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Elbows Up: Canada’s Tax Policy Opportunity in 2025

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In this issue of *Perspectives*, we focus on tax policy measures to improve Canada’s tax system in the current turbulent world. Threats to longstanding models of international trade and investment make it increasingly urgent that Canada overhaul its tax system. In this introductory article, I comment on the broad principles that should guide any tax reform initiatives. Other articles in the issue focus on some specific recommended reforms.

2025 is an interesting time to be a tax practitioner in Canada. Fiscal issues are top of mind for Canadians, and recent developments (including the capital gains inclusion rate fiasco of 2024) have produced an appetite for change.

As I discussed in a recent article (*BLG Insights*, February 6, 2025), Canada’s new government has many significant decisions to make, on a number of important tax issues. These issues include the urgent need to focus on improving productivity and to scrap the digital services tax, which is a significant

trade irritant to the United States. Calls for comprehensive tax reform have become louder, and a re-evaluation of what we tax, and of the mix of taxes needed to achieve an optimal result, is long overdue. Inherent in that exercise is a threshold question: What are we trying to achieve through tax reform—simply raising revenue, or something more? In today’s environment, the answer must be the latter.

In any case, a good place to start is to examine the positive experiences of other jurisdictions in reforming their tax systems.

International Success Stories: The Case of Ireland

A number of other countries have succeeded in designing their tax systems to achieve specific economic objectives. Ireland, for example, is an instructive case that Canada should consider. Over roughly 20 years, Ireland eliminated sector-specific tax incentives and lowered its corporate income tax (CIT) rate on business income to 12.5 percent. This measure succeeded in attracting foreign direct investment, slashing unemployment, and moving the country’s economy toward higher-value activities; it also increased CIT revenue (see O’Rourke et al., in the June 2020 issue of this newsletter).

At the same time, Ireland funds a generous array of social programs with a progressive personal income tax regime (see Paez, “Irish Pay Higher Taxes and Reap Better Benefits, Report Says,” *Tax Notes International*, April 21, 2025). Clearly, much thought was put into these reforms, which demonstrate that a well-designed tax system need not be a “race to the bottom.” A stronger overall economy, yielding higher incomes and living standards, enables increased per capita tax revenue despite a top personal tax rate well below the psychologically important 50 percent level that represents a tipping point for many high-income earners.

Ireland’s thoughtful redesign of its tax system should serve to inspire Canada.

Principles of Potential Canadian Tax Reforms

It is easy to imagine what a country with Canada’s extensive natural resources, robust network of international trade and tax agreements, and highly educated, diverse civil society could achieve with the right tax system in place. Comprehensive tax reform aimed at achieving specific economic goals, informed

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by other countries' real-world experience (rather than driven by ideology or political considerations), should be at the top of the new government's economic agenda.

Having a tax system that facilitates specific commercial objectives is critically important. The simplicity of the 1960s-era Carter commission's slogan of "a buck is a buck" has an obvious conceptual attractiveness; however, it ignores the different costs and benefits of the various ways in which a buck can be generated. Taxing all of them identically, as a matter of ideological purity, is a missed opportunity to create positive incentives for activities with real economic benefits and puts too much emphasis on avoiding the distortionary effects of fiscal policy choices.

Example: Canada as a Head Office Jurisdiction

In some cases, it may be desirable to lightly tax (or even to exempt from tax) income arising from activities that generate either societal benefits or other income that can itself be taxed. For example, Canada has historically (albeit decreasingly) been home to the head offices of many mining companies with no Canadian mines. This is in large part because of this country's stable and predictable legal system; its vast network of international agreements; its stock exchanges, which play a leading role in the mining sector; and its ecosystem of engineers, financiers, lawyers, and accountants with unparalleled industry knowledge and experience. The revenues from Canadian income tax and other taxes on these activities should be regarded as "found money" for Canada, given that the mines involved are in foreign countries, and that the head offices could in theory have been established anywhere.

This alone is enough to justify the exemption from Canadian taxation granted to earnings from foreign operations under Canada's longstanding exempt surplus regime. These rules generally exclude from Canadian taxation any dividends derived from the active business operations of foreign subsidiaries located in countries with which Canada has a tax treaty or a tax information exchange agreement.

It is worth noting that other countries go further, exempting capital gains on the eventual sale of these foreign subsidiaries' shares under "participation exemption" regimes, which can vary significantly in their design, as discussed in a recent KPMG publication (*Roadmap to the Introduction of a Participation Exemption*, December 2023). Canada should consider implementing such a regime, as others have proposed. (See, for example, Turner, "Easing Foreign Affiliate Compliance Burdens in a Full Exemption System for Foreign-Source Active Business Income," in the 2020 Conference Report, available on *TaxFind*.)

There is nothing inherently improper about designing a tax system that attracts to Canada business activity that is globally mobile, especially if such activity creates spinoff jobs and incremental tax revenue for Canada. This country, with its many inherent advantages and an extensive network of tax,

trade, and business investment treaties, could make itself one of the world's most desirable head office jurisdictions by ensuring that its tax system includes features that help attract the type of geographically mobile commercial activity that most benefits Canada.

Principles for Domestic Tax Measures

The same principle applies domestically: in this context, too, we should (1) identify a desirable commercial activity that in turn produces other income-generating activity or other positive spillovers within Canada, (2) determine what features of our tax system might promote these outcomes, and (3) design that system accordingly. Within the existing income tax regime, the previous government's proposal to adopt a patent box regime in Canada is a worthy initiative, as is the proposed extension of accelerated capital cost allowance to stimulate capital investment as a means of addressing Canada's chronic productivity issues.

Attracting risk-tolerant capital investment in small or early-stage ventures should be another pressing policy goal for Canada. This type of investment has the potential to promote businesses and raise related tax revenues that are worth many times the original investment. The tax system can use various levers to incentivize such high-risk capital allocation. They range from greater risk-sharing mechanisms—such as the flowthrough of expenditures to investors (as proposed by the Liberals, in their election platform, for specific types of activities), investment tax credits, and more generous rules for using losses from failed ventures—to lighter taxation of successful outcomes, including reduced capital gains taxes and rollover provisions for reinvestment. Although tax is, of course, only one of many factors driving investment decisions, thoughtfully designed and properly targeted tax incentives can enhance business investment. The fundamental point is that our tax policy needs to be designed not only within a framework of general principles but also with very specific cause-and-effect objectives in mind.

International Trends in a Changing World

As discussed above, it is important to consider design changes with an eye to what other countries are doing; there are always lessons to be learned, and Canada's tax system needs to be internationally competitive. At the same time, policy makers must remain mindful of what is best for Canada and should not necessarily join every multilateral tax initiative. International tax comity is one thing; international tax consensus is less realistic, as recent events have shown. Canada can be a responsible and reliable member of the global tax community without signing on to measures that unduly constrain our tax decision making and produce outcomes that are not in Canada's best interest.

The pillar 2 saga is perhaps the most instructive example of this. As Wilkie has artfully and very thoroughly argued

(see “Pillar 2—‘What’s It All About?’” *Tax Notes International*, April 24, 2023), this entire exercise rests on a false premise and ultimately amounts to a solution—if it can generously be called that—in search of a problem. Canada’s foreign affiliate system already accomplishes much of what the pillar 2 initiative targets, and it is by no means obvious that whatever remains (essentially “countries appropriating each other’s unoccupied tax room”) is either good economic policy for Canada or something that other countries will not ostensibly agree to and then circumvent by other means.

The fact that the new US administration has now refused to sign on to the pillar 2 project—forcing the project’s proponents into various contortions to convince each other that the existing US tax system is already compliant with pillar 2 (see Soong, “Countries Want To Seek Path Forward with U.S. on Pillar 2,” *Tax Notes International*, April 21, 2025)—should encourage Canada to rethink its participation in this initiative, as the European business community is urging the European Union to do. Countries will always compete with one another economically, via tax and other measures, and to pretend otherwise is delusional. Designing our tax system to be broadly consistent with general principles of fair and acceptable fiscal competition based on historical norms (such as the OECD multilateral instrument countering tax treaty abuse) should be more than sufficient to maintain Canada’s reputation as a rule-abiding and fair competitor.

Indeed, the breakdown in implementing the pillar 2 global anti-base erosion (GloBE) rules is telling; it reflects a growing reluctance among countries to subordinate their fiscal independence and economic self-interest to perceived international ideals. Nowhere is this unwillingness more prevalent than in the United States, where a host of aggressive tax measures aimed at foreign countries alleged to be acting unfairly in some way toward America are under consideration in various forms. These measures include (1) increasing US withholding taxes on payments to non-residents, and (2) expanding the base erosion and anti-abuse tax (BEAT) to US members (or branches) of foreign-parented groups. (Some of these measures are helpfully summarized in Rolfes et al., “Evaluating Possible U.S. Retaliatory Tax Measures,” *Tax Notes International*, April 21, 2025.)

In some cases, these proposals expressly override existing bilateral tax treaties that the United States has entered into; in other cases, treaty provisions are effectively displaced by the operation of the “later in time” rule in US law, under which subsequently enacted domestic legislation prevails over earlier treaty obligations (see, for example, *Lindsey v. Commissioner of Internal Revenue*, 98 TC 672, which holds that treaties do not take precedence over domestic law in the United States (IRC section 7852(d)). Although a willingness to disregard treaties is principally (at least from Canada’s perspective) a US phenomenon, it is not, to be fair, unique to the United States.

(See Vergouwen, “The Interaction Between Directives and Tax Treaties: Three Case Studies” (2024) 78:9/10 *Bulletin for International Taxation* 405-15.) This is the new world we find ourselves in, and we need to be clear-sighted, when designing our tax policy, about how other countries pursue their own self-interest, how difficult multilateral consensus is to achieve, and how quickly facts on the ground can change.

Recent events demonstrate another phenomenon relevant to tax policy formulation—namely, the convergence of tax and trade issues as two sides of the same coin that must be approached as such. Tariffs are essentially single-stage sales taxes on specific goods imported from specific countries. Among the many grievances (real or imagined) cited by the Trump administration in its Fair and Reciprocal Plan on Trade announcement of February 13, 2025 is Canada’s digital services tax (DST), enacted contrary to the advice of the business community. Whatever the tax policy merits of a DST in isolation, it was astonishingly foolish for Canada to impose this tax (retroactively to 2022, no less), given the extent to which our economy is tied to that of the country whose multinationals are disproportionately affected by the tax, and given, too, the paltry revenue Canada’s DST raises and the fact that it is effectively being passed along to Canadian consumers.

The US reaction to the DST was utterly predictable. The entire exercise served only to irritate our largest trading partner and create yet another pretext for the Trump administration’s tariff assault on Canada. The European Union’s recent threat to impose tariffs on US-sourced services via “a levy on the advertising revenues of digital services” further blurs whatever distinction exists between taxes and tariffs (see Khalaf et al., “EU Could Tax Big Tech If Trump Trade Talks Fail, Says von der Leyen,” *Financial Times*, April 10, 2025), and it illustrates the interconnection of tax and trade policy.

