Submission to the House of Commons Standing Committee

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by

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That the Standing Committee on Finance be instructed to undertake a study on income inequality in Canada and that this study include, but not be limited to, (i) a review of Canada's federal and provincial systems of personal income taxation and income supports, (ii) an examination of best practices that reduce income inequality and improve GDP per capita, (iii) the identification of any significant gaps in the federal system of taxation and income support that contribute to income inequality, as well as any significant disincentives to paid work in the formal economy that may exist as part of a "welfare trap", (iv) recommendations on how best to improve the equality of opportunity and prosperity for all Canadians; and that the Committee report its findings to the House within one year of the adoption of this motion.

This is an opportune time to take a critical look at the tax-transfer system in Canada. Over the past several years, income inequality has increased in Canada, as it has in other OECD countries. At the same time, the tax-transfers system has become less effective in responding, so after-tax inequality has risen. There are a number of reasons for this, having to do with international competition driving down upper-income tax rates and revenue-raising being decentralized to the provinces. As well, there have been secular changes in the tax system, such as changes in the tax treatment of capital income, changes in the structure of labour markets and unemployment, and the effect of changes in federal-provincial transfers on provincial social protection programs.

All of these have reduced the automatic responsiveness of the tax-transfer system to income shocks, and this has been particularly noticeable at the top and bottom of the income distribution. For example, real welfare incomes have declined substantially since the mid-1990s. And top marginal tax rates have declined significantly.

There have been several piecemeal changes to the income tax system, many of which have benefitted primarily the middle- and upper-income classes, though in an often selective way. These include things like retirement savings incentives (RRSPs, RPPs, TFSAs), education savings incentives (RESPs), and targeted tax credits such as those applying to public transit fares and child recreation programs. Arguably, one of the most important innovations in tax-transfer policy has been the introduction of refundable tax credits, which established the two novel features of refundability and income-conditioning of tax credits. These are potentially important elements of an equitable tax-transfer system, but they have yet to be fully exploited.

The reforms that have been undertaken over the past several years have been uncoordinated, and have applied to one element at a time. What we are left with is a tax-transfer system with a lack of harmonization among its various components. In particular, there are relatively discrete changes in circumstances at different margins, including especially unemployed persons who are eligible for EI versus those are not eligible and those on welfare, income earners who are taxpaying versus those who are not, those who become disabled, and those who retire from working. The lack of coordination is particularly felt between federal and provincial parts of the tax-transfer system. As a general statement, those who fall under provincial responsibility (e.g., persons on welfare and the disabled) have fared less well than those who fall under federal responsibility (the retired, EI recipients). More generally, while income recipients pay taxes to both the federal and provincial governments, transfer recipients tend to be more dependent on one level of government with limited support from the other. As the federation has become more decentralized, groups for whom the provinces are responsible have fallen behind, and there is limited support from the federal government to prevent that..

While it would be ideal to rationalize the whole tax-transfer system by a comprehensive reform, that would be demanding politically. Nonetheless, it is possible to address some of the main shortcomings of the existing system by individual measures, albeit with an eye to the overall effect on the tax-transfer system.

What follows are proposals for a series of measures that in my view would make the tax-transfer system fairer without sacrificing efficiency or tax revenues. As with any revenue-neutral reform that improves fairness, there would be gainers and losers. At the same time, the losers would include many who have benefited from windfall gains in the past. The other objective of the reforms worth emphasizing is that they would serve to make the tax-transfer system more resilient to shocks. The tax-transfer system is one of the main mechanisms for absorbing and adjusting to shocks in a federation, the others being federal-provincial transfers and labour mobility. Here is my list of the highest priority reforms to the tax-transfer system.

