

An Agenda for Tax Reform in Canada

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Context

Two historic anniversaries

- ▶ 100+ years since the Income Tax Act 1917
- ▶ 50+ years since the Carter Report 1966

Carter Report Principles still inform tax law & structure

- ▶ Comprehensive income as ideal tax base: **ability-to-pay**
- ▶ Corporate tax as **withholding device** for income tax
- ▶ Rate structure progressive above some level of non-discretionary income: **equal sacrifice**
- ▶ Mintz Report 1998 reaffirmed Carter view of corporate tax
- ▶ Federal *Report on Tax Expenditures* uses comprehensive income as its benchmark (except for GST!)

Tax system still nominally based on comprehensive income ideal, but has evolved on piecemeal basis far from that ideal ⇒

Milestones of Tax Policy Thinking since Carter

Kaldor, Meade, US Treasury Blueprints: Focus on the tax base

- ▶ Tax personal consumption to avoid double taxation of savings
- ▶ Base corporate tax on rents (cash-flow-equivalent)
No need for withholding
- ▶ Inheritance tax for equality of opportunity

Optimal tax revolution: Emphasizes the rate structure

- ▶ Ideal personal tax based on social welfare maximization
Limited progressivity at top, more progressive at bottom
Preferential taxation of capital income
- ▶ Mirrlees Review, President's Panel, Henry Review:
Similar to Meade, but recognize importance of rents as a component of both corporate and personal income

Milestones, continued

Further extensions

- ▶ **Equality of opportunity**
Emphasize ex ante opportunities vs consequences of choices
- ▶ **Participation decision**
Case for participation subsidy at low incomes
- ▶ **Consequences of behavioural economics**
Case for sheltering saving for retirement
- ▶ **Sales taxes**
VAT as efficient revenue-raising tax
- ▶ **Roles for excise taxes**
Externalities (pollution, congestion); Sin goods
Case against using excises for redistributive purposes

Setting the Stage

1. Main Piecemeal Tax Changes since Carter
2. Changes in Circumstances
3. Changes in Tax Principles
4. Changes in Tax Policy Practices

Piecemeal Tax Changes since Carter

- ▶ Gradual expansion of sheltered savings vehicles: RPPs, RRSPs, TFSAs
- ▶ GST/HST/QST: based on consumption, not income
- ▶ Conversion of deductions to non-refundable tax credits, introduction of RTCs, flattening of rate structure
- ▶ Harmonization of federal PIT, CIT and GST with provinces, and RTS equalization
- ▶ Minimal changes to CIT: Base-broadening and rate-reduction
 - ⇒ Still based on shareholder income for withholding
 - ⇒ Integration via dividend tax credit, capital gains exemption
 - ⇒ Move to territorial CIT system
 - ⇒ Distorts investment, financing, innovation/risk
- ▶ Abolition of inheritance/succession tax

Changes in Circumstances

- ▶ Globalization of markets for capital, high-skilled labour, intermediate goods; opportunities for income-shifting
⇒ Constrains tax policy
- ▶ Increased competitiveness, esp. in manufacturing
- ▶ Growing inequality of income and wealth in OECD countries
⇒ Benefits of productivity growth accruing to top incomes
⇒ Increasing proportion of wealth becomes bequests
- ▶ Reallocation of production from goods to services, especially technology-based; demand for educated workforce
- ▶ Decline in productivity growth
- ▶ Aging of the population
⇒ Implications for intergenerational transfers
- ▶ Growing prominence of precarious work

Changes in Tax Principles I

- ▶ Move from ex ante ability-to-pay approach to ex post social welfare maximization approach
Comprehensive income \longrightarrow Consumption (primarily)
- ▶ Case for different tax rates on earnings and capital income (schedular tax)
- ▶ More progressive rate structure
 - \Rightarrow More capital income included at top
 - \Rightarrow More refundability, higher transfers at bottom
- ▶ Behavioral case for sheltering savings
 - \Rightarrow Too little saving for retirement
- ▶ Differences in mechanisms for sheltering capital income
Tax deferred (RRP, RRSP) vs tax prepaid (TFSA, housing)
Case for penalizing early withdrawal