A further grievance cited by the United States as a basis for tariffs is the imposition of value-added taxes, such as Canada’s GST on US exports. This is a somewhat baffling claim, given that virtually all of the 175 countries that levy such taxes apply them on goods acquired for use domestically, whether imported or locally produced. The most charitable possible interpretation of this US claim is that if one squints hard enough, it’s at least possible to see the outlines of a VAT-as-an-export-subsidy argument—although even that explanation has been persuasively debunked by various commentators (including American ones). There has recently been speculation that the United States may reintroduce, in some form, earlier proposals to narrow the circumstances in which it grants its taxpayers a foreign tax credit—tying eligibility to the design of the relevant foreign tax system. Such changes could distort incentives, favouring domestic expansion over foreign investment (see Herzfeld, “What Role for International Tax in a Trump Tariff World?” *Tax Notes International*, April 14, 2025). Like it or not, taxes, tariffs, and trade policy in general are intertwined.

Conclusions

To maximize its international attractiveness in an increasingly competitive world, Canada needs to overhaul its tax system in a profound and thoughtful way. At a minimum, this will require a careful consideration both of the country's economic objectives and of the specific design features most likely to achieve these objectives, with an approach informed by, though not necessarily the same as, other countries'. Moreover, tax and trade policies must be integrated in order to produce results that are in Canada's best interests.

All Canadians should wish Canada's new government well in this undertaking. ■

The Tax Shift the Economy Needs

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Canada's economy is under strain. Real GDP per capita has stagnated since the pandemic, and our per capita growth rate has trailed that of the United States and most OECD peers since the 1990s. Although the current headwinds originate from Donald Trump's aggressive trade policies, the longer-run trend reflects deeper, longstanding, homegrown concerns: weak productivity growth and flagging capital investment. Since 2015, business investment per worker has declined (C.D. Howe Institute [commentary no. 666](#)), and productivity—whether measured in simple terms or by more refined indicators—continues to disappoint.

Strengthening the foundations for growth should be a top policy priority in the face of global trade disruptions. (For an example of how this might be done, see the economic strategy set out in the C.D. Howe Institute's Special Policy Report, [April 4, 2025](#).) No single measure will fix Canada's economic underperformance overnight. But a well-designed, practical tax reform, enacted swiftly, could provide substantial support. A shift in the tax mix—inspired by the C.D. Howe Institute's recent shadow budget (C.D. Howe Institute [commentary no. 679](#))—that reduces the economic harm of taxation without sacrificing revenue or core public services offers a promising route forward.

Here's a Proposal . . .

- Reduce federal personal income tax (PIT) rates by 4 percentage points in the third, fourth, and fifth brackets.
- Reduce the federal corporate income tax (CIT) rate from 15 percent to 13 percent.
- Return the GST rate to 7 percent from 5 percent.
- Add \$6,000 to the existing basic personal amount top-up, making it fully available to individuals in the first two tax brackets, with a gradual phaseout between the thresholds of the third and fifth brackets.

- Reduce the federal age credit (currently about \$9,000) to \$4,000.
- Enhance the medical expense tax credit by cutting the eligibility thresholds in half.

As explained below, this proposal would be revenue-neutral. It would significantly enhance Canada's tax competitiveness by encouraging greater investment in physical and human capital, risk taking, and work effort—while limiting the distributional impact of the tax shift.

. . . To Reduce the Economic Harm from Taxation

Taxes affect behaviour, making some economic distortions unavoidable. However, economic research consistently shows that some taxes are more harmful to economic growth and more prone to tax avoidance than others. Reforms aimed at altering the tax structure to minimize reliance on the most detrimental taxes and to increase the use of those with lower economic impacts can lead to economic improvements without changing overall tax revenues.

As economist Bev Dahlby and others have shown, different tax bases come with different marginal costs of public funds (MCFs)—that is, the cost of raising an additional dollar of tax revenue, including the resulting economic harm. (See, for example, Dahlby, *The Marginal Cost of Public Funds: Theory and Applications* (Cambridge, MA: MIT Press, 2008).) The cost of raising revenue from each tax base depends not only on its marginal impact on economic activity, but also on existing tax rates and the share of revenue drawn from that base. In general, corporate and personal income taxes impose higher economic costs per additional dollar raised than consumption taxes. Reforming the tax system with this in mind—lowering high MCF taxes and replacing them with more efficient sources—can improve incentives to invest, save, take risks, and work, all of which are essential for boosting Canada's long-run growth potential.

Corporate taxes are an especially damaging factor in business investment decisions. Higher CIT rates reduce the profitability of new investments, whether in physical assets such as machinery or in intangible assets such as intellectual property. Conversely, lower CIT rates increase after-tax returns on investments, making projects more attractive and encouraging businesses to expand. A lower statutory CIT rate also makes a country more attractive to foreign investors, encouraging them to establish or relocate activities there, including by opening new facilities. This consideration is particularly important for Canada today, given the ongoing trade tensions with the United States.

Quantifying the impact of taxation on economic growth at a macro level has proved challenging, in part because the government expenditures funded by taxes also spur growth (see [OECD Economics Department Working Papers no. 713](#)).

Studies that show the strongest negative effects of taxation on economic growth typically rely on microdata and focus on specific growth drivers such as investment, productivity, and labour. These studies often examine marginal impacts—that is, how small changes in tax parameters affect current levels of specific drivers of economic activity.

For instance, in 2008, OECD researchers, using high-quality firm-level data from multiple countries, clearly identified negative effects of corporate taxes on productivity and investment (OECD Economics Department Working Papers no. 641). Similarly, a 2010 World Bank/Harvard study, using a standardized database of businesses across 85 countries, found that corporate taxes significantly reduce overall investment, foreign direct investment (FDI), and entrepreneurship. (See Djankov et al., “The Effect of Corporate Taxes on Investment and Entrepreneurship” (2010) 2:3 *American Economic Journal: Macroeconomics* 31-64.)

On the PIT side, studies that have shown the greatest impact of income taxes on wage earnings tend to concentrate on secondary earners in families, and on seniors. The PIT’s immediate impact on primary earners’ wages is often modest or negligible. However, accounting for the impact of the PIT on job experience and training, more recent studies have shown a larger impact of the PIT on earnings and productivity in the long run. Tax-avoidance opportunities are greater for higher-income groups, as widely documented in the literature (see the estimates by Laurin in C.D. Howe Institute E-Brief, December 3, 2015; by Milligan and Smart, in *NBER Working Paper* no. 20489; and by Office of the Parliamentary Budget Officer’s report by Perrault). Taxes on consumption, especially when they account for a smaller portion of government revenues than income taxes, are generally shown to have a less adverse impact on the economy than income taxes do (see Nguyen et al., “The Macroeconomic Effects of Income and Consumption Tax Changes” (2021) 13:2 *American Economic Journal: Economic Policy* 439-66).

The key insight offered by this body of research is that since some tax bases are more distortionary than others at their current rates, shifting the tax burden toward less harmful sources can yield meaningful economic gains. According to recent federal MCF estimates, the tax rate shift outlined here could result in a long-term improvement in economic welfare of up to \$15 billion annually, calculated on a present-value basis (see Dahlby and Ferede, *What Are the Economic Costs of Raising Revenue by the Canadian Federal Government?* (Vancouver: Fraser Institute, 2022)).

... and Provide Tax Relief for Lower-Income Earners as Well

The proposed \$6,000 increase in the basic personal amount top-up, targeted at individuals in the bottom two income tax brackets, would provide income tax relief across the income

distribution while mitigating the impact of the two-point GST increase on lower-income earners. Some will argue that the income-tested GST tax credit should be increased to match the GST rate increase. But the credit was not reduced when the GST rate fell from 7 percent to 5 percent in the 2010s. In fact, the current value of the GST credit is already calibrated to compensate lower-income individuals for GST paid at a rate of 7 percent. Others may argue that phasing out the basic personal amount top-up between the third and fifth tax brackets would raise the marginal effective tax rate for those affected. Although this is true, the increase would be minimal—roughly three-quarters of a percentage point.

Seniors are now the least likely age group in Canada to live in poverty, making the longstanding emphasis on preferential tax treatment for the elderly increasingly outdated (*Canadian Income Survey, 2022*). The proposed reduction in the base amount of the age credit would be more than offset by the enhanced basic personal amount, ensuring that affected seniors would not face a tax increase.

At the same time, seniors are more likely to incur significant medical expenses as they age. Currently, the medical expense tax credit applies only to costs exceeding 3 percent of net income or \$2,834, whichever is lower. Reducing these thresholds to 1.5 percent of net income and \$1,420 would enhance the value of the medical expense credit, providing meaningful relief to many seniors.

Revenue Neutrality

The tax shift reform proposed here is broadly revenue-neutral, as shown in the accompanying table. For illustrative purposes, revenue estimates are presented for the 2027-28 fiscal year, allowing time for behavioural adjustments to take effect.

A Revenue-Neutral Tax Shift

	GST	CIT	PIT	Total
<i>\$ billions, fiscal year 2027-28</i>				
Baseline tax revenue	66.9	96.2	253.9	417.1
Initial tax revenue change	26.8	-8.9	-26.8	-9.0
Revenue impact of behavioural responses	-0.5	2.5	6.7	8.8
Projected tax revenue after policy changes	93.2	89.8	233.8	416.9

Baseline tax revenues are projected on the basis of GDP growth rates from the latest Public Accounts of Canada report. Initial revenue changes reflect static estimates—that is, they assume no behavioural response. PIT calculations are based on Statistics Canada’s Social Policy Simulation Database and Model (SPSD/M), version 30.3. Behavioural responses for PIT are estimated by using a taxable income elasticity of 0.5, appropriate for higher income levels (see Department of Finance’s estimates in *Tax Expenditures and Evaluations 2010*). For CIT, an elasticity of 0.33 is applied, a weighted average based on findings from *Tax Expenditures and Evaluations 2014*. The elasticity of the GST base is set at half the PIT elasticity. We also assume that one-quarter of the increase in after-tax corporate profits will be distributed as eligible dividends, and that the gross-up and credit rates will be adjusted to preserve current levels of integration. Totals may not add because of rounding.

First, the CIT reduction would raise the expected after-tax return on new business investments, making more projects financially viable and stimulating both capital accumulation and economic activity. It could also encourage some multinational profits to shift back into Canada. Second, lower PIT rates would reduce incentives for tax avoidance and encourage greater work effort, risk taking, and entrepreneurship. Third, although the GST increase would also trigger behavioural responses—ranging from avoidance to real economic effects—these are expected to be more modest than those for PIT, given the GST's broader base, lower rate, and fewer avoidance opportunities.