1. **Refundable and non-refundable tax credits.** Most tax credits, whether refundable or not, can be interpreted as integral parts of the income tax rate structure. Along with the rate structure, they determine the progressivity of the income tax. Their purpose is to impart fairness to the income tax, as opposed to influencing the behaviour of taxpayers. Some changes would enhance the fairness of these tax credits.
    - Make all tax credits refundable. As it stands, non-refundable tax credits are of no value to persons in a non-taxpaying position, and as such, taxpayers and non-taxpayers are treated asymmetrically. Making all tax credits refundable is feasible, and would turn the tax system into a proper negative income tax system. As well, it would help make up for the deficiency of transfers received by unemployed persons who are not eligible for EI, who rely on the provinces for support, and whose incomes are typically well below the poverty line.
    - Significantly enhance the disability tax credit, make it refundable, and make it available to all persons receiving provincial disability support. It is a scandal that the most disadvantaged persons in society are given so little support by the federal government.
    - Enhance the targeting of tax credits by conditioning all of them on income as is now done for refundable tax credits. This will help pay the cost of making non-refundable tax credits refundable.
    - Some tax credits are of questionable value from a fairness perspective, and in some cases amount to windfall gains to selective categories of taxpayers.

Examples might include those for public transit use and those for child activities. All tax credits should be reviewed from the point of view of their cost-effectiveness and fairness.

2. **The EI-welfare nexus.** The EI and welfare programs are not harmonized, and the transition of the unemployed from one to the other is not smooth. Increasingly persons who are involuntarily unemployed are not eligible for EI or have exhausted their eligibility, and must fall back on welfare. Getting from welfare back to work is more difficult than getting from EI back to work. Coordinating EI and welfare is very problematic because EI is federal and welfare is provincial. Nonetheless, the issue is important enough to think a bit outside the box to look for solutions. Some ideas for reform include the following.
    - Consider making EI into a two-tier system, where the first tier would be based on replacing employment income like the current system and would last for a limited amount of time. The second tier would take over when workers are unemployed for longer times, and the benefits would be based on need. After second-tier benefits are exhausted, workers would then revert to provincial welfare programs. A two-tier system is used in some other countries, and many countries fully coordinate EI and welfare.
    - Training and employment services should be available to all workers, whether on one of the two EI tiers or on provincial welfare.
    - Work incentives are important, especially for the longer-term unemployed. Limits on earnings that now apply in provincial welfare programs should be considerably relaxed, and tax-back rates reduced. The Working Income Tax Benefit should be used to encourage participation. Active labour market programs should continue to be explored.
    - Enhancing EI by introducing a second tier and allowing part-time earnings would have to be accompanied with enforcement of rules requiring that eligibility be contingent on actively seeking jobs and accepting suitable job offers. This is already a requirement, but it is important to emphasize that the

generosity of EI is very much affected by the credibility of the administrative rules.

- EI premiums are a very regressive tax. EI should be financed from general revenues, as they are in many other countries.

3. **Capital income taxation.** Capital income is taxed in a very uneven way in Canada. Much of it is sheltered from tax via RRSPs, RPPs, TFSAs, housing, etc. That which remains taxed is also treated unevenly: interest is fully taxed, dividends from Canadian corporations are afforded a dividend tax credit, and capital gains are taxed preferentially. The latter two are rationalized as satisfying an integration objective by notionally reimbursing shareholders for taxes paid at the corporate level. Neither bequests nor inheritances are taxed. There are good arguments based on fairness for taxing capital income, especially for persons at higher income levels who have exhausted their RRSP/RPP/TFSA contribution limits. At the same time, the case for taxing capital income at a lower rate than taxing labour income can also be made, as is the case in many European countries (the so-called dual opr Nordic income tax system). I suggest the following reforms of taxation of capital income.
    - Eliminate the dividend tax credit. There is no longer any good argument for using this device to integrate corporate and personal taxes. There is good reason to believe that corporate taxes are not ultimately borne by shareholders, but are shifted to workers and consumers. The dividend tax credit amounts to a subsidy on shareholder asset income. Moreover, integration is very imperfect.
    - Make the taxation of interest, dividends and capital gains uniform. Maintain contribution limits on savings for retirement (i.e., do not move to a full consumption-based tax system)
    - These reforms will enhance the fairness of the income tax system since they will mainly be felt by higher-income persons, and will generate more revenue to support refundable tax credits.
4. **Business income taxation.** The corporate tax is a highly distortionary tax. It discourages investment, favours some industries over others, encourages debt finance, and discourages innovation and risk-taking. Other countries have introduced reforms to

