with the same material standard of living contribute the same amount to support government programs. Similarly the control theory has intuitive appeal. It would seem just that two individuals who confronted the same options pay the same amount of
Some individuals might decide to spend their income on expensive vacations, others might decide to share it with a spouse. Arguably these are personal decisions that should not affect the individual’s tax liabilities. More could be said about these two potential definitions of income in order to clarify our intuitions about their relative fairness, however, the point here is simply to illustrate one important implication of these two concepts of income. There is not much question that the control theory of income underlies the design of the Canadian income tax system, even though it is not applied entirely consistently.

The relative fairness of the benefit or control theory of income does not, of course, exhaust the debate over which is the most appropriate tax base. For example, if one believes that the market distribution of income is unjust, and that the tax system should be used to achieve a more socially acceptable distribution of income, then there is a strong case for adopting the control theory since that means the tax would be levied directly on the earned income of individuals, regardless of its perceived fairness compared to the benefit theory. Also, even if the benefit theory of income is adopted, that does not necessarily lead to family-unit taxation. Family-unit taxation would only be the correct result in terms of fairness if it could be shown that spouses generally pool all of their income and that the value of the labour performed by the spouse who works in the home in the one-earner family should be ignored for tax purposes. Finally, even if the benefit theory of income were considered to be fairer than the control theory, before family-unit taxation were adopted an analyst would also have to consider the neutrality and simplicity of individual versus family-unit taxation.

In the basic tax course horizontal and vertical equity are frequently applied to tax measures, particularly to personal expenses such as child care expenses, medical expenses, charitable contributions, the expenses of raising children, and casualty losses. This rather extended discussion of family-unit taxation was simply to make the point that invariably what is at stake in these discussions is some normative theory of income and its reach.

7.3 Neutrality

The second traditional criterion by which taxes are evaluated is frequently referred to as neutrality: taxes should avoid distorting the workings of the market mechanism or personal decisions. The assumption underlying this criterion is that in free markets individuals will make decisions about how hard to work, how much to save, what goods to purchase, what relationships to enter into, and so forth, by comparing the benefits they derive from these actions with their costs. Since individuals are the best judges of the benefits and costs to themselves with respect to particular choices, their welfare will be maximized if their decisions are made freely on the basis of market prices and personal preferences. Taxes that distort individual choices will give rise to an excess burden or deadweight loss. The neutrality criteria requires that tax rules be drafted to minimize the excess burden of taxation.

Taxes can obviously affect a wide range of personal and business decisions; the difficult questions are in what contexts do taxes matter and how much do they matter. Most public finance scholars now distinguish between a hierarchy of responses to tax changes. Standing at the top of the hierarchy is the timing of transactions. Timing decisions appear to be very responsive to tax changes. In the second tier of the hierarchy are financial and accounting changes, essentially
compensation and portfolio changes. They are also somewhat responsive to tax changes. On the bottom of the hierarchy are real decisions by individuals and firms, for example, decisions about how much to work, how much to save, and where to live. These are least responsive to tax changes.

As you proceed through the basic course, always explore the effects that the various rules might have on the behaviour of individuals. In most areas it is almost impossible to draft a completely neutral rule. Moreover, some would argue that the economic concept of excess burden rests upon shaky empirical and hidden normative judgments underlying the presumptive appropriateness of the free market allocation of resources. Therefore, instead of asking whether the rules are neutral, it is perhaps more useful to ask whether the likely incentive effects are appropriate (based upon an explicit normative judgement).

7.4 Simplicity

Simplicity is a term used by tax analysts to refer compendiously to a variety of desirable administrative attributes of a tax system. It is increasingly recognized as an important criteria in assessing tax rules. Some argue that people are beginning to despair at the complexity of tax laws and thus the legitimacy of taxation is being threatened. Also, the more complex the tax system the larger the tax planning and compliance industry. Some argue that people in this industry are imposing an increasingly large deadweight loss on the economy.

Many major design features of the income tax law, such as the failure to tax the imputed rental value of homes, the taxation of capital gains only when they are realized and the pre-set depreciation schedules, are explained, in part, by administrative considerations. Once again, as you proceed through the basic course you should identify the ways in which almost all the detail rules have been shaped by administrative considerations. The following is a brief list of those considerations.

Comprehensibility. The tax system should be understandable to the people to whom it applies. This does not mean that lay persons should be able to read and understand it, but it means that the principles that underlie the rules should have an intuitive appeal and that they should be consistently implemented. The logic of the Act should be obvious.

Certainty. The application of the tax system to particular transactions should be determinable, predictable, and reasonably certain. The rules are most likely to be applied consistently if their underlying purposes are evident. In some areas, to provide certainty, bright-line tests or factual presumptions should be used.

Compliance Convenience. Taxpayers should not have to devote undue time or incur undue costs in complying with the tax system. Only recently a body of empirical literature is developing on the magnitude of the various compliance costs that the tax system imposes on individuals and businesses. By almost any measure, it appears that the cost to taxpayers of complying with the income tax is high.
Administrative Convenience. The administrative cost of collecting and enforcing the law should be reasonable. In many cases, administrative costs (costs borne by the government) and compliance costs (costs borne by individual taxpayers) are close substitutes. In most cases the costs are more equitably distributed if they are borne by the government.

Difficult to Avoid and Evade. The tax system should offer minimal opportunity for noncompliance. A tax system that is difficult to enforce creates arguably the most serious form of unfairness: the tax burden is shifted from dishonest to honest taxpayers.

