Fair and Progressive Taxation

Background

After seven years of deficits created by cuts to the GST and corporate income tax, as well as the 2008–09 financial and economic crisis, the federal government will likely balance its budget this year. Despite declines in the price of oil, the federal government is expected to record growing surpluses over the longer term in part because of steep cuts to federal programs and services that will bring federal spending as a share of the economy to a 70-year low.

The big question is what should we do with these surpluses? Should we use them to cut taxes, pay down the debt, or to invest in our communities, public services, and the economy?

It is clear what direction the federal government wants to take. The Family Tax Cut, announced in October, would allow couples with children under age 18 to nominally transfer up to $50,000 in income from the higher earning spouse to the lower earning spouse, potentially lowering the tax liability of the higher earning spouse.

The federal government's income splitting policy is designed to benefit families where there is one middle- or high-income earning parent and one parent with little or no income. The result is that the benefits of income splitting are highly concentrated among high-income families, whose incomes already make it possible for one parent to forgo paid work to spend more time with their children. Only 50% of families with children under 18 will receive any benefit from income splitting, and that is only if they can navigate the 85 additional steps on their tax forms. Of that 50% who gain, 18% will receive roughly a dollar a day. Only 11% of families with children will receive the maximum $2,000 benefit from income splitting. This benefit to a small number of high-income families will come at an estimated cost of $2 billion annually.

Regressive tax cuts have already reduced federal revenues to the smallest share of the economy they've been in over 70 years — before we had universal health care, the Canada Pension Plan, and Employment Insurance. These and other federal public services are much diminished because of the current cuts. If federal taxes were at the same share of the economy as in the year 2000, they would be $50 billion higher — and there would have been no need for the cuts the government made to supposedly balance the budget. We certainly don't need any more regressive tax cuts.

The federal government is also planning to increase the annual limit for income that can be sheltered in Tax Free Savings Accounts (TFSAS). While one argument for introducing TFSAS was to provide those with lower incomes a more effective way of saving for retirement, only a small share of those with lower incomes make use of this

tax. Only 2% of the total tax benefit of TFSAS go the fifth of Canadians with the lowest incomes. A whopping 37% of the benefits of TFSAS go to the richest fifth of Canadians.[1] Increasing the annual limit will just exacerbate this inequality. The cost of TFSAS grows substantially over time, as more savings are cumulatively sheltered. This tax cut currently costs $410 million. However, that cost is expected to grow to $14.7 billion a year to the federal government and $7.6 billion to the provinces in lost revenue by 2060.[2]

We need to boost revenue by restoring the fairness and progressivity of our tax system, and use this to re-build Canada.

Our tax system must be reformed so that it:

- *Promotes equity and equality.* Canada's overall tax system has become so regressive that the top 1% pays a lower share of income in tax than the poorest 10%.[3] Not only is this unfair, it's also bad for the economy. The IMF, World Bank, OECD and Standard and Poors now agree that growing income inequality is hampering economic growth. We need to restore fairness and progressivity to our tax system. Our tax system should also be used to promote intergenerational equity, as a tool to reduce pollution and damaging climate change.
- *Increases efficiency.* To minimize distortions, taxes should be broadly based with limited tax loopholes, except where justified for reasons of equity or effectiveness. The last reform of Canada's tax system — back in 1966, almost 50 years ago — was based on the principle that "a buck is a buck," which meant that income from different sources should be taxed at similar rates. There are so many loopholes and opportunities for tax avoidance that few wealthy people pay their fair share, and the tax system has become so riddled with ineffective tax measures that it is almost impossibly complicated to navigate without the assistance of a tax professional. A priority for tax reform should be to tax income from capital and business at the same rate as income from labour, and to eliminate regressive and ineffective tax measures and loopholes.
- *Is effective.* Tax rates should be sufficient to raise revenues to pay for the public services Canadians need and deserve. Varying rates exemptions, deductions, and credits should be used only where they are proven to be more effective than alternatives for achieving important economic, social, and environmental objectives. Our governments should enforce tax laws by strengthening instead of weakening the compliance of wealthy corporations and individuals so that everyone pays their fair share.

