Fair and Progressive Taxation

Background

The tide is finally turning.

After decades of tax cuts that largely benefited the most affluent and large corporations, there is now growing recognition around the world that these policies have failed. Regressive and unfair tax cuts have done little to grow the economy. Instead they've reduced revenues, increased deficits, increased inequality and led to cuts in public services.

Public pressure and political change have finally led to the introduction of progressive tax measures by many governments to help raise higher revenues and make tax systems fairer. But it's not just the public and politicians who are now advocating progressive tax measures. Economists and traditionally conservative organizations such as the International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD) are advising governments to eliminate regressive tax loopholes and introduce progressive tax measures to raise revenues and improve the effectiveness of their tax systems. Business organizations and some of the world's wealthiest individuals have also urged politicians to increase taxes on business and top incomes.

The Alternative Federal Budget (AFB) has called for progressive tax measures in Canada for many years. There is even greater urgency to reform our tax system now. These measures must take account of current economic circumstances and not undermine economic recovery, while establishing a fairer, more equitable tax system that supports sustainable economic growth based on the principles of good tax policy.

Good tax policy demands that our taxes be designed as an integrated system. Income from different sources — whether from employment, business, or investments — should be subject to relatively similar rates of tax; otherwise those with the means to shift income to lower-taxed areas will do so. This is a deadweight loss for the economy and undermines the integrity of the tax system.

To prevent widespread tax avoidance, tax collection must be supported by fair, effective enforcement. Regressive taxes that fall more heavily on lower incomes — such as sales, property, and payroll taxes — should be balanced with much more progressive income taxes and tax credits to make the overall tax system fair.

The tax system also needs to be simplified by eliminating ineffective and unfair deductions and loopholes. In many cases direct public support — e.g., for children's sports and recreation, public transit, research and development, post-secondary education, and child care — is much more cost effective and fair than tax deductions and benefits for these activities. Some tax preferences — such as for stock options — have not only been highly inequitable, but have also had a perverse and negative effect on the economic behaviour of CEOs and their companies. Reforms to simplify these aspects of the tax system will not only make it more effective economically, they will also reduce the costs of adminis-

tration and compliance for the government and public alike.

The following sections summarize major tax measures included in this year's AFB. More details on specific measures and estimated revenues are included in a background document.

Introduce A New Federal Tax Bracket of 35% on Income Over $250,000

Canada's richest 1% has taken the lion's share of income growth over the past decade, but it pays a lower overall rate of tax than all other income groups, including the poorest 10%.

Three decades ago, before a succession of Conservative and Liberal governments cut their tax rates, Canada's top federal income rate was 43% for taxable income over $119,000 (equal to about $290,000 today) and 39% for incomes over $77,400 (about $190,000 in current dollars). Now Canada's highest income tax rate is only 29% for taxable income over $135,054. This applies whether your taxable income is $150,000 or $15 million.

Canada's top federal income tax rate is far below the top U.S. federal income tax rates. These were raised from 35% to 39.6% for income over $400,000 in President Obama's recent budget agreements with the Republicans. Effective income tax rates on top incomes in the U.S. are even higher because the value of personal exemptions are phased out for higher incomes and because payroll taxes aren't capped.

The AFB will restore badly needed progressivity to Canada's tax system by introducing a new federal tax rate of 35% for taxable income over $250,000. This new rate will only affect the less than 1% of Canadians who make more than $250,000 and will only apply to their income above this level.

Estimated revenue: $2.7 billion (explicitly accounts for elasticity and other impacts, e.g., capital gains).[1]

Restore Corporate Tax Rates

The federal government has slashed tax rates for business over the past decade, cutting the corporate tax rate in half from 29.12% in 2000 to 15% in 2011 while also eliminating capital taxes and reducing taxes on capital gains.

These and other cuts for business were supposed to stimulate investment and trickle down in the form of higher wages for workers, but instead the opposite has happened. Corporate profits have escalated along with CEO and executive compensation, while business investment as a share of the economy has declined and productivity along with real wages have been stagnant. As a result, corporations have stockpiled over $600 billion in cash and short-term securities — equivalent to more than a third of Canada's annual economic output.[2]

Little of this has trickled down to ordinary Canadians and increasing amounts are flowing out of the country.