The Oxygen the Economy Needs

Governments, federal and provincial, have largely prioritized equity and redistribution in recent tax reforms. They must now shift their focus to boosting Canadians' incomes by improving the tax system's economic efficiency. Our proposal would give the economy the oxygen it needs to thrive in a challenging global environment—without reducing public services or adding to the fiscal burden. ■

Strategic Expansion of the SR & ED Credit

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In this article, we discuss current threats to Canadian prosperity. In the face of these threats, the federal government should follow through on proposals and election promises to liberalize the scientific research and experimental development (SR & ED) rules. In addition, the government should relax the existing requirement that research be performed in Canada.

Background

From its earliest days in late January 2025, the second Trump administration began disregarding free-trade commitments made by previous administrations. Dubious executive orders have been issued, imposing significant tariffs on major trading partners, including Canada. As of this writing, the scope and extent of the new tariffs change by the day, giving rise to unprecedented uncertainty and posing grave threats to some sectors of the economy. The Canada-United States-Mexico Agreement (CUSMA) entered into force on July 1, 2020, and by its terms is scheduled for a joint review starting on July 1, 2026—though there has been widespread speculation that this review may be accelerated.

It remains uncertain whether the new measures will be long-term, but the new tariffs, together with a corporate tax rate lowered to 15 percent for US manufacturing firms, could affect the volume of our exports and our industrial landscape (see Avi-Yonah, “A Lower Corporate Tax Rate for Domestic

Manufacturing?” *Tax Notes*, December 20, 2024). The stated objective of the new administration is to encourage the relocation of manufacturing production to the United States (see The White House, *America First Trade Policy*, 2025), potentially at the expense of Canada, where US interests hold more than US\$450 billion in foreign direct investment (FDI) (United States, BEA, “Direct Investment by Country and Industry, 2023,” *News Release*, July 23, 2024).

For many Americans working in public administration or in institutions funded by the US government, the arrival of the Trump administration signals job losses. Layoffs are planned across multiple departments and agencies, including the Department of Defense, the National Oceanic and Atmospheric Administration, the Environmental Protection Agency, health agencies, the National Nuclear Security Administration, and the Department of Energy. (See the article by Mallapaty in *Nature*, March 13, 2025.) Cuts to research funding in areas such as climate change and infectious diseases, and in other areas not aligned with the new administration's priorities, are also being implemented, causing layoffs in the private sector, including at universities (see Blais, in the *Globe and Mail*, May 4, 2025).

New Opportunities for Canada?

These trade tensions will force Canadian businesses to be more competitive—both in order to maintain exports to the United States and to develop new markets. In fact, Canada lags significantly behind the United States—and other G7 countries except Japan—in labour productivity, measured as gross domestic product (the added value in an economy) per hour worked (see *OECD Compendium of Productivity Indicators 2024*).

Productivity is driven by education, market efficiency, infrastructure, institutions, and innovation. The last factor—innovation—depends on research and development (R & D) investment, a field where Canada underperforms. In 2023, Canada's gross domestic R & D spending was 1.8 percent of GDP, substantially less than the OECD average of 2.7 percent. Among G7 countries, only Italy spent less (OECD, *Gross Domestic Spending on R&D*).

The uncertainty that the Trump administration has created regarding federal research funding is jeopardizing many US scientists' projects (see the article by Zimmermann in *American Association for the Advancement of Science*, March 11, 2025). This gives rise to a tremendous opportunity for Canada, as US researchers have begun sounding out their Canadian colleagues about potential opportunities north of the border. The European Research Council has already doubled the value of a grant designed to attract researchers to EU countries (*Nature*, April 1, 2025). These developments suggest that Canadian tax policy should focus on improving the tax system's support for R & D.

Broadening of SR & ED

Improving support for business innovation in Canada has been on the federal government's agenda for several years. Following two rounds of public consultations, the previous government announced a proposal to revise SR & ED credits in the 2024 fall economic statement (FES), presented in the House of Commons on December 16, 2024 (at 262-65). Specifically, it was proposed that (1) the 35 percent credit be extended to non-foreign controlled public corporations, (2) the expenditure limit for the 35 percent credit be raised, and (3) capital expenditures be eligible for the credit, as they were before 2014. The new government should follow through on these 2024 FES announcements.

In addition, the Liberal party's election platform promises further expansion of the SR & ED program. Among the promised changes are (1) an increase in the claimable amount under the SR & ED program; (2) the introduction of a new type of flowthrough shares to support companies in artificial intelligence, quantum computing, biotech, and advanced manufacturing; and (3) the introduction of a long-studied patent box regime that reduces the tax rate applicable to income generated from the commercialization of R & D performed in Canada. It is promised that this will end "the trend of subsidizing the U.S. economy with Canadian-grown ideas." The new government should implement these promised reforms.

Location Restriction in SR & ED Rules

Amid all of these proposals and promises, no changes have been proposed to the SR & ED rules that currently apply to payments to third parties, such as universities and research institutes. Nor have any changes been proposed to the requirement that expenses related to research contracts pertain to work conducted in Canada. Most provincial R & D tax credits are based on the federal rules and likewise require the work to be performed within a given province's borders ("the location restriction").

In our view, the location restriction may be justified from the standpoint of maximizing research benefits—specifically, tax revenue generated in Canada, enhanced spillover effects from the geographic proximity of researchers and institutions, and the enrichment of local researchers' knowledge. However, it should be noted that the location restriction also limits the involvement of foreign researchers in Canadian businesses' R & D projects.

In this context, it is worth noting that income earned by researchers on a project will not necessarily be taxed in Canada solely because the research is done in Canada. In fact, income derived by foreign consultants in connection with a Canadian research project will often not be taxable in Canada. If the consultant is a resident of the United States or of another country with which Canada has a tax treaty, the consultant's income will generally escape Canadian taxation because it is

not attributable to a "permanent establishment" in Canada and is therefore considered exempt business income under provisions such as article VII of the Canada-US treaty. Thus, even if an R & D service contract is carried out in Canada, a foreign consultant's income is usually not taxable in Canada. It follows that the location restriction cannot be justified solely on the assumption that it will inevitably result in the researchers' fees being taxed in Canada.

Given the increasing specialization in research (where niche expertise is unevenly distributed across countries) and the many possibilities for remote work and collaboration, does restricting the SR & ED credit to local work really make sense for Canada? This question is particularly relevant for American researchers who are unable to complete projects of interest to Canadian companies or whose expertise suddenly becomes available.

Canada's (and the provinces') knowledge base in R & D is inherently limited, and it is reasonable to ask whether SR & ED rules that tend to limit the involvement of foreign researchers are in Canada's best interest. It is true that the United States itself imposes a location restriction in its tax rules for R & D benefits, but it is a country with approximately 10 times the population of Canada. However, many other countries do not impose such a restriction. Research conducted in any country in the European Union (EU) or European Economic Area (EEA) is eligible for R & D tax credits in several European countries, including Spain, France, and Germany. In Italy, R & D expenditures performed abroad are eligible if conducted in any EU or EEA member state or in another jurisdiction that has signed a tax information exchange agreement with Italy. Until recently, UK rules provided that R & D activities conducted abroad were not restricted; since 2024, foreign R & D can still be eligible for tax credits, but only if the necessity for overseas work is demonstrated. In Australia, foreign R & D is eligible for tax incentives provided it can be demonstrated that the work could not be conducted domestically. Japan imposes no territorial restrictions on R & D spending eligibility (FI Group, *International R&D Tax Incentives—Guide 2024*).

A Possible Exception to the Location Restriction

Canada should maintain the general requirement that R & D activities be carried out in Canada, but the current US situation should prompt consideration of an exception that would make foreign service contracts eligible for the SR & ED credit. This is not merely about seizing a potentially short-term opportunity; it is also about evaluating whether it is time to broaden eligible expenditures to improve access to knowledge developed beyond our borders—not only in the United States. Such an expansion would be consistent with the approaches taken in many other countries.

In assessing such a change, the government should first determine whether expanding eligible expenditures would offer Canadian businesses sufficient incentive to acquire the

targeted knowledge and expertise. Drawing on the experience of other countries, the government could consider several conditions in designing an exception for foreign R & D activities. For example, it may be worth assessing whether such activities should require pre-certification for related expenses to qualify. Consideration could also be given to imposing limits on eligible expenses—either as a fixed amount or as a proportion computed with reference to domestic R & D expenditures. Also, eligibility could be restricted to certain categories of consultants or made contingent on consultants holding specific certifications. These conditions should aim to balance policy objectives with the administrative burden imposed on both taxpayers and the tax authorities.

The measure should also include conditions (incorporated into service contracts) ensuring that the intellectual property developed through foreign R & D activities is held in Canada, and that the knowledge acquired from these activities is fully transferred to Canada. This condition is essential when it comes to R & D activities conducted abroad. Just as support for domestic R & D is justified by its positive impact on the economy and productivity, Canadian support for foreign R & D can be justified—provided that the resulting technology is owned by Canadians.

Finally, it is worth considering whether SR & ED eligibility should be extended to all expenditures incurred in sending Canadian employees abroad to collaborate with research groups or consultants. These employees should be expected, as a condition of eligibility, to take part in the research and absorb the newly developed knowledge. Currently, eligible salaries for R & D work conducted outside Canada are capped at 10 percent of total salaries for R & D performed in Canada (ITA, subsection 37(1.5)). This limit should be carefully reconsidered.

Conclusion

The trade war launched by the United States—our main trading partner—poses numerous challenges for Canada. This situation compels us to clearly assess our strengths and weaknesses in order to improve our policies, including those related to R & D. Low investment in R & D is not a new issue in Canada, and while some reform proposals are already on the table, both the federal and provincial governments should consider making additional adjustments to their tax policies in order to further promote innovation. One such adjustment should involve revisiting the location restriction for eligible activities. ■

Coping with the Turbulence Ahead: Updating Canada's Tax Administration

Jennifer Robson, Carleton University

As of this writing, there remain more than 1,300 days in Donald Trump's second term as president of the United States. Within his first 100 days, President Trump imposed unprecedented tariffs on Canada, Mexico, and China, and then threatened similarly unprecedented tariffs on effectively all of America's trading partners. It is unclear whether an off-ramp exists for this unilateral declaration of global economic warfare. What is clear is that Canada, as a modest-sized open economy reliant on international trade, will experience substantial economic (and political) turbulence for some time to come.

Even the rapid renegotiation of a trade agreement with the United States may not prevent economic instability for the 12.5 percent of Canadian jobs estimated to be directly or indirectly related to exports to the United States. Those jobs are distributed across the country in communities most exposed to changes in the Canada-US trade relationship (see [Chejfec](#), in *Institute for Research on Public Policy*, March 13, 2025; and [Tapp](#), in *Canadian Chamber of Commerce*, February 11, 2025).