Major Initiatives

Eliminate Regressive, Ineffective Tax Loopholes and Simplify the Tax System

Canada's tax system has become riddled with ineffective, regressive, and expensive tax loopholes and preferences. While some

tax credits and deductions are effective, progressive, and make sense, others do little more than benefit the wealthy and distort the tax system. The AFB would immediately take steps to eliminate or restrict the most regressive of these, including:

- *Family income splitting*: This primarily benefits a small minority of the highest-income families and is economically as well as socially regressive. *Annual savings: $2 billion.*

- *Tax Free Savings Accounts*: Total lifetime contributions for TFSAs will be capped at existing levels, e.g. $36,500. *Annual savings: $100 million, but rising rapidly.*

- *Stock option deduction*: This loophole allows CEOs and executives to pay tax on their compensation at half the rate the rest of us pay on our employment income. It is not only highly regressive, it is also expensive and bad for the economy because it distorts business decisions by encouraging CEOs to inflate short-term stock prices through share buybacks (thereby padding their own wallets) instead of investing in the economy. *Annual savings: $610 million.*

- *Capital gains deduction*: Individuals and corporations with income from capital investments are also able to pay tax at half the rate of employment income through the capital gains deduction. This is also a very expensive loophole, costing the federal government over $9 billion annually, with most of the benefits going to corporations and wealthy individuals. The AFB would tax income from capital at the same rate as employment income after adjusting for inflation. Other existing capital gains exemptions, such as for principal residences, family farming, fishing, small business, personal use property, etc., would be maintained. *Estimated net annual savings after adjusting for inflation, behavioural factors, and higher underlying tax rates: $7.5 billion.*

- *Corporate meals and entertainment expense deduction*: This allows businesses to deduct half the cost of meals and entertainment expenses, including the cost of season's tickets and private boxes at sports events. It can be used for inappropriate lobbying, is widely abused, and makes some sporting events inaccessible for ordinary Canadians. *Annual savings: $400 million.*

- *Fossil fuel and mining subsidies*: While they have been scaled back, federal tax subsidies to the fossil fuel and mining industries still amount to hundreds of millions annually. The AFB would cancel those direct subsidies (see the Environment and Climate Change chapter).

- *RRSP contributions*: As outlined in the Retirement Security chapter, the AFB would limit RRSP contributions to $20,000 annually and cancel pension income splitting. *Annual savings: $2.6 billion.*

- *Post-secondary education tax measures*: The AFB would replace a range of tax credits with significantly reduced tuition fees and direct, income-tested

grants (see the Post-Secondary Education chapter).

The AFB will also eliminate or restrict a number of other boutique tax credits and use the savings as part of significantly increased funding for public programs, such as public transit, fitness, recreation, and research and development. Direct public funding is generally far more effective than tax credits and preferences.

Restore Corporate Income Tax Rates

The AFB will increase the federal general corporate income tax rate from 15% to 22%, just below what it was in 2006, but considerably below the 29.1% rate it was 15 years ago. Restoring the general corporate income tax rate from 15% to 22% will provide estimated additional annual revenue of $12 billion. As part of this increase, the AFB will introduce a 7% non-refundable Investment Tax Credit (ITC) on profits invested in fixed assets in Canada in excess of depreciation. Upon full implementation the ITC would have an annual cost of $8 billion. Structured in this way, the ITC would only provide a reward to companies investing in Canada, not all companies, as a generalized corporate tax rate reduction has in the past.

The deep corporate tax cuts of the past decade have failed to stimulate business investment, which is lower as a share of the economy than it was in 2000. Since then corporations have made record profits and amassed over $600 billion in excess cash surpluses, which they have used for speculative purposes, which is destabilizing for the economy.

The AFB will also increase the income tax rate that applies for "small business" (for the first $500,000 of business profit) from 11% to 15% to preserve proportionality between these rates. The estimated increased annual revenue from increasing the small business tax rate will be $2.2 billion.

Introduce a New Top Income Tax Rate of 35% on Incomes Over $250,000

The top 1% of income earners have accumulated a large share of total income growth over the past three decades in Canada, as they have elsewhere in the world. We need income taxes to be more progressive to counterbalance the regressive impact of sales, property, and payroll taxes so the overall tax system is fair. The federal government's top rate at 29% for taxable income over $138,586 is well below the top federal rate in the United States, where it is almost 40%. The estimated increased annual revenue from this change will be $3 billion.

Tackle Tax Havens and Tax Evasion

Canada is losing billions of dollars to tax haven-facilitated tax evasion and tax avoidance. Instead of stepping up efforts to curb tax evasion by wealthy individuals and large corporations, the government has been laying off auditors and crippling the Canada Revenue Agency's ability to ensure everyone pays their fair share of taxes. The AFB would make tackling tax havens a priority for enforcement, and enact the following

measures to ensure tax fairness and raise badly needed additional revenue.