Canada's average combined federal and provincial corporate tax rate, at 26%, is lower than most other major industrialized nations, and notably lower than the United States combined average federal-state corporate tax rate of 39%. Corporate income tax rates in Ireland, Iceland, Greece and some Eastern European countries remain at 20% or lower. These countries led the race to the bottom with corporate tax cuts during the last decade. These corporate tax cuts helped fuel an unsustainable boom and then financial crisis

and bust in their economies from which they are still trying to recover. Our federal government should learn from their mistakes and not continue to try and emulate them. Even business groups, such as the New Brunswick Business Council have called on their government to increase corporate tax rates.

Tax rates on corporate income that are significantly lower than personal income tax rates also fuel wasteful tax avoidance activities by those with the ability to channel and retain income through corporations taxed at a lower rate. This makes it appear that lower tax rates stimulate economic activity and higher revenues, when in fact much of it is just accountants shifting income to take advantage of lower rates.

The Alternative Federal Budget will ramp up the federal general corporate income tax rate to 21% by January 1, 2016. This is the same rate that applied in 2007 but without the 1.12% surtax that was in effect until that year.

The corporate income tax rate on the oil, gas and minerals sector will be restored to the higher rate of 28% outlined in the Sectoral Development chapter. These are the most profitable in Canada, yet they benefit from large direct and indirect subsidies — including tax preferences and low royalty rates — with a large share of the profits going to foreign owners. Canada's wealth of non-renewable resources should be shared, and not exploited and exported as rapidly as possible at the expense of future generations. Higher tax rates on this sector will also help to stabilize the economy by moderating the boom-bust episodes they generate.

Estimated revenue: $8 billion.

Eliminate Tax Loopholes and Simplify the Tax System

Canada's tax system has become riddled with an array of ineffective, regressive, and expensive tax preferences and loopholes. While some tax credits and deductions are effective and progressive, others do little more than benefit the wealthy and distort our tax system.

In most cases, providing direct funding for public programs — such as public transit, child care, post-secondary education, research and development, sports and arts programs, and services for the disabled — is much more effective than tax preferences or benefits in these areas. The 2012 Federal Budget took a positive step in this direction by limiting and reducing the value of the Scientific Research & Experimental Development tax credit and increasing direct grants — as the AFB and the federal Expert Panel on Support to R&D had recommended.

Eliminating costly tax preferences would not only supply funds to provide more effective and targeted programs in these areas, it would also simplify the tax system. This might mean less work for tax accountants, but it will also mean fewer headaches and less time spent filling out tax forms for Canadians.

One of the most egregious tax loopholes is the *stock option deduction*, which allows high-paid executives to pay tax on their compensation at half the rate ordinary Canadians pay on their employment income. Not only is it highly regressive, but it also helps fuel the kind of reckless speculation and stock manipulation that resulted in the financial crisis.

The related capital gains deduction allows investment income to be taxed at half the rate of employment income, but it doesn't adjust for inflation or encourage longer-term

TABLE 5 Tax Loopholes and Preferences

	2013 Revenue
Eliminate stock option deduction, which costs the federal government an estimated $760 million a year, with 90% of the benefits of this loophole going to the top 1% of tax filers.	$760 million
Tax personal and corporate capital gains at the full rate, instead of at half the rate of ordinary employment and business income. However, the gains would be adjusted for inflation so taxpayers don't pay taxes on increases solely due to inflation.	$6,300 million
Eliminate the corporate meals and entertainment expense deduction. This allows businesses to deduct the cost of meals and entertainment, such as private boxes at sports events.	$400 million
Eliminate mining and fossil fuel tax subsidies. The fossil fuel and mining industries, which benefit from low provincial royalty rates, also continues to benefit from significant federal tax subsidies. These include the accelerated depreciation, the Canadian exploration expense, the development expense and flow-through share deductions. The federal government has promised to reduce some of these subsidies, but these are limited.	$1,400 million
Cap Tax Free Savings Accounts (TFSAs). TFSAs, which now provide taxpayers with $20,000 in tax-sheltered investment room and are increasing every year, could eventually cost the federal government over $6 billion a year in foregone revenues. The AFB will cap TFSAs at a total lifetime amount of $20,000. The savings from capping this program may be relatively low in the first year, but they escalate in future years.	$100 million
Withholding tax on assets held in tax havens. Wealthy Canadians and businesses hold over $160 billion in tax havens, kept there both to avoid scrutiny and taxes. Applying a modest 1% annual withholding tax to these assets would generate $1.6 billion annually and encourage those with funds offshore to bring their assets back home.	$1,600 million
Total	**$10+ billion**

investment. The AFB would make the tax system fair by taxing income from capital at the same rate as employment income after adjusting for inflation.

