

DOMINION OF CANADA
INCOME TAX.

TAXATION BRANCH, DEPARTMENT OF FINANCE.

RETURN OF ANNUAL INCOME OF INDIVIDUALS OR LEGAL REPRESENTATIVE
OF INDIVIDUALS UNABLE TO MAKE THE RETURN.

(As provided by The Income War Tax Act, 1917.)

DESCRIPTION OF INCOME.

GROSS INCOME DERIVED FROM—

1. Salaries and wages..... \$.
2. Professions and vocations.....
3. Commissions.....
4. Business, trade, commerce or sales or..... per real or personal.
5. Farming (Horticulture, dairying or.....
6. Rents.....
7. Dividends.....

ZERO TO 50 IN 100 YEARS

The HISTORY and
DEVELOPMENT of CANADA'S
PERSONAL INCOME TAX

CONTRIBUTING EDITORS

WILLIAM WATSON AND
JASON CLEMENS

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Executive Summary

In recognition of the 100th anniversary of Canada's personal income tax (PIT), the Fraser Institute asked a group of accomplished scholars to analyze and assess the emergence, development, and current state of Canada's federal personal income tax. The following provides a short synopsis of the essays.

The first four essays that make up the volume start at the tax's beginning. As William Watson argues, to historians the summer of 1917 is best known not for the income tax but for the conscription debate. For the first almost three full years of war, Robert Borden's government had avoided introducing conscription but in 1917 finally felt obliged to enact it. In timing that was not coincidental, it announced the "War Income Tax" literally days later. With young Canadians heading to war, most people felt that richer Canadians should be forced to contribute more to the war effort. Contrary to popular mythology, the tax was not explicitly temporary. Rather, finance minister Sir Thomas White recommended only that it be reconsidered after the war.

Over the following 100 years, as a second essay by Watson describes, a handful of key federal budgets produced the PIT we know today. Tax withholding was introduced in 1943. In 1971, J. Edgar Benson taxed capital gains for the first time, while two years later John Turner brought in full indexing of tax bracket thresholds. Base-broadening exercises (broadening the tax base to lower tax rates) failed in 1981 but succeeded in 1987.

Livio Di Matteo's essay contrasts today's personal income tax with where the tax started. One great difference between now and then is how little revenue the income tax originally raised. As a share of total federal revenue, personal income taxes went from just 2.6 percent in 1918 to an expected 51 percent in 2017.

The number of Canadians who pay personal income taxes has also risen sharply. As late as 1938, only 2.3 percent of the population filed income taxes. Now almost 75 per cent of Canadians do.

A main argument against the PIT, even with the relatively low rates and high thresholds of 1917, was that it would hurt Canada's competitiveness. As one of the essays points out, Canada now has one of the highest top PIT rates and it kicks in at comparatively low levels of income for high-skilled workers,

professionals, and entrepreneurs. Put simply, the worries of 1917 have been borne out: personal income taxes are the tax area where, globally, Canada is least competitive. This is made all the worse when one considers that Canada now taxes capital gains, which, as Herbert Grubel and Jason Clemens point out, for the first 105 years of Confederation Ottawa did not do.

Several other essays also look at the current state of the PIT. François Vaillancourt and Charles Lammam conclude that it now costs roughly \$500 per household to comply with filing personal income taxes, a sum that is a much greater share of a low-income family's budget than a higher-income family's. Mainly, the income tax system is more costly because it is more complex. For example, an Income Tax Act that was just six pages in 1917 is now 1,412 pages. The tax form, just 23 lines long in 1917, had by 2015 grown to 328 lines. Vaillancourt and Lammam conclude that tax reform based on simplifying the tax code is long overdue.

As Bev Dahlby's essay points out, there are also economic costs to worry about. Efficiency costs occur when beneficial activity would have been undertaken, but tax rates and rules prevent or discourage it. Dahlby's research shows that in every province, these indirect costs now exceed the direct cost of taxation, which is simply the money we transfer to the taxing government. His provincial-level estimates are striking. The cost of raising \$1 of PIT revenue exceeds \$2 in all provinces, while in Quebec it exceeds \$3, in Newfoundland and Labrador \$4, and in Ontario almost \$7. Given these costs, projects financed with PIT revenues would have to exhibit benefits of more than \$7 for every \$1 spent on them in order to be justifiable. The list of such projects can't be very long.

The final three essays focus on how to get a smarter tax system embodying better incentives for work, savings, investment, and entrepreneurship. The recommendations include reducing or eliminating many of the tax credits and other privileges now embedded in the tax code in order to allow for lower, efficiency-enhancing tax rates that raise the same overall revenue. In his essay, Jack Mintz recommends replacing the PIT with a PCT, a personal consumption tax.

After 100 years of Canada's federal personal income tax, it's clear we need broad reform to counter many of the concerns—including complexity and lack of competitiveness—that were voiced in the original 1917 debates on the new tax.

Foreword

In six words, the history of Canada’s federal income tax is “From zero to 50 in 100”—from zero percent of federal tax revenue in 1917, that is, to over 50 percent of a much bigger revenue in 100 years. That’s the path the tax has taken in its first century. The bill giving us an income tax was introduced in the Commons on July 25, 1917, and received Royal Assent two months later on September 20. The tax began to be collected the following spring. Birthdays are naturally a time for reflection, so it is fitting as the income tax reaches 100 years old to take a few more than six words to assess and reconsider it, which is what the nine essays in this volume do .

In his masterwork, *The Wealth of Nations*, Adam Smith¹ enumerated the four requirements—he called them maxims—of a good tax system. Though in somewhat different language, most economists still use these maxims as guideposts today.