8 Criteria for Evaluating Tax Expenditures

8.1 Definition of Tax Expenditures

As alluded to a number of times in this introductory chapter, the Act is not only a tax collecting statute it is also a significant government spending statute. This insight – that the Act is comprised of two analytically distinct types of provisions -- is without question one of the most important for those who wish to understand, apply and interpret the Act. Technical tax provisions are those provisions that establish the basic structural elements of the tax system: the tax base, the filing unit, the accounting period rules, the rates, and the rules of administration. These rules are required in order to make the statute effective for raising revenue and redistributing income and are drafted and evaluated using the traditional tax policy criteria of equity, neutrality and simplicity. But there are over 100 provisions that deal with individual taxation in the Act that cannot be explained by reference to these criteria. These provisions have nothing to do with defining the basic elements of the tax system, instead their purposes are to provide implicit subsidies for those who behave in ways that the government wishes to encourage or who are deemed to be entitled to some form of relief because of their personal circumstances. These provisions are now widely referred to as tax expenditures. They take the form of special tax exemptions or deductions, tax credits, lower rates of tax or provisions that allow taxes to be deferred.

The Department of Finance publishes annually a document entitled, Government of Canada: Tax Expenditures, in which it lists, describes and estimates the cost of these tax expenditures to the federal government. To provide a sense of the pervasiveness of these provisions the following is a sample of provisions under only three of the subject area headings and their estimated cost for 2000 (all dollars figures are millions). Under the heading “Education” the Department lists: tuition fee credit ($335), education credit ($205); education and tuition fee credits transferred ($315); carry-forward of tuition and education credits ($40); student loan interest credit ($150); exemption of first $500 of scholarships and bursary income ($6 million); deduction of teacher’s exchange fund contributions (not available); registered education savings plan (not available). Under the heading “Family” the Department lists: spousal credit ($1,220); equivalent-to-spouse credit ($475); infirm dependent credit ($58); caregiver credit ($125); and, deferral of capital gain through transfer to spouse (not available). Under the heading “Health” they list: non-taxation of business-paid health and dental benefits ($1,695); disability credit ($280); medical expense credit ($475); and, medical expense supplement for earners ($40).
The concept of tax expenditures was developed largely by Stanley Surrey, a professor of law at Harvard Law School and Assistant Secretary of Tax Policy in the U.S. Treasury Department during the 1960s. Over the years there has been an extensive debate in the tax policy literature about the definition of tax expenditures and whether it was coherent at all to try to distinguish between technical tax provisions and tax expenditures because many provisions, such as the medical expense and charitable contributions credits, could be rationalized as either technical tax provisions or tax expenditures. That debate need not be rehearsed here since it was largely unproductive and the concept has been widely accepted since the 1980s, except to make this point. The arguments that many economists and business people, in particular, made to show that the concept was in some way incoherent, reflected a misunderstanding about the nature of conceptual reasoning. The term “tax expenditure” refers only to a concept. It does not purport to rest upon an empirical or normative judgement. It simply suggests a way of categorizing provisions in the tax system in order to clarify our thinking about them. Just because many provisions that are sometimes labelled tax expenditures might also arguably be justified in terms of traditional tax criteria does not mean the concept is not useful. Any concept, tax expenditures are no exception, can be deconstructed. There is simply no phenomena in the world that can be divided up into incontestable categories. The most we can ask of our concepts, or the way that we categorize phenomena, is that they promote clarity of thought. That would seem to be a standard the concept of tax expenditure can easily meet.

Generally, two methods are used in classifying tax provisions as tax expenditures. One method involves constructing a benchmark tax system using the traditional tax policy criteria. All deviations in the Act from this benchmark are labelled tax expenditures. A second method involves labelling as tax expenditures all those tax provisions that are justified by reference to a government spending objective and that are arguably being used as alternatives to direct government spending programs.

The fact that tax expenditures are functionally equivalent to a direct government spending program can be easily illustrated. Assume that the government wished to subsidize 50% of the cost of child care expense of two-earner families. It has two straightforward ways of doing so. It can invite qualifying individuals to submit their child care receipts every year and write them a cheque for 50% of the expenses, or the government can allow the qualifying individuals to deduct their expenses from their income for tax purposes. If the individuals are in the 50% tax bracket a deduction of say $7,000 for child care expenses will save them $3,500 tax. In terms of the after-tax income of the individuals and of the revenues and expenditures of the government, the tax expenditure is equivalent to the direct spending program. In effect, with the tax deduction, instead of writing the individual a cheque directly, the government has simply allowed them to offset their government subsidy against their tax liability.

8.2 Evaluating Tax Expenditures

In terms of studying and understanding the Act, the significance of identifying tax expenditures is that while technical provisions are evaluated using tax criteria -- equity, neutrality and simplicity - -tax expenditures are evaluated using budgetary criteria, the same criteria that are used in evaluating spending programs (since that is what they are). If a provision might be justified using
either tax and budgetary criteria, instead of entering into an often fruitless analysis of whether it is a technical or tax expenditure provision, it should be analysed using both sets of criteria.

Three budgetary questions might be asked about every tax expenditure. First, what government objective is being served by the tax expenditure? Normally, the answer to this question will involve the identification of some market failure that the subsidy program is attempting to correct. However, it may involve the identification of some objective other than the furtherance of social welfare such as social justice or gender equity.

Second, assuming that the tax expenditure is serving some valid government objective, then it should be assessed using the same budgetary criteria used in assessing government spending programs: Are the benefits distributed fairly? Is the program target efficient, that is, are the benefits well targeted on the intended beneficiaries and not unreasonably over- or under-inclusive of those beneficiaries? Does the program avoid causing any unintended distorting effects? Are the administrative and compliance costs of the program reasonable? Does the government have control over the spending program and is it political accountable for it? Is the program appropriately implemented?

