

# The Tax System

Progressive taxation should be central to Canada's deficit debate. As a share of the economy, federal spending remains near historic lows. Even if one were inclined to cut expenditures, there is little room to do so. Deficit-fighters should instead focus on the revenue side of the ledger.

The government forecasts that an economic recovery will increase revenues. The Alternative Federal Budget notes that, in a context of high unemployment, job-creation programs would further increase tax revenues. As outlined in the preceding chapter, additional spending on such programs entails a somewhat larger deficit in the coming fiscal year, but smaller deficits in the future.

However, even with low official unemployment before the economic crisis, deep tax cuts had already pushed the federal budget to the brink of deficit. As the Parliamentary Budget Officer recently concluded, "statutory corporate income tax and GST rate reductions push the projected level of structural revenues relative to potential income close to their lowest level since 1976–77."<sup>1</sup> Sustainable federal finances require reversing these tax cuts and/or expanding other taxes.

Last year's AFB struck a balance between running stimulative deficits during the recession and avoiding structural deficits afterward. It proposed a package of tax increases effective July 1, 2011. Most of these increases apply to investment income, which is particularly sensitive to the business cycle and concentrated among the rich. Such tax reform would counter income inequality and generate significantly more revenue as corporate profits and financial markets recover. This year's AFB updates and continues that approach.

Provincial income taxes generally apply to income as defined by the federal government. Although the AFB projects only federal revenues, it is important to note that broadening the tax base to include more capital gains, other investment income and stock options would also substantially increase provincial revenues.

## Tax high incomes

Beginning in the 2011 tax year, the AFB will establish a new 31.5% tax bracket for income over \$250,000. This change will affect only the richest 0.8% of Canadian tax-filers and will coincide

with the expiry of the Bush tax cuts for Americans making more than \$250,000. It will raise \$3.8 billion over three fiscal years.

The AFB will limit RRSP contributions to \$20,000 per year, the maximum in effect for the 2008 tax year. Since RRSP contribution room equals 18% of earnings, only Canadians making more than \$111,000 annually will be affected. By modestly reducing RRSP tax deductions at the top end, this limit will retain \$0.9 billion of revenue over three fiscal years.

### Cap Tax Free Savings Accounts

Although most Canadians do not have sufficient savings to maximize their RRSP contributions, the 2008 federal budget introduced another tax-assisted savings vehicle. Adults will be allowed to contribute up to \$5,000 annually to Tax Free Savings Accounts.

Proponents contend that TFSAs will help low-income earners, who have little incentive to contribute to RRSPs because withdrawals during retirement are clawed back from the Guaranteed Income Supplement. In fact, most of the gains from TFSAs will flow to the affluent minority of Canadians who have significant annual savings in excess of the RRSP-contribution limit. Finance Canada estimates that, as TFSAs expand over the next two decades, their cost will balloon to \$3 billion per year in lost federal revenues.<sup>2</sup>

The AFB maintains the \$10,000 of contribution room given to each Canadian so far, but will not add to it in future years. This policy will enable low-income Canadians to save tax-free without losing GIS benefits, but will not permit the wealthy to accumulate huge additional pools of tax-free savings at public expense. Capping TFSAs will save \$0.2 billion over the first three fiscal years and exponentially more in subsequent fiscal years.

### Fully tax capital gains

Canadian income tax applies to the full value of employment earnings, but to only half the value of capital gains. In 2009, this inequity cost \$3.2 billion in lost personal tax revenue and \$3.2 billion in lost corporate tax revenue. It had been almost twice as expensive prior to the stock-market crash.<sup>3</sup> Half of taxable capital gains (49.6%) accrue to the richest 0.8% of tax-filers, who enjoy annual incomes over \$250,000.<sup>4</sup>

The justifications are that light taxation of capital gains encourages investment and that the portion of capital gains that simply reflects inflation should not be taxed. But trading financial instruments or property often does not lead to genuinely productive investment, as the economic crisis painfully illustrated.

The AFB will tax the full value of capital gains — over and above inflation — that are realized after July 1, 2011. This approach will increase federal revenues by \$12.9 billion over two fiscal years.

### Fully tax stock options

The Canadian tax system treats employee stock options as capital gains rather than as employment earnings, and does not tax such options until they are exercised. The 2000 federal budget introduced some of these provisions in response to the supposed “brain drain” from Canada to the United States, a notion that has since been debunked. In 2009, the favourable tax treatment of stock options reduced tax revenue by \$0.8 billion.<sup>5</sup>

The main beneficiaries are highly-paid corporate executives. Based on the value of options vested or exercised in 2008, this tax subsidy was worth an average of \$700,000 to each of Canada’s top 100 Chief Executive Officers.<sup>6</sup>

Starting on July 1, 2011, the AFB will tax the full value of employee stock options when they are given. Recipients will claim subsequent changes in the value of these options as capital gains or

losses upon realization. This approach will collect an additional \$1.8 billion over two fiscal years.

