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Fairness by Design

A Framework for Tax Reform in Canada

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Summary

AT A TIME of rising income and wealth inequality, restoring fairness should be the primary objective of the Canadian tax system. In this paper, we present a framework for a progressive tax reform strategy for Canada drawn from our review of the literature on tax policy design. These reforms set out the foundation for a fair tax system that is capable of raising revenues with minimal distortions to investment in productive and sustainable economic activities, and that will result in a more just distribution of income and direct improvements in the life of low-income households.

A good tax system must be progressive for reasons of fairness and justice, but also on economic grounds. A tax of the same percentage of income requires less sacrifice from those who are already able to provide for a comfortable life than from those struggling to make ends meet. In more technical terms, the *marginal utility of money* declines as income rises. It follows that a system of progressive taxes and transfers that redistributes income more equally increases social welfare.

While tax reform is a key policy lever to tackle inequality, changes in the Canadian tax system since the mid-1990s have tended to reinforce growing inequality in market incomes instead of tempering it. Income tax cuts have disproportionately benefitted higher income groups, while changes in regressive taxes, including consumption, payroll and property taxes have increased total tax rates for households at the bottom of the income distribution.

Our proposal for improving fairness in the Canadian tax system draws on two major tax bases: income and value added. These bases are often pit-

ted against each other as alternative approaches, but we believe that there is a compelling case for having two broad tax bases, as there are widely-acknowledged practical limits to how much any given base can be taxed due to political resistance and/or disincentive effects.

Fundamentally, all tax and transfer policies must be considered as the interconnected elements of a single, well-integrated tax *system*. Personal income tax and transfer measures are the most progressive elements of any tax system. Value added taxes like the GST, though inherently regressive, can be an effective way of raising revenues to fund public services as long as adequate income transfers are provided to low- and modest-income households to compensate them for their loss of purchasing power, and the tax *system* remains progressive overall.

While there is room for different specific formulations, we recommend that a fair tax reform package for Canada focus on the following seven priority areas:

1. Broaden the income tax base to reflect the individual's actual *command over resources*. We recommend taxing income from all sources according to the same progressive rate schedule, including self-employment income, property, savings and dividend income and capital gains. This would eliminate the preferential tax treatment that currently exists for many sources of income for high earners — investment income form stock options and capital gains, for example — that are taxed more lightly than income from wages and salaries. In some cases, such as lottery winnings, sales of principal residences, other long-held assets or family farm/business bequests, provisions for income averaging over several years should be implemented to accommodate large fluctuations in annual income.

2. Rationalize tax expenditures. Canada's income tax system contains a large number of deductions and tax credits (both refundable and non-refundable), known collectively as *tax expenditures*, many of which disproportionately benefit high-income earners. Given that they are very expensive to the public purse, we recommend that their effectiveness and distributional impacts be carefully evaluated. A number of tax deductions and credits may need to be modified, scaled down or eliminated, in particular the RRSP and registered pension plan deductions, the basic personal amount, spouse or common-law partner amount and the amounts of eligible dependents and children, the employee stock options deduction, and the charitable donations tax credit.

3. Increase top marginal income tax rates. We recommend the addition of one or more high income tax brackets (for example, at the top 1% and 0.1% of income) to improve tax fairness and tackle income inequality at the top end. A recent U.S. study estimates that the *optimal* top marginal tax rate for the top 1% of earners is 73% (and as much as 80% if there are no deductions and loopholes to allow tax avoidance).[1] These rates are substantially higher than the prevailing Canadian top marginal tax rates.

4. Stop the corporate tax "race to the bottom". We recommend increasing corporate income tax rates, which are currently the lowest among G8 countries. A shift of business taxation to a *cash-flow* tax base should replace the current system of arbitrary rules of depreciation and capital cost allowances that differ by sector. This would fully tax pure economic rents, the returns from ownership of assets. Higher taxes on natural resources should also be considered.

5. Implement inheritance and/or wealth taxes. These taxes help improve social mobility and reduce the concentration of wealth at the very top by limiting the extent to which capital (and the opportunities it buys) is passed across generations. Canada is currently one of the few developed countries that does not tax bequests and inheritances. We recommend that large inheritances and gifts be included in the recipient's taxable income. In addition, large holdings of wealth should also be taxes at an annual rate, broadening the base of existing property taxes to include financial market assets.

6. Use consumption taxes cautiously. Value-added consumption taxes may be used to supplement revenues collected from a progressive, broad-based income tax, but should not form the main basis of the Canadian tax system. On the other hand, carbon taxes and financial transactions taxes are examples of specific consumption taxes aimed at internalizing external costs, which should be embraced.

7. Implement a basic or guaranteed income. We recommend amalgamating the various income-tested tax credits and benefits into a single, streamlined income transfer that would phase out gradually similar in structure to the OAS and the CCTB. The transfer would be broad-based, and designed to take into account individual circumstances such as family size, number of young children, family members with disabilities, etc. Such a transfer would be flexible and could easily accommodate new tax measures introduced in the future.

The exact combination of reforms should be developed on the basis of a comprehensive review of the tax system. A Fair Tax Commission should be convened to examine how federal taxes and transfers work together as a system and make recommendations for changes. Ideally, the Commission would include an expert and well-respected team made up of both academics and practitioners, and would engage Canadians from all walks of life in a meaningful and broad-based public dialogue and deliberation process to produce a framework for restoring fairness to our tax system.

Introduction

> The necessaries of life occasion the great expense of the poor. They find it difficult to get food, and the greater part of their little revenue is spent in getting it. The luxuries and vanities of life occasion the principal expense of the rich, and a magnificent house embellishes and sets off to the best advantage all the other luxuries and vanities which they possess. A tax upon house-rents, therefore, would in general fall heaviest upon the rich; and in this sort of inequality there would not, perhaps, be anything very unreasonable. It is not very unreasonable that the rich should contribute to the public expense, not only in proportion to their revenue, but something more than in that proportion.
>
> Adam Smith, *The Wealth of Nations*

ADAM SMITH, THE father of modern economics, was one of the first advocates for what is known as progressive taxation: the fundamental principle that those with higher incomes pay more tax, not only in dollar terms but also as a share of their income, than those with lower incomes. In economics this principle of basing tax contributions on ability-to-pay is known as *vertical equity* and some form of it is built into virtually every tax system today.

Governments need revenue to provide a safe, stable environment for all communities and individuals to thrive. This makes taxes fundamental to a modern society: they pay for setting up and enforcing regulations to ensure that our food is safe, our water and air are clean, our human rights are respected, and they allow us to provide supports and services to one an-

other when facing illness, disability, unemployment, crime, natural disasters, poverty or old age.

The global recession and financial crisis of 2008–09 served as a painful reminder that our highly connected and financialized economy demands a stronger, not weaker, role for governments, both in terms of regulation and in stepping in to provide an economic stimulus when the private sector is weak. In addition, the defining challenge of our generation, tackling climate change, requires bold and coordinated global action by well-resourced national governments. Ensuring that the tax system can raise the appropriate amount of revenues in a fair and equitable manner is thus of central importance to the functioning of a modern state.

In this paper, we make the case for progressive tax reform in Canada. In Part 1, we outline the rationale for progressive taxation, and its particular importance in the context of rising income inequality. We also review recent changes in the Canadian tax system that have undermined progressivity, and how these have contributed to rising inequality. In Part 2 of this paper, we present a framework for a progressive tax reform strategy for Canada drawn from our review of the literature on tax policy design. These reforms set out the foundation for a fair tax system that is capable of raising revenues with minimal distortions to investment in productive and sustainable economic activities, and that will result in a more just distribution of income and direct improvements in the life of low-income households.

Part 1

The Case for Progressive Taxation

A RECENT AND comprehensive review of the economics of taxation, the Mirrlees Review in the United Kingdom, concluded that a good tax system must be both progressive and neutral. This is to say that it "can raise the revenue that government needs to achieve its spending and distributional ambitions whilst minimizing economic and administrative inefficiency, keeping the system as simple and transparent as possible, and avoiding arbitrary tax differentiation across people and forms of economic activity."[2] These principles of a good tax system are not new or controversial; they have been articulated by other major tax reviews in the past, though there is still an active debate in the economics and law literature on how to best operationalize them through public policy.

A good tax system must be progressive for reasons of fairness and justice, but also on economic grounds.[3] Raising the same percentage of income in tax requires less sacrifice from those who are already able to provide for a comfortable life than from those who are struggling to make ends meet. In economics the *marginal utility of money* declines as income rises — that is, the perceived and actual benefit derived from an extra dollar of income is much higher for someone panhandling on the street than for someone driv-

ing past in a Mercedes. It follows that social welfare is higher when resources are more equally distributed — at least up to the point where incentives to work and invest in productive activities get severely distorted. In addition, to the extent that money can buy opportunities, particularly for young children, progressive taxation serves to redistribute opportunities and improve social mobility. Therefore, progressive taxes and transfers that redistribute income increase social welfare.

Some economists argue that there is a limit to how much redistribution can be achieved through the tax system because individuals respond to taxes and transfers by reducing their work effort and their propensity to save and invest, which reduces social welfare in the long run. This is the classic trade-off between equity and efficiency. Recent research finds that the optimal balance between equity and efficiency depends largely on how unequally pre-tax income is distributed. In economies with very high levels of income inequality and concentration of incomes at the very top, like the U.S. and Canada, a high and rising marginal tax rate at the top maximizes social welfare.[4]

In a hypothethical world where market income is distributed equally, there would be no need for progressive taxation; government revenues could be raised optimally with a single tax rate, also known as a flat tax. A capitalist economy ("the market") left to its own devices, however, does not distribute incomes equally — at least not in the absence of other labour market institutions such as strong labour unions, and decent minimum wages that alter the distribution of income.[5]

In the presence of significant income inequality, progressive taxation ensures that necessary revenues are collected with a smaller shared sacrifice than a proportional tax system would impose. It also directly reduces the inequality arising from the distribution of market incomes, producing a more equal distribution of after-tax (or disposable) income. It does this in two ways: by reducing the incomes of the richest, and by generating revenues that can be used to reduce inequality through public expenditures, such as direct income transfers to low-income households and the provision of public services and infrastructure that have greater relative benefit to low-income households.