- First, “the subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities.”
- Second, “the tax which each individual is bound to pay ought to be certain, and not arbitrary...”
- Third, “every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it.”
- Fourth, and finally, “every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state.” Modern economists call this do-the-least-damage-possible doctrine “economic efficiency.”

In short: ability to pay, certainty, taxpayer-friendliness, and economic efficiency. The following essays touch on each of these timeless tax principles and one or two more, as well.

To set the scene, we start with an essay by one of us (Watson) on how the federal government raised revenue before 1917. One great difference

¹ Adam Smith (1776), *An Inquiry into the Nature and Causes of the Wealth of Nations*.

between now and then is just how little revenue it did raise in the beginning. Even after adjusting for inflation and population growth, federal revenues were not even six percent of what they are today. They mainly came from customs and excise taxes and, on the eve of the income tax, a new Business Profits War Tax, though it brought in only a little over five percent of all federal revenues. Unlike in this century, when Canada is one of the OECD's heaviest income-taxers, for the country's first 50 years Ottawa mainly taxed the goods that people consumed, thus, in effect, running a consumption tax, which is many modern economists' preferred form of taxation.²

Why we have an income tax, the subject of the volume's second essay, by the same author, focuses on the first of Smith's maxims, ability to pay. In Canadian political history, the summer of 1917 is best known, not for the income tax, but for the conscription debate. Robert Borden's government had avoided introducing compulsory military service for the first three years of World War I but finally felt it necessary that summer to enact it, which it did just days before announcing the "War Income Tax" (the income tax's name until after the Second Great War). The timing is not coincidental. A phrase in the air that summer was "the conscription of wealth." With young Canadians about to be forced to risk life and limb in military service most people felt it only fair that those with high incomes be required to contribute to the war effort, too, not just asked to do so voluntarily in various bond drives. Given the temporary nature of the emergency and the fact that in 1916 the Business War Profits Tax had been given an explicit end date, it was a little strange that in introducing the new tax, Finance Minister Sir Thomas White did not promise that it, too, would be temporary. But he recommended only that it be reconsidered after the war.

Taxes should be certain, not arbitrary, Adam Smith said. Canada's income tax usually has been certain—at any given time, that is—but from year to year and decade to decade it has been altered many, many times. Following up on his recent Fraser Institute study, *A Federal Fiscal History, Canada: 1867-2017*, Livio Di Matteo covers some of the history of the personal income tax in a hundred-year review of rates and revenues. As his figures show, personal income taxes have risen from 2.6 percent of total federal revenue in 1918 to an expected 51 percent in 2017. Although the income tax's growth has been persistent, the biggest jumps were at the beginning of World War II and in the late 1960s. Not surprisingly, the number of Canadians who pay income tax has also risen sharply. As late as 1938, only 2.3 percent of us filed income taxes. In 1955, 24 percent did. In 1975, 52 percent. And today, almost 75 percent do. As

² See both Jack Mintz' essay and the discussion of it at the end of this Foreword.



Di Matteo notes, although in the late 20th century there were periodic efforts to reduce the number and level of income tax rates and to broaden the income tax base, for the first time since the 1970s the first budget of Prime Minister Justin Trudeau's government added a bracket and introduced a non-temporary increase in the top rate.

Building on Di Matteo's historical overview, the volume's third Watson contribution looks at six budgets that gave us the income tax we know today. All but one, that from 1987, were from Liberal finance ministers. James Robb's budgets of the late 1920s slashed income tax rates but did not eliminate the tax, thus missing what very likely was the only realistic opportunity to do so. J.L. Ilesley introduced tax withholding—"pay as you earn"—in the 1943 budget. In 1971, J. Edgar Benson taxed capital gains for the first time and used the revenues thus generated to, among other things, lower top rates. In 1973, John Turner brought in full indexing of both rates and bracket thresholds. Allan MacEachen's politically disastrous 1981 budget showed that base-broadening, rate-reducing exercises sprung by surprise can be risky, while Michael Wilson's 1987 tax reform succeeded where MacEachen had failed.

How taxpayer-friendly (Smith's maxim 3) is our current system? Not very, conclude François Vaillancourt and Charles Lammam in their essay on tax compliance costs and the growing complexity of the income tax. Compliance costs, they report, run at around \$500 per household, both in out-of-pocket expenses on expert help and computer software, as well as in taxpayers' own time. Moreover, the cost is regressive: The \$500 represents more of a low-income family's budget than a higher-income family's. Why are compliance costs so high? At least in part because of the system's complexity: for every word in the six-page War Income Tax Act of 1917 there are now 257 in what has morphed into a 1,412-page Act. In just 18 years, from 1996 to 2014, Ottawa added 27 tax expenditures, bringing the total to 128. By 2015 the tax form that had been just 23 lines long in 1917 had grown to 328 lines. Vaillancourt and Lammam conclude that "meaningful tax simplification has yet to occur in Canada" and is now long overdue.

Bev Dahlby looks at another source of inefficiency in the income tax system. The direct burden of taxation is the money the taxpayer is asked to transfer to the government. What economists call the "excess" burden, which is what Smith described in his maxim 4, is the cost in lost well-being of any changes in behaviour the tax induces. Dahlby shows that, these days, at the margin, the excess burden is actually greater than the direct burden, which means the total burden, direct plus excess, is more than twice the direct burden. The exact size of the excess burden varies from province to province depending on the existing extent of taxation, how high the marginal tax

rate already is, and the responsiveness of each province's income tax base to further increases in marginal rates. The total cost of taxation per the last \$1 of revenue raised is greater than \$2 in all provinces, in Quebec it is greater than \$3, in Newfoundland and Labrador it is almost \$4, and in Ontario it is almost \$7, a truly astonishing number. In order to pass a cost-benefit analysis, public projects financed with such expensive tax dollars would have to exhibit benefits of more than \$7 per \$1 spent on them. The list of such projects surely can't be very long.