Given the complexity and diversity of modern supply chains, as well as the spillover effects within communities and between sectors, it is difficult to accurately predict the impact of these tariffs on employment, business liquidity, and community economic development. This poses a challenge for effective policy making and for the implementation of economic adjustment measures, such as employment insurance (including wage subsidies to prevent layoffs) and tax credits designed to promote investment or advance growth in key industries.

Tax Administration as an Early-Warning System

The early-warning data currently available to policy makers are useful, but they suffer from limitations in detail and timeliness, and in the time and effort required from respondents to provide the necessary information. For example, as explained by [Statistics Canada](#), the [Survey of Employment, Payrolls and Hours](#) collects a monthly census of administrative data from the CRA on summary payroll remittances and responses to questionnaires sent to 15,000 businesses. But the survey has serious limitations; it collects data only during the sampling period (the last seven days of the month), and the results are published only two months later. The [Labour Force Survey](#) collects monthly data on self-reported activity in the Canadian workforce. But it similarly samples only one week in the month and is published one month in arrears. Also, owing to sample size and response levels, the labour force data generally cannot yield reliable estimates at the more localized levels needed to monitor community-level changes.

Improved real-time administrative data from the CRA would offer a far better information source without increasing burdens for employers. Following the COVID-19 pandemic, the agency launched the [ePayroll project](#), aimed at developing an electronic payroll solution to facilitate real-time reporting of regular and detailed payroll information. As the National Payroll Institute [noted](#) in a 2025 pre-budget submission, “the need for an ePayroll system became evident during the COVID-19 pandemic, following the federal government’s attempt to facilitate emergency payments, such as the Canada Emergency Response Benefit.”

As I noted in a 2024 article (“State Capacity and Administrative Burdens on Citizens: Time for Export Controls and Transparency” (2024) 67:4 *Canadian Public Administration* 598-608), the CRA’s work to design and consult on an ePayroll solution has, unfortunately, ground to an effective halt. But it can and should be revived. The payroll remittance system in Canada is ready to catch up to the systems in peer jurisdictions such as the United Kingdom, Australia, and Ireland, where administrative burdens have been reduced, economic data have been improved, and tax administration has been made more efficient. (See Ross’s [article](#) in *Global Government Forum*, January 13, 2025.)

Payroll professionals and the employers they serve are ready to collaborate. The first priority should be to launch a feasible pilot project with lead employers in key sectors, such as automotive manufacturing, allowing them to share with the CRA regular payroll data in a secure environment, on a schedule that matches their usual processing timelines. From there, the system can be expanded to shift more employers from the current remittance system to one in which payroll data are shared with the CRA. After a successful introductory period, additional capabilities should be added to build a sustainable and reliable administrative system for reporting and remitting income and payroll taxes deducted at source.

Simplifying Tax Administration

The newly elected Carney government has also committed, in its [platform](#), to renewing efforts to automate personal income tax filing for eligible Canadians. Since at least 2015, elected federal officials have reiterated their commitment to reducing administrative burdens on taxpayers and modernizing the tax-filing process, particularly when this process serves as a pathway to eligibility for government programs and services. (See this article by Genest-Grégoire et al., in (2024) 50:3 *Canadian Public Policy* 292-310.) Canada is now one of only a few remaining advanced economies in which all taxpayers are expected (though not always required) to complete a detailed and complex annual return—a process that reconciles their taxable income and taxes owing against taxes deducted at source (or paid by instalment), along with information provided directly to the tax agency.

The current system of annual personal income tax returns imposes significant compliance costs on individuals—in terms of time, effort, and out-of-pocket expenses for tax preparation services or software. (See Vaillancourt and Li, *Personal Income Tax Compliance for Canadians: How and at What Cost?* (2024); and the Genest-Grégoire article noted above.) Although the CRA has made some strides in automating parts of the tax-filing experience—for example, through automatic downloads of third-party information into tax-preparation software—the overall effort (or tax pain) required of individual taxpayers has remained largely unchanged, as explained in a 2024 *Perspectives* [article](#) by Godbout and Vaillancourt.

On the one hand, efforts to simplify tax administration for taxpayers (including but not limited to prepopulated tax forms) may also pave the way for future simplification of the ITA itself, as noted by Evans in a 2024 *Perspectives* [article](#). On the other hand, some assessments of the options for tax agency reconciliation (a more accurate term than automatic filing) have led to the conclusion that simplification of the ITA should be a precondition for administrative simplification; see the article by Laurin and Dahir, in *C.D. Howe Institute commentary no. 616*. There is a middle ground.

Genest-Grégoire et al. estimate that nearly one-third of Canadian taxpayers have returns simple enough to be prefilled by the CRA, with a very high concentration of such taxpayers among lower-income individuals, particularly those receiving provincial social assistance benefits. Progress toward tax agency reconciliation can be made through improved data-sharing agreements between provincial governments and the CRA and through the expansion of public access to the CRA’s direct-filing services, which are currently reserved for a small number of taxpayers identified and invited by the agency. The short-lived [Direct File](#) project in the United States offers a useful model for the CRA to follow. Further progress could be made by improving third-party sources of information for the CRA, ideally in tandem with a growing ePayroll capability.

Conclusion

Modernizing Canada’s key tax administrative systems—payroll reporting and personal income tax returns—may not appear, at first glance, as urgent as tax measures aimed at boosting domestic investment, innovation, or sustainable growth. But in the current environment, investments in the modernization of these systems are fundamentally about bolstering the infrastructural capacities of the Canadian federal state. In the months and years ahead, we will need a government that has a greater capacity to respond both to turbulent events and to citizens’ expectations. ■

De-Risking the Tax System in an Era of Growing Uncertainty

Trevor Tombe, University of Calgary

Starting in late 2024 and accelerating into early 2025, Canada's economy has faced an unprecedented surge in policy uncertainty. One particularly useful measure shows that by March 2025, economic policy uncertainty in Canada had risen to levels approximately 5.4 times higher than a year earlier. Among the nearly two dozen countries for which this measure is calculated, Canada has experienced, by far, the largest spike in uncertainty. There are several reasons for this sharp rise.

First, the re-election of President Trump in the United States led to dramatic shifts in American trade policy—an especially critical development for a small, open economy like Canada's. Roughly one-quarter of Canada's gross domestic product (GDP) comes from exports to the United States, and a similar share is tied to imports. Most of the imported products are capital goods and intermediate inputs used across Canadian industries. The introduction of new US tariffs on steel, aluminum, and autos—along with broader US threats to impose tariffs on nearly all bilateral trade—has naturally heightened uncertainty about the economic environment.

Second, domestic political developments have added to the instability. In 2024, shifting federal dynamics led to the prorogation of Parliament and the resignation of Canada's prime minister. This triggered a period of leadership selection, followed by a federal election; both of these developments amplified questions about the direction of national economic policy. Significant proposed tax changes, including an increase to the capital gains inclusion rate, were left in limbo, creating uncertainty for taxpayers filing 2024 returns.

Beyond policy, the markets themselves are potentially more volatile—from commodities to global financial assets. And while tensions with the United States may eventually ease, the outlook for Canadian businesses is still clouded by uncertainty, which can have potentially significant effects on the economy. Indeed, based on historical relationships among (1) economic policy uncertainty, (2) investment levels, and (3) labour market outcomes, the spike in economic uncertainty could lead to sharp drops in business investment and increases in the unemployment rate (see Baker et al., "Measuring Economic Policy Uncertainty" (2016) 131:4 *Quarterly Journal of Economics* 1593-1636). This makes it an opportune time for policy makers to identify the ways in which our tax system might inadvertently be adding to this uncertainty—and how we might, instead, reform the system to reduce risk.

Capital Gains and Inflation

One area of focus could be capital gains taxation. When someone owns an asset that appreciates over time, they realize a

capital gain upon its sale. For tax purposes, this gain is calculated in nominal terms—the purchase price is subtracted from the sale price, and half of the resulting amount is included in taxable income. Crucially, this calculation does not adjust for changes in the purchasing power of money over time, and the 50 percent inclusion rate is a poor approximation of real gains. (For further discussion, see this [article](#) by McMillan in the 2023 *Canadian Tax Journal*.)

This can be a factor in investment decisions. As the dollar's purchasing power declines over time, failing to index capital gains for inflation exposes asset owners to tax burdens on what may be purely nominal gains, rather than gains that reflect real economic improvement. And increases in future inflation volatility worsen this issue, as it becomes more difficult to plan. To be clear, this issue isn't just about capital gains and inflation. Inflation and taxation interact in many ways to distort economic decisions. (Robson and Laurin explored this interaction at length in a recent C.D. Howe Institute [E-Brief](#), August 9, 2023.)

A relatively straightforward reform—one among many possibilities—would be to adjust an asset's cost base by the change in the consumer price index (CPI) between the time of purchase and the sale. This would ensure that only real (inflation-adjusted) increases in value are taxed. Admittedly, this approach could pose administrative challenges, particularly for certain asset types, and might create pressure to index other types of capital income, interest deductions, and more. Nonetheless, this reform could eliminate a certain type of inflation risk that investors currently face. Canada would not be the first country to adopt this approach. Australia featured indexation when it first introduced the taxation of capital gains, although it eliminated this feature in 1999. The United Kingdom also abandoned efforts to index gains. However, countries such as Chile, Israel, and Mexico continue to apply [explicit inflation adjustments](#) to capital gains.

There may be many practical lessons to learn from the Australian and UK experiences. However, given the potential increase in supply-side shocks—such as those that materially contributed to recent inflation dynamics in Canada and globally—indexation may be a reform worth considering.

Beyond its effect on investment incentives, the rationale for this reform aligns with the so-called [Haig-Simons definition of income](#), which defines income as any change in a taxpayer's ability to consume. If an asset appreciates only in line with inflation, the taxpayer's real consumption power has not increased. Taxing such nominal gains treats taxpayers as wealthier than they actually are—violating principles of horizontal equity and potentially distorting investment decisions.

Loss Carryforwards

Another avenue for reform concerns how the corporate income tax system treats business losses. Business activity is

inherently risky. When risk pays off, firms pay corporate income tax on their profits. But when firms incur losses, an amount in respect of those losses is not immediately (if ever) refunded. Instead, firms are generally allowed to carry forward losses to offset future profits, though only at their nominal value and only for a limited time. This asymmetry creates a disincentive for firms to engage in riskier investments, which may be especially problematic in a world where economic risk is increasing.

A well-established body of literature explores potential alternatives to the treatment of loss carryforwards, including some alternatives that involve significant changes to the entire structure of corporate taxation—as discussed in 2016 C.D Howe Institute commentary no. 452. But one reform worth considering does not entail a wholesale change to the entire system: it involves allowing firms to carry forward all losses with an interest-like adjustment. Under this system, losses could be carried forward (or backward) in time, increasing (or decreasing) in value at an interest rate that reflects the time value of money. And—except in cases where practical administrative constraints demand a prescribed time frame—there would be no fixed time limit on how long such losses could be applied. Furthermore, losses could be transferred and used by any entity that acquired another entity with such losses on the books.

