Intelligence MEMOS

From: Kevin Milligan

To: Concerned Canadians

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Re: **Lessons for Canada in Republican Tax Plan**

The tax reform debate in the United States is taking more firm shape in recent weeks, with a new Republican proposal in the House of Representatives that is scheduled for a vote next week.

It would be easy to criticize much about the US House proposal. Three items in particular: the package is deficit-financed, it tilts the benefits of tax cuts up the income distribution ladder to the highest earners, and many of its key elements are only temporary, rather than permanent changes.

But instead of focusing on the negative elements, let's look instead at what positive lessons can be taken from the US tax reform debate to inform the long-run path of tax reform in Canada.

I see two major elements that make sense in the US example that should be considered for future Canadian tax reform efforts.

First, there is a serious attempt to clean up tax expenditures by removing deductions and credits. The US House proposal goes beyond the low-hanging fruit and restricts some of the most politically sensitive tax measures in the US tax code, like the deductibility of mortgage interest and state and local taxes. Limiting deductions brings three benefits. It raises revenue which can be recycled into revenue-neutral tax cuts, it simplifies the tax system, and it allows government efforts to focus on direct spending measures to address social priorities which are often more efficient than ill-targeted tax deductions.

The second noteworthy element of the US House proposal is the introduction of immediate expensing to the corporate tax system in the United States. Immediate expensing front-loads the economic incentive to invest, compared to the normal drawn-out depreciation schedule. When expensing is combined with the removal of interest deductibility, corporate tax is transformed into a cash-flow tax, which removes the tax advantage of debt over equity financing, and also improves long-run investment incentives.

In Canada, both of these areas of taxation need more action. The tax-expenditure review in 2016 did yield a handful of tax expenditures that were removed in Budget 2017. However, it is clear that more work remains to be done on tax expenditures to clean up the Canadian federal tax system.

On corporate taxes, more serious analysis and consideration of fundamental reform, like the Allowance for Corporate Equity proposed by Robin Boadway and Jean-Francois Tremblay for the C.D. Howe Institute, would be fruitful in boosting the growth potential of the Canadian economy.

Of course, with the zigs and zags of the US legislative process, it is still too early to lock in the final tax package that will emerge. But Canadians who care about priming our tax system for fairness and growth can already take some lessons from our American neighbours.

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