In their essay, Robert Murphy and Milagros Palacios ask how competitive Canada's marginal tax rates are. Not very, is their answer. Before the 2016 hike in the top federal rate to 33 percent, Canada's top rate was middle-of-the-road in the G7 countries plus Australia. It was greater than the rate in the UK, the US, Germany, and Australia, but less than in Japan, France, and Italy. The effect of the 2016 increase was to move Canada above Italy. More importantly, since North America is our economic space, Canadian top rates are uncompetitive compared to rates in the United States. At the moment, British Columbia has the lowest combined federal-provincial top rate in Canada. Yet fully 42 US states have a lower combined federal-state top rate than BC. Murphy and Palacios conclude that Canadian marginal rates are not competitive—even before the United States embarks on a major tax reform, as the Trump Administration seems intent on doing.

The problems with Canada's uncompetitive personal income tax rates are made all the more worrying when one considers that the top personal income tax rates in Canada take effect at relatively low levels of income. In other words, the top personal income tax rates in Canada are high and take effect at low levels of income when compared to other industrialized countries.

The volume's final essays are more prescriptive. Herbert Grubel and one of us (Clemens) argue against increasing taxes on capital gains. At first blush, maintaining the "inclusion rate" for capital gains at just 50 percent, its current federal value, would seem to run contrary to the usual view of economists that the best approach to income taxes is to "broaden the base and lower the rate." Grubel and Clemens argue, however, that although such an approach is fine in theory, in practice it ignores the real-world shortcomings of capital gains taxes, which both create a "lock-in" effect, since tax is only paid when the asset is sold and the gain realized, and also tax nominal gains in asset values rather than real gains, which can create serious unfairness and inefficiency during inflations. At such times, increases in asset values that merely compensate for economy-wide increases in prices are taxed as if they were increases in the taxpayer's real purchasing power. Finally, Grubel and Clemens argue, capital gains are the income most typically earned by entrepreneurs, so that taxes on

capital gains discourage entrepreneurship, an activity that throws off myriad benefits for society in general.

In their essay, Charles Lammam and Niels Veldhuis argue the case for reforming the personal income tax as it turns 100. Though successive finance ministers have embraced the idea of broadening the income tax base and lowering tax rates, Lammam and Veldhuis maintain “there has been almost no progress in making the federal personal income tax system more competitive and part of a pro-growth agenda.” In fact, the 2016 federal budget moved in the opposite direction by introducing a new top tax bracket with a four-point higher top rate. The proliferation of tax expenditures in recent decades provides an opportunity for substantial reform. Lammam and Veldhuis would eliminate any tax expenditures that make the personal income tax less like a consumption tax and would use the resulting savings, which could approach \$20 billion a year, to entirely eliminate the two middle tax rates (20.5 and 26 percent), with the result that the vast majority of Canadians would face a marginal rate of either zero or 15 percent.

Finally, Jack Mintz argues that, rather than modify the income tax to make it more closely resemble a consumption tax, we should bite the bullet, abandon income as a tax base, and switch to a “personal tax on consumed income.” Thus taxpayers would be assessed on their income minus their savings. This is a fairer way to tax, Mintz argues, both because a person’s consumption can be a better measure of his or her well-being and because taxing only consumption avoids the double taxation of saving. Under an income tax, people pay tax when they first earn income but also then again on the return from any saving they do out of their income. Thus people who choose to save a given income pay extra tax compared to those who decide to spend it all at once. Not only is this not fair, Mintz argues, but favouring current consumption in this way can also lead people to make inefficient decisions about saving vs. spending. He describes several ways in which a personal consumption tax, which would have higher rates for higher consumers, would also be simpler to administer than the current income tax. In sum, he concludes, switching to consumption as our tax base would “unleash entrepreneurship, investment, and risk-taking.”

—*William Watson and Jason Clemens*

DOMINION OF CANADA

To be filled in by Inspector.

To be filled in at the office of the Commissioner of Taxation.

District of WINNIPEG

Date

Number

Number.....

Audited by.....

INCOME TAX.

TAXATION BRANCH, DEPARTMENT OF FINANCE.

RETURN OF ANNUAL INCOME OF INDIVIDUALS OR LEGAL REPRESENTATIVE OF INDIVIDUALS UNABLE TO MAKE THE RETURN.

(As provided by The Income War Tax Act, 1917.)

Return of Income received during the year ended 31st December, 19.....

Name in full (surname first).....

Address.....

Occupation.....

Place of residence during 19.....

Married or unmarried, widow or widower without dependent children.....

DESCRIPTION OF INCOME.