Such a change would make the tax treatment of profits and losses more symmetric, enhancing neutrality and reducing the tax-induced penalty on risk taking. If future economic volatility increases, the underlying riskiness of any given business investment is also likely to rise. In that context, liberalizing the treatment of loss carryforwards would become even more valuable.

Full Expensing

Another change that could help mitigate risk within the tax system concerns the speed with which companies can write off their capital investments in computing income for tax purposes. Currently, for most types of investments made by corporations, the full amount of the investment may be deducted, but only gradually, over a specified period sometimes lasting many years.

In 2018, in response to changes in the US tax system, the federal government introduced special rules allowing accelerated depreciation of certain specified capital assets. This measure, known as the accelerated investment incentive (AII), was enacted as a temporary provision that would begin to be phased out in 2024. But in the 2024 fall economic statement, largely in response to rising economic uncertainty between Canada and the United States, the previous government announced that it would cancel the planned phaseout and proposed to fully reinstate the AII for a five-year period, with a four-year phaseout beginning after 2029. The new government is expected to proceed with this proposal. While the extension

of the measure was helpful, it would be better if the policy were made permanent.

The temporary nature of these measures creates its own form of policy uncertainty. Firms are left guessing about how their future investments will be treated for tax purposes, which adds another layer of unpredictability to the effective tax rate on new investment. Allowing full and permanent expensing of all capital investment may be one way to mitigate this risk. It would also reduce the effective tax rate implicitly imposed on new investment.

When companies are required to spread out the cost of investments gradually over time, the real value of those deductions diminishes, reducing the tax savings they provide. Under certain conditions, allowing full and immediate expensing of capital investment is effectively equivalent to applying a zero percent tax rate on the returns from those new investments. (See McKenzie, in “Finances of the Nation” in the 2016 *Canadian Tax Journal*.) This creates a much stronger incentive for businesses to invest in machinery, equipment, plants, and other forms of productive capital. Moreover, making full expensing a permanent feature of the ITA would eliminate the policy risk associated with repeated changes to depreciation schedules—a risk that businesses currently must factor into their decisions.

Conclusion

In sum, economic policy uncertainty is at a historic high in Canada, and the tax system should not add to the uncertainty firms already face. By adjusting capital gains taxation to account for inflation, improving the treatment of business losses, and allowing the full expensing of capital investment, we could help mitigate risk and encourage greater business investment.

To be clear, these changes come with important tradeoffs. In particular, they effectively shift certain risks from taxpayers to the government. For example, indexing capital gains to inflation would reduce government revenues by reducing the effective size of the capital gains tax base, with potentially greater revenue losses if inflation unexpectedly spikes. Allowing corporate losses to be carried forward with interest might also reduce overall corporate tax revenues. However, if such a policy proves effective in boosting innovation and investment, the resulting expansion of the tax base over time may compensate for this lost revenue. Similarly, full expensing may reduce government revenues, especially in the short term.

That said, these are evidence-informed reforms that could help ensure that our tax system supports growth and investment during a time of heightened uncertainty. After several years of weak economic growth, lagging productivity, and disappointing rates of business investment and capital formation, such measures may also help contribute to a stronger Canadian economy. ■

Mitigating the Inequities of High Progressivity: Income Averaging and Spousal Unit Taxation

Geoffrey Turner, Davies Ward Phillips & Vineberg LLP

With the federal election now settled and fiscal pressures intensifying, Canada's highly progressive personal income tax (PIT) rate structure seems likely to persist. Indeed, if the re-elected Liberal government reduces, as promised, the rate applicable to the lowest income bracket, lower-income individuals will face even more sharply escalating marginal tax rates as their incomes rise.

If high levels of progressivity in the PIT system continue, reform should focus on alleviating the unfairly high tax burdens that our progressive rate structure imposes on two categories of taxpayers: (1) individuals whose income is irregular over time, and (2) families in which spouses earn dissimilar incomes and therefore fall into different tax brackets. The [1966 Carter commission report](#) recognized these inequities and it proposed solutions, including income averaging and a family taxation unit. It is now time for those recommendations to be implemented.

Is Canada's Income Tax Too Progressive?

Canada's PIT system is founded on the notion that individuals with a greater ability to pay, as measured by their taxable income, should bear a disproportionately higher tax burden. Thus, we describe our income tax as "progressive" because the marginal tax rate increases as a taxpayer's annual income increases.

For example, an [Ontario resident](#) currently faces a zero tax rate on income up to the basic exemption of \$16,129. Beyond that, the combined federal and provincial marginal rate rises through 13 successive income brackets to a top rate of 53.53 percent for incomes exceeding \$253,415. Comparable rate structures and top marginal rates apply in [other provinces](#), although the top rates in Saskatchewan and Alberta are lower, peaking at 47.5 percent and 48 percent, respectively. By comparison, 15 years ago, the highest marginal rate for an [Ontario resident](#) was 46.41 percent. Although the prevailing system at that time was already progressive, the degree of progressivity and the top marginal rates have since increased sharply.

The steep progressivity of the current system supports the very effective redistributive function of our personal-income-tax and social-transfer system, significantly mitigating income inequality in Canada. A widely accepted measure of inequality is the "[Gini coefficient](#)." A Gini coefficient of 1 connotes extreme inequality, while a coefficient of nil indicates perfect equality. According to Statistics Canada data ([table 11-10-0134-01](#)), Canada's 2023 pre-tax "adjusted market income" Gini score of 0.429 was significantly reduced to 0.300 once taxes

and transfers were taken into account. An international comparison using [OECD data](#) for 2021 indicates that, according to the after-tax disposable income Gini score, Canada ranked among the least unequal OECD countries at 0.292 in that year and was much less unequal than the United States, whose Gini score was 0.375.

In any case, Canada's use of highly progressive income taxes to reduce income inequality comes at a cost: it exacerbates disincentives to generate income. The extent of these adverse incentives can be measured. Indeed, the Parliamentary Budget Office (PBO) recently issued a report ([Office of the Parliamentary Budget Officer's report](#) by Perrault) focused on the so-called elasticity of taxable income (ETI). ETI measures the responsiveness of individual taxpayers to changes in income taxation.

The PBO concluded that the ETI of Canadians is relatively high, particularly for those in the higher tax brackets. This means that individuals in this country, especially those with higher incomes (facing higher tax rates), respond to increases in marginal tax rates by reducing their incomes—that is, by working and earning less. It also means that, as the PBO noted, "tax reforms that lead to a decrease in the marginal tax rate for these individuals will have their budgetary impact mitigated by the behavioural response." In other words, the fiscal cost of reducing top marginal rates would be significantly offset by tax revenues from increased work and earnings among taxpayers affected by the reduction.

The opportunity cost of our steeply progressive tax system is the additional wealth Canadians would create if the rate structure escalated less aggressively, with lower marginal tax rates to encourage income generation by all taxpayers.

Vertical and Horizontal Inequities Arising from Progressive Rates

Progressivity is generally justified on the grounds of vertical equity. But Canada has arguably taken this principle too far. According to Statistics Canada's 2022 tax data ([table 11-10-0055-01](#)), the top 1 percent of income earners (those earning over \$283,200) paid 22.1 percent of all personal income taxes; the top 10 percent (those earning over \$111,900) paid 55.2 percent of such taxes. Whatever one's ideological perspective, this seems like a disproportionately heavy tax burden for a relatively small number of Canadians. That said, this result may be precisely the outcome intended 10 years ago when the political choice was made to sharply increase the federal marginal tax rate on Canada's highest income earners. In my view, it ought to be dialed back.

The interaction between Canada's steeply progressive tax system and other features of this system causes insidious horizontal inequities for some ordinary Canadians—individuals who are not necessarily "rich" in the tax policy sense of having an elevated ability to pay.

The PIT system has five basic elements: (1) the tax unit, (2) the tax base, (3) the measurement period, (4) tax rates, and (5) administrative rules. Canada's tax unit is the individual; an alternative tax unit is the family, which is often the economic unit around which people organize their financial affairs. The measurement period in Canada is the calendar year. As a result of this convenient but arbitrary time frame, taxable income (the tax base) is measured over each calendar year, without reference to taxable income in prior or subsequent years. For some taxpayers, these features of our system can distort the measures of their actual ability to pay and, in some cases, result in unfairly high tax burdens.

Consider workers who temporarily reduce their earnings to have children or upgrade their qualifications, or workers who earn income from inherently volatile business sources or from large, infrequently realized capital gains. Over time, these taxpayers could have the same aggregate income—and thus the same ability to pay—as taxpayers with more stable incomes year to year. However, the “lumpiness” of their incomes, measured on the arbitrary annual basis, can push them into higher income brackets in peak-income years, resulting in disproportionately high tax burdens. A 2017 C.D. Howe Institute study ([commentary no. 494](#)) found that this tax penalty for irregular incomes is especially pronounced among lower-income earners and self-employed entrepreneurs. The Carter commission (vol. 3, [chapter 13](#)) recommended that these horizontal inequities be abated by making income averaging available to all taxpayers, and income averaging became a feature of the ITA for many years.

With respect to the taxing unit, the Carter commission (vol. 3, [chapter 10](#)) concluded that a better measure of ability to pay is the consolidated income of families (spouses and dependent children) because families constitute the basic economic grouping in Canadian society. Although the 1972 tax reform did not adopt this recommendation, family income is nevertheless used (appropriately) to means-test eligibility for various social programs and credits, including the [Canada child benefit](#), [Canada workers benefit](#), and [GST/HST credit](#). But the individual, rather than the family, remains the basic taxing unit in Canada, despite the fact that family income may better gauge ability to pay.

If Canada had a flatter rate structure, these inequities would be less consequential. However, by choosing to increase progressivity, Canada has also chosen to increase the potential for unfairness, particularly for individuals with volatile incomes and for families in which one spouse earns most of the income. Under our progressive rate structure, these people may bear heavier tax burdens than similarly situated taxpayers—for example, individuals whose incomes are stable over time, or families in which both spouses earn comparable incomes in the same income bracket.

Elective Income Averaging Alternatives

Although Canada has historical experience with three methods of elective income averaging designed to mitigate horizontal inequities for those with irregular incomes, none has been used since 1988. Limited lump-sum averaging currently applies for specific pay equity settlements (under sections 110.2 and 120.31 of the ITA), but this is not suitable as a model for broader application.

Block averaging (available to farmers, fishers, and authors until 1982) was a backward-looking election that allowed taxpayers to recalculate their tax liability for the current and preceding four taxation years as if their income in each year had been equal to the average income over the five-year period. Any excess tax during those years was then refunded. Taxpayers could not reuse any of the five years in any future block, meaning that the provision could not be invoked again for at least another five years, during which time tax liabilities were computed according to the standard rules.