Third, a question that can be asked about every tax expenditure program is whether or not the objective served by it could not be better served by some other governing policy instrument. In most cases, the obvious alternative instrument would be a direct spending program, however, in some cases the objectives served by tax expenditures could also be served by government regulation or public provision. Those who favour the use of the tax system to deliver subsidies argue that the advantages of tax expenditures include the fact that they tend to be simpler in design than direct subsidies, they involve less bureaucratic discretion than direct subsidies, they encourage private decision-making, they use an established framework of administration, and they involve less stigma than direct government hand-outs. Those who oppose the use of the tax system to deliver subsidies argue that almost all these claimed virtues of tax expenditures are not advantages of placing spending programmes in the tax system, but instead are alleged advantages of automatic cheque-writing programs as opposed to discretionary grant programmes. That is, they are alleged advantages of the design of the program not whether they are delivered as direct spending programs or an offset against tax liabilities.

Those who oppose the use of tax system to deliver subsidies argue that the disadvantages of tax expenditures include the fact that they are open-ended programs over which the government has little control; if they are delivered as tax deductions (as opposed to credits) they have a perverse upside-down effect (the greater the taxpayer’s marginal tax rate the greater the implicit subsidy); even if they are delivered as tax credits they are not available to nontaxpaying individuals unless the credits are refundable; when placed in the tax system these spending programmes are almost inevitable subject to more abuse than direct spending programmes; they increase the complexity of the tax system and tax administration; they increase the perceived unfairness of the tax system; since they are not reported in government budgetary documents the government is less accountable for them; and, they are less transparent than direct subsidies.

Some tax analysts argue that almost all tax expenditures should be removed from the income tax system, and that removing these subsidies is the only true pathway to tax reform. Those that are not serving any valid government objective should be simply repealed; those that are serving a
valid government objective should be redesigned as direct subsidy programmes. Those that remain in the Act should be placed in a separate part of the Act where they would not obscure the logic of the technical tax system and would not complicate its interpretation and administration. As you proceed through the basic course, ask yourself which tax expenditures you think should be repealed, which should be replaced with a direct subsidy program, and which should be redesigned.

9 Principles of Statutory Interpretation.

9.1 Importance of Statutory Skills

Many law school courses still emphasize the study of common law cases, however, most lawyers in practice spend much more time working with legislative materials and the courts treatment of these materials. Furthermore, in the modern welfare state legislation and regulations are obviously far more significant instruments of public policy than common law judgements. A course in income tax law provides an excellent opportunity to continue to develop your skills in working with legislative materials. Like skills in policy analysis, and most other skills that are learned in the basic tax course, these skills are readily transferrable to other areas of law.

Income tax law is entirely statutory in origin: unlike some other areas of legislative law it is not a codification of previously developed judicial principles. The common law did not impose an obligation on individuals to share in the financing of public goods or to redistribute some of their wealth to others. Most of the details of tax law are expressed in statutory language. Amendments to tax legislation are proposed and implemented annually. All of the institutions of government involve themselves in the scrutiny of tax law. It is administered by the largest bureaucracy in government, by far. That bureaucracy, the Canada Customs and Revenue Agency, publishes a bewildering variety of administrative documents ranging from interpretation bulletins to pamphlets and leaflets. For all these reasons, tax law is a perfect area in which to learn about statutes and the legislative and administrative processes.

At one level, learning about legislative materials involves simply learning to read and understand complex statutes. There is only one way to do this: read statutes. To assist in developing this skill, you should, of course, not only read statutes, but read them critically and purposefully. When studying a provision in the Act always observe where it is located in the structure of the Act. There is a basic logic, even symmetry, to the structure of the Act, as there is to all statutes, and a familiarity with this structure greatly assists in understanding individual sections. When reading provisions in the Act you should note the various levels of paragraphing within each provision, their relationship to one another, and the functions they serve; the use of defined terms; the formatting of each section, particularly the word patterns for describing mathematical formulas; and, the common grammatical patterns used in statutes. A familiarity with these features of statutes will make reading them much easier.

At another level, learning about statutes involves learning about the problems of drafting. Which sections of the Act reflect bad drafting techniques and which present exemplary and imaginative
solutions to drafting problems? In drafting, what are the trade-offs involved in using specific language as opposed to general legislative formulations? When should bright-line tests be used and what form should they take? What types of issues should the drafter delegate for resolution to the courts or to an administrative agency of government? Are there categories of problems that do not yield to statutory resolution and is it possible to generalize about them? Much of what lawyers do involves attempting to order affairs by verbal formulation. Studying tax law, and the techniques used by some of the country’s best (certainly busiest) drafters, can be an effective way of learning this important skill of every well educated lawyer.

Most importantly, and also most perplexing, learning about statutes means learning how to interpret them and apply them to an infinite variety of factual contexts. This involves learning to read statutes with a sensitivity to the variety of potential usages that every word has and with a sensitivity to the multiple contexts that can be drawn upon to assist in determining the appropriate usage of a word in a statute. It involves learning how to identify and work with the purposes that underlie statutory formulation and how to use tax and budgetary criteria to determine the reach of these purposes. A skillful advocate can draw upon an immensely rich source of materials in arguing that a particular usage should be attributed to a statutory formulation; to creatively mine these materials you should be thoroughly familiar with the various theories of statutory interpretation and the argumentative strategies that each would allow. Again, tax law provides an unrivalled opportunity to learn these skills. One reason for this is that in dealing with tax law cases judges often seem much more self-conscious about the problems of statutory interpretation than they do in other areas of the law where interpretive issues arise. Judges of the Supreme Court of Canada feel the need to expound a theory of statutory interpretation in almost every tax case they decide. Every new Supreme Court of Canada tax case brings forth a predictable deluge of comments from tax lawyers. Consequently, the tax literature is rich with articles and opinions on the problems of statutory interpretation.