GROSS INCOME DERIVED FROM—

1. Salaries and wages.....	\$.....	.....	.....	.....	.....	.....
2. Professions and vocations.....	.....	.....	.....	.....	.....	.....
3. Commissions.....	.....	.....	.....	.....	.....	.....
4. Business, trade, commerce or sales or dealings in property, whether real or personal.....	.....	.....	.....	.....	.....	.....
5. Farming (Horticulture, dairying or other branches).....	.....	.....	.....	.....	.....	.....
6. Rents.....	.....	.....	.....	.....	.....	.....
7. Dividends.....	.....	.....	.....	.....	.....	.....
.....
.....
.....
8. Interest on notes, mortgages, bank deposits and securities other than reported in item 7.....	.....	.....	.....	.....	.....	.....
.....
.....
.....
9. Fiduciaries, (Income received from guardians, trustees, executors, administrators, agents, receivers or persons acting in a fiduciary capacity).....	.....	.....	.....	.....	.....	.....
.....
.....
.....
.....
10. Royalties from mines, oil and gas wells, patents, franchises and other legalized privileges.....	.....	.....	.....	.....	.....	.....
.....
11. Interest from Dominion of Canada Bonds, issued exempt from Income Tax.....	.....	.....	.....	.....	.....	.....
12. Other sources not enumerated above.....	.....	.....	.....	.....	.....	.....
.....
.....
.....
.....
.....
.....
.....
13. Total Income.....	.....	.....	.....	.....	.....	.....

There should be inserted on the blank lines full particulars of the different accounts that are included and marked in accordance with the items, should be attached to this return.

The attention of taxpayer is directed to the following Sections of The Income War Tax Act, 1917.

Section 3. (1) Defines Income.

- “ 3. (1) (a), (b), (c), (d), Explain exemption and deduction from Income.
- “ 4. (3) Provides for returns to be made by persons carrying on business in partnership.
- “ 5. (a) and (b) Explain deductions to be made from Income Tax.
- “ 6. (1) Provides for returns to be made by any person acting as a Fiduciary.
- “ 7. (1) Provides for the filing of returns on or before the twenty-eighth day of February in each year.

(Returns in triplicate should be prepared, one copy of which will be retained by the taxpayer and two delivered to the Inspector of Taxation for the District of Winnipeg.)

- (2) Provides for returns by Corporations, etc.
- (4) Provides for returns by Employers of their Employees, and by Corporations of dividends paid to shareholders.
- “ 9. (1) Penalty for not making returns.
(2) Penalty for false statement in returns.
- “ 10. (1) Penalty for default of payment.

NOTE.—When the Net Income exceeds (a) \$1,500, in the case of unmarried persons or of widows or widowers without dependent children or (b) \$3,000 in the case of all other persons, the tax thereon must be calculated as per Schedule below:

4 %	normal tax on total income over	(a) \$1,500			
		(b) \$3,000			
	and in addition thereto,				
2 %	supertax on amount of income over	\$ 6,000	and not over	\$ 10,000	
5 “	“ “ “ “	10,000	“	20,000	
8 “	“ “ “ “	20,000	“	30,000	
10 “	“ “ “ “	30,000	“	50,000	
15 “	“ “ “ “	50,000	“	100,000	
25 “	“ “ “ “	100,000			

NOTE.—The items 24 to 34 are to be filled in by the officers of The Taxation Branch.

24. Total Income (brought from item 13).....	\$				
25. Exemptions and deductions (brought from item 22).....					
Net Income.....					
26. Exemption of \$1,500 or \$3,000 as the case may be.....	\$				
27. Dividends and other incomes on which the normal tax has been paid.....					
Exemptions as per items 26 and 27.....					
28. Taxable income on which the normal tax is to be calculated.....	\$				
29. Taxable income on which the supertax is to be calculated.....					
30. Total normal tax.....					
31. Total supertax.....					
32. Total tax.....					
33. Amount paid under Business Profits War Tax Act, 1916 (brought from item 23).....					
34. Amount of Tax to be paid.....					

The Way We Were: A Small Government Taxing Consumption



William Watson

McGill University economist and Fraser Institute senior fellow

The federal budget of 1917, Canada's last without an income tax, was brought down on April 24 of that year, just 12 days after what many regard as the country's coming of age at the battle of Vimy Ridge. In his budget speech, which, like many in that era and none in our own, took up only three and a half pages of *Hansard*,³ Conservative Finance Minister Sir Thomas White presented a breakdown of revenues for the fiscal year that had ended March 31 (see table 1).

How things have changed in a hundred years! A century ago a finance minister actually spelled out all the zeroes in a federal revenue or expenditure item, occasionally even to the cent. Yet despite the long strings of zeroes, the amounts are tiny by modern standards. Inflation has been epidemic between now and then, of course, but even after being inflated up to the dollars of 2016⁴ the 1917 numbers are minuscule. In today's dollars, total federal revenue in 1917 was just \$3.65 billion, compared to \$295 billion in budget year 2015-16, an amount more than 80 times greater.⁵ To be sure, Canada's population has grown since 1917. But it is only four and a half times larger than it was.⁶ So even after adjusting for population, today's federal revenue per person is more

³ Hansard (1917). Parliament of Canada: Debates of the House of Commons, Library of Parliament, <http://parl.canadiana.ca/> (pp. 318-21). All of Canada's federal budgets, from 1867 on, are available on the Library of Parliament website: <http://www.lop.parl.gc.ca/ParlInfo/compilations/parliament/budget.aspx>.

⁴ This calculation is done by multiplying the 1917 numbers by 15.74, reflecting the almost 16-fold increase in prices in the last 99 years (see Bank of Canada (n.d.), Inflation Calculator, Bank of Canada, <http://www.bankofcanada.ca/rates/related/inflation-calculator/>).

⁵ See Canada (2016), *Fiscal Reference Tables 2016*, Government of Canada, Department of Finance, <https://www.fin.gc.ca/frt-trf/2016/frt-trf-16-eng.asp>.

⁶ Canada had 36.3 million people in July 2016 versus 8.1 million in 1917.