Some have defended market income inequalities and opposed redistributive policies on the grounds that that they "punish success" and that the well-off have earned their high incomes through hard work, shrewd investing and superior entrepreneurial ability. However, this line of argument ignores the role of luck and chance in determining outcomes in today's econ-

omy: being born to "good" parents and provided with a nurturing environment in early childhood; gender, ethnicity, temperament and looks; chance encounters and other accidents of fate. These factors have at least as much of a role in one's income as hard work. It is therefore just and fair to tax the beneficiaries of luck at higher rates.

While convincing arguments could be made for tax neutrality on the real returns to hard work on both justice and economic efficiency grounds, there is no reason why we should not tax away the super-normal returns to luck entirely, which are essentially economic rents (and therefore taxing them will not reduce efficiency). Even if the rich had a moral claim to their high incomes, there are good reasons why redistribution benefits society as a whole. A large and growing body of research from the social sciences shows that income inequality is corrosive for society and that more equal distributions of disposable income and wealth are associated with better performance in a host of areas. Canadian economist Miles Corak finds that redistributive public policies are fundamental for achieving equality of opportunity and higher levels of social mobility in a society.[6] This makes a strong case for progressive taxation on justice grounds, as a key piece in a broader government strategy to redistribute opportunities more equally among all members of society.

In their groundbreaking book *The Spirit Level*, Richard Wilkinson and Kate Pickett provide ample empirical evidence that even in rich countries, greater inequality leads to adverse social and health outcomes.[7] They found that countries (and U.S. states) with higher income inequality tend to have higher rates of addictions and mental health problems, higher rates of teenage pregnancies, higher school dropout rates and lower overall educational attainment, more chronic health problems and higher rates of violence and crime than those with a more equal distribution of income and wealth. Wilkinson and Pickett also documented that income inequality erodes social cohesion and trust in society.[8] Putting all of these findings together, they created an index of social and health problems, which they found is positively correlated with inequality.

Because of the strong linkages between high levels of inequality and health and social problems, their research makes a compelling case that reducing inequality would improve quality of life — most notably for the poorest, but due to "gradients" also for those with higher incomes — by much more than could be achieved through economic growth alone. This is consistent with recent research on the economics of happiness and life satisfaction, which shows that above a certain amount of income, our happiness/

well-being is determined by a range of other factors such as our health, education, the quality of our communities and family relationships. Beyond basic necessities, well-being is determined less by absolute income and more by relative income.[9]

Income inequality has adverse environmental impacts as well. For example, Marc Lee and Amanda Card estimate that GHG emissions for the top income quintile of households were nearly double that of the bottom quintile.[10] A distributional analysis by Lee of BC's carbon tax found that the top 1% of households had emissions three times the average, and almost six times the emissions of households in the bottom decile.[11] Thus, reduced consumption at the high end would have positive environmental impact by targeting precisely the households that have the largest carbon footprints. Indeed, inequality may hinder action on climate change if members of society do not feel that they are all "in the same boat."

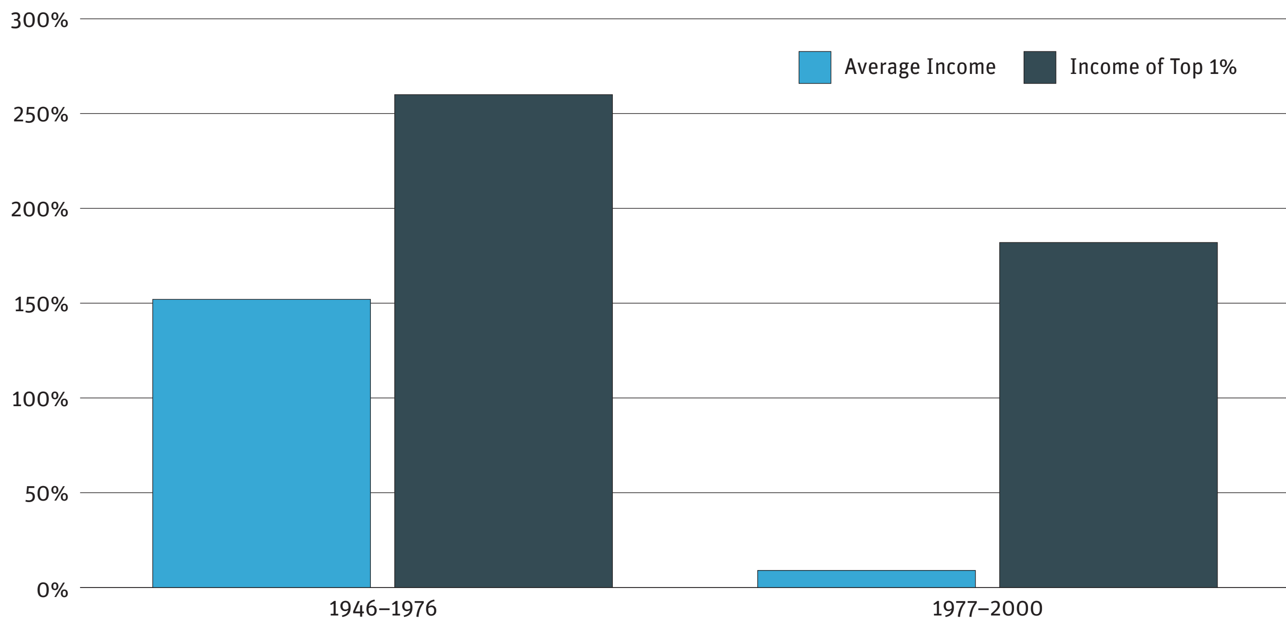
The Canadian Context: Eroding Tax Fairness at a Time of Rising Income Inequality

The Canadian tax system is overdue for reform. The last comprehensive tax-and-transfer policy review, the Carter Commission, was half a century ago, in 1966. A number of major reforms have been undertaken since (including pension and EI reform, business tax reform and the introduction of a value-added consumption tax, the GST) but these have been piecemeal and focused on individual aspects of the tax system. As one of Canada's prominent public finance experts, Robin Boadway, argues, it is crucial to evaluate all taxes and transfer policies as interconnected elements of a single, integrated system, something that has not been done in recent Canadian history.[12]

A fair and well-designed tax-and-transfer system must take into account existing social and economic realities, and in particular, the pre-tax (or market) distribution of income that serves as its base. Fairness and equity in the distribution of total taxes are particularly pressing issues today given the recent rapid growth of market income inequality in Canada (and internationally), and the associated increasing concentration of income and wealth.

Research by the Organization for Economic Cooperation and Development (OECD) documents rapid increases in both inequality and poverty rates in Canada since the mid-1990s, and finds that Canada saw the fastest growth in income inequality between the mid-1990s and the mid-2000s among all OECD countries except for Finland.[13] The Gini coefficient, the most common

FIGURE 1 Growth In Income For the Top 1%



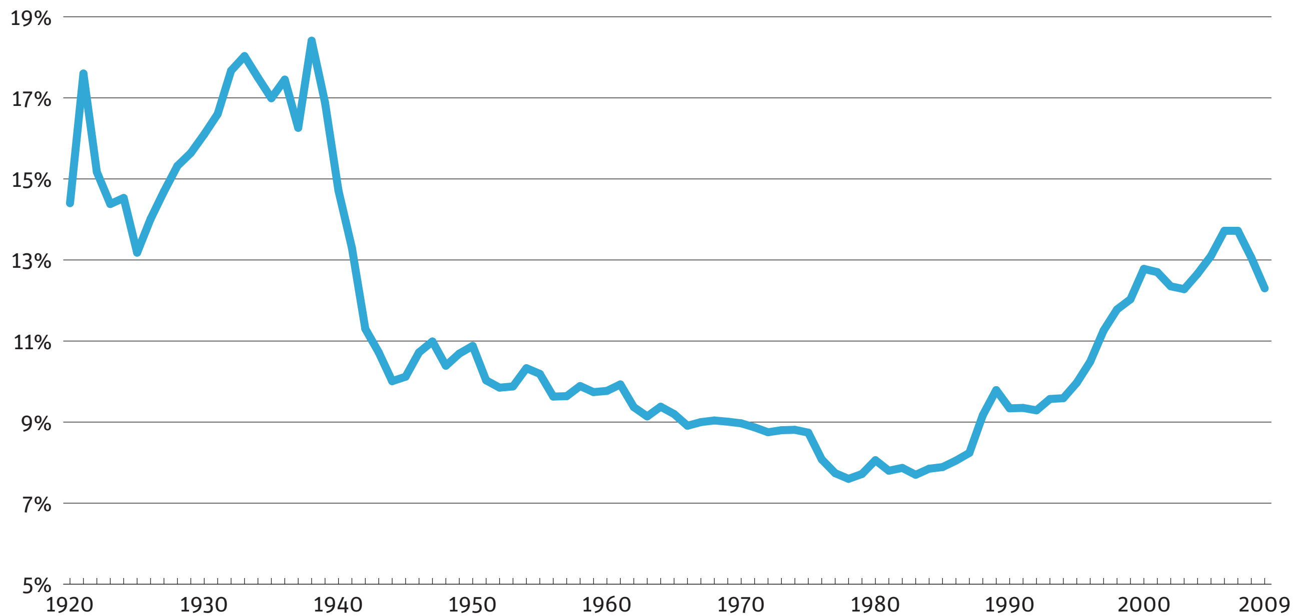
Source Yalnizyan, Armine. 2010. *The Rise of Canada's Richest 1%*. Ottawa: Canadian Centre for Policy Alternatives.

single measure of income inequality, has risen from 0.38 to 0.45 between 1976 and 2010 for market income (adjusted for family size).[14] The average income of the top 10% of Canadians in 2007 was 10 times higher than that of the bottom 10%, a substantial increase since the early 1990s, when top 10% incomes were only 8 times higher.[15]

Much of the increase in Canadian income inequality is driven by changes at the top of the income distribution, where a very small group of "super-rich" Canadians are taking home a staggering share of the gains from economic growth.[16] Using tax data, economist Armine Yalnizyan found that the richest 1% of Canadians received almost one third of all income growth in the two decades between 1987 and 2007.[17]