Changes in Tax Principles II

- ▶ Weak case for CIT/PIT integration
 - ⇒ Most capital income sheltered
 - ⇒ Incidence of CIT largely borne by wages
- ▶ Case for basing business & capital income tax on rents
 - ⇒ Evidence that rents of large firms and investors are large
 - ⇒ Cash-flow tax encourages investment and risk-taking
 - ⇒ Preference for deferred-tax sheltering
 - ⇒ Limit to sheltering of capital income
- ▶ Case for participation subsidy and/or wage subsidy at bottom
 - ⇒ Canada Workers Benefit (supply-side incentive)
 - ⇒ Employment subsidy to firms (demand-side incentive)
- ▶ Intergenerational equity
 - ⇒ Reduce public debt and implicit liabilities of government
 - ⇒ Preference for registered assets over tax prepaid
- ▶ Case for lifetime tax on inheritances

Changes in Tax Practices Worldwide

- ▶ Change in tax mix: Income tax to VAT
- ▶ Preferential capital income taxation: Sheltering, dual/schedular tax
- ▶ Less progressive personal taxes despite growing inequality
- ▶ Some movement to rent-based business tax: ACE corporate tax, cash-flow resource tax
- ▶ Move to territorial base for CIT and lowering of rates
- ▶ Preferential treatment of R&D/innovation: Credits, subsidies, patent boxes
- ▶ OECD BEPS initiative and information sharing
- ▶ Demise of wealth tax and less use of inheritance/bequest tax
- ▶ New emphasis on excise taxes: pollution, congestion, sin taxes

Republican Party corporate tax proposal for destination-based cash-flow tax partly implemented in US

An Agenda for Tax Reform in Canada

1. Main Features of Existing System
2. Inconsistencies in the Tax System
3. Broad Proposal for Tax Reform
4. Reform of Personal Income Tax and Transfers
5. Reform of Corporate Income Tax
6. Other Long-Term Tax Reforms

Main Features of Existing System I: PIT

Mix of comprehensive income and consumption tax

- ▶ Large share of savings sheltered, but incoherently:
 - ⇒ RRSP/RPP, TFSA, housing, GST/HST
 - ⇒ Personal business income is not sheltered
- ▶ Inheritances and gifts not taxed
- ▶ Integration with CIT imperfect and arguably unnecessary
- ▶ Capital gains are taxed favourably, and economic rents or windfalls poorly taxed (TFSAs, housing)
- ▶ Rate structure has limited progressivity at bottom given non-refundability of most credits, while some demographic groups treated favourably relative to others
- ▶ METRs high for some taxpayers due to stacking of tax-back rates applying to different credits
- ▶ Limited income insurance for precarious workers

Main Features of Existing System II: CIT

Designed to withhold shareholder income at source

- ▶ Tax base distortionary: discourages investment, favours some industries, encourages debt finance and tax competition
- ▶ CIT base conflicts with PIT base due to sheltering
- ▶ Difficult to base CIT on shareholder income because of measurement problems
- ▶ CCPCs sheltered to some extent via LGCE and capital gains rollovers, but otherwise fully integrated with PIT so pay full personal tax rates
- ▶ As mentioned, unincorporated business income not sheltered
- ▶ Scope of small business deduction excessively broad
- ▶ Generous R&D credits, especially for small businesses
- ▶ Loss-offsetting limited

Summary of Inconsistencies in Canadian Tax System

- ▶ Some assets sheltered, others not
- ▶ Forms of sheltering inconsistent
- ▶ Design of CIT as withholding device ineffective, unnecessary, distortionary
 - ⇒ Implications for CIT base
 - ⇒ Favourable taxation of dividends, capital gains
- ▶ Rents and windfalls not fully taxed
- ▶ Progressivity ineffective
 - ⇒ Non-refundability of tax credits
 - ⇒ Small size of participation subsidy (CWB)
 - ⇒ Capital income not well taxed at top
- ▶ Small business tax rate does not fulfill objective