The AFB would eliminate a number of other tax loopholes and preferences. These include tax preferences for meals and entertainment expenses, fossil fuel tax subsidies, and other areas. The AFB would increase the effectiveness of public spending by eliminating these tax expenditures while increasing program funding in these areas.

In addition to eliminating costly, regressive and ineffective tax preferences and loopholes and simplifying tax returns, the AFB will make filing taxes much easier and less expensive by providing online software for free filing for all tax returns through the Canada Revenue Agency. Canadians shouldn't have to spend money to file their taxes.

Estimated revenue: approximately $10 billion.

Increase Taxes on Banks and Finance

Canadian banks are racking up another year of record profits. Not only have banks and other financial institutions benefited more than any other industry sector from corporate tax cuts, but they also benefit from the exemption of financial services from value-added taxes such as the GST and provincial Harmonized Sales Taxes.

Following the global financial and economic crisis, there's been a strong revival of interest around the world in financial transactions taxes (FTTs) and other forms of taxing finance. These are being implemented to pay for some of the costs of the crisis, to reduce excessive financial speculation and activity, steer more resources into productive investments, and reduce the risk of further financial crises. Taxes on finance are also highly progressive, since they are paid almost entirely by the financial sector and by wealthy individuals, and thus reduce inequality.

France and Hungary have just introduced FTTs at a national level over the past year while Italy, Spain and Portugal have also announced their intention to do so. The European Parliament also overwhelmingly voted to allow 11 member states to proceed with a harmonized FTT through the European Union's process of "enhanced cooperation." The European Commission estimates that a European-wide FTT at rate of 0.1% on stocks with even lower rates on bonds and derivatives could generate $85 billion annually.

Financial transactions taxes can be more effective if they are implemented through international agreements at a global level, but that hasn't stopped numerous countries — including Switzerland, the U.K. and China among many others — from having very effective financial transactions in place for decades (and for centuries in the case of the U.K.).[3]

The Alternative Federal Budget would seek an agreement with provinces to introduce a broad-based financial transactions tax at a rate of 0.5% on transactions of stocks — the same rate as exists in the U.K. — and at lower rates on bonds and financial derivatives. This would generate over $4 billion a year in annual revenues (assuming a 50% reduction in volume, largely high-frequency trading).

If there are obstacles to introducing a financial transactions tax as a result of provincial jurisdiction over securities, the AFB will proceed with a Financial Activities Tax on the financial sector, as proposed by the IMF to compensate for the exemption of financial services from value-added taxes. A Financial Activities Tax at a rate of 5% on financial sector profits and compensation would generate approximately $5 billion annually.

Estimated Revenues: $4 billion.

Introduce Smart Green Taxes, Including a Progressive Harmonized Carbon Tax

Following the failure of the Kyoto Protocol, which was based on an international cap-and-trade scheme, worldwide greenhouse gas emissions are now 58% higher than they were in 1990 and not five percent less as was set out in the climate change treaty.

It's not just the Kyoto Protocol that has failed, but regional emission trading schemes such as Europe's have had numerous problems, including high price volatility, fraud and windfall profits. Some suggest that, despite costing close to $300 billion, they have had almost no effect[4] in reducing emissions; at the same time, providing carbon credit funds to certain projects has often had perverse and negative[5] consequences for impoverished and indigenous people in the developing world.

It's time for a new approach.

Canada should move forward with a national carbon tax integrated with provincial carbon taxes, with a large share of the revenues going towards a strongly progressive green tax refund. This will ensure that a

majority of Canadian households would always be better off after accounting for their increased costs as a result of the carbon tax.

Carbon taxes are more transparent, less corruptible and economically more efficient mechanisms for putting a price on carbon than quantity quotas through cap-and-trade schemes. Carbon taxes also provide a clear price signal for business, organizations, and consumers, and avoid the speculation, uncertainty and unfair windfall gains associated with cap-and-trade systems. Many European nations have effective carbon taxes and there's increased interest in the United States for carbon taxes, with a proposal for a $30/tonne carbon tax from MIT even endorsed by David Frum, the Canadian-born U.S. Republican party advisor.

A national carbon tax would also include border tax adjustments on imports and exports to ensure Canadian industry isn't put at a competitive disadvantage.

Imports from countries that don't have similar measures will be taxed at an appropriate rate to reflect emissions associated with their production, processing and transport, with an exemption for imports from highly impoverished nations. Exporters to countries without similar climate change measures would be provided rebates. These border tax adjustments would put pressure on other countries to enact climate change measures.