It hasn't always been this way: earlier in the 20th century, the top 1% took home less than 8% of all income gains in every decade between 1928 and 1977. While incomes at the top have more than doubled over the last 30 years, the average Canadian income has grown by less than 20% over that time (as shown in *Figure 1*). As a result of the rapid growth in incomes at the very top, the share of total income taken home by Canada's richest 1% rose

FIGURE 2 Share of Total Income, Richest 1% Canada, 1920–2009



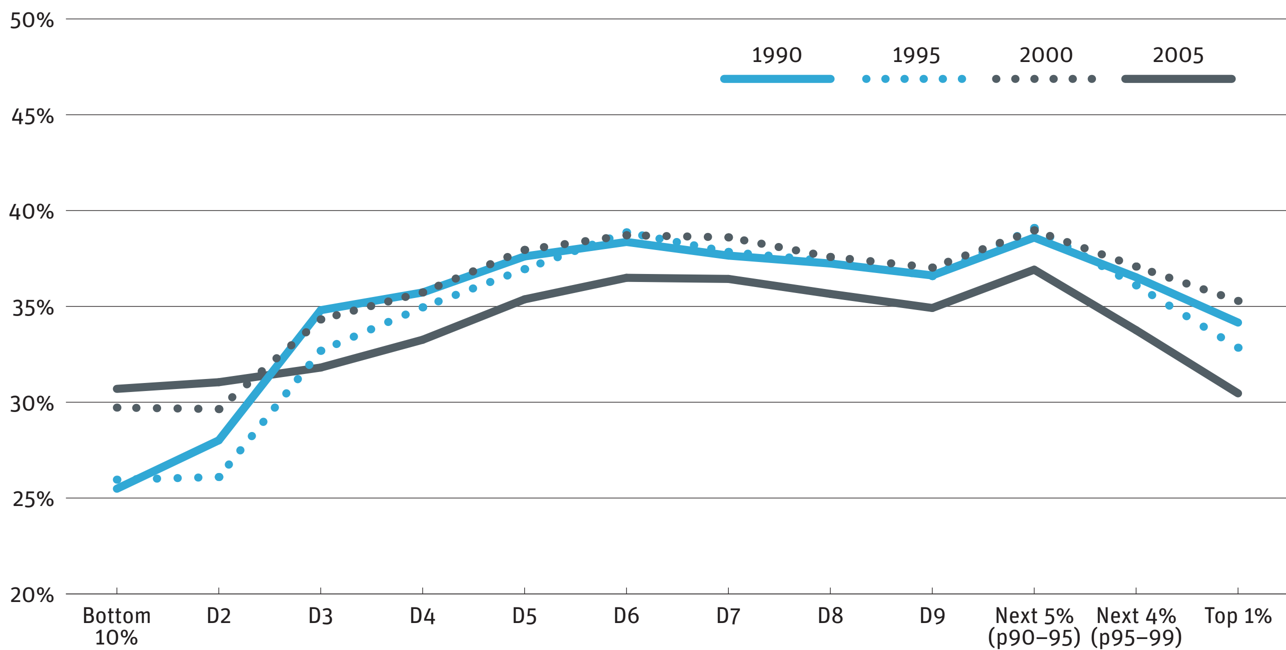
Source Data provided by Michael Veall, published in Michael Veall. 2012. "Top Income Shares in Canada: Recent Trends and Policy Implications." *Canadian Journal of Economics*. 45 (4): 1247–1272 (Figure 1).

from a low of 7.7% in the late 1970s to 13.8% in 2007.[18] The top 1% income share hasn't been as high since the Second World War (as shown in *Figure 2*).

What is particularly relevant for tax design is that the recent sharp growth in inequality is driven largely by changes in the labour market and specifically, the widening gap between wages of part-time, temporary contract workers at the bottom and soaring compensation packages for business executives at the top.

While market outcomes have become more and more unequal, changes to the Canadian tax system since the mid-1990s have tended to reinforce those inequalities rather than lean against them.[19] The most recent comprehensive study of tax incidence in Canada by Marc Lee finds that tax changes between 1990 and 2005 have greatly eroded the progressivity of our tax system.[20] By 2005, the tax system was progressive only up to the middle of the income distribution, then flattened out and actually became regressive at the very top. As a result, Canada's top 1% faced overall tax rates slightly lower than those of households in the bottom 10%, with the highest tax rates found in the middle to upper-middle part of the income distribution.

FIGURE 3 Total Tax Rates, 1990 to 2005



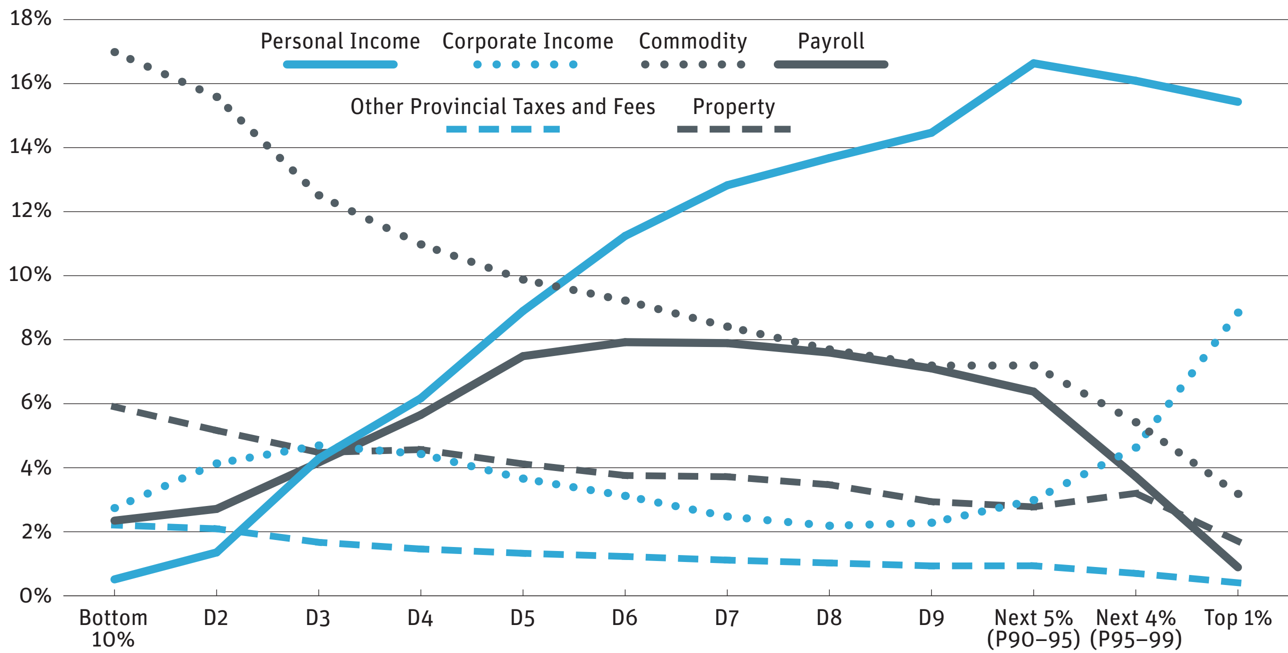
Source Lee, Marc. 2007. *Eroding Tax Fairness: Tax Incidence in Canada, 1990 to 2005*. Ottawa: Canadian Centre for Policy Alternatives.

As *Figure 3* shows, top tax rates have dropped the most income groups over this time frame, while rates at the bottom have actually increased, due to a number of small changes in regressive taxes, including consumption, payroll and property taxes and other provincial taxes and fees. The peak tax rates are faced by households in the middle of the income distribution, who pay about six percentage points more of their income in tax than both the top and the bottom. This pattern violates the taxation principle of vertical equity.

Note that while the personal income tax remains relatively progressive, with income brackets that apply higher tax rates as individuals earn higher amounts of income, it is only one of several taxes people pay. Other taxes in the Canadian tax mix, such as sales taxes, are actually regressive, which is to say that lower income families pay a higher effective tax rate than those with higher incomes (as shown in *Figure 4*).[21]

Taxes are not always designed to be uniformly progressive or regressive over the course of the income distribution. Payroll taxes, such as CPP contributions, are initially progressive because a minimum threshold applies before workers start paying the tax, but a ceiling on total contributions

FIGURE 4 Tax Rates by Type of Tax, 2005



Source Lee, Marc. 2007. *Eroding Tax Fairness: Tax Incidence in Canada, 1990 to 2005*. Ottawa: Canadian Centre for Policy Alternatives.

means they are regressive higher up the income distribution (at income levels above the legislated ceiling). This is why it is particularly important to evaluate the tax system as a whole rather than evaluating individual tax changes in isolation.

Tax cuts were the major factor behind the erosion of Canada's tax fairness, with personal income tax cuts leading the reduction in rates at the top. These cuts disproportionately benefited those with the highest incomes. Provinces have led the way in introducing regressive tax changes. The incidence of overall provincial taxes was relatively flat in 1990, but had become almost uniformly regressive by 2005. Federal tax cuts exacerbated the problem. Higher payroll taxes offset the impact of income tax cuts for the middle of the distribution, but reduced tax fairness at the bottom.

Ad-hoc tax changes over the last two decades have seriously weakened the redistributive role of Canada's tax system at a time when market inequalities call for more, not less redistribution.[22] A key step towards more progressive taxes would be to ensure that wealthier individuals contribute their fair share to the public purse. The federal income tax is the most progressive of Canada's taxes, but its progressivity is undermined because many sources

of income for high earners — investment income from stock options and capital gains, for example — are given preferential tax treatment and taxed more lightly than income from wages and salaries. And while statutory tax rates increase with income (through tax brackets), higher income Canadians are also able to avail themselves of generous tax deductions like RRSP contributions that greatly lower their effective tax rates. At the same time, top earners will have long maxed out total contributions to payroll taxes; that is, the total taxes they pay for their pensions and unemployment insurance stop growing even as their total incomes soar.