#### Tax financial transactions

The basic idea of a transactions tax is to raise money by levying a low rate of tax on financial sector activities which are seen to be of limited utility or even damaging to the real economy. Keynes called for a tax on equities trading to reduce the froth of short-term speculative behaviour which had nothing to do with real investment. James Tobin wanted to give greater weight to economic fundamentals and to central banks when it came to the setting of interest rates in the world of opportunity for speculation opened up by floating exchange rates. A low transactions tax, it is argued, has little or no impact upon useful, longer-term transactions, but limits “noise” trading and very short-term “in-and-out” speculation.

The economic crisis has created widespread support for a tax on securities transactions to recoup the cost of bailing out financial institutions. The tax rate would be a small fraction of one percent (0.3% to be exact), low enough to have essentially no effect on the financing of real economic activity. But it would be enough to deter purely speculative activity involving huge volumes of transactions that individually provide very low returns.

European leaders are proposing a financial transactions tax, and the G-20 has commissioned the International Monetary Fund to study the concept. Unfortunately, Canada’s Finance Minister has been the most outspoken opponent. While the U.S. administration has not endorsed a tax on transactions, it is proposing a new tax on the liabilities of large financial institutions.

Various types of financial transactions are liable for taxation. A tax on currency exchanges is the most widely recognized method of this type of transaction. The AFB recognizes that Canada could not realistically tax currency transactions

unless the United States and others also did so. However, in global forums, the Canadian government should be advocating for such a tax rather than against it.

In the absence of international agreement on the subject, the AFB will push forward with a tax on securities transactions in Canada. Every time a stock trades hands, for instance, a small 0.3% charge will be levied. This type of taxation is in line with a similar tax in the U.K. and does not require the same type of international coordination required of a currency exchange tax. Over its first three years, it is expected to raise just under a billion dollars.

#### Reinstate corporate taxes

The AFB will maintain the 2010 federal corporate income tax rate of 18% until July 1, 2011. It will then reinstate the 21% general rate and 1.12% corporate surtax that had been in effect from 2004 through 2007, the year before the recession started. Even when added to provincial corporate taxes, this rate is well below the U.S. average and lower than most G-7 countries.

The AFB’s general corporate tax rate will increase revenues by \$22 billion over three fiscal years. Also on July 1, 2011, the AFB will end the corporate tax deduction for meal and entertainment expenses, saving \$0.5 billion over two years.

As discussed in the Sectoral Development chapter, the AFB will enact a 28% corporate tax rate for the oil and gas industry, raising \$2.2 billion over two years. There are precedents for a special tax rate on oil and gas. While the federal government began cutting its general rate below 28% in 2001, it maintained a 28% rate for resource companies until 2003.<sup>7</sup> The United Kingdom currently levies a higher corporate tax rate for petroleum companies than for other companies.

Canada’s current Conservative government has adopted and deepened corporate tax cuts announced by the previous Liberal government.

Specifically, it has legislated a 15% federal corporate tax rate by 2012.

However, according to Finance Canada's own numbers, corporate tax cuts are the least effective form of stimulus. It estimates that every dollar of annual corporate tax cuts adds only 10 cents to Gross Domestic Product (GDP) in the current year and 20 cents in the next year. By comparison, each dollar of annual infrastructure spending adds a dollar to current GDP and \$1.50 to next year's GDP.<sup>8</sup>

Corporate tax cuts have also proven ineffective at promoting investment over the longer-term. As Statistics Canada observes, "Over much of the last decade, corporations as a whole have been posting record profits. Meanwhile, business fixed capital investment has been relatively sluggish in recent years." Before the financial crisis, TD Bank noted that the ratio of business investment to profits had fallen to an all-time low.<sup>9</sup>

The C.D. Howe Institute has built the case for corporate tax cuts around lowering Canada's marginal effective tax rate (METR) to compete with other countries. But marginal tax rates are not the appropriate measure of international competitiveness. An investor deciding where to locate a facility is concerned about the investment's total tax liability (i.e., the average tax rate), not the tax on the last dollar invested (i.e. the marginal rate).<sup>10</sup>

In any case, the Institute exaggerates Canada's METR. Specifically, its calculations exclude local business taxes, which are particularly low in Canada, and research and development tax incentives, which are particularly generous here. It includes inventories, which Canadian tax-accounting rules subject to an especially high METR. But the goal is surely to promote investment in fixed capital as opposed to inventories. Yet, even by the C.D. Howe Institute's overstated measure, Canada's METR is already in line with the global average, if countries are weighted according to economic size.

If reducing Canada's METR were an important priority, across-the-board CIT cuts are not a cost-effective way of doing so. The C.D. Howe Institute estimates that Canada's METR fell by 0.9% between 2008 and 2009. Only 0.3% of this reduction reflected the half-point cut in the statutory corporate tax rate between those years. The remaining 0.6% reflected the accelerated capital cost allowance for computers introduced in the 2009 federal Budget.<sup>11</sup>

Finance Canada estimates that accelerated depreciation for computers costs \$350 million annually.<sup>12</sup> Cutting the corporate tax rate by half a percentage point cost more than twice this amount, but reduced Canada's METR by only half as much. In this case, the targeted measure was at least four times more cost-effective than across-the-board tax cuts.