The AFB will increase the capacity of the Canada Revenue Agency to go after tax evasion facilitated by tax havens, and limit corporate tax dodging by amending the tax rules to require that there be "economic substance" to any offshore subsidiaries for them to be considered valid transactions for calculating income taxes, as has been proposed in Bill C-621. An investment of $30 million in boosting the CRA capacity in the international compliance division in 2005 yielded $2.5 billion over four years. The problem is much worse now so an even bigger investment is needed. The AFB would boost tax haven-focused enforcement capacity by $50 million, which is expected to raise an additional $5 billion over four years.

Canadian direct foreign investment in tax havens increased to $170 billion in 2013. This amounts to a quarter of all Canadian direct foreign investment abroad. The main reason for channelling investments through tax havens is to evade or avoid paying taxes in Canada. Applying a 1% withholding tax on Canadian assets held in tax havens would likely raise revenue of about $2 billion.

The AFB will also support other measures to combat corporate tax base erosion and profit-shifting (BEPS) that have been proposed by the OECD and G20, including country-by-country reporting of corporate profits and taxes paid, strengthening beneficial ownership registration, and preventing the abuse of tax treaties.

Bring Back Inheritance and Wealth Taxes

Unlike the United States and most European countries, Canada has no wealth or inheritance tax except for property taxes, which are a regressive form of wealth tax. The IMF recently estimated that Canada could generate $12 billion from a tax of just 1% on the net wealth of the wealthiest 10% of households.

The AFB would introduce a minimum inheritance tax of 45% on estates of over $5 million (e.g., after a $5 million deduction) in a similar way to the estate tax in the United States. This would produce estimated annual revenue of $2 billion.

Increase Taxes on Banks and Finance

Banks and other financial companies not only benefit from an implicit "too big to fail" guarantee and subsidy from the government, the financial industry also benefits from the exemption of financial services from value-added taxes such as the GST. The AFB would rectify this by introducing either a Financial Activities Tax (FAT), as proposed by the IMF, at a rate of 5% on profits and remuneration in the financial sector, or a broad-based Financial Transactions Tax (FTT) at a rate of 0.5% on transactions of stocks (similar to the rate in the U.K.) and at lower rates in bonds and financial derivatives. Both of these would generate a similar amount of revenues, estimated at $5 billion annually.

Climate Protection and Green Taxes

The Kyoto Accord to reduce greenhouse gas emissions ultimately failed not only because of the political opposition of countries such as Canada but also because the process and methods for achieving the accord's goals were flawed. The Kyoto Accord was based on a global cap-and-trade model which, along with regional cap-and-trade schemes, has largely failed. With a new treaty planned for the UN conference in Paris in December 2015, we have a chance to start off in a more effective direction. With a United States-China agreement recently signed on climate change, Canada will become even more of a pariah unless we take national action. Carbon taxes are more efficient, more transparent, and less corruptible mechanisms for putting a price on carbon than cap-and-trade schemes. They are also preferable for business and the economy because they ensure a clear and predictable price not subject to uncertainty or speculation.

As we have proposed for many years, the AFB will introduce a national harmonized carbon tax that would be integrated with existing provincial carbon taxes to ensure a minimum rate starting at $30 per tonne across Canada. However, because carbon taxes are regressive, at least half the revenues generated would go towards a progressive green tax refund that would ensure a majority of Canadians would be better off after accounting for their increased costs as a result of the carbon tax. Every adult resident in a province where the national carbon tax is in effect would receive an annual green refund cheque for $300 (or $10 per $1-per-tonne of the carbon tax) while children would receive $150. The green refund amount would be adjusted together with any changes in the carbon tax. The remaining revenues would be used to fund climate change transition, adaptation, and mitigation measures, including investments in public transit, green energy, energy retrofit for low-income households, and other greenhouse gas reducing initiatives.

The national carbon tax would also include border tax adjustments to ensure Canadian industry is not put at a competitive disadvantage. Imports from countries without similar environmental protection measures would be taxed at appropriate rates to reflect emissions associated with their production, processing, and transport, with specific exemptions for highly impoverished nations. Exports to countries without comparable provisions could receive rebates. These border tax adjustments would put pressure on other countries to enact similar climate change measures. The carbon tax would generate annual revenue of $16 billion. The Green Tax Refund would incur a net annual cost of $8.8 billion.

Notes

1 The Parliamentary Budget Office, The Tax-Fee Savings Account, February 24th, 2015.

2 The Parliamentary Budget Office, The Tax-Fee Savings Account, February 24th, 2015.

3 Lee, Marc (2007). *Eroding Tax Fairness*. Ottawa: Canadian Centre for Policy Alternatives.