Low-income households, in contrast, pay little in income tax, but are also generally unable to avail themselves of many credits and deductions that, in the end, disproportionately benefit those with high incomes. The exceptions are refundable tax credits and income-tested transfers such as the Goods and Services Tax Credit and the Canada Child Tax Benefit (CCTB).[23] The challenge at the bottom of the income distribution ladder is that consumption taxes like the GST are regressive in that everybody pays exactly the same rate. Lower income families consume almost all of their income (and then some, with many households in debt), so they end up paying a higher share of their total income in the GST than higher income households, who can afford to save or invest a significant share of their incomes. While exempting basic necessities and providing a small income-tested transfer (the GST credit) can improve tax fairness among the lowest income families, this system could greatly be improved by increasing the GST credit and extending its reach into middle-income levels.

Part 2

An Agenda for Progressive Tax Reform

A FAIR CANADIAN tax system must be progressive across all sources of income and all types of taxes: federal, provincial/territorial and local. That said, large-scale progressive tax reforms are best undertaken at the federal level to ensure that all Canadians, regardless of their place of residence, are taxed under the same fair system, and to avert harmful tax competition among provinces. This is why we focus on federal tax reforms that will make Canada's tax system more progressive, although many of the findings and recommendations presented would also be relevant for provincial governments. Federal taxes (including payroll taxes like EI and CPP premiums) raise just under half of all taxes in Canada today, but the federal government has given away considerable fiscal room to the provinces and territories over the last two decades.[24] This may have to be re-evaluated to ensure that the Canadian tax system is progressive in its entirety.

Our proposal for a fair tax system draws on two major tax bases: income and value added. These bases are often pitted against each other as alternative approaches, but we believe that there is a compelling case for having two broad tax bases for political economy reasons, as there are widely-acknowledged practical limits to how much any given base can be taxed due

to political resistance and/or disincentive effects. We stick to the broad elements of progressive tax reform, and note that there is much room for different specific formulations.

Fundamentally, all tax and transfer policies must be considered as the interconnected elements of a single, well-integrated tax *system*. Personal income tax and transfer measures are the most progressive elements of any tax system and are, as the Mirrlees review explains, widely considered to be the "right tools for achieving distributional objectives."[25] Value added taxes like the GST, though inherently regressive, can be an effective way of raising revenues to fund public services as long as adequate income transfers are provided to low- and modest-income households to compensate them for their loss of purchasing power, and the tax *system* remains progressive overall.

We recommend that a fair tax reform package for Canada focus on the following seven priority areas:

1. Broaden the Income Tax Base

A fair tax system should be based on a broad or comprehensive income concept that reflects the individual's actual *command over resources*. This is also known as *horizontal equity*: the principle that two people with the same amount of income in a given year pay the same rate of tax regardless of the source of that income. Bay Street accountant Kenneth Carter who headed a Royal Commission on taxation in the late 1960s captured this notion with his comment "a buck is a buck." This principle has been eroded in Canada substantially in recent decades in the name of promoting economic efficiency and growth by lowering and in some cases eliminating income tax rates on capital income.

There is an active and spirited debate in the modern tax literature on the best way to tax income from capital.[26] Many economists argue that income from capital should be taxed at a lower rate than income from labour, or not at all, to encourage savings (and thus investment and economic growth). It is not clear why this need be the case — in a fiat money system, the expansion of credit money through the banking system finances new investment, so investment is not limited by the deposits saved by households. Nor is there any evidence that the Canadian economy suffers from a shortage of capital. In fact, the accumulated cash holdings of private non-financial corporations are at record high levels as a result of recent corporate income tax cuts, and were valued at $567 billion in the second quarter of 2012.[27]

Arguments for preferential treatment of capital income have been predicated on theoretical micro-efficiency gains for which there is simply no compelling evidence.[28] Reduced rates on capital income unfairly privilege high-income households, who tend to earn a larger share of their income from capital, and thereby increase income and wealth inequality. Broadening the tax base would allow government to raise the same amount of revenue with lower tax rates, or, if desired, to raise more revenue at the prevailing rates.

Currently, different forms of income face different tax treatment under the Canadian income tax system. Wages and salaries are taxed in accordance with the four federal tax brackets and rates. In contrast, only half the value of realized capital gains from financial assets and secondary real estate sales is counted as income for tax purposes. Sales of primary residences are not subject to any capital gains tax (even though considerable gains can and have been made in hot urban real estate markets). And there is a lifetime capital gains exemption of $750,000 for farmers and small businesses.

Realized capital gains represent real dollars in sellers' pockets and should be fully included in the income tax base. Forgone revenues are substantial: partial inclusion of capital gains represented an income loss of $3.6 billion, the lifetime capital gains exemption for small business costs $560 million, and the non-taxation of capital gains on principal residences $4.2 billion in 2011.[29] Differences in tax treatment due to untaxed or lightly taxed sources of income — made in the name of efficiency — in fact create incentives for tax avoidance and evasion (for example, tax-motivated conversions of high-taxed labour income into low-taxed capital gains or dividends through corporations). Moving to a comprehensive personal income tax base would ensure that all sources of income are taxed at the same rates and reduce distortions related to the increasingly lucrative business of "tax planning."

Capital income from investments in Tax Free Savings Accounts (TFSAs) is exempt from income tax entirely. The TFSA is a relatively new program, launched in 2009, but the emerging evidence shows that even with the current maximum of $5,500 per person per year, these savings vehicles will significantly reduce the income tax base in Canada over a generation and represent pure windfall gains for the wealthiest Canadians, undermining both efficiency and fairness in the tax system (and even more so if annual deposit limits are increased further).[30] This program should be eliminated, or, at a minimum, restricted to investments that meet a public interest test such as investments in the green economy. Registered Education Savings Plans, which work on the same principle of non-taxation of capital income, privilege families with large enough incomes to invest in them, and should

likewise be scrapped in favour of grants aimed at facilitating greater access for students from low-income families.

Outside of capital gains on principal residences, the most significant sources of income that are currently tax-free are: gifts and bequests, inheritances, lottery winnings, and certain employer-provided benefits such as extended health benefits and pension plan contributions.

Capital income is distributed even more unequally than employment income. Canada Revenue Agency tax statistics show that in 2010, Canadians with income over $250,000 were more than three times as likely to have earned income from interest and other investment than those with income under $50,000, seven times as likely to have taxable dividend income, and almost ten times as likely to have income from capital gains.

Typically, the forms of income taxed at lower (or zero) rates tend to make up a larger share of the income for richer Canadians. This reinforces widening income inequalities and reduces the revenue-collection capacity of the tax system.

In light of these practical and equity concerns, we recommend broadening the income tax base to ensure that income from all sources is taxed according to the same progressive rate schedule, including self-employment income, property, savings and dividend income and capital gains. In some cases, such as lottery winnings, sales of principal residences, other long-held assets or family farm/business bequests, provisions for income averaging over several years should be implemented to accommodate large fluctuations in annual income. This could include a deduction for general inflation so that only gains above that would be subject to full income tax. The key principle is that capital gains be taxed in the same manner as income from wages and salaries.[31]

2. Rationalize Tax Expenditures

Canada's income tax system contains a large number of deductions and tax credits (both refundable and non-refundable), known collectively as *tax expenditures*. Rather than actual expenditures funded by taxes, these represent forgone tax revenue and lower effective tax rates. While the top marginal federal tax rate is currently 29%, the average effective income tax rate paid by the richest 1% of Canadians was 19.7% in 2008.[32]

Some tax expenditures seek to achieve a public policy objective, such as increased saving for retirement, investment in research and develop-

ment, investment in economic activities (such as exploration and mining), and support for charitable activities. Others are in place to assist individuals who have reduced ability to pay taxes due to personal circumstances (such as deductions for medical expenditures and tax credits for children), or because they incur costs before income can be earned (education). Other tax expenditures represent adjustments to avoid double taxation at corporate and personal levels.

In recent years, we have seen a proliferation of relatively small tax deductions and credits that cater to very narrow groups, such as the public transit tax credit and the children's fitness and arts tax credits. These credits are wasteful, make the tax system less transparent and add to the complexity of the income tax system, yet once they are put in place there is little public accountability of the amount of money spent on them or their effectiveness. A number of recent studies have challenged the effectiveness of some tax expenditure programs to achieve their stated goals, including many of the "boutique" tax credits and RRSPs.[33]

Whether or not these measures are desirable and effective in achieving their objectives, they have distributional impacts in that they affect the taxes paid by different income and demographic groups, and indirectly by reducing available revenues that could be used for income transfers or public services. Indeed, a large number of current deductions and credits disproportionately benefit high earners, as can be seen in the tax data from Canada Revenue Agency shown in *Table 1*. The table breaks out income and key deductions and credits by three total income groups: greater than $250,000 income, $50,000 to $250,000 income, and less than $50,000 income.[34] The table shows that while tax filers with income greater than $250,000 made up only 0.8% of all tax filers in 2010, they claimed 89% of the value of the security options deduction, 66% of all exploration and development expense tax credits, 50% of all taxable capital gains and 40% of the federal dividend tax credit. In contrast, tax filers with income under $50,000 made up 73% of all tax filers and earned 38% of the total income in Canada, but claimed less than 0.5% of the value of the security options deduction, 2% of the exploration and development expense tax credits, 10% of the taxable capital gains and 9% of the federal dividend tax credit.

Finance Canada provides estimates of the value of tax expenditures in the federal income tax system in their annual *Tax Expenditures and Evaluations* reports. In total, personal income tax expenditures are projected to cost the federal treasury $143.7 billion for 2011—equivalent to 72% of federal total taxation revenues and 120% of federal income tax revenues in

TABLE 1 Selected Individual Tax Statistics, 2010 Tax Year

	Tax filers with less than $50,000 income	Tax filers with income between $50,000 and $250,000	Tax filers with income greater than $250,000
Number of tax filers	9,767,100	6,460,690	186,100
Share of all tax filers	73.1%	26.1%	0.8%
Value of income, deductions and credits claimed by each group as a share of the total amount claimed			
Employment income	31.9%	60.4%	7.6%
Taxable amount of dividends	11.4%	50.7%	37.8%
Taxable capital gains	9.9%	40.3%	49.8%
Registered Retirement Savings Plan income	43.5%	50.1%	6.4%
Total income assessed	37.7%	52.2%	10.1%
Registered pension plan contributions	17.9%	80.3%	1.8%
Registered Retirement Savings Plan deduction	17.9%	73.2%	8.9%
Exploration and development expenses	2.1%	31.8%	66.0%
Security options deductions	0.3%	10.3%	89.4%
Taxable income assessed	37.9%	52.0%	10.1%
Children’s fitness amount	30.9%	65.1%	4.0%
Allowable charitable donations and government gifts	23.5%	51.8%	24.7%
Federal dividend tax credit	9.2%	50.5%	40.3%
Total federal and provincial tax payable	17.3%	62.9%	19.8%
Average effective income tax rate			
Federal	4.7%	12.3%	19.9%
Federal and provincial	6.8%	17.9%	29.0%

Source Authors’ calculations from Canada Revenue Agency, T1 Preliminary Statistics 2010 tax year, Table 2: All Returns by Total Income Class, http://www.cra-arc.gc.ca/gncy/stts/gb10/pst/ntrm/table2-eng.html. Accessed Nov. 15, 2012.