Table 1: Federal Revenues, Budget of April 24, 1917

Revenue source	\$	Percent of total	In \$2016
Customs tariff	134,000,000	57.8	2,109,160,000
Excise taxes	24,000,000	10.3	377,760,000
Business profits war tax	12,500,000	5.4	196,750,000
Other	61,500,000	26.5	968,010,000
Total	232,000,000	100.0	3,651,680,000

than 18 times larger in real terms than it was in early 1917, roughly \$8,200 per person now compared to only \$450 per person then (with both amounts expressed in \$2016).

Translating from the dollars of one century to those of another isn't easy, of course. Many goods we have today we didn't have then and *vice versa*. Who now heats their homes with coal shoveled through a grate or cools their food with weekly deliveries of ice blocks for their icebox? No one then talked on a cell phone or took airplane trips. Moreover, using the consumer price index to figure out the value of goods purchased through the government sector can also be misleading, since the prices of what government spends its tax revenues on may have risen more quickly than the index of all consumer prices. Even allowing for possible measurement biases, however, there's little doubt that today's federal government is orders of magnitude bigger than even the wartime federal government of 1917.

How Ottawa raised revenue was also quite different in 1917. As had been true since Confederation 50 years earlier, Ottawa got most of its money—between a half and two-thirds of the total—from the customs tariff, that is, general taxes on imported goods levied at the border. The \$134 million brought in that way in 1917 is equivalent to \$2.1 billion in \$2016. As it turns out, in fiscal year 2015-16, Ottawa actually collected \$5.9 billion in customs tariffs, close to three times its tariff revenue of 1917 and almost two-thirds more than its *total* revenue 100 years ago. Yet the federal government has grown so much that this three-times greater tariff revenue now accounts for just 1.8% of its total revenue and is an almost forgotten part of the tax mix.

At first blush, the then all-important customs tariff might seem to be a consumption tax, of which economists tend to approve, since consumption taxes avoid the “double taxation of saving.” (By contrast, income taxes hit a

Table 2: Share of Federal Revenues (percent of total), 1917 and 2016

Revenue source	1917	2016
Personal income taxes	0	49.0
Non-resident income taxes	0	2.2
Goods and services tax	0	11.2
Energy taxes	0	1.9
Employment insurance premiums	0	7.8
Corporate income taxes	5.4	14.0
Other taxes and duties	10.3	2.0
Other revenue	26.5	10.1
Customs import duties	57.8	1.8
Total	100.0	100.0

person first on his or her income, but also then again when that same income, if saved, earns a return.) On the other hand, to the extent that the tariff taxed intermediate goods, construction materials, or machinery, its weight would also be felt by savers, whose savings, lent to industry, often went to such purposes. Out of any given income, people can only consume or save. If you tax people on both their consumption and their saving, you are effectively taxing them on their income. At the time, however, the tariff was widely regarded as, and may well have been, a tax on consumers.

The same holds true for excise taxes, which are taxes on specific goods. An increase in excises was one of the first steps taken to finance war spending. Their exact effects depend on who consumes the goods being taxed. The increase for champagne and sparkling wine had some MPs cheering “Hear, hear” when Finance Minister White announced it in February 1915.⁷ Other excises, such as for tea, coffee, and tobacco, were on products consumed across income groups, which likely made them regressive in their impact, that is, proportionally heavier on low-income than high-income consumers.

“Other” revenues accounted for more than a quarter of all federal revenue in 1917. Among them were income from the post office and railway

⁷ *Hansard*, 1915: 86.

departments, which were not yet Crown corporations but operated like any other department of government. The revenues they generated were balanced off by their operating expenditures. In that era, unlike today, the post office typically ran a small surplus and so contributed net revenue to the government. The railway department, however, often required large net spending.

In early 1917, the only federal tax aimed at any kind of income was the Business Profits War Tax, introduced just a year earlier to tax the “profiteering” that was universally derided as a contemptible aspect of the wartime home front. The Borden government’s view well into 1917 was that such a tax, retroactive to the start of the war and imposed at a steeply rising rate on any profits over seven percent, was the best way to seize incomes swollen by the wartime boom. In its first year in operation, however, the profits tax accounted for only a little over five percent of federal revenue.

The federal government’s sources of revenue in 1917 are a stark contrast with those of today, as table 2 illustrates.

Today the personal income tax, though not the only game in town, is by far the most important, accounting for almost half of federal revenues and bringing in \$145 billion, an amount equivalent to 7.3% of GDP. Such extensive reliance on the personal income tax puts Canada at the extreme among OECD countries. In 2014, Canadian governments got 36.2% of their revenues from the personal income tax. The OECD average was 24.0%, while only Denmark (54.0%), Australia (41.0%), the United States (39.3%) and New Zealand (38.6%) relied on personal taxes more than we did.⁸

Taking all income and income-type taxes together, including personal, non-resident, and corporate, as well as employment insurance premiums, which are a tax on wage income, the total comes to almost three-quarters of federal revenues and 10.9% of GDP. By contrast, in 1917, just 5.4% of Ottawa’s revenues came from an income tax, the new Business Profits War Tax.

Whether Canada’s federal government would have grown so dramatically between 1917 and 2017 without the income tax is an interesting counterfactual question. Whether our 100-year transition to such extensive reliance on income taxes needs to be reconsidered is an important practical question.

⁸ OECD (2016), *Revenue Statistics 1965-2015*, Organisation for Economic Cooperation and Development: Table 3.10.

Why We Have an Income Tax: The “Conscription of Wealth”



William Watson

McGill University economist and Fraser Institute senior fellow

“In such experience as I have had with taxation—and it has been considerable—there is only one tax that I know of that is popular, and that is the tax that is on the other fellow.”