General income averaging—available to all taxpayers from 1972 to 1982—could apply if a taxpayer's current-year income exceeded a threshold based on the average income from the preceding four years. In such cases, the marginal tax rate applicable to the portion of current income exceeding the threshold (that is, the unusually high income) could be reduced to align with the rate applicable to the threshold level. This mechanism helped taxpayers who were experiencing income spikes in a given year relative to prior years, but it did not offer relief for income reductions.

General forward averaging (applicable from 1982 to 1988) allowed taxpayers to shift a portion of their current-year income into future years. The deferred income was subject to a prepayment of tax and added to an income pool that was later drawn down and taxed at the marginal rates applicable in future years, with credit given for the initial prepaid tax. General forward averaging was thus advantageous for taxpayers anticipating lower income—and therefore lower marginal tax rates—in future years.

Elective Spousal Tax Unit

The Carter commission recommended a mandatory family taxation unit for married spouses and their dependent children. This was not implemented, primarily due to concerns that secondary earners (in the late 1960s, generally married women) would be disincentivized to work because their additional income would in effect be taxed at the higher marginal rate applicable to the primary earner (in that era, usually the husband).

Of course, much has changed since the 1960s, but a mandatory family taxation unit could still create disincentives for secondary earners—regardless of gender. A sensible approach

would be to allow spouses to jointly elect to be taxed as a spousal tax unit. This would be similar to the elective “married filing jointly” option in the United States and in most of the 10 other OECD countries that allow some form of joint tax filing for spouses. The elective spousal tax unit could also be extended to common-law partners. This would promote tax neutrality with respect to the decision to marry, and it would align with the existing equivalence in tax treatment for married spouses and common-law partners under the ITA.

Recommendations

I recommend that Canada’s new government proceed with measures to mitigate some of the unfairness resulting from the steep progressivity of Canada’s PIT system. Specifically, Canada should adopt income averaging and allow the elective treatment of the family—rather than the individual—as the basic tax unit.

Income averaging could be achieved in different ways, as noted above. Block averaging offers the advantage of addressing inequities for taxpayers whose incomes either rise or fall into different income brackets during the relevant years. It is also, arguably, easier for most taxpayers to understand and apply because, as a backward-looking approach, it uses actual recent tax history—making the consequences of electing into the system more predictable. I recommend that block averaging be implemented to alleviate the excess tax burdens imposed on individuals with irregular incomes. Consideration should also be given to reinstating general income averaging and general forward averaging as complementary approaches.

With respect to the tax unit, the Carter commission made a compelling case for measuring ability to pay on the basis of family income. However, this recommendation should be updated to reflect contemporary Canada, permitting spouses (including common-law partners) but not children to elect to be treated as a single tax unit. Such a reform would help restore horizontal equity for families with uneven income contributions and could also help simplify the complex income-splitting rules, which might be rendered redundant by such a measure.

Although these reforms would by no means address all of the challenges in Canada’s PIT system, they would at least mitigate some of the prevailing unfairness arising from steep progressivity. ■

Improving the Competitiveness of Canada’s Personal and Corporate Income Tax System

Jake Fuss and Grady Munro, Fraser Institute

Canada is at a turning point. After years of lacklustre growth, declining rates of productivity, and stagnating living standards, the Canadian economy has taken another hit from punishing US tariffs. In a recent report, the Bank of Canada (Monetary Policy Report—April 2025) estimated that the Canadian economy could enter a “significant recession that permanently lowers the standard of living in Canada.”

It is urgent that we enact policy reforms that will help offset the serious consequences of US tariffs while also addressing longstanding economic issues from well before President Trump’s election. Now is not the time to tinker around the edges of the current system. Canada needs ambitious and meaningful reform. Through the tax system, policy makers, both federal and provincial, should prioritize changes that make Canada’s personal and corporate income tax system more competitive.

Canada’s Personal and Corporate Tax Competitiveness

“Tax competitiveness” refers to the idea that countries around the world compete to attract highly skilled labour, entrepreneurs, businesses, and investments. While many factors determine whether a country can attract these necessary economic ingredients, the tax regime is one lever that countries can use to compete for these resources.

Canada’s income tax rates are less competitive than other advanced countries’ rates. The Tax Foundation (US) recently ranked 38 countries within the Organisation for Economic Co-operation and Development (OECD) from most to least competitive, and it found that Canada’s personal and corporate taxes ranked 31st and 26th, respectively (Mengden, “International Tax Competitiveness Index 2024,” *Tax Foundation*, October 21, 2024). In terms of competitiveness, in other words, Canada’s personal and corporate taxes ranked in the bottom third of advanced countries.

Fuss and Munro, in a 2024 paper for the Fraser Institute, compare Canada’s combined (federal and provincial) statutory marginal personal income tax (PIT) rates with those in the United States and other OECD countries. In the US comparison, combined marginal PIT rates in every Canadian province exceeded those in nearly every US state across a range of incomes—from \$50,000 to \$300,000—as well as at the top marginal rates. In the comparison with other OECD countries, Canada’s top marginal PIT rate of 53.5 percent (based on the combined federal-provincial rate in Ontario) ranked fifth-highest out of 38 countries.

Canada's corporate income tax (CIT) rates are similarly uncompetitive on the world stage. A recent analysis by [Trevor Tombe](#), which compared the combined statutory CIT rates in every country for which the OECD collects data, demonstrated that Canada's representative federal-provincial headline CIT rate of 26.1 percent is higher than the global average, and ranks in the top half of countries. The United States and many European countries impose lower statutory CIT rates than Canada does.

In the same study, Tombe compared the marginal effective tax rates (METRs) imposed on new investments in each country. METRs account for the various credits, deductions, and other features (such as Canada's "accelerated investment incentive") offered by governments that tend to lower CIT liability. Tombe found that although Canada's METR, in the global context, ranks somewhat more favourably than its headline rate, it remains higher than the METR of many peer countries, including the United States, the United Kingdom, and Germany.

Canada's lack of CIT competitiveness is concerning, particularly in the case of its headline rate. Headline CIT rates exert considerable influence over large-scale, highly profitable investments that involve discrete decisions ([Devereux and Griffith, 2003](#); [Bazel and Mintz, 2021](#)). For example, a business considering whether to build a multi-billion-dollar production facility in Canada may focus more on the headline tax rate than on the METR, since the former affects the profitability of the entire investment.

Improving PIT Competitiveness

To improve the competitiveness of Canada's personal taxes, both the federal and provincial governments should seek to lower marginal PIT rates. By lowering Canadian PIT rates relative to the United States and other countries, Canada would better position itself to attract and retain highly skilled labour such as doctors, engineers, and inventors ([Akcigit et al., 2015](#); [Mintz, 2016](#)). Improving Canada's competitiveness is particularly important in the context of the ongoing trade war, which has seen the Canada-US relationship become less cooperative and more competitive in nature.

Lowering marginal PIT rates would also improve economic incentives for working Canadians. The tax rate levied on each additional dollar earned has considerable influence on the behaviour of individuals ([Murphy et al., 2013](#)). By lowering this rate, the government would help stimulate economic growth by improving the incentive for individuals to engage in productive activities such as working, entrepreneurship, and investing. Simply put, greater PIT competitiveness, along with greater incentives to work more or start a business, would help bolster Canada's economy.

Although all governments in Canada should seek to lower PIT rates, we recommend that the federal government take the

lead by implementing ambitious, across-the-board 25 percent cuts to all PIT rates ([Fuss et al., 2025](#)). It is estimated that if these cuts were implemented over two years, total federal revenues in 2026-27 would decline \$15.8 billion (or 3.2 percent) from 2024-25 levels. Such a reduction in revenues, though significant, is neither unprecedented nor insurmountable. British Columbia implemented a similar 25 percent cut to all provincial PIT rates in the early 2000s that, in addition to other tax changes, lowered provincial revenues by 6 percent over two years ([Fuss et al., 2025](#)). In spite of this, the province subsequently balanced its budget while enjoying considerable economic success.

Federal PIT rates currently range from 15 to 33 percent; a 25 percent reduction would result in rates ranging from 11.25 to 24.75 percent—and in a significant improvement in the competitiveness of Canada's PIT rates. This modified federal rate schedule would see Canada's representative top combined marginal PIT rate fall from 5th- to 18th-highest in the OECD. Any additional provincial PIT cuts would further enhance Canada's competitiveness.

Improving CIT Competitiveness

To improve the competitiveness of Canada's corporate taxes, governments should consider more innovative reforms. One policy option is to lower statutory CIT rates. As mentioned above, although Canada's headline rate is not one of the highest in the world, it still has room to improve in relation to the United States and many European countries.

Another more significant policy option is to transform Canada's system of corporate taxes (both federal and provincial) into something entirely new by no longer taxing profits as they are earned but instead taxing only distributions to shareholders. This approach—recommended by both [Mintz and Tombe](#), and implemented by Estonia and Latvia—involves taxing corporate profits only as and when they are distributed by way of a dividend payment, share buyback, or other distribution. Profits that are retained or reinvested would not be taxed. This reform would provide some key advantages over Canada's existing CIT system. In particular, it would help stimulate greater business investment by lowering the METR on new investments that are financed solely by reinvested profits. This effect is quite desirable, given that greater investment is needed to address Canada's current productivity crisis. (See the [December 2023 issue of *Perspectives*](#) for other tax measures designed to improve productivity.)

Reforming the federal and provincial CIT to apply only to profit distributions would also greatly improve Canada's tax competitiveness in relation to that of other advanced countries. As noted, Estonia and Latvia have adopted this approach, and their regimes consistently rank among the most competitive tax systems in the world. In a recent [study](#), [Mengden](#) ranked Latvia and Estonia as the first- and second-most competitive

corporate tax systems in the OECD, respectively. Although compliance with the OECD's pillar 2 initiative (which we, in any event, oppose in principle) poses challenges, the application of pillar 2 to Estonia and Latvia has been deferred for six years, as noted in a recent article by Mengden (*"Pillar Two Implementation in Europe, 2024," Tax Foundation Europe*, November 5, 2024).

Paying for Tax Reform

Although the proposed CIT reform discussed above could be designed to be revenue-neutral (see Mintz, 2022), the proposed cuts to PIT rates would reduce government revenues. Allowing these changes to add to federal debt on an ongoing basis would entail fiscal costs, even when interest rates are low (see Dahlby et al., 2022). Governments should therefore introduce offsetting measures to pay for these reforms.

Research from Alesina and Ardagna (NBER Working Paper no. 15438, 2010) finds that, in efforts to control deficits, reducing government spending is less damaging than increasing taxes. In the past, Canadian governments (both federal and provincial) have utilized spending reductions both to balance the budget and to lower taxes, enjoying considerable economic success as a result (Clemens et al., 2017). Such reductions should involve a comprehensive review of all spending (at both the federal and provincial levels). That said, a recent study highlights eight spending areas—amounting to \$10.7 billion in 2024-25—that could be a starting point for a federal review (Fuss and Munro, 2025).