There are countless books and articles on statutory interpretation and this is not the place to repeat what can easily be found in them. However, to provide a framework for at least beginning to think about the interpretative enterprise in tax cases, the basic approaches to statutory interpretation are set out here. For every tax case that you study you should try to discern which approach the court took, why they took it, and whether there was a more appropriate approach. That is, in proceeding through the course you should not only develop an understanding of the approaches taken to statutory interpretation by Canadian courts and the range of arguments that they find legitimate and persuasive but also develop your own theory of what approach the courts should be taking.

As a preliminary matter, in reading tax cases it is helpful to imagine that judges have three responsibilities in deciding tax cases: first, to determine the appropriate usage of the relevant words in the legislation; second, to examine the legal rights and obligations the taxpayer in the case has created and to characterize them for tax purposes; and third, to discourage tax avoidance by, for example, ignoring or recharacterizing a taxpayer’s transaction in appropriate cases. Not all commentators distinguish between these three responsibilities of judges, but some tax analysts find it useful. Although most of this section is devoted to a discussion of statutory interpretation the other two responsibilities of judges are separately and briefly reviewed.
9.2 Approaches to Determining the Usage of Words in a Statute

9.2.1 General
Judges use a number of different approaches in determining the usage of words in the Act (or any statute for that matter) and commentators have classified them in different ways. Commonly only two basic approaches are contrasted: the plain meaning approach and the purposive approach. However, for the purpose of acquiring an understanding of how judges are interpreting the Act, and for the purpose of constructing creative and persuasive arguments about how they should resolve a particular case, it is helpful to slice the approaches to statutory interpretation a little finer. It is possible to identify at least 11 different approaches to interpreting the Act. Again, the only point of briefly reviewing them here is to provide a framework to assist you in thinking about the approaches judges have taken in tax cases. Also, an understanding of the various approaches should provide you with a rich source of arguments in particular cases. Practice applying as many of the approaches as you can to each interpretive issue raised in the cases and problems in these materials.

9.2.2 Literal or Strict Approach
This is the approach traditionally taken to tax statutes by the nineteenth century judges who developed the common law. Basically, the approach assumes that words used in a statute have only one meaning and that in tax cases the taxpayer must be found to come within the clear and literal meaning of the words in order to be taxed. No consideration is given to the intent of Parliament, the purpose of the legislation, or the consequences of the court’s interpretation. In addition to the assumption that words have only one literal meaning, this approach also assumes that tax is an unjustified interference with the rights of private property holders and therefore should be construed strictly.

Consistent with the “one-word one-meaning” premise of this approach, but inconsistent with the “tax law as unjustified interference with private property” premise, judges using this approach would sometimes find a taxpayer taxable even though it would appear inequitable and contrary to the purpose of the legislation. They would justify this result by asserting, “there is no equity about a tax.” Also, there were two decision-making rules for resolving doubtful cases associated with this approach: on the one hand, if judges were interpreting a charging section they were to resolve their doubt in favour of the taxpayer since tax law were presumed to be burdensome; on the other hand, if they were interpreting an exemption or deduction they were to resolve their doubts in favour of the government since exemptions were presumed to be matters of legislative grace. These competing decision-making rules never made any sense. Both assumptions underlying them were incorrect. Tax laws are not an unjustified interference with private property, they represent the same kind of social judgments as those underlying the creation of property rights, and exemptions are not matters of legislative grace, they reflect legislative policy judgements. Moreover, whether a section is cast as part of the charging section or an exemption is often simply a drafting choice. In more recent years, without any discussion whatsoever, the Supreme Court of Canada set aside these two presumptions and has stated that all questions of doubt should be resolved in the taxpayer’s favour.
There are a number of problems with the strict or literal approach to statutory interpretation. Most obviously, it rests upon a misunderstanding of the nature of language; words invariably have countless different usages that can vary depending upon the context in which they are used. It promotes tax avoidance since it encourages taxpayers to attempt to plan around what they see as the literal meaning of words in the statute knowing that these words will be read “strictly.” This predictable reaction by taxpayers results, in turn, in the necessity for extremely detailed legislative rules which are often complex and difficult to understand. The approach also gives rise to a good deal of uncertainty and unpredictability in the law since judges can never seem to agree upon the literal meaning of words used in the statute (which is understandable enough since words do not have literal meanings). Finally, the approach is explicitly undemocratic. The approach reflects the nineteenth century common law judges’ distrust of Parliament and their concerted efforts to deliberately limit the reach of legislation.

In spite of these difficulties, this approach was followed by most (but not all) Canadian judges until 1984 when the Supreme Court of Canada announced in a landmark case, *Stubart Investments Ltd. v. R.*,¹⁵ that the approach was no longer to be followed. Although the Supreme Court has reiterated on numerous occasions that this approach is not to be followed, some commentators suggest that the Supreme Court still often takes a literal or strict approach to the interpretation of the Act. After reading the cases, you decide.

### 9.2.3 Plain Meaning Approach

This is the approach that most Supreme Court of Canada judges now insist they take in matters of statutory interpretation. Although it has features in common with the strict approach -- in particular its emphasis on textualism -- and some commentators insist that it is basically the same approach, the Supreme Court is of the view that this approach is different than the strict approach. In particular, under this approach it appears to be conceded that words can have a number of acceptable usages, that the internal context of the statutes is important in determining the usage of words, and that in the case of ambiguity resort may be had to “the scheme of the Act, the object of the Act, and the intention of Parliament”

Typically, under the plain meaning approach the courts assume that the legislature uses words in their ordinary sense: What would the words convey to the “ordinary” or reasonable reader? To determine this, judges rely on their own linguistic experience, however, they will often consult a dictionary. If the word has a technical or legal usage, and the context suggests that it was intended to have this technical or legal usage in the statute, the court will prefer this usage over the word’s ordinary usage.