2011/12.[35] Corporate income tax expenditures are estimated at an additional $27.1 billion. While it would not be desirable to eliminate many of these measures due to the structural issues or public policy considerations mentioned above, the sheer magnitude of forgone tax revenues calls for a re-evaluation of tax expenditures, their effectiveness and their distributional impacts. Of particular interest from a distributional perspective are:

RRSP and registered pension plan deductions (net tax expenditure of $9.9 billion and $15.6 billion respectively in 2011): These deductions reduce income for tax purposes in order to encourage savings for retirement, at which time withdrawals are taxed at, typically, a lower rate than at the time

initial income is earned. The evidence shows that these deductions disproportionately benefit individuals with higher incomes (see *Table 1* above). In the case of RRSPs, which are "optional," only a small handful earn enough to take full advantage of their contribution room.[36] Clearly, families who are living paycheck to paycheck are unlikely to make much use of these measures.

Broad-based non-refundable tax credits—basic personal amount, spouse or common-law partner amount, amount for eligible dependents and children ($29.5 billion, $1.4 billion, $0.8 billion and $1.5 billion, respectively): These non-refundable tax credits effectively exempt the first $10,527 of individual net income (after deductions) from taxation, serving as a de facto personal income tax bottom bracket of 0% (the amount exempt from taxes is higher for those with a stay-at-home or low-earning spouse and children). While this reduces the tax rate of low-income households, many low-income households do not earn enough to benefit from the full amount of this non-refundable credit (18% of tax-filers reported total income under $10,000 in 2010). More importantly, the credit also clearly benefits the most affluent individuals who pay no tax on the first $10,527 of their net income. This is a very expensive way to reduce tax rates for low- and modest-income Canadians. Eliminating or substantially reducing these credits and flowing the resulting revenue back to low- and modest-income households in the form of a transfer would greatly strengthen the progressivity of the tax system (more on this below).

Employee stock option deduction ($725 million): This deduction permits recipients of stock options to pay tax at half the statutory rate of ordinary income when they are realized. The principal beneficiaries of this measure are a very small number of already highly-paid CEOs and executives, who receive very large tax savings as a result.[37] For example, Toby Sanger estimates that this measure saved $24 million in taxes for Robert Gratton, former CEO of Power Corp in just one tax year.[38] CRA data shows that only 0.2% of all tax-filers claimed a security options deduction and 89% of the value of the deduction went to individuals with income over $250,000 (see *Table 1* above).

Charitable donations and gifts ($2.3 billion personal and $390 million corporate): This tax credit enables well-off individuals and families to determine privately what types of charitable activities will be pursued by society.[39] In the words of Neil Brooks, it "allows them to buy public monuments and recognition for themselves and to give legitimacy to social indifference."[40] In fact, the Canadian government has increased its reliance on charity to

tackle pressing social problems, such as feeding and housing the marginalized, problems that are more appropriately tackled by elected and publicly accountable policy-makers. Moreover, the credit's two tiers (a 15% credit for the first $200 and 29% above that) are structured in a way that provides greater benefit to higher-income households.

3. Increase Top Income Tax Rates

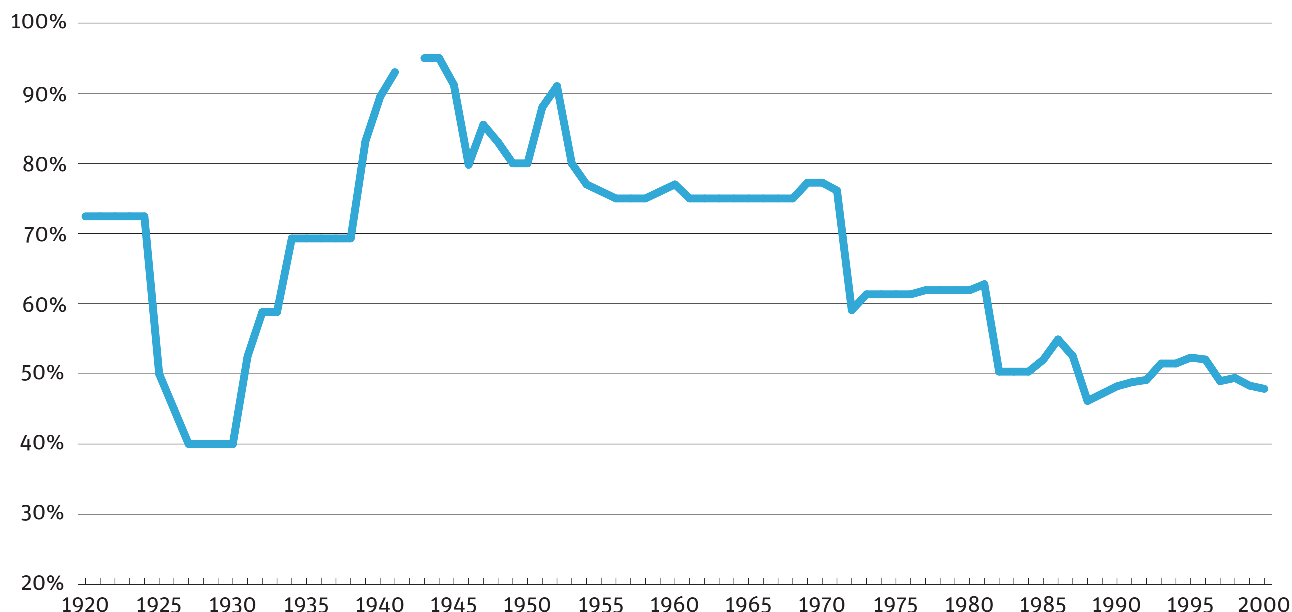
In Canada, the addition of one or more high-income tax brackets would greatly improve tax fairness while also tackling income inequality at the top end. Canada has seen significant declines in both the top marginal income tax rate and the income level at which it kicks in since the early 1970s. These rate reductions at the top have made our tax system less effective in mitigating market-driven increases in inequality and particularly the concentration of income at the top. Economists Emmanuel Saez and Michael Veall looked at the top marginal income tax rate in Canada between 1920 and 2000, using the province of Ontario as an example, and found that, by the year 2000, the top rate had fallen to lowest level since the Great Depression (as shown in *Figure 5*).[41] There were no changes to the top tax rates federally or in Ontario between 2000 and 2011, leaving the top marginal income tax rate at 46.41%.

However, this trend of lower taxes at the top may be at an end, at least provincially. Ontario introduced a new tax bracket for income over $500,000, as of July 1, 2012.[42] Quebec increased the tax rate for those making more than $100,000 per year as of January 1, 2013. And BC NDP Leader, Adrian Dix, has signaled that his party's 2013 election platform will include a tax increase for British Columbians with high incomes.

The top income tax bracket in Canada kicked in at income of $132,406 in 2012. While less than 5% of Canadian tax filers had total income over that threshold in 2010, the reality of increasing income concentration at the very top suggests that additional tax brackets should be set at the top 1% and 0.1% of income. Research on Canadian income distribution suggests that appropriate thresholds may be around $240,000 and $650,000.[43]

While there may be a theoretical limit to how progressive upper-bracket tax rates can be, we are not close to rates that would have adverse economic consequences. A U.S. study by Diamond and Saez estimates the *optimal* top marginal tax rate (applying to income above the threshold for the top 1% of earners) to be 73%, taking into account real economic responses to

FIGURE 5 Top Marginal Income Tax Rage for Ontario, 1920–2000



Note Includes federal tax and Ontario provincial tax.
Source Yalnizyan, Armine. 2010. *The Rise of Canada's Richest 1%*. Ottawa: Canadian Centre for Policy Alternatives. Data originally from Saez and Veall. 2005. "The Evolution of High Incomes in Northern America: Lessons from Canadian Evidence." American Economic Review, 95 (3): 831–849.

tax changes among high-income earners, and as much as 80% if a broader income tax base is used and there are no deductions and loopholes to allow tax avoidance.[44] These amounts are substantially higher than the prevailing U.S. top marginal tax rate of 42.5%.

In a recent review of tax and transfer policy in Canada, Robin Boadway notes that capital income tends to be more responsive to changes in the tax rate than labour income and argues that this is a compelling reason for separation of capital income from labour income for tax purposes.[45] Boadway is a proponent of what is known as a "dual-income" tax system in which labour income is taxed at steep progressive rates while capital income is taxed according to a different rate schedule (he suggests a flat rate). This type of tax model is used by the Nordic countries, which have been successful at combining greater equality with dynamic economies (though it is not clear whether this is because of a streamlined tax system or other factors that produce a much more equal market income distribution to begin with).

We are not persuaded that such reforms are necessary in Canada, and favour a comprehensive income tax base as the fairest way to implement a progressive tax system. That said, practical implementation issues and con-

cerns of capital flight merit the consideration of a dual-income tax system, a second-best solution with regard to fairness. Such a shift would worsen inequality because higher income individuals, who tend to get a higher share of their income from capital, would be paying lower effective tax rates. To compensate for this and ensure that the tax *system* overall remains progressive, dual-income taxation should be accompanied by inheritance and gift/bequest taxes and more steeply progressive personal income taxes.[46]

4. Stop the Corporate Tax "Race to the Bottom"

Corporations are legal vehicles by which individuals pool their capital in order to accumulate income. Corporation income taxes have emerged as means of ensuring that all income gets taxed and reducing the incentive for individuals to shelter income from tax by keeping it within a corporation. At some point, however, income and capital gains must revert back to an individual (during one's lifetime or upon death), at which point they would be subject to the personal income tax system.