their corporate tax systems (and at the same time to their unincorporated business income tax systems) that address some of these issues. Examples include Australia, Belgium, Italy, and Brazil. Well-known tax reform commissions in other countries have argued in favour of making the corporate tax system more efficient (President's Panel in the USA, Mirrlees Review in the UK, Henry Report in Australia). The aim of these reforms is to convert the business tax system into a tax on above-normal profits, or rents to use the technical term. The most common proposal is to move to what is called an Allowance for Corporate Equity system (ACE), which in simple terms allows firms to deduct a cost for equity financing as well as a cost for debt finance. This reform generates revenue by taxing above-normal profits earned by corporations without affecting their incentive to invest. It complements rationalizing the personal tax-transfer structure, especially eliminating the dividend tax credit.

5. **Federal-provincial division of tax room.** One important source of tension on maintaining a reasonably progressive tax-transfer system is the division of the tax room between the federal and provincial governments. The share of the income tax room occupied by the federal government relative to the province has implications for national fairness in some different ways. Most important, provincial tax-transfer systems are likely to be less progressive than federal ones because of pressures of fiscal competition. This can be seen in practice by the fact that provincial income taxes are generally less progressive than the federal one, and transfers to welfare recipients have fallen behind cost of living increases since the elimination of CAP shared-cost transfers. As well, a more decentralized income tax system increases fiscal disparities among provinces and puts more pressure on the Equalization system, which is already under severe pressure because of the resource boom. The enormous horizontal fiscal imbalances that now exist in Canada after Equalization is taken into account imply that provinces are able to provide different levels of essential public services to their citizens. To address this, policies should be taken to prevent a further erosion of the share of federal tax room. Most important, the level of federal transfers to the provinces for Equalization and social programs (CHT, CST) should not be eroded. I would support the following policies.

- The Equalization program should be fully formula-driven. In particular, there should not be any limit imposed, such as the GDP growth limit.
- Federal social transfers (CST, CHT) should grow at the same pace as provincial program expenditures. Otherwise, provincial taxes must rise relative to federal taxes.
- Social transfers should be conditioned on provincial revenue capacities to address the large fiscal imbalances that the current system is unable to deal with (because Equalization only applies to the low-capacity provinces).

6. **Equality of opportunity.** Section 36(1) of the *Constitution Act, 1981* stipulates among other things that the Government of Canada and the provincial governments are committed to "promoting equal opportunities for the well-being of Canadians." The main policies for achieving this are educational and training policies, although universal health care could well be interpreted as a prerequisite for equality of opportunity. By and large, education policy in Canada is well-designed and goes some way to allowing all young Canadians the opportunity to achieve a level of education commensurate with their talents regardless of need. There is universal public primary and secondary education. Post-secondary education is costly and risky, but the tax system offers a number of provisions that help deal with the cost, including various educational tax credits and RESPs. In addition, supplemental vehicles are available that ease the financial burden for students from low-and middle-income families. These include the Canada Educational Savings Grant, which supplements RESPs for all families, the Additional Canada Educational Savings Grant for RESP contributors from low- and middle-income families, the Canada Learning Bond that establishes an RESP for low-income families. As well, the Canada Student Loans and Grants Program provide necessary financing to low- and middle-income families. The provinces supplement these federal programs as well. There is probably still some work to be done on fine-tuning equal opportunities programs. On balance, the programs serve middle-income families very well. Low-income families would be better served if there were more targeting of tax benefits, such as conditioning education tax credits on parental income and enhancing the Canada Learning Bond amounts.

7. **Inheritance taxation.** Of course, one of the most important potential instruments for equality of opportunity is missing from the Canadian arsenal of policies, and that is an inheritance tax. However, I suspect that we cannot expect to see such a tax any time soon. The continued taxation of capital income of high-income persons is partly rationalized on this account.