In recent years, this approach has been adopted not only by Canadian judges, but it has also been adopted by conservative judges in the United States and defended by (mainly) right-wing legal commentators. In adopting this approach, these American judges and commentators are explicit about their deep distrust of the rationality of the legislative process -- drawing upon the insights and theories of the political theory of public choice -- and a corresponding preference for private ordering. Public choice theorists apply economic methodology to the study of political institutions. Based upon their theories they suggest that legislative enactments are not motivated by the public interest, but instead they reflect arbitrary outcomes, private interest deals and re-election posturing. Believing that statutes are the result of a deeply flawed process, these judges and commentators naturally adopt an approach to statutory interpretation that reduces the reach of statutory law. In addition, they claim a number of benefits of this approach to statutory interpretation: it limits judicial discretion, advances the values of certainty and predictability, respects legislative supremacy, facilitates decision-making by inexpert judges, and creates incentives to draft precise and easily understood legislation.

Canadian commentators who have been critical of the Supreme Court for clinging to a textual approach to statutory interpretation have pointed out a number of problems with the plain meaning approach. These arguments have also been made in an extensive American literature on statutory interpretation. First, such an approach is obviously incomplete where the legislature has delegated lawmaking power to the courts, for example, through the use of general words; where words are vague; where there are gaps in the rules; where a sentence contains syntactical ambiguity; where the language of the statute is over- or under-inclusive of its obvious purpose; and, where circumstances have changed since enactment of the provision. Second, and more fundamentally, like the strict approach, the plain meaning approach assumes words have a meaning independent of the total context in which they are used. Yet, almost all linguists would suggest that no words have a pre-interpretation meaning. Although in some cases it might appear possible to determine how a word is being used without interpretation, or without regard to its context, this is only because the interpreter has assumed a context or had some preconceived idea of how the word is being used. Third, the plain meaning approach is inconsistent with s. 12 of the Interpretation Act, which provides, “Every enactment is deemed remedial, and shall be given such fair, large and liberal construction and interpretation as best ensures the attainment of its objects.” Fourth, the approach ignores the fact that statutory language is necessarily intended to achieve a purpose. Fifth, the approach shares all the problems of the strict approach -- although not perhaps to the same degree -- in particular, it mandates detailed drafting which in turn reduces the understandability of the Act and encourages tax avoidance.

9.2.4 The Avoidance of Absurd Results Approach (The “Golden” Rule)
This is a very old and well-accepted approach to statutory interpretation. It basically provides that statutes should never be construed in such a way that the result is absurd, even if the clear
language of the statute would appear to suggest such a result. The approach was adopted by the courts as a qualification to the literal or strict approach in order to avoid some of the manifest absurdities to which that approach can give rise.

The obvious problem with this approach is determining what amounts to an absurd result. If it only applies when the result is truly absurd or totally unreasonable then it is a special and very limited application of the pragmatic, policy approach. If an absurd result is any result that appears unjust, anomalous or unreasonable then this approach is comparable to the more comprehensive pragmatic, policy approach, which is described below. Judges have never agreed on the standard of “absurdity” to apply, but nevertheless they still resort occasionally to this approach in tax cases. Watch for it and try to determine the standard of “absurdity” applied by the judge.

9.2.5 The Mischief Rule (Heydon’s Case, 1584)
The so-called mischief rule was adopted by the courts as long ago as the sixteenth century. It received its most influential formulation in Heydon’s Case (1584) which invited judges to construe statutes by determining what “mischief and defect for which the common law did not provide,” and thus which called for the legislation, and then construe the statute to “suppress the mischief, and advance the remedy.” This approach would appear to be a special and limited application of the purposive approach, described below. Although judges still refer to it, it would appear to have little application now that almost all statutes are essentially regulatory instead of aimed at correcting some “mischief” not remedied by the common law. But again, it is sometimes referred to in tax cases, particular where the interpretation of a tax expenditure is in issue.

9.2.6 The Legislative Intent and History Approach
Under this approach the judges attempt to determine the usage of words in the statute by ascertaining the intent of the legislative body that enacted the statute. Unlike the purposive approach, discussed below, here the objective is not to look at some broad legislative aim or purpose but instead to see more particularly how the enacting legislature intended the issue of statutory interpretation to be resolved. Among other things, this involves searching through the legislative history, including committee hearings and the Parliamentary debates, to see whether or not the resolution of the specific issues was addressed in the legislative process.

Although in some cases this approach might provide guidance in determining the usage of words in a statute, it is unlikely to be helpful in many cases. In most cases the interpretative problem arises because it was not anticipated by the drafters or the various participants in the legislative process. An even more serious impediment to the efficacious application of this approach is the fact that statutes are the product of a collective body, a legislative assembly, that is unlikely to have an intent. Most members of the legislative body are likely to be completely unfamiliar with the details of the legislation they enact. To the extent individual members have an intent with regard to how a particular issue should be settled if it arises under the statute, it would likely be impossible to aggregate these intents in some way. Furthermore, even if they had a collective intent it would be almost unknowable. Also, even if such an intent was discernable from the legislative record, it is unclear that the legislative body intended the problem to be resolved in the way anticipated if, for example, circumstances changed. Nevertheless, in spite of the difficulties, in some tax cases Parliamentary debates, explanatory notes, and so on are referred to in an effort
to determine the intent of Parliament. They are most frequently referred to for this purpose in cases involving tax expenditures.

### 9.2.7 Purposive Approach

Under the purposive approach, in attempting to determine the usage of the words in a statute, the judges look at the social goals and policies at which the provision is aimed and the reasons that it was enacted. This approach was an outgrowth of the legal realist’s attack on the legal formalism inherent in textualist approaches. It was particularly popular among academic commentators in the 1950s and 1960s. This approach has allegedly been applied in a number of recent Supreme Court cases.