About one-third of the revenue lost through corporate tax reductions will simply be transferred to the U.S. government, which taxes American corporations on a worldwide basis. When an American company repatriates profits from Canada to the United States, it pays the 35% American federal corporate tax rate minus taxes already paid in Canada. If our federal plus provincial rate is at least 35%, these corporations do not owe American tax on their Canadian profits.

Ongoing federal and provincial corporate tax cuts are reducing our combined rate from 36% in 2007 to 25% by 2013. American companies operating here will have to pay this rate difference back to Washington, shifting up to \$6 billion annually from Canadian governments to the U.S. Treasury. If provincial governments also stopped cutting their corporate taxes, the AFB's federal corporate tax proposals would be sufficient to retain most of this revenue in Canada.<sup>13</sup>

#### Partially reverse the GST cut

The GST is a regressive tax, but an important source of needed public funds. The Conservative government cut it from 7% to 5%. The AFB

**TABLE 7 AFB Tax Measures**

|                                      | 2010–11 | 2011–12   | 2012–13    |
|--------------------------------------|---------|-----------|------------|
| 31.5% Top Personal Income Tax Rate   | (\$386) | (\$1,639) | (\$ 1,755) |
| Cap Annual RRSP Contributions        | (\$240) | (\$ 293)  | (\$ 347)   |
| Cap Tax Free Savings Accounts        | (\$ 5)  | (\$ 50)   | (\$ 190)   |
| Fully Tax Capital Gains              |         | (\$4,920) | (\$ 8,000) |
| Fully Tax Stock Options              |         | (\$ 705)  | (\$ 1,050) |
| Financial Transaction Tax            | (316)   | (323)     | (329)      |
| 22.12% General Corporate Tax Rate*   | (\$661) | (\$8,086) | (\$13,300) |
| 29.12% Corporate Tax for Oil and Gas |         | (\$ 925)  | (\$ 1,308) |
| No Meal and Entertainment Deduction  |         | (\$ 208)  | (\$ 314)   |
| 6% Goods and Services Tax            |         |           | (\$ 5,175) |

\* Also includes maintaining 18% through June 30, 2011.

will ultimately restore a 6% rate to regain half of the lost fiscal capacity and more than compensate low-income Canadians by enhancing the refundable GST credit. More broadly, the progressive effect of higher public expenditures will more than offset the regressive effect of higher consumption taxes.

However, the recession proved worse than expected, so stimulating consumer demand to propel a recovery remains a high priority. Mid-2011 may still be the wrong time to increase consumption taxes. Therefore, this year's AFB leaves the GST rate at 5% until July 1, 2012. This delay will also give residents of Ontario and British Columbia longer to adjust to the Harmonized Sales Tax (which includes the GST) before increasing its rate by 1%. During the portion of the 2012–13 fiscal year that this additional point of GST will apply, it will generate an additional \$5.2 billion of public revenue.

### Notes

<sup>1</sup> Office of the Parliamentary Budget Officer, *Estimating Potential GDP and the Government's Structural Budget Balance*, January 2010, page ii.

<sup>2</sup> Finance Canada, *Budget 2008*, p. 82.

<sup>3</sup> Finance Canada, *Tax Expenditures and Evaluations 2009*, pages 16 and 23.

<sup>4</sup> Canada Revenue Agency, *Income Statistics 2009*, Basic Table 2 (data for the 2007 tax year).

<sup>5</sup> Finance Canada, *Tax Expenditures and Evaluations 2009*, page 15.

<sup>6</sup> Hugh Mackenzie, *A Soft Landing: Recession and Canada's 100 Highest Paid CEOs*, CCPA paper (January 2010), page 10.

<sup>7</sup> Finance Canada, *Budget 2003*, p. 146.

<sup>8</sup> Finance Canada, *Budget 2009*, p. 240 (Table A1.1).

<sup>9</sup> References for this paragraph are available in Andrew Jackson and Erin Weir, "The Conservative Tax Record," in *The Harper Record*, edited by Teresa Healy (Ottawa: CCPA, 2008), pp. 58–60.

<sup>10</sup> Robin Boadway, "National Tax Policy for an International Economy: Comments," in *Room to Manoeuvre?*, edited by Thomas Courchene (Montreal & Kingston: McGill-Queen's University Press, 1999).

<sup>11</sup> Duanjie Chen and Jack Mintz, *The Path to Prosperity: Internationally Competitive Rates and a Level Playing Field*, C. D. Howe Institute Commentary No. 295 (September 2009), page 15 (Table 4).

<sup>12</sup> Finance Canada, *Budget 2009*, p. 185 (Table 3.8).

<sup>13</sup> Erin Weir, *The Treasury Transfer Effect: Are Canada's Corporate Tax Cuts Shifting Billions to the U.S. Treasury?*, CCPA paper (November 2009).