Governments could also make other changes to the tax system that would offset some of the impact of reduced income taxes while improving economic incentives. Economists have long pushed to change Canada's tax mix by raising value-added taxes (VATs) to offset reductions in income taxes, and this possibility should be explored in future years. As a starting point, governments should broaden the tax base by eliminating selected "tax expenditures." To make Canada more attractive to highly skilled workers and capital investment, the immediate goals should be to reduce the overall tax burden and remove distortions caused by income taxes.

Tax expenditures include all credits, deductions, exemptions, and other special preferences that reduce taxpayers' liability relative to a benchmark tax system. They add complexity and may distort incentives. In some cases, they do little to improve economic incentives or growth, because they may be poorly targeted or redundant, or fail to achieve their intended goals. For example, the federal government provides several tax credits for retirees, such as the age credit and pension income credit, despite the existence of programs intended to serve the same purpose—the Canada Pension Plan, the guaranteed income supplement, and old age security. The layering of measures aimed at the same objective unnecessarily increases complexity.

Both the federal and provincial governments should seek to eliminate inefficient PIT and CIT expenditures, but Fuss and Palacios highlight 49 federal tax expenditures, in particular, that are economically costly and should be reconsidered. Although these include entrenched and longstanding measures, eliminating them would provide a substantial payoff. It is estimated that doing so would have increased federal revenues by \$32.1 billion in 2023-24 alone.

Conclusion

The threat of US-imposed tariffs, combined with stagnant living standards and persistently declining productivity rates, calls for governments across the country to implement new policies that will help Canadians prosper in the face of these challenges. To this end, policy makers should aim to improve the competitiveness of Canada's personal and corporate income taxes. Specifically, they should consider broad-based reductions in marginal PIT rates. They should also consider transforming Canada's corporate tax system into one that taxes only corporate distributions, not reinvested profits. These changes would encourage greater investment in the economy at a critical time. ■

From Buying Canadian to Saving Canada: An Untapped Solution to Our Fiscal Challenges

Armine Yalnizyan, Economist and Atkinson Fellow on the Future of Workers

The chaotic global trade war unleashed by US President Donald Trump guarantees a difficult and profound transition for the Canadian economy. A common recommendation for addressing this challenge is to reduce taxes. In recent election campaigns, virtually all federal and provincial politicians, across the political spectrum, proposed some version of this prescription.

But tax cuts reduce government revenues, creating new problems for the future health of the Canadian economy. If we experience a recession, as is widely predicted, the private sector is likely to shrink, requiring governments to do more, not less. Demographic factors, too, will place higher demands on publicly funded services—such as child care, health care, and long-term care—for the foreseeable future. And the urgent pursuit of greater economic sovereignty and stronger national defence will necessitate greater public investment. In these circumstances, Canada will need more, not less, public revenue.

In this article, I explore the viability of a specific revenue option for the federal government—namely, a modernized version of the Victory Bonds that were issued during past wars. The new retail "Save Canada Bonds" would be available only to Canadian-resident individuals. Purchases would be capped at

an annual per-person limit of \$100,000, and tax-free interest paid only at maturity. While the following discussion provides broad strokes for crafting the proposed new bonds, further work would be required to flesh out the details.

Economic and Fiscal Outlook: Recession and Revenue Loss

Recent policy uncertainty and tariff-rate whiplash appear to make a recession—potentially, a quite prolonged one—in-avoidable in Canada. According to a 2024 Parliamentary Budget Office (PBO) report, a 1 percent reduction in real GDP is estimated to reduce federal revenues by \$4.5 billion, mostly through lower personal and corporate income tax receipts.

In early March 2025, before the full scope, scale, and flip-flopping nature of the tariff announcements had been revealed, and as a federal election unfolded, the PBO published an Economic and Fiscal Outlook. It noted that, should the tariff war proceed as threatened, Canadians could expect real GDP to decline by 2 percent. The PBO has since confirmed to this author that at least \$9 billion in federal revenues could be lost due to Trump's tariffs. On top of the billions in government revenue lost because of reduced economic activity, billions more will be forgone because of tax cuts.

The new Liberal government has not yet produced a budget, but the costing plan it produced for the April 2025 election shows that the planned “middle class” tax cut is expected to reduce government revenues by \$4.2 billion in its first year. The decision not to increase the capital gains inclusion rate will reduce planned revenues by a further \$1.2 billion in 2025-26. It is estimated that the GST cut on home purchases will cost \$383 million this year. Taken together, the planned tax cuts will reduce annual federal revenues by \$10.9 billion by the fourth year (that is, 2028-29). (Notably, the elimination of the consumer carbon tax and related rebate program increases government revenues by \$400 million. See tables A1.6 and A1.7 of Budget 2024.)

If the recession plays out as feared, the government faces difficult choices: raise taxes, spend less, or borrow more. Raising taxes seems politically infeasible, and major cuts to spending at this time seem imprudent. On the spending side, although some efficiency gains may be possible, the savings that result are unlikely to be large enough to offset anticipated increases in defence spending and transfer payments to individuals and provinces. This leaves door number three: borrowing more.

According to the 2023-24 Annual Financial Report of the Government of Canada (at 28), Canada has the lowest net total government debt burden of the entire G7, by a huge margin. Canada's credit rating remains strong, even as the US credit rating declines. Government bond issues are regularly oversubscribed. Currently, a 10-year bond yields 3.25 percent annually. And while Canadian household debt is near record

levels, many Canadians are also saving, some of them a lot. Economy-wide, Statistics Canada shows households are saving at rates not seen since 1996.

Recent volatility in publicly traded equities has reduced the appetite for risk. At the same time, Canadians are alarmed by President Trump's “51st state” campaign and belligerence toward their country—the United States' long-time ally and closest trading partner. (Canada is the world's top destination for American exports.)

The “Never 51” response from Canadians has unified spirits in a way not seen since the 100th anniversary of Canada and Expo 67, creating a “buy Canadian” movement. We could create a “save Canada” movement, too, by encouraging Canadians to put savings to work, reimagining the Canadian economy. Trump has decided to wage trade war. Perhaps it's time for a wartime public finance vehicle.

Wartime Victory Bonds

During the First World War, the Canadian government created Victory Bonds as an option for *all* citizens, not just deep-pocketed investors, to help pay for the wartime effort. Reintroduced during the Second World War, they became even more of a “people's” program. In each case, savers received a guaranteed, government-backed return during a time of huge economic uncertainty.

Victory Bonds were a wild success. During the First World War (as the Canadian War Museum website recounts), more money was raised from the purchase of Victory Bonds than from taxes. Initially, sales were made exclusively to Canadian buyers. The secondary market was tightly controlled, with foreign purchases limited until after the war. Victory Bonds were part of a significant investment reorientation for Canada—away from a substantially international market for Canadian bond issues (with an estimated 87 percent of public and private bonds sold to foreign investors) toward a predominantly domestic market (with approximately 83 percent of such bonds held by Canadian investors during the war). (See David Roberts's account of this process.)

During the Second World War, Victory Bonds were sold in denominations from \$50 to \$100,000, with maturities ranging from 6 to 14 years. Interest rates ranged from 1.5 percent for short-term bonds to 3 percent for long-term bonds, at a time when the central bank's rate was 2.5 percent. The first issue in 1940 sold out in 48 hours. Over the course of nine fundraising campaigns held during the war, almost \$12 billion was raised (\$248 billion in today's terms, which is 54 percent of current annual federal revenues). That is more than was raised by considerably increased tax revenues during the war. Half of the bonds were purchased by corporations, half by individual citizens. Even children (as Ed Stozek has described) were encouraged to participate by buying war stamps at 25 cents each, about \$5 today. When they had saved \$4 worth of stamps, they got a \$5 war savings certificate, a tidy 25 percent return.

A Proposal for Today: Save Canada Bonds

A 2025 version of war bonds would have tax-free returns, like the Victory Bonds in 1917 and 1918. Maturities could be set at 5 or 10 years, with returns based on the prevailing rates for guaranteed investment certificates (GICs) offered by financial institutions (and guaranteed by the Canada Deposit Insurance Corporation) at the time of issue. The tax-free nature of the returns would justify a rate lower than current market yields.

Rather than paying interest annually, Save Canada Bonds would pay compounded annual interest at maturity. This structure would give the government time to invest publicly in ways that spur growth or offset decline while deferring debt-payment obligations during a cash-strapped period.

The 2025-26 fiscal year offering would be limited to \$6 billion. Both the offered amount and the yield would be updated annually over the next five years or longer. Save Canada Bonds could be held only by natural persons resident in Canada. Corporations, trusts, partnerships, and non-residents would be prohibited from holding them. An annual per-person purchase cap of \$100,000 would apply. To encourage savings by workers and even children, denominations could range from \$100 to \$100,000.

Keep your money safe in a time of uncertainty. Build a stronger Canada when we need it. What's not to love? Another pertinent question is: What could go wrong? There are issues to consider.

Pricing

The Canada Savings Bond (CSB), introduced in 1946, was the child of the Victory Bond, but this extremely popular, low-risk initiative became increasingly uncompetitive over time. By the time CSBs were discontinued in 2017, a 10-year CSB offered only a 1.5 percent return, while other 10-year government bonds offered over 2 percent. The yield was too low.

As a result of my *Toronto Star* column of March 21, 2025 (which reinvigorated the discussion of war bonds), the PBO was asked to cost a proposal: namely, a 10-year bond that paid 5 percent annually. The average 10-year government of Canada bond yielded around 3 percent at the time (March 2025). Prohibitive additional costs to the government ruled out the proposal. The yield was too high.

Yields could be set below prevailing market rates because of the tax-free status of the returns—potentially low enough to offset forgone capital gains tax revenue.

Crowding Out

There is nothing more frustrating than wanting to participate in a patriotic act and being barred from entry because some big player got there first. That is why only Canadian-resident individuals would be eligible to purchase these bonds, preventing large pension plans, banks, investment funds, corporations, and foreign investors from a tax-free return at Canadian indi-

vidual taxpayers' expense. An annual individual purchase cap would further promote broad access and help reduce inequality.

Liquidity

In the summer of 1917, the government issued two-year bonds, knowing that some people would need access to their funds sooner than a five-year term allowed. To address this need today, governments could establish rules for a secondary market for people seeking liquidity before maturity. The bonds could also include a provision for early redemption, subject to a penalty.

Mandate

Wartime Victory Bonds not only raised money at the lowest possible cost; they also raised morale in the face of formidable odds. They encouraged voluntary participation to help address a pressing public threat. They were purpose-led. For such a venture, the sales strategy and communication make all the difference.