The claimed advantage of this approach is that by interpreting the provision in light of its purposes, courts co-operate in the fulfilment of these aims and objects in a manner consistent with the proper role of an unelected judiciary in a democratic society. That is to say, by adopting this approach the courts properly see themselves as engaged in a cooperative law-making enterprise along with the legislative body. Also, this approach lessens the opportunities for abusive tax avoidance and reduces the need for lengthy and complex drafting and frequent amendments to the Act.

This approach has been criticized in the area of tax law, particularly by tax practitioners, on a number of grounds: if the purpose of the provision determines the usage of words in it, the application of the provision will not be apparent on its face; the purpose of a statute is often difficult to determine and always contestable; many legislative provisions do not have purposes since they simply represent the compromises reached among legislators seeking re-election, bureaucrats seeking increased power, and special interest group leaders seeking advantages for their members; it gives judges too much discretion to reach their preferred policy decision; sources that might be used to determine legislative purpose, such as Parliamentary debates, budget documents, committee reports, explanatory notes, and press releases are difficult to research and often inconclusive; and, reliance on purpose may suggest results that are over- or under-inclusive of any possible usage of the words in the provision.

In view of these many problems with the purposive approach -- understood as enacting the purpose that the legislative body had in mind -- legal process scholars in the United States argued in the 1950s that in solving hard cases the court should simply “assume, unless the contrary unmistakably appears, that the legislature was made up of reasonable persons pursuing reasonable purposes reasonably.” In a similar vein another legal commentator counselled courts to “strive to make sense as a whole out of our law as a whole.” This suggestion, that the courts should attempt to make sense out of regulatory statutes and treat them as if they were drafted by would reasonable people acting reasonably is a conspicuous outgrowth of 1950s jurisprudence, when the “end of ideology” thesis played such a large role in political science and the law schools. Nevertheless, in urging judges to interpret statutes so that they are reasonable and make sense, this method of interpretation paved the way for a much more openly policy-oriented approach to statutory interpretation.
9.2.8 Pragmatic, Policy Approach

To varying degrees, all of the above approaches to statutory interpretation derive their legitimacy from a view that the role of the courts in reaching decisions involving statutory interpretation is to apply judgments made by the legislative body. They themselves are not called upon to invoke general principles or to balance competing policy considerations. That is to say, under these approaches judges are not expected to behave as independent policy forums whose mission is to improve and rationalize the tax laws but instead to act simply as agents of the legislative body.

Some commentators take strong exception to this agency view of the role of judges in cases involving statutory interpretation. These commentators make a number of arguments. First, they argue that simply as a matter of logic it is impossible for judges not to make policy judgments in interpreting statutes. Words are not self-interpreting and in most cases where there is a gap, ambiguity or conflict in a statute the courts have no option but to make a policy choice. Second, they make the empirical claim that theories of statutory interpretation based upon a premise that the role of the judges is to implement a judgement made by the legislative body -- in part because of the incoherence of the notion -- will invariably lead to a great deal of uncertainty, lack of predictability and inconsistency. Third, they argue that a pragmatic, policy-oriented approach to statutory interpretation is more consistent with democratic values in that it requires judges to give public-regarding reasons for their decisions and thus promotes deliberative democracy. Fourth, an approach that acknowledges an explicit policy role for the courts is more consistent with the comparative institutional competence of courts and judges. Judges are trained in problem-solving. There is reason to suppose that confronted with concrete problems that must be resolved, and unhindered by political considerations, judges often have a comparative advantage over legislatures in formulating efficacious and sensible rules for governing the type of situation described in the case with which they are confronted. Finally, encouraging judges to consider the policy consequences of their decisions allows for changing values and circumstances to be reflected in the details of the law and results in greater policy coherence.

Under this approach to statutory interpretation, the role of judges in tax cases should be to decide what decision would reflect the most sensible tax policy result. Their role, and the reasons that they give for their decision, should be no different than the role and the reasons that might be given by tax analysts in the Finance Department who have been asked by the Minister of Finance to clarify the meaning of the statute on an issue in dispute. That is, the role of judges in tax cases should not involve parsing the words and phrases of the tax legislation, or attempting to decipher the legislature’s true intent or purpose from the legislative debates or some other source, or, even less, trying to make sense out of some goofy old English case decided long before the development of modern tax policy analysis. Instead, it should involve the operation of the creative process inherent in tax policy analysis. It should involve three steps: (1) the postulation of a range of plausible, alternative policy options for each interpretive issue; (2) a consideration of the consequences of each in terms of tax fairness, the neutrality of the tax system, administrative practicality, and other relevant evaluative criteria; and then (3) a choice among the alternatives based upon what makes the most sense in terms of tax principles (given the general structure of the tax legislation being interpreted). This process necessarily entails an explication of the basic principles, theories and tools of analysis that are needed for a sensible, serious discussion of income tax policy. Basically, there should be no sharp distinction between tax policy and tax interpretation; between what treasury department tax analysts do in formulating tax statutes and what judges do in interpreting and applying them.
Whether or not you think this is the correct approach to statutory interpretation, you should analyze every case you read and decide which is the correct result in terms of tax policy principles. This not only provides good practice in developing skills of tax analysis, but also you can be sure that the correct result in terms of tax policy principles is a consideration, even if an inarticulate consideration, in every judicial decision. Judges are not totally immune from attempting to do the right thing.

9.2.9 Modern Approach (Words-in-Total Context)

In interpreting statutes the Supreme Court frequently quotes with approval the so-called modern principle of statutory construction as summarized by one of Canada’s foremost statutory drafters, E.A. Driedger: 16 “To-day there is only one principle or approach, namely, the words of an Act are to be read in their entire context in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act and the intention of parliament.” The Supreme Court has referred to this quotation in almost every tax case, and purports to be following it. Are they?