A detailed review of corporate tax reform is beyond the scope of this paper. However, we note that it would be possible for Canadian corporate income tax rates to rise given that at 28.8% overall (provincial and federal combined) they are currently the lowest among G8 countries, and considerably lower than U.S. rates (44.8%)[47]. The U.S. taxes corporations based on their worldwide income, so Canadian corporate tax rates lower than the U.S. rates represent a transfer of tax revenue from the Canadian to the U.S. government.[48]

Rhys Kesselman argues for a shift of business taxation to a *cash-flow* tax base.[49] This approach applies tax on total revenues less total expenditures, including full capital costs at the time they are incurred. This would replace arbitrary rules on depreciation and capital cost allowances that differ by sector (providing preferential treatment of natural resource sectors in Canada, for example) and that are not appropriate for capital investments with different lifecycles (mechanical boilers vs. laptop computers, for example).

Such an approach would not tax funds that are transferred to individuals (these would be taxed as personal income) and would enable taxation of all currently non-taxable employer-provided non-cash benefits (e.g., health insurance, personal use of company cars, box seats for the Toronto Maple Leafs) under a broad-based income tax. Other formulations, such as Mirrlees', also allow for non-taxation of capital income up to a *normal* rate

of return, but we see no compelling evidence why this should be a policy priority for business taxation.

A cash-flow approach rightly supports the full taxation of pure economic rents, the returns from the ownership of assets. Robin Boadway builds on this idea as it relates to natural resource industries, which account for a significant and increasing share of Canada's economic activity. Higher tax rates on natural resources are a potential "efficient source of government revenues and a particularly important source of revenues for the federal government given its obligation to equalize provincial revenue capacities."[50]

5. Implement Inheritance and/or Wealth Taxes

Inheritance taxes are based on, in the words of Sam Fleischacker, "the principle that social privileges should be earned, should be a reward for contribution to society, rather than handed out by government leaders or passed down by aristocratic dynasties."[51] Taxes on transfers of wealth (gifts and bequests) are based on the same principle, just not linked to time of death. By limiting the extent to which capital (and the opportunities it buys) is passed across generations, wealth transfer taxes equalize opportunities and increase social mobility, while reducing the concentration of income at the very top.

Taxes on transfers of wealth, whether bequests or inheritances, close the loop on comprehensive income taxation. In effect, as noted by Mirrlees, "the main difference between lifetime income and lifetime expenditure is gifts and bequests. There is a good case for taxing such transfers of wealth, particularly to the next generation." Canada is one of the few developed countries that does not currently tax bequests and inheritances.

To ensure that all Canadians contribute their fair share in taxes, large inheritances and gifts should be included in the recipient's taxable income. Neil Brooks proposes a cut-off of $3 million for inclusion of inheritances and gifts in taxable income, although this threshold could arguably be lowered to $1 million. While there is room for debate on where to draw the threshold, the key point is that taxing bequests is essential for fairness and equality of opportunity.

In addition to transfers of wealth, holdings of wealth should also be taxed at an annual rate. This would improve tax fairness since wealth is even more unequally distributed than income. Provincial property taxes are in essence a wealth tax on real estate, which is the principal form of asset ownership for a large share of the population (BC has both a property tax

and a property transfer tax). A federal tax on wealth would simply broaden the base to include financial market assets, ownership of which is highly concentrated at the top of the income distribution. Indeed, a private version of a wealth tax already exists in the form of annual fees for many whose financial wealth is held in mutual funds.

Brooks proposes that wealth holdings over $3 million would pay a 1 per cent tax on their fair market value annually.[52] Such a tax could also have important incentive effects, by increasing the likelihood that wealthy investors will put their money to work in productive activities.

6. Use Consumption Taxes Cautiously

There are significant political economy advantages to a direct consumption or value-added sales tax (VAT) like the GST: governments tend to face less pressure to introduce loopholes, deductions and credits to a flat VAT than to progressive income taxes. Because of the minimal tax evasion opportunities of value-added consumption taxes, they are widely recognized as large revenue generators for government and widely employed in OECD countries (with the exception of the U.S.). In fact, the primary opposition against VAT from conservatives in the U.S. is that they would raise too much revenue and lead to a large expansion of government.

Where consumption tax arguably fails, however, is on equity grounds. Consumption taxes are regressive because lower income individuals end up paying a larger share of their income on tax. Even if an adequate compensation mechanism is implemented for households of low and modest incomes, consumption taxes alone cannot achieve tax fairness at the top of the distribution. The reality is that the richest spend such a small share of their income on consumption that it is practically impossible to have a progressive tax system without taxing savings as well (through a broad-based income tax).

Neil Brooks raises another important equity concern with consumption taxes from a life-cycle perspective: consumption taxes tend to be "levied on individuals at a time in their life when they can least afford to pay, namely, when they are consuming most of their incomes as opposed to saving it" such as when they are starting out in the workforce, have young children, face unexpected large bills, lose their jobs or are retired and live on their savings.[53] It is fairer to tax individuals through income tax when they are in their peak earning years, when they can afford to save and paying taxes requires

the least amount of sacrifice. In addition, consumption taxes discriminate against women, who continue to earn less than men in the 21st century, and therefore consume a higher share of their income than men. Women thus also end up paying a higher share of their total income in consumption tax.

Canada has moved in the direction of increasing its reliance on consumption taxes at both the provincial and federal level.[54] Theoretical rationales for shifting to consumption taxes generally do not hold up empirically, and there are important normative issues as to why, for example, not interfering with people's time preferences of consumption ought to be an aspiration of public policy. Canada remains more reliant on income tax than many OECD countries and this should continue.

Value-added consumption taxes may be used to supplement revenues collected from a progressive, broad-based income tax, but should not form the main basis of the Canadian tax system. On the other hand, carbon taxes and financial transactions taxes are examples of specific consumption taxes aimed at internalizing external costs, which improves the functioning of market-based economies and should be embraced.

Consumption taxes have also formed part of the policy mix for social "bads." Taxes on alcohol and cigarettes are well-known examples. In recent years, calls for action on climate change have included forms of carbon pricing such as carbon taxes (similar to fuel taxes but applying to all sources of carbon dioxide emissions). A review of BC's carbon tax by Marc Lee finds that the tax itself is regressive but how revenues are spent matters a great deal in assessing its overall distributional impact.[55] To avert worsening inequality, Lee recommends using half of carbon tax revenues to create a carbon credit that would flow back to low- and middle-income households while using the other half of revenues to support climate actions such as public transit investment.

Another case is a Financial Transactions Tax (also known as a *Tobin* tax or a *Robin Hood Tax*), which is a levy on financial market transactions with the goal of discouraging excessive speculative trading without discouraging productive investment. The idea is not new, but it has enjoyed increased popularity in the aftermath of the global financial crisis. There are three main reasons to pursue an FTT: 1) it has the potential to curb volatility and speculation in financial markets, 2) it is a fair form of taxation because it is aimed at the financial sector, a tremendously profitable but very lightly taxed industry, and 3) it is potentially capable of collecting large amounts of tax revenues. In addition, current developments in technology have made the

tax feasible today (when Tobin proposed the concept of the tax in the early 1970s, he argued that such a tax was desirable, but not feasible in practice).

France was the first country to introduce a financial transaction tax after the global financial crisis, which came into effect on August 1, 2012 (the tax is expected to generate 500 million euros annually to be used domestically to reduce the budget deficit). The European Commission outlined plans in September 2011 for an EU-wide financial securities tax to come into effect in 2014.[56] Even if the revenues collected through this tax were not spent within Canada, an FTT would still improve the fairness of our tax system by increasing the share of taxes collected from wealthier Canadians and producing a more equal distribution of after-tax income.

7. Implement a Basic or Guaranteed Income

One of the ways that redistribution is achieved in the tax system is by providing direct income transfers to lower-income families (usually based on the previous year's assessed income). The five largest ones at the federal level are the Canada Child Tax Benefit (with its associated low-income National Child Benefit supplement and the Child Disability Benefit), the GST credit, the Working Income Tax Benefit, the Universal Child Care Benefit and Old Age Security (with its Guaranteed Income Supplement).[57] Together, these programs are valued at $53.2 billion.[58]

These transfers have different income cut-offs and phase out at different rates even though a family could qualify for more than one of these in a particular year (child benefits, WITB and GST credit, for example). Add provincial low-income credits and transfers to the mix, and it becomes clear that Canada does not have a coherent system of supports for low-income families but rather a patchwork of uncoordinated programs.

As a result of all benefits phasing out rapidly around incomes in the range of $25,000 to $40,000 for families with children, families in this income range face a very high marginal effective tax rate. For example, a family income increase of $5,000 from $35,000 to $40,000 for a two-parent family with one child would result in a loss of CCTB and GST credits alone equivalent to a marginal tax of 17% on the extra income earned, which is on top of the federal tax rate of 15% and the EI and CPP premium rates on that extra income.[59] That alone is a marginal tax rate of 32%. But this earnings increase, which would take the family slightly above the poverty rate for a three-person family in a large Canadian city ($35,657 in 2011, according to

LICO before tax) would likely lead to the clawing back or loss of other provincial tax credits, income-tested transfers and subsidies the family previously qualified for. Depending on the province, the family might lose part or all of a rental assistance subsidy, childcare subsidy, assistance with the repayment of the parents' student loans. When all of these are combined, the total "tax" on the extra $5,000 earned might add up to more than 100%.[60]

The high marginal tax rates in relatively low family-income ranges are a longstanding policy problem of Canada's income tax system. While much of the action happens in the provincial tax system, where tax benefits combine with stand-alone income-tested subsidy programs (for example, child care and rental assistance subsidies, which tend to phase out faster than the transfers delivered through the tax system over the same range of relatively low incomes), the federal income tax system contributes significantly to this problem.