—Sir Thomas White, House of Commons debate on the income tax,
August 3, 1917⁹

Conventional wisdom has it that Canada’s income tax was introduced as a temporary measure. That’s not quite true. It did begin during a temporary emergency, the Great War, and it was officially named the *War Tax Upon Incomes*. But when at 3 pm on July 25, 1917, Sir Thomas White, Toronto journalist, tax assessor, and financier turned wartime finance minister, rose in the Commons to describe the new federal income tax he was proposing, he never used the word “temporary.”¹⁰ Of the tax’s duration, the minister said only that “I have placed no time limit upon this taxation measure; but I do suggest... that after the war is over [it] should be deliberately reviewed... with the view of judging whether it is suitable to the conditions which then prevail.”¹¹ This was

⁹ Hansard (1917), *Parliament of Canada: Debates of the House of Commons*, Library of Parliament, <http://parl.canadiana.ca/> (p. 4121).

¹⁰ One thing that was explicitly temporary about the tax was where it was introduced: in the ground-floor hall of what is now the Canadian Museum of Nature, to which Parliament had moved in February 1916, the afternoon after a nighttime fire originating in the reading room had destroyed most of the Centre Block, killing seven people. To general amusement, the Senate used a room directly above that usually displayed fossils—dead ones, that is.

¹¹ *Hansard*, 1917: 3765.

in pointed contrast to the approach he had taken with the 1916 *Business Profits War Tax*, which initially he had limited to taxing war profits earned from 1914 through 1917. In the debate on the proposed new income tax, at least one MP confidently predicted, and celebrated, that it was here to stay. The opposition Liberals' finance critic welcomed the tax, saying, "I have no doubt that the principle contained in the taxation proposals just submitted... will be approved of by the country."¹²

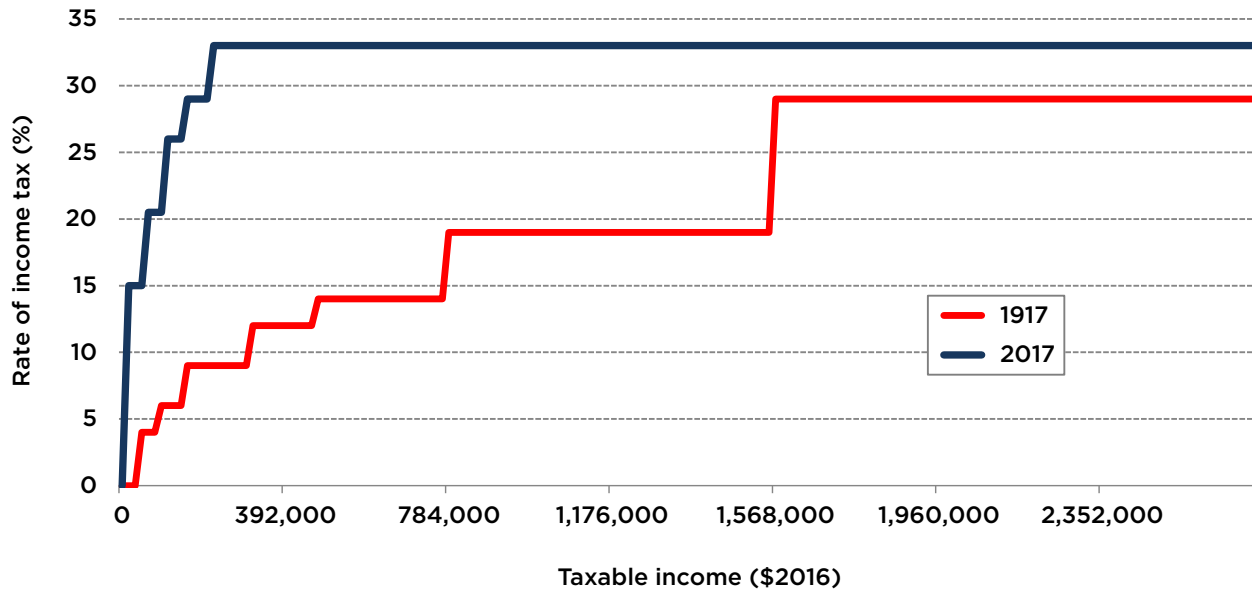
In July 1917, Canada was almost three years into the bloodiest war ever. The Dominion's contribution was heading toward 500,000 men in uniform, an astonishing number in a country whose entire population, male and female, was barely eight million. Yet through the winter and spring of 1917, Minister White had continued to resist taxing personal incomes. He conceded an income tax might eventually be needed. But he repeatedly took care, even in the first few paragraphs of his speech introducing the new tax, to enumerate the arguments against it, including:

- Unlike the UK, which taxed incomes first during the Napoleonic Wars and then again from the government of Robert Peel in 1842, Canada was a large and spread-out country, without great concentration of wealth, so the tax would be hard to administer—although the Business Profits War Tax was run in Ottawa by a staff of 40, tiny by modern standards, which ultimately was kept on to help administer the income tax.¹³
- The income tax was a direct tax, i.e., it had a person or firm's name on it. But direct taxes were the only kind the British North America Act let provinces levy. Several provinces and some cities (including Ottawa and Toronto) already had income taxes, so a federal income tax would be the third such tax some Canadians would pay.
- Canada needed new immigrants as well as abundant foreign investment to fulfill the destiny proclaimed for it in the first years of the century by Prime Minister Sir Wilfrid Laurier (who in 1917, as Leader of the Opposition, was an active participant in the Commons debates on the income tax). Any income tax, White argued, let alone one with a high rate, would threaten Canada's growth.