In her third edition of Driedger’s well-known text, Ruth Sullivan states the modern approach in the following way: 17

There is only one rule in modern interpretation, namely, courts are obliged to determine the meaning of legislation in its total context, having regard to the purpose of the legislation, the consequences of proposed interpretations, the presumptions and special rules of interpretation, as well as admissible external aids. In other words, the courts must consider and take into account all relevant and admissible indicators of legislative meaning. After taking these into account, the court must then adopt an interpretation that is appropriate. An appropriate interpretation is one that can be justified in terms of (a) its plausibility, that is, its compliance with the legislative text; (b) its efficacy, that is, its promotion of the legislative purpose; and (c) its acceptability, that is, the outcome is reasonable and just.


In addition to the text and the purpose, Ruth Sullivan makes it clear that judges should always consider the consequences of their decisions, that is that they should always engage in a policy analysis of the issues they confront. Although the Supreme Court has not yet sanctioned this revision of the modern approach, in almost every case they make some reference to the consequences of the various usages of the words being interpreted and remark upon whether those consequences appear sensible. As you read cases search for reflections of the judges’ concerns about the consequences of their decisions.

9.2.10 Use of Conventions of Statutory Interpretation

Over the years, the courts have developed a number of “maxims,” “canons,” or “principles” of statutory interpretation. These conventions are said to allow judges to draw inferences about the usage of words based upon the language, format, and subject matter of the statute being interpreted. Many of the older treatises on statutory interpretation were organized around these canons and there has been a great debate in the legal literature over their precise significance. Basically, they simply represent common sense propositions about the usage of words. They are frequently resorted to in tax cases and students should be familiar with them. Obviously they are only aids to interpretation and the inference they give rise to can be easily rebutted by contrary considerations. Those frequently referred to in tax cases are listed below. They provide a rich source of arguments in attempting to persuade a judge to adopt a particular interpretation, however, they should be used with common sense.

Conventions of statutory interpretation that are frequently referred to in tax cases include the following: words used in bilingual legislation should be given their shared meaning; the same word used in a statute should be assumed to have a consistent usage; every word in the statute should be given a meaning; the usage of words should be determined by the usage of words with which they are associated; where a general word follows a specific enumeration, the general word should be limited to persons and things similar to those enumerated; a particular provisions should be interpreted in the light of the whole statute; one provision should not be interpreted to negate another; and, where there is a potential conflict, specific provisions should prevail over general provisions in the same statute.

9.2.11 Presumptions of Legislative Intent (Substantive Canons)

The textual, grammar and whole act canons mentioned above are, in large part, linguistic or syntactic guidelines that are policy-neutral. In addition to these canons, in determining the usage of words in a statute judges sometimes invoke presumptions of legislative intent that reflect widely held values and policies. These canons are not policy-neutral but instead bias judicial decision-making towards reflecting these widely held values. The courts have not been consistent in the effect that they give to these substantive canons. Normally they treat them as “presumptions,” that is as suggesting a presumptive outcome at the beginning of the interpretive process, that can be overcome by persuasive arguments suggesting the contrary interpretation. In some cases the judges appear to require a particularly clear legislative statement to overcome these presumptions. When you read cases in which one of these presumptions are applicable carefully analyze the effect the judge gave to it.
Presumptions of legislative intent that are frequently referred to in tax cases include the following: penalty provisions should be interpreted strictly; some deference should be given to administrative interpretations; doubts should be resolved in favour of the taxpayer; statutes should be construed to avoid constitutional invalidity; there is a presumption against double deductions and inclusions; statutes should be presumed not to be applied retroactively; and statutes should be construed in a way that protects Aboriginal rights and respects the rights and freedoms enumerated in the Canadian Charter of Rights and Freedoms.

9.3 Characterizing the Taxpayer’s Transaction

9.3.1 General

Tax laws are not self-contained: they are applied to taxpayers’ transactions based upon the legal rights and obligations the taxpayers have created in private law. Therefore, another important task of judges in tax cases is to examine the legal rights and obligations taxpayers have created and to characterize them for tax purposes. In characterizing taxpayers’ transactions for tax purposes the judges responsibility is to ensure that taxpayers are not permitted to intentionally exaggerate the divergence between taxable income as it would be determined by the measurement of economic income and taxable income as it is determined in an income tax system that must, for example, necessarily rely upon legal concepts as proxies for changes in economic income and in which income is measured only when realized. The types of situations that commonly give rise to difficulties in characterizing taxpayers’ transactions might be divided into the following five broad categories.

9.3.2 Ineffective Transactions.

These are situations in which the legal rights and obligations taxpayers purport to have created have not in fact been created due to their negligence. The courts have taken somewhat divergent views with respect to ineffective transactions. Although normally such transactions will be ignored for tax purposes, in some cases judges have been willing to give effect to taxpayers’ obvious intentions with respect to a transaction even though they might not have been documented in a form that was legally enforceable.

9.3.3 Shams.

These are situations in which the legal rights and obligations taxpayers purport to have created have not in fact been created because the parties did not intend them to be created. The term sham is normally used to refer to a situation in which taxpayers have deliberately misrepresented the rights and obligations they have created. The courts are unanimous that sham transactions should be ignored for tax purposes.
9.3.4  Mischaracterized legal rights or obligations.

A third relatively straightforward situation in terms of characterizing taxpayers’ transactions is one in which the taxpayers have simply mischaracterized the legal rights and obligations they have created. For example, if the parties refer to their relationship as being that of a payer and an independent contractor, but in fact they have created legal rights and obligations that might be more accurately characterized as that of an employee and employer, their legal relationship will be correctly characterized for tax purposes.