As with all forms of carbon pricing, carbon taxes are regressive. They most hurt those on low incomes, who also have the least ability to adapt and invest in more efficient measures. Hence a large share of the revenues raised would be devoted to a progressive green tax refund which would provide a majority of Canadians with a larger annual credit than they pay out in carbon taxes.

To maximize its effectiveness, a national carbon tax will be combined with complementary investments in research and development, energy efficiency, renewable energy, incentives, regulations, and education and other measures to help industry, communities, and workers adapt.

A national carbon tax at a rate of $30/tonne would be introduced on July 1, 2015, raising approximately $10 billion a year from the 350 megatonnes emitted from transportation, heating and other relatively small sources. It would generate another $7.5 billion annually from the approximately 500 large industrial facilities responsible for 250 megatonnes, or more than a third of Canada's total greenhouse gas emissions. The federal tax would apply where provincial carbon taxes are not in effect or are at a lower rate. Gross revenues net of provincial adjustments and border tax adjustments would be approximately $15 billion annually.

A green tax refund would be introduced earlier on January 1, 2015, at an approximate cost of $7.5 billion annually, with cheques sent out for $300 per person and amounts phased out for family incomes above $100,000. This annual amount is higher than the quarterly GST credit payments and would be available for family income levels at twice the maximum GST income threshold. Additional credits would be provided for those living in northern and rural communities where fuel and energy use is generally higher.

It would be increased as necessary to meet Canada's greenhouse gas reduction targets. The credit would be increased together with increases in the carbon tax at a rate of $10 per $1/tonne increase in the carbon tax. This would ensure that a majority of Canadian households would always be better off.

Gross revenue: $15 billion
Green Tax refund: $7.5 billion
Net income: ~$8 billion

Inheritance tax

Unlike the United States and most European countries, Canada has no wealth, inheritance, or estate tax. Capital gains taxes may be levied on some portion of inheritances, but they don't apply to the base amounts and are often avoided. This means those who are lucky enough to be born into a privileged family can benefit from enormous inheritances without paying any tax.

The AFB proposes a minimum inheritance tax of 45% on large estates that are passed on to the heirs of wealthy families on amounts in excess of $5 million. It would apply in a similar way as the Estate Tax in the United States, prior to and integrated with capital gains taxes, and at similar rates that have applied there.[6]

Estate and Gift Taxes have generated between $20 billion and $30 billion in revenue annually[7] in the United States. It is reasonable to assume that a similarly designed estate tax in Canada would generate approximately $1.5 billion a year in revenues.

This inheritance tax would only apply to amounts in excess of $5 million (e.g., after a $5 million deduction). Capital gains taxes would continue to apply for inheritances below $5 million, but at the full rate and indexed for inflation. This means for inheritances of cottages or other property that have been held in the family for decades, taxes would likely be lower than under the existing system.

Revenue: approximately $1.5 billion in 2014–15.

Notes

1 This analysis is based on Statistic Canada's Social Policy Simulation Database and Model (SPSD/M). The assumptions and calculations underlying the simulation results were prepared by David Macdonald and the responsibility for the use and interpretation of these data is entirely that of the authors. The SPSD/M simulation "morning after" estimate is $3.9 billion. However, the AFB assume only 70% will be collected, leaving $2.7 billion.

2 Stanford, Jim. (2013). "The Failure of Corporate Tax Cuts to Stimulate Business Investment Spending" in *The Great Revenue Robbery*, Between the Lines Publishing.

3 Sanger, Toby. (2013). "Financial Transaction Taxes: The Battle for a Small but Important Tax" in *The Great Revenue Robbery*, Between the Lines Publishing; also *Fair Shares: How Banks, Brokers and the Financial Industry Can Pay Fairer Taxes*, (2011). CCPA.

4 http://www.theaustralian.com.au/national-affairs/europes-287bn-carbon-waste-ubs-report/story-fn59niix-1226203068972

5 http://www.thecarbonrush.net/

6 The U.S. Estate Tax was at a 55% rate for estates above $675,000 in 2001, but has been reduced since then. It was gradually reduced to a 45% rate that applied from 2007 to 2009, but has been temporarily re-introduced at a 35% rate for estates over $5 million for 2011 and 2012.

7 http://www.cbo.gov/ftpdocs/108xx/doc10841/Estate_GiftTax_Brief.shtml