¹² *Hansard*, 1917: 3765

¹³ R.W. Breadner (1919), The Canadian Business Profits and Income War Tax Acts: I. The Business Profits War Tax Act, *The Bulletin of the National Tax Association* IV, 4 (January): 96, <https://www.jstor.org/stable/41785272>. In August 1917, the government estimated collection costs at \$600,000 for the income tax, compared to \$150,000 for the Business Profits War Tax (*Hansard*, 1917: 4686).

Figure 1: Federal income tax rates: 1917 vs 2017



Source: Bank of Canada (n.d.) Inflation Calculator. Web-based calculator. Bank of Canada. <<http://www.bankof-canada.ca/rates/related/inflation-calculator/>>, as of March 23, 2017.

- And, finally, the graduated Business War Profits Tax was efficiently skimming off the rapid growth of business income generated by the booming wartime economy. (The new US income tax, introduced in 1913, was small by comparison, White argued.) If the profits tax did miss some high incomes, well, wealthy Canadians were being very generous in buying the government's Victory Bonds. An income tax might discourage such lending.

What changed Minister White's mind? In a word: conscription. In the summer of 1917, the Commons debated and approved compulsory military service, which until then had been avoided. Quebec separation aside, conscription was the most divisive issue Canadian politics ever contended with. In the election of December 1917, it badly split both the Liberal Party and the country.

Both morally and practically, however, conscription was key to the income tax.

Casualties had been appalling almost from the first day of war. Many in the Commons and the country felt that seizing people's actual persons to serve

a public purpose that might well involve their death or dismemberment was intolerably unfair unless property were also subject to seizure, especially from those not making physical sacrifices themselves. A phrase in the air that summer was “the conscription of wealth”: If young men were to be conscripted, wealth should be, too.¹⁴ The idea was so current that shortly before introducing his income tax, White felt obliged to state formally in the Commons that if he taxed anything new, he would tax income, not wealth.

Though he introduced it just a week after conscription was voted, White's own stated motive for the new tax was mainly practical, not moral. The income tax would be needed, he said, to finance the up to 100,000 more soldiers, sailors, and airmen that conscription would deliver.

The tax White finally proposed was of a form barely recognizable today (see chart). It featured a personal exemption for families on the first \$3,000 of income and for unattached individuals on the first \$2,000 (amended downward during debate to \$1,500). Above that, everyone paid four percent at the margin, with graduated surtaxes on top of that. Figure 1 compares the original 1917 rate structure with today's, with all dollars expressed in \$2016, each of which is worth roughly one-fifteenth of a 1917 dollar. What stands out most starkly is that the 1917 surtaxes rise only very gradually and reach their maximum at an income of \$1.6 million. There were no credits or exemptions for children or other dependents (“It does not seem to me possible,” said White, “although it appeals to one's sympathies, to make [such] a distinction.”¹⁵) There was no capital gains taxation: it would be too complicated (“In the administration of an income tax,” White argued, “you must get down to a sound, but rough-and-ready basis—a basis of good sense.”¹⁶) Finally, there was no offset for provincial or municipal income taxes, although there was one for taxes already paid on dividends.

Should the income tax have been temporary? The moral and practical emergencies both ended in November 1918. On the other hand, because of debt, in fiscal terms the war lingered for another two decades. Despite immediate and substantial hikes in virtually all existing taxes, as well as the eventual introduction of new taxes on profits and income, Ottawa's debt

¹⁴ “We cannot fight this war on the principle of limited liability,” declared Michael Clark, MP for Red Deer, on June 26 (*Hansard*, 1917: 2664). In the debate at third reading, one MP quoted McGill University economist and world-famous humourist Stephen Leacock: “Our present taxes are, for war time, ridiculously low, as far as all people of comfortable, or even of decent, means are concerned” (*Hansard*, 1917: 4651).

¹⁵ *Hansard*, 1917: 4102.

¹⁶ *Hansard*, 1917: 4076.

quintupled in nominal terms during the war, from \$335 million in March 1914 to \$1.6 billion in March 1919,¹⁷ a number then regarded as verging on apocalyptic. Although after the Armistice there was no longer a need for armaments or soldiers, money had to be spent reintegrating those of the 500,000 who did return, many of them severely damaged by battle. The practical pressure did abate as, after a difficult initial recovery from war, the economy began to grow rapidly in the mid-1920s. But the moral pressure remained: People with higher incomes were better able to pay the continuing war finance. On top of that, there is the democratic ratchet: that a change has been hard to make doesn't mean it is easy to reverse.

¹⁷ *Hansard*, 1919: 3135.

Major Changes to the Federal Personal Income Tax: 1917-2017



by Livio Di Matteo

Professor of economics, Lakehead University

As a result of the funding demands of World War I, Canada's federal government introduced both a personal and corporate income tax in 1917. The advent of the personal income tax in particular marked a significant shift in federal taxation philosophy. In the first years of Confederation, it had been felt that taxing incomes would detract from Canada's competitive position as one of the lowest taxed countries in the world.¹⁸ Indeed, it's worth noting that Canada's federal personal income tax only came into being once the United States had brought in its own income tax in 1913.¹⁹ This essay highlights some of the major changes to the federal personal income tax in its first hundred years.

Canada's federal personal income tax came into effect September 20, 1917 with a 4 percent tax on all income of single people (unmarried persons and widows or widowers without dependent children) over \$1,500.²⁰ For everyone else, the personal exemption was \$3,000. In today's dollars, the exemptions would be worth approximately \$24,500 and \$50,000, respectively.²¹ To be clear,

¹⁸ J.H. Perry (1955), Taxes, Tariffs and Subsidies, in *A History of Canadian Fiscal Development*, volumes 1 and 2, University of Toronto Press: 144. For another account see also W.I. Gillespie (1991), *Tax, Borrow and Spend: Financing Federal Government Spending in Canada, 1867-1990*, Carleton University Press.