The government should clearly and widely broadcast how the proceeds of the bond issuances will be deployed. Will they help Canada become a new energy superpower, or help build a modern energy grid to help the country become more energy self-sufficient? Will the funds be invested in critical public infrastructure—for extracting critical minerals, or building affordable housing, or addressing a health crisis? Or will they be used to assist in defending the north? Clarity of purpose is all-important. This can't be a slush fund.

Conclusion

In this “elbows up” moment, no retail vehicle exists for those who want to see some of their savings used to strengthen economic sovereignty and help the government repel US threats. It seems a lost opportunity, patriotically and fiscally.

Like the Victory Bonds issued during wartime, Save Canada Bonds would not only raise funds for the federal government, but also create a new savings refuge, providing asset stability and preservation of value in a time of heightened uncertainty and volatility. Mission-driven bonds are a safe bet, even at low rates of return.

These bonds are likely to be acquired mainly by higher-income individuals who already face hefty tax bills. The tax exemption would allow the bonds to be priced at a “patriotic” interest rate. Holders would benefit by supporting the national cause; at the same time, they would reduce current tax bills and gain a new source of income to fund taxes they incur on other income.

A broad-based desire to participate in shaping our country's future is not just for patriots. It can and should be good for business, investing public funds in a way that leverages greater Canadian development and ownership of the innovations and new ventures needed to build an economy that is less entangled with the United States than in the past.

The next few years will bring tough fights over Canada's economic sovereignty and fiscal stability. Save Canada Bonds offer a powerful addition to our arsenal—a weapon designed for a fight we intend to win. ■

Author's postscript: I am grateful for the insights of Canadian economic historian Shirley Tillotson. Beyond her vast knowledge of literature on the period, Tillotson's own analysis of Victory Bonds in *Give and Take: The Citizen-Taxpayer and the Rise of Canadian Democracy* (Vancouver: UBC Press, 2017) is particularly illuminating. All errors of omission or commission in this article are mine alone.

Canada Can Offer a Contrast to Erratic US Policy

Alan Cole, *Tax Foundation* (US)

Tax policy is always difficult. Canadian policy has been made more difficult by the erratic, unprincipled, and hostile behaviour of the US executive branch, which has already rolled out and suspended or cancelled a variety of tariff plans within just six months of the 2024 US presidential election.

As an American, I believe my government has made serious tax policy errors, errors that will cause Americans and Canadians economic pain. At the same time, these errors present Canada with an opportunity to distinguish itself as a superior policy environment for North American business by avoiding its neighbour's mistakes in the taxation of trade, consumption, and income.

Parry and Capitalize on US Trade Mistakes

First, trade. President Trump's tariff plan is a mistake, and Canada should fend it off while promoting its own superior approach. The US tariffs on Canada violate the United States-Mexico-Canada Agreement (USMCA) and should be removed. Canada should strongly incentivize the United States to remove these tariffs. The incentives could involve retaliation; concessions, such as removing the digital services tax (DST), which is considered discriminatory by the US government; and pressure on the US president, which could be applied by working with American companies.

In the meantime, Canada can tout its superior approach to taxation and trade. For example, Canada has the GST. The GST is similar to value-added taxes (VATs) imposed by virtually all developed countries, with the notable exception of the United States. While both the GST and tariffs impose a tax on imports (a parallel highlighted by Trump), the GST—like most VATs—provides businesses with input tax credits and zero-rates exports. This gives Canada a concrete advantage in tradable manufactured goods: if a firm locates a factory in Canada, imports some intermediate products, and exports a final product to the rest of the world, any GST paid on the imported

intermediate goods is rebated. This approach, known as a border adjustment, creates no extra layer of tax on the manufacturing process, in contrast to Trump's tariffs, which impose real costs on businesses using imported inputs. Canada therefore has a straightforward advantage in selling manufactured goods to the rest of the world.

When it comes to selling into the United States directly, the picture is a bit more complex. A company may benefit from producing goods inside Trump's tariff wall, in the case of a pre-existing factory. For a new facility, however, the tariffs may increase the cost of construction in the short run, with no guarantee that the advantage of the tariff wall will endure after Trump's presidency.

Indeed, the instability of US policy creates a competitive advantage for Canada that extends beyond the merits of any specific tax design. By simply offering stability—a policy trait highly valued by investors—Canada can further attract international capital. It can also reiterate a commitment to the consistent and non-discriminatory use of longstanding tax tools such as income and consumption taxes, making the frenetic US approach all the more unattractive by comparison.

Allot Income Tax Cuts Efficiently

Next, consider income taxes. In recent years, both the United States and Canada have used accelerated depreciation or expensing policies that speed up the deductibility of business capital investment. However, without new legislation to keep these policies, they will eventually be scaled back in both countries. Both are currently considering temporary extensions. In the United States, draft legislation from the Ways and Means Committee would extend most of these provisions through 2029. In Canada, the previous government announced in the 2024 fall economic statement its intention to defer the phase-out of the "accelerated investment incentive" (AII), originally slated to begin in 2024; however, the measure is still proposed to be phased out starting in 2030. It is widely expected that the new government will follow through on these changes.

In both countries, a temporary extension is a good start, but these provisions, which allow for subtle timing changes in expense recognition, should be made permanent. They improve the incentive to invest. An ordinary income tax base, in the absence of expensing, creates a bias against investment. When a company invests in a new plant or equipment, it bears the full cost upfront, but the tax system allows it to deduct that loss of cash only gradually, over many years. This method of tax accounting follows the rules of an income statement. An alternative approach, however, is to follow the logic of the statement of cash flows, which would reflect the investment cost more immediately, aligning tax treatment more closely with the company's actual cash outlay.

The latter approach is superior. The most parsimonious model for making investment decisions is the discounted cash flow analysis, which, as its name suggests, uses the cash flow

standard—not the income standard—to evaluate projects. When tax policy follows the income standard, such that taxable income is recognized before corresponding cash flows are received, taxes are effectively paid “too early,” which discourages investment. Because money today is worth more than money in the future, delaying deductions through amortization or depreciation creates a bias against capital expenses. Legislation that accelerates depreciation ameliorates this problem, and full expensing does so even more effectively.

These policies don’t just help investment; they help it with exceptional efficiency. Some measures designed to boost business investment, such as lowering headline corporate income tax rates, can reduce tax burdens on past investments (known as “inframarginal” investments) that are so profitable they would have been made even under less generous tax rules. Such measures benefit businesses, but they do not change business behaviour. Therefore, tax cuts for pre-existing or inframarginal investments do not accomplish the goal of boosting new investment, though they may have other purposes, such as discouraging the relocation of mobile business operations.

What does change taxpayer behaviour is the tax burden on the marginal investment—an investment that is only modestly profitable and depends on neutral tax treatment to be worthwhile. Canadian economist Jack Mintz calculated this burden in 2021, showing that the tax burden on such investments in Canada declined from 20.7 percent in 2016 to 15.6 percent in 2020, a decline he attributed primarily to the AII ([Bazel and Mintz, in *SPP Research Papers* \(2021\) 14:21](#)).

These timing shifts for investment deductions offer no tax cut for pre-existing investments and only a limited break for wildly profitable investments. However, they provide businesses with a substantial incentive to go ahead with modestly profitable but nonetheless beneficial investments. This makes these deductions more efficient than the typical tax cut.

Mintz noted—and research by my own employer, the US-based Tax Foundation, has also shown—that, owing to this measure, Canada has been more competitive than its peer countries in recent years. Canada should seek to preserve this advantage by making the AII permanent (Mengden, “[International Tax Competitiveness Index 2024](#),” *Tax Foundation*, October 21, 2024).

The United States faces a situation similar to Canada’s: temporary accelerated depreciation policies are set to expire. However, the United States is less competitive, and another problem looms for the upcoming US tax legislation: the president has made a variety of less efficient income tax promises—such as exempting tips, overtime pay, and auto loan interest from income tax. These expensive income tax cuts may “crowd out” the extension of more efficient reforms to the tax base. Canada would do well to limit unnecessary gimmicks and instead preserve its competitive treatment of capital costs. With greater party discipline and a near-majority in Parliament,

Canada’s government may have more cover to focus on sound policy rather than coalition management.

Make Use of Broad Consumption Tax Bases

A final US policy mistake is the weakness or absence of domestic consumption taxes, which forces policy makers to rummage for money elsewhere. Canada should distance itself from the US approach and strengthen its GST base.

Like Canada, the United States has consumption taxes at the subnational level. However, these taxes are applied to a limited, narrow base, excluding some goods and many services, and they often fail to provide input tax credits for businesses. With limited consumption tax bases, US states typically lean on additional revenue sources, such as property and income taxes, to make ends meet.

Unlike Canada, the United States has no federal consumption tax at all. This is another policy mistake—at least, if one accepts current US revenue requirements as given. Consumption taxes, when designed well, are an efficient and broad source of revenue. The US choice to forgo them at the federal level and structure them poorly at the state level has left significant revenue potential untapped.

The absence of a federal consumption tax puts significant pressure on the rest of the US tax system—pressure that it cannot necessarily withstand. The United States currently has comparatively high borrowing rates relative to Canada, which suggests that existing revenues are insufficient. Worse still, US lawmakers sometimes resort to “creative” options to find the missing revenues elsewhere. From Senator Bernie Sanders’s wealth tax to President Trump’s tariffs, most of these novel ideas are misguided.

Peer countries in the Organisation for Economic Co-operation and Development (OECD) frequently apply consumption taxes that have both higher rates and broader bases than the US and Canadian taxes. OECD VAT rates are typically in the double digits; the largest developed markets in Europe, such as the United Kingdom, Germany, and France, have rates exceeding those found even in the highest-taxed Canadian provinces. Furthermore, several countries have broadened their VAT bases to include almost all final consumption, including services and politically sensitive goods. Canada’s system of consumption taxes falls somewhere between the US approach, with its comparatively low rate and narrow base (for example, exemptions for basic groceries and, more recently, for home heating oil), and the broader, more comprehensive approach of a typical OECD country.

On consumption taxes, Canada should lean a bit more toward the model of its OECD peers. Among anglosphere countries, New Zealand stands out for having a very complete GST with almost no exemptions. An effort to broaden the GST base may bring tough political challenges—particularly from GST-exempt businesses—but it could help Canada preserve its

low GST rate while improving revenue collection and reducing pressure on other parts of the tax system. In this context, the current proposal to reduce GST on housing is a step backward. In general, broadening the GST base is likely to be less economically painful than raising rates. For example, improvements to the GST base could create fiscal space for the extension of accelerated investment deductions and for the removal of the DST (a relatively cheap concession), as part of a détente with the United States. Such reforms would distance Canada from the worst US tax policies and make it a stable and attractive destination for global investors eyeing North American markets. ■

The editor of *Perspectives on Tax Law & Policy* welcomes submissions of ideas or of written material that has not been published or submitted elsewhere. Please write to Jeffrey Trossman at jeffrey.trossman@blakes.com.
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