This could be resolved by amalgamating the separate tax credits and benefits into a single income transfer (tax benefit) that would phase out gradually over a large income range similar in structure to the OAS and the CCTB. An alternative formulation is that the transfer would not be phased out, but would instead be taxable. The transfer would be broad-based, and designed to take into account individual circumstances such as family size, number of young children, family members with disabilities, etc.[61]

We recommend that the benefit level be set at a significantly higher maximum level than the current GST transfer, so that this transfer would greatly increase the total income of the poorest Canadians and serve as a key pillar of a federal anti-poverty strategy. Ideally, it would be coordinated with provincial/territorial tax systems and replace the need for provincial social assistance payments and bureaucracies, making all income support federal and part of a coherent cradle-to-grave system that all Canadians have access to, regardless of where they live. Importantly, it would not be a substitute for provision of decent public services but in addition to them.

The current payroll tax approach to Employment Insurance could also be rolled into this system. Employers and employees would no longer pay EI premiums, but recently unemployed workers would be eligible for a top-up on their basic income consistent with current income support levels under EI benefits. Beyond the middle of the income distribution, current EI premiums are regressive as contributions max out at $45,900, a modest level of earnings (they are flat at incomes under this cutoff). For employers they act as a disincentive, an additional cost of hiring a new worker. Benefits have limited redistribution built into them at low-income levels as benefits are based

on wages earned during employment, and tough eligibility requirements, which discriminate against new entrants to the labour force and workers in casual and precarious jobs that do not provide a lot of hours.

This transfer would be expensive but could readily be funded from the additional revenues gained from base broadening of the income tax. Such a transfer would be flexible and could easily accommodate new tax measures introduced in the future. For example, it could be merged with a new federal carbon-pricing scheme (which would be regressive on its own) in a manner that offsets the regressive impact of the tax on low- to middle-income households without creating high marginal income tax rates for Canadian families with modest incomes.[62]

Conclusion

AT A TIME of rising income inequality and unprecedented concentration of wealth in the hands of a small group of super-rich Canadians, restoring fairness should be the primary objective of the Canadian tax system. This involves broadening the income tax base to ensure that all forms of income are subject to the same progressive tax rates, raising marginal income tax rates on top incomes, eliminating tax credits and deductions that disproportionately benefit the richest Canadians and introducing a single streamlined income-tested transfer for low- and modest-income families.

In addition, we must reduce our reliance on revenues collected from regressive taxes that weigh heavily on Canadians at the bottom of the income distribution. While we do not believe that every single tax should be progressive on its own, if the federal personal income tax is going to be the workhorse of fairness in the tax system, then it should represent a large enough share of all tax revenues that it can do its job.

Democratically elected governments have the prerogative to use the tax system to achieve their particular policy priorities. However, in order to ensure that fairness is maintained despite frequent changes in the tax system, it is important that Finance Canada undertakes regular reviews of the progressivity and distributional effects of the entire federal tax system (e.g., every 5 years). Currently, such reviews are undertaken on an ad-hoc basis and often only cover the personal income tax system.[63]

The exact combination of reforms should be developed on the basis of a comprehensive review of the tax system. A Fair Tax Commission should

be convened to examine how federal taxes and transfers work together as a system and make recommendations for changes. Ideally, the Commission would include an expert and well-respected team made up of both academics and practitioners, and would engage Canadians from all walks of life in a meaningful and broad-based public dialogue and deliberation process to produce a framework for tax reform.

Notes

1 Diamond, Peter and Emmanuel Saez (2011). "The Case for Progressive Tax: From Basic Research to Policy Recommendations." *Journal of Economic Perspectives*. Vol 25 (4). p. 165–190.

2 Mirrlees, James, Stuart Adam, Tim Besley, Richard Blundell, Stephen Bond, Robert Chote, Malcolm Gammie, Paul Johnson, Gareth Myles and James Poterba (The Mirrlees Review) (2011), *Tax by Design* (Oxford: Oxford University Press). pp. 471–2, http://www.ifs.org.uk/mirrleesreview/. This finding is consistent with other comprehensive tax reviews by the Meade Report on Taxation in the UK (1978) and the Carter Royal Commission in Canada (1969).

3 This is the conclusion of the state-of-the-art economic analysis by American economists Peter Diamond and Emmanual Saez in the *Journal of Economic Perspectives*, and a key recommendation of the Mirrlees Review in the UK, the most comprehensive tax review undertaken in the developed world in the last decade. Diamond, Peter and Emmanuel Saez (2011). "The Case for Progressive Tax: From Basic Research to Policy Recommendations." *Journal of Economic Perspectives*. Vol 25 (4). pp. 165–190.

4 Diamond and Saez (2011).

5 While it is beyond the scope of this paper, it should be noted that the distribution of market incomes in any modern economy is not exogenous but is to a large extent an outcome of public policy. For example, strong labour unions and relatively high minimum wages increase the share of income going to workers, and limited-liability laws allow risk-taking that can reap great monetary benefits through pooling and accumulation of capital while limiting the downside risk to the amounts invested, thus increasing the share of income going to the owners of capital.

6 Corak, Miles. 2011. "Inequality from Generation to Generation: The United States in Comparison" (http://milescorak.files.wordpress.com/2012/01/inequality-from-generation-to-generation-the-united-states-in-comparison-v3.pdf) (forthcoming in Economics of Inequality, Poverty and Discrimination in the 21st Century, edited by Robert S. Rycroft. Santa Barbara, CA: ABC-Clio Publishers).

7 Wilkinson and Pickett (2009), *The Spirit Level: Why More Equal Societies Almost Always Do Better,* London, New York: Allen Lane.

8 The authors consider a number of causality issues and competing explanations, but arrive at one key explanation for why inequality has this effect: psychosocial issues related to increased social status competition and status anxiety that accompany greater inequality.

9 Robert Frank argues that relative income matters because inequality in consumption yields negative externalities. In recent decades in the U.S., most of the total income gains have been captured by top income earners. And as the rich have built larger mansions, for example, "they shift the frame of reference that defines an acceptable house for those slightly below them on the income scale" and so forth down the line. Frank muses that these "expenditure cascades" impose a negative "positional externality" reflected in households "working longer hours, saving less, borrowing more, commuting longer distances, and filing for personal bankruptcy" at greater rates than previous cohorts. See R. Frank, *Are Positional Externalities Different from Other Externalities?*, paper presented at Why Inequality Matters: Lessons for Policy from the Economics of Happiness, hosted by the Brookings Institution, Washington DC, June 4–5, 2003, http://www.brookings.edu/gs/events/externalities.pdf

10 M. Lee and A. Card, *Who Occupies the Sky? The Distribution of GHGs in Canada*, Behind the Numbers, Canadian Centre for Policy Alternatives, November 2011, http://www.policyalternatives.ca/publications/reports/who-occupies-sky

11 M. Lee, *Fair and Effective Carbon Pricing: Lessons from BC*, Canadian Centre for Policy Alternatives, February 2011, http://www.policyalternatives.ca/publications/reports/fair-and-effective-carbon-pricing

12 Boadway, Robin. 2011. "Rethinking Tax-Transfer Policy for 21st Century Canada," in Fred Gorbet and Andrew Sharpe (eds.). *New Directions for Intelligent Government in Canada: Papers in Honour of Ian Stewart*, pp. 163–204. Centre for the Study of Living Standards.

13 As measured by the change in Gini coefficient. From OECD. 2008. *Growing Unequal? Income Distribution and Poverty in OECD countries*.

14 Statistics Canada in Cansim Table 202-0709. For a closer look at the trends in different income inequality measures since the mid-1980s, see OECD. 2011. *Divided We Stand: Why Inequality Keeps Rising*. An Overview of Growing Income Inequalities in OECD Countries: Main Findings. Paris: OECD.

15 OECD. 2011. *Divided We Stand: Why Inequality Keeps Rising*. Country Note: Canada. Paris: OECD.

16 This trend was first documented in Saez, Emmanuel and Michael Veall. 2005. "The Evolution of High Incomes in Northern America: Lessons from Canadian Evidence." *American Economic Review*, 95 (3): 831 - 849.

17 Yalnizyan, Armine. 2010.

18 Yalnizyan, Armine. 2010. *The Rise of Canada's Richest 1%.* Ottawa: Canadian Centre for Policy Alternatives.

19 See, for example, the Conference Board of Canada. 2011. "Is Canada becoming more unequal?" *Hot Topic: Canada Inequality*.

20 Lee, Marc. 2007. *Eroding Tax Fairness: Tax Incidence in Canada, 1990 to 2005*. Ottawa: CCPA. http://www.policyalternatives.ca/publications/reports/eroding-tax-fairness

21 Sales taxes like the Goods and Services Tax (GST) are regressive because lower-income families tend to consume almost all of their income (and then some, with many households in debt), so they end up paying a higher share of their total income in the GST than higher income households, who can afford to save a significant chunk of their incomes. While exempting basic ne-

cessities and providing a small income transfer, the GST credit, improve tax fairness among the lowest income families, the tax remains regressive at modest and high incomes.

22 Both the International Monetary Fund and the OECD have recently argued that rising income inequality is damaging for the economy. Wilkinson and Pickett's seminal book, *The Spirit Level*, provides ample empirical evidence that greater inequality leads to adverse social and health outcomes in rich countries. Berg, Andrew and Jonathan Ostry. 2011. "Equality and Efficiency: Is there a trade-off between the two or do they go hand in hand?" *Finance and Development* (September). Washington: IMF; OECD. 2011. "Divided We Stand: Why Inequality Keeps Rising." Remarks by Angel Gurría. OECD Secretary-General, delivered during the press conference for the launch of this report. 5 December. Paris: OECD; Wilkinson, Richard and Kate Pickett 2009. *The Spirit Level: Why More Equal Societies Almost Always Do Better*. London, New York: Allen Lane.

23 Tax credits appear on income tax forms as reductions in tax payable. Tax benefits are paid out on an annual basis based on the previous year's income. The GST credit is thus technically a tax benefit.

24 Federal government taxes (including payroll taxes) made up 45% of all taxes collected in Canada in 2011. Data from Statistics Canada's Government Financial Statistics, Cansim table 385-0032.