A Broad Proposal for Tax Reform

Draws on proposals made in Canada and abroad, on advances in the academic literature, and on practices elsewhere

Builds on existing system and satisfies the following principles

- ▶ Progressive tax on earnings and capital income, with sheltering of normal returns for low- and middle-income persons and base-broadening at top
- ▶ Savings for retirement sheltered in limited and coherent way
- ▶ Preferential tax on capital income achieved by GST/HST
- ▶ Rents or windfall gains fully taxed where possible, including on housing and shares, and inheritance tax revisited
- ▶ Efficient rent-based business tax system with incentives for innovation and productivity growth
- ▶ Integration of PIT and CIT abolished
- ▶ More progressive income tax at lower end using enhanced RTCs, while preserving labour participation incentives

Reform of the Personal Income Tax I

Preferential treatment of capital income largely achieved by broad-based GST combined with progressive PIT

Sheltering of capital income should focus on retirement saving

- ▶ Restrict withdrawals of RRSPs and TFSAs
- ▶ Enhance RRSPs vis-à-vis TFSAs to capture windfalls and rents
- ▶ Tax personal businesses on cash-flow/ACE basis; abolish LCGE since personal business income will be sheltered
- ▶ Tax capital gains on owner-occupied housing beyond some exemption level
- ▶ Eliminate capital gains exemption and dividend tax credit since integration no longer warranted; fully tax stock options
- ▶ Make CPP and EI premiums deductions rather than credits
- ▶ Eliminate pension income-splitting
- ▶ Reinstate income averaging to address income volatility

Reform of the Personal Income Tax II

Rationalize non-refundable and refundable tax credit

- ▶ Abolish Age, Pension, Employment, and 'boutique' credits
- ▶ Make NRTCs refundable, especially those that are redistributive, unless good contrary arguments exist
- ▶ Enhance Basic Personal Credit, make refundable and income-tested, and combine with GST credit
- ▶ Establish refundable disability tax credit
- ▶ Enhance CWB to encourage participation
- ▶ Harmonize tax-back of various credits, including CCB, to avoid stacking of tax-back rates

Constitutes a move toward basic income guarantee

Reform of Corporate Income Tax

- ▶ Change base to R+F cash flow or its equivalent:
ACE via deduction for equity finance using normal return
- ▶ Retain small business deduction, but reimpose cumulative limit to target small, new firms
- ▶ Explore enhancing refundability of losses by pass-throughs
- ▶ Allow deduction of cost of stock options as they become fully taxed at the personal level
- ▶ R&D incentives
 - ⇒ Eliminate preferential SR&ED to small businesses
 - ⇒ Consider patent box offering preferred tax rate on proceeds from patents developed domestically
- ▶ Adopt full territorial system for corporate investments abroad, adopt consolidated accounting for the allocations of corporate tax revenues to provinces

Other Longer-Term Tax Reforms

Enhance accountability of tax expenditures

- ▶ Add distributive dimension where feasible
- ▶ Prepare intergenerational accounts
- ▶ Harmonize with provincial tax expenditures

Move toward fed-prov basic income guarantee by harmonizing NRTC, RTC, provincial welfare/disability systems

Preserve existing tax harmonization arrangements

Income-contingent loan system for post-secondary education

Consider cumulative lifetime inheritance tax with exemption in lieu of deemed realization of capital gains at death

Summing Up

Key elements of proposed tax reform

- ▶ Preferential treatment of capital income largely achieved by tax mix of GST and income tax
- ▶ Sheltering of capital income mainly to encourage saving for retirement; otherwise fully tax capital income
- ▶ Rationalization of sheltering of various assets, with preference given to tax-deferred methods (RRSP, RPP) over tax-prepaid methods (TFSA, housing)
- ▶ Business income tax designed to tax rents: cash-flow equivalent tax (such as ACE) applied to both corporations and personal businesses
- ▶ Integration abolished (dividend tax credit, capital gains exemption)
- ▶ Small business deduction retained but restricted to young, growing firms by cumulative income limit