9.3.5  Legal rights and obligations that do not intend to be enforced.

In many cases, particularly if the parties have an ongoing economic relationship, the legal form of their business transactions is a matter of indifference to them. For tax purposes how should the courts characterize a legal transaction that it is clear the parties do not intend to enforce? The courts have generally ignored the parties intentions and have assessed tax based upon the legal rights and obligations created by the parties. However, arguably, if there is evidence that taxpayers do not intend to enforce the legal rights and obligations they have created, their economic position has not changed and neither should their tax liability.

9.3.6  Form and Substance.

In some situations the legal form of the taxpayer’s transaction is different than its economic substance. Parties often have a choice of legal forms to achieve the same economic consequences; for example, they can choose to fashion the conveyance of an asset for its useful life either as a sale or a lease, or they can raise capital and provide a promised rate of return and a defined degree of security using an instrument written as either a debt or an equity instrument in company law. The Canadian courts have generally stated that they will only look at the legal form of the parties’ transaction in characterizing it for tax purposes and will not examine the economic substance. However, one could argue that since tax policy distinguishes between taxpayers on the basis of their economic circumstances, courts should be free to assess them on the basis of the economic substance of their transactions.

9.4  Discouraging Tax Avoidance

If judges properly discharge their responsibility of giving the usage of the words in the statute and of characterizing the taxpayer’s transaction appropriately, there should be little room for tax avoidance. Nevertheless, since some tax avoidance transactions might still be possible, one might argue that an additional responsibility of judges is to prevent income tax avoidance, when it is administratively feasible. Since it is impossible to anticipate all tax avoidance opportunities when drafting legislation, judges should have the ultimate responsibility of preventing tax avoidance.

It is generally accepted that a tax avoidance transaction is one that has three characteristics: (1) it results in a mismeasurement of taxpayers’ economic income so that they pay less tax than they
would have paid if they were taxed on their economic income; (2) it is engaged in by taxpayers
for the sole or primary purpose of obtaining such a tax benefit; and, (3) it is not a mismeasurement
of economic income that was contemplated for administrative or policy reasons by the structure of
the tax legislation.

Tax avoidance transactions should be minimized for a number of reasons: they lead to a
misallocation of resources; they are a deadweight loss to the economy since no real activity that
benefits someone is undertaken; they create unfairness since some people are placed to take
advantage of it while others are not or refuse to so; they have adverse distributional consequences,
the rich and the shrewd benefit most; they diminish the legitimacy of the tax system and threaten
self assessment; and arguably they damage the social capital and fabric of the country.

In a well known case in the early 1980s, the Supreme Court suggested that there was no
“business purpose” test in Canada. Even though the only reason the taxpayer engaged in a
particular transaction was to gain a tax benefit the transaction could not be ignored for tax
purposes. In response to this case, in 1988 the government enacted a general anti-avoidance rule,
section 245. This is not the place to take up the details of this rule, but basically it provides
legislative authority for the proposition that judges have a responsibility to prevent tax avoidance.
Once again, as you proceed throughout the course, attempt to identify those cases that involve tax
avoidance schemes.

10 Making Sense of Income Tax Laws

The central message of this introductory chapter is that a thorough understanding of the principles
of technical tax policy and of tax expenditure analysis is needed, not only to critique tax law rules,
but also to understand and interpret them. When drafters are drafting a tax provision they begin
by considering the goals of the provision. They then try to formulate an approach that will
achieve these goals in a way that is equitable, neutral and simple. That is, drafters begin with an
overall understanding of both the problem they are dealing with and the evaluative criteria that
need to be balanced. Only then do they attempt to write language that will implement these
policies. In attempting to understand tax law it makes sense to try to place yourself in the position
of the drafters and retrace their steps. Also, in interpreting the provisions, to make sense out of
them and to be fair to the drafters, you should take the same approach the drafters did, namely,
determine the tax principles at stake and then look at the language. Since the drafters inevitably
had this larger tax policy context in mind when they wrote the provisions, it is an essential part of
the context in interpreting the provisions. Consequently, understanding tax policy analysis is as
important to the person who wishes to understand and interpret tax law as it is to the policy-
makers themselves.

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In developing skills of policy analysis it is necessary to assume that the tax policy outcomes you are studying are the result of rational policy choices. But many provisions in the *Act* cannot be justified in these terms and there is little value in trying to rationalize the irrational. As in every other area of law, the social, economic and political determinants of tax law are diverse. Political scientists who study the public policy process have developed a number of theories or explanations to account for legislative outputs. Some stress the importance of prevailing ideas and ideologies; others argue that environmental factors, such as Canada’s proximity to the United States, largely determine policy outputs; others argue that policy outputs are largely determined by the distribution of economic power in Canadian society (some are of the view that economic power is widely dispersed, others take that view that it is highly concentrated); others argue that policy outputs are determined, or at least are severely constrained, by the structure of the economy and by the reliance on private investment; public choice theorists argue that policy outputs can largely be explained by examining the self-interest of the proximate decision-makers, civil servants seeking to increase their own power and prestige, politicians hoping to get re-elected and interest group leaders attempting to appease their members. As you examine each aspect of tax law you will greatly enrich your understanding if you speculate on the influence of these different factors on the law’s development.

Each of us has a world-view, or a set of assumptions about how the world works, that we resort to in attempting to organize and understand the confusing welter of information we receive about the political and social world. This is what the person meant who said “when you are a hammer everything looks like a nail.” Since tax law is so intimately connected with many of the most pressing issues of the day, our ideological view of the world tends to have a decisive effect on our understanding of it. However, like everything else in life, tax law can be reasonably and useful viewed from a number of different perspectives. There is no ascertainable “truth” in tax law but only partial truths that are dependent upon one’s perspective. Thus theoretical and methodological pluralism is the only way to understand the tax (or any other) world. By any account, a well educated lawyer must be able to view issues from different points of view. Also, by attempting to view tax law from different perspectives, students will be better able to explore their own values and the values of others.

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