25 Mirrlees, op cit.

26 Neil Brooks provides a detailed summary of the arguments on both sides, which we won't reproduce here. See Brooks, Neil. 2007. "An Overview of the Role of the VAT, Fundamental Tax Reform, and a Defense of the Income Tax." In Krever, Richard and David White (eds.) *GST in Retrospect and Prospect*.

27 Data from Statistics Canada, CANSIM Table 378-0121: National balance sheet accounts. Bank of Canada Governor Mark Carney recently made national news after raising concern about corporate cash surpluses that are not being invested, which he described as "dead money" for the economy.

28 See P. Diamond and E. Saez (2011). "The Case for Progressive Tax: From Basic Research to Policy Recommendations." *Journal of Economic Perspectives*. Vol 25 (4). pp. 165–190.

29 As estimated by Finance Canada. 2012. *Tax Expenditures and Evaluations 2011*. These figures are on the personal income tax side, but corporations also benefit from the partial inclusion of capital gains. The corporate income tax costs of the preferential tax treatment of capital gains were estimated at $3.9 billion in 2011.

30 See, for example, Milligan, Kevin. 2012. "Policy Forum: The Tax-Free Savings Account — Introduction and Simulations of Potential Revenue Costs." *Canadian Tax Journal*. Vol. 60. Issue 2, pp. 355–60., Kesselman, J. Rhys. 2012. "Policy Forum: Expanding the Tax-Free Savings Account — Requisite Companion Reforms." *Canadian Tax Journal*. Vol. 60. Issue 2, pp. 375–89.

31 A "buck is a buck" as stated by the 1969 Carter Royal Commission. We also reject the proposition that a deduction be granted for capital income up to a "risk-free rate of return," usually equivalent to the rate on government bonds as there are no empirical grounds why this should be the case.

32 As estimated by Department of Finance Canada. 2012. *Tax Expenditures and Evaluations 2011*.

33 These "boutique tax credits" have been shown to provide windfall gains for middle- and upper-income families rather than actual incentives that change behaviour. See P.S. Taylor and B. Sand, 2011, *Harper's Tax Boutique: Rethinking Tax Expenditures in a Time of Deficit,* Frontier Centre for Public Policy. The RRSP is proving inadequate as a mechanism to generate sufficient retirement savings for Canadians. See, for example, M. Wolfson, 2011. *Projecting the Adequacy of Canadians' Retirement Incomes: Current Prospects and Possible Reform Options*. Institute for Research on Public Policy: Montreal. Most current research points to the unsuitability of voluntary

programs such as the RRSP to serve as a basis of a retirement income security program, due to low participation rates.

34 Some caution is required in interpretation as tax data are based on individual filings and therefore do not adequately represent differences in household income where two or more individuals may have income.

35 Authors' calculation based on data from Finance Canada, *Tax Expenditures and Evaluations 2011* and *Fiscal Reference Tables 2012*. Note that Finance Canada figures are for 2011, while the Table has data from the 2010 tax year (latest year available for each). These tax expenditure totals do not take account of the interactions among the different tax expenditures and likely understate their true cost to the federal treasury. Above and beyond these amounts are the cost of tax expenditures to provincial treasuries.

36 The RRSP deduction limit is set at 18% of earned income up to a cap of $22,450 — an amount close to half of the median annual earnings of full-time workers in Canada, which was $46,300 in 2010.

37 Sandler, Daniel. 2001. "The Tax Treatment of Employee Stock Options: Generous to a Fault." *Canadian Tax Journal*. Vol. 49 (2):259–319.

38 T. Sanger, "Stock options, the buyback boondoggle and the crisis of capitalism" in *Relentlessly Progressive Economics* blog, March 3, 2010, http://www.progressive-economics.ca/2010/03/03/stock-options-the-buyback-boondoggle-and-the-crisis-of-capitalism/

39 A similar case can be made against tax credits for political donations, although the value of this tax expenditure is much smaller ($32 million in 2011) than charitable giving because the tax credit is capped at $650 per year (the cap is reached with a political donation of $1,275 and no further tax credit is given for donations over that amount).

40 N. Brooks, "A Democratic Tax Reform for Canada" in *Canadian Dimension*, March 3, 2007, http://canadiandimension.com/articles/1797/. For a more detailed critique of the charitable tax credit, see N. Brooks, 2001, "Tax Credit for Charitable Contributions: Giving Credit where None Is Due" in *Between State and Market: Essays on Charities Law and Policy in Canada*, eds. J. Phillips, B. Chapman, D. Stevens. McGill-Queens University Press.

41 Saez, Emmanuel and Michael Veall. 2005. "The Evolution of High Incomes in Northern America: Lessons from Canadian Evidence," *American Economic Review*, 95 (3): 831 - 849. There were no changes to the top tax rates federally or in Ontario between 2000 and 2011.

42 After the surtax of 13.16%, this will increase the top marginal income tax rate in Ontario to 47.97% in 2012 and 49.53% in 2013, when fully phased in.

43 Fortin, Nicole, David A. Green, Thomas Lemieux, Kevin Milligan, Craig Riddell. 2012. "Canadian Inequality: Recent Developments and Policy Options," *Canadian Public Policy*. Vol. 38 (2): pp. 121–145 estimate that the threshold for the top 1% was $230,000 in 2005, 2010 CRA preliminary statistics show that only 0.8% of taxfilers had income over $250,000. Estimates for the threshold of 0.1% from Yalnizyan, Armine. 2010. *The Rise of Canada's Richest 1%*. Ottawa: Canadian Centre for Policy Alternatives.

44 P. Diamond and E. Saez, "The Case for a Progressive Tax: From Basic Research to Policy Recommendations" in *Journal of Economic Perspectives*—Volume 25, Number 4, Fall 2011, pp. 165–190.

45 Boadway, Robin. 2011. "Rethinking Tax-Transfer Policy for 21st Century Canada," in Fred Gorbet and Andrew Sharpe (eds.). *New Directions for Intelligent Government in Canada: Papers in Honour of Ian Stewart*, pp. 163–204. Centre for the Study of Living Standards.

46 Having a progressive income tax system with strong redistributional power is particularly important for countries with high levels of market income inequality. Countries with fewer wage

disparities, such as the Nordic countries, have more leeway to raise revenues in less progressive ways without exacerbating already large income inequality problems. If Canada was to consider a dual-income tax system with low capital taxation and relatively high reliance on a regressive value-added tax it should be accompanied by labour market measures such as much higher union coverage.

47 PricewaterhouseCooper (PwC), the World Bank and International Finance Corp. (IFC). 2012. *Paying Taxes 2012: The Global Picture*. www.pwc.com/payingtaxes.

48 E. Weir, "The Treasury Transfer Effect" in Relentlessly Progressive Economics blog, November 3, 2009, http://www.progressive-economics.ca/2009/11/03/treasury-transfer-effect/ and "The Treasury Transfer Effect — You Read it Here First," April 20, 2011, http://www.progressive-economics.ca/2011/04/20/treasury-transfer-here-first/

49 J.R. Kesselman, *Tax Design for a Northern Tiger*, Institute for Research on Public Policy, Choices, Vol. 10, No. 1, March 2004.

50 R. Boadway, *Tax-Transfer Policy for 21st Century Canada*, prepared for Authors Workshop for the Ian Stewart Festschrift, Ottawa, April 20–21, 2011, http://www.csls.ca/festschrift/Boadway.pdf

51 S. Fleischacker, "Why Capitalists should like Estate Taxes" in Salon, February 15, 2001, http://www.salon.com/2001/02/15/estate_tax_2/singleton/

52 Brooks 2007, op cit.

53 Brooks, Neil. 2007.

54 This has been achieved by introducing the GST federally (and increasing rates of provincial sales taxes) as well as by narrowing the base of the income tax by excluding retirement savings in RRSP and RPP accounts (so that taxable income more closely resembles income consumed).

55 M. Lee. 2011. Fair and Effective Carbon Pricing: Lessons from BC, Canadian Centre for Policy Alternatives, http://www.policyalternatives.ca/publications/reports/fair-and-effective-carbon-pricing

56 European Commission. Press Release. 2012. "The Financial Transaction Tax will Reduce Member States' GNI contributions to the EU budget by 50%." http://europa.eu/rapid/pressReleasesAction.do?reference=IP/12/300

57 The UCCB is the only income transfer that is not income tested. It is provided as a taxable benefit, which means that some higher earning families receive a lower amount net of tax (unless they are single-earner families, in which case they would receive the maximum amount of the benefit regardless of the total family income).

58 As estimated by Finance Canada. 2012. *Tax Expenditures and Evaluations 2011*.

59 Authors' calculations for 2012 tax year, based on Canada Revenue Agency tax forms, the CCTB online calculator for the period July 2012 to June 2013 (http://www.cra-arc.gc.ca/bnfts/clcltr/cctb_clcltr-eng.html) and the GST online calculator for the period July 2012 to June 2013 (http://www.cra-arc.gc.ca/bnfts/clcltr/gstc_clcltr-eng.html).

60 For a more detailed discussion of this issue, see J. Stapleton, 2007, *Why Is It So Tough To Get Ahead? How Our Tangled Social Programs Pathologize the Transition to Self-Reliance*. Toronto: Metcalf Foundation.

61 That said, we note that tax returns are filed on an individual basis, and feminist scholars have argued for transfers to individuals rather than families as there are gender-related income distribution issues within households. For an overview of issues associated with a Guaranteed Annual Income, see M. Young and J. Mulvale, *Possibilities and Prospects: The Debate Over a Guar-*

anteed Income, CCPA, October 2009, http://www.policyalternatives.ca/publications/reports/possibilities-and-prospects

62 A study on carbon pricing in BC by Marc Lee argues for half of carbon tax revenues to be used as a new carbon transfer, and shows that it could be designed in a way that the bottom 80% of households get a positive transfer (modeled on the CCTB with a long phase-out) and the bottom half of households would receive, on average, more in credits than they would pay in tax. See M. Lee. 2011. *Fair and Effective Carbon Pricing: Lessons from BC*. Vancouver: Canadian Centre for Policy Alternatives.

63 See Department of Finance Canada. 2012. "Distributional Impact of the Federal Personal Income Tax System and Refundable Credits: Analysis by Income, Sex, Age and Family Status." Part 2 in *Tax Expenditures and Evaluations 2011*.

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