¹⁹ The United States actually imposed its first personal income tax in 1861 to fund the Civil War but it was repealed in 1872. The US Congress enacted a new income tax in October of 1913.

²⁰ *The Income War Tax Act, 1917*, 7-8 *George V.* Chap. 28. This legislation was completely redrafted after World War II and a new Income Tax Act came into effect on January 1, 1949.

²¹ In 2016 dollars deflated using CPI 1914-2015, v41693271 Canada; All-items (2002 = 100). For 2016 and 2017 assuming 2 percent inflation (Statistics Canada (2015), *Table 8-1*:

in today's dollars, the first federal personal income tax exempted the first \$24,500 of income for single people and the first \$50,000 for everyone else. For reference, the basic personal exemption for 2016 is \$11,474.

For married Canadians with dependents and an annual income greater than \$6,000 (roughly \$99,500 in today's dollars), the tax rate ranged from 2 to 22 percent.²² However, because of the relatively high dollar exemptions, only between 2 and 8 percent of individuals had to file tax returns during the initial years of the federal personal income tax.

It was World War II that saw the federal personal income tax expand dramatically. There was a flat 20 percent surtax imposed on all income tax payable by persons other than corporations in 1939 followed by the introduction of a new tax on income known as the National Defence Tax.²³ Further rate increases along with reduced exemptions were introduced in 1942.

Perhaps the most notable of these changes was the introduction of high marginal tax rates. For example, the pre-World War II marginal tax rate on taxable income between \$1,000 and \$2,000 in the dollars of the day was 4 percent. By 1942, it had increased to 44 percent. For taxable income between \$10,000 and \$15,000 it was 13.7 percent before the war, but fully 69 percent by 1942.²⁴

While these rates came down after the war, they remained substantially higher than they had been before the war. By 1971, for instance, the average Canadian was subject to much higher average and marginal tax rates than had been the case in 1946.²⁵

Moreover, the proportion of the population having to file income taxes rose and then continued to rise in the postwar era. In 1938, for instance, only 2.3 percent of the population filed personal income taxes, whereas by 1955 24 percent of the population did. By 1975 that number had grown to 52 percent

Annual average percentage changes for the Consumer Price Index — Major components, not seasonally adjusted Canada, Government of Canada, <http://www.statcan.gc.ca/pub/62-001-x/2015011/t081-eng.htm>, as of March 28, 2017).

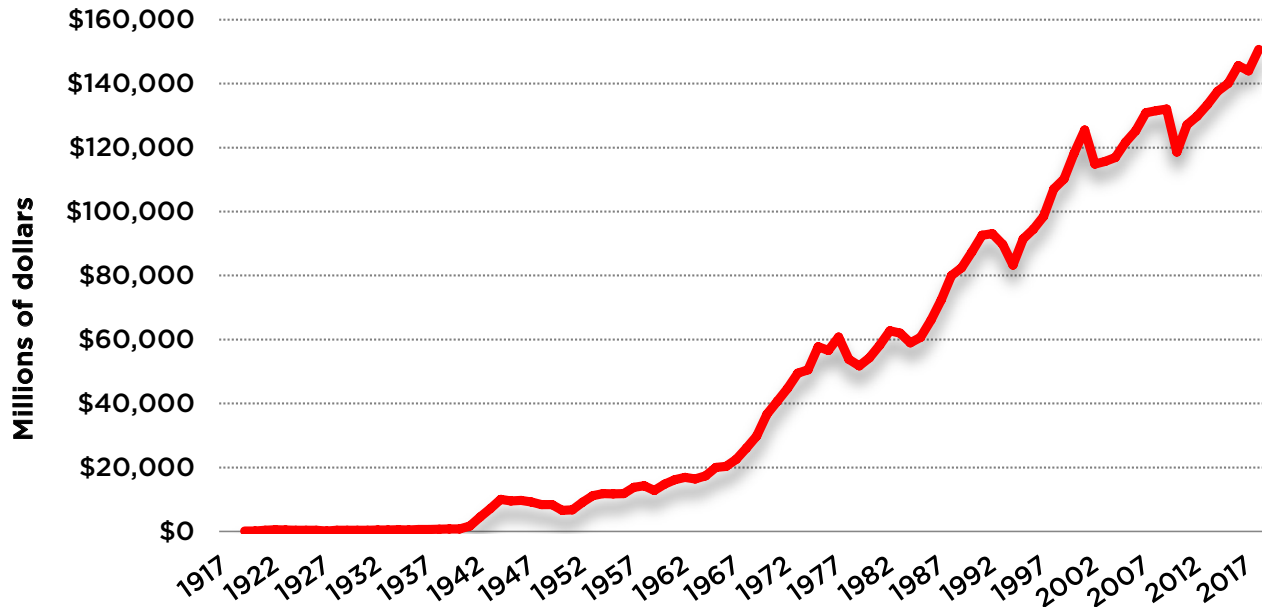
²² B. Pontifex (1917), *The Income War Tax Act 1917 with Explanations by the Minister of Finance as Reported in Hansard and Instructions of Finance Department*, Carswell Company Ltd.

²³ Perry (1955), Taxes, Tariffs and Subsidies: 360. See also C. Campbell (2013), J.L. Ilesley and the Transformation of the Canadian Tax System: 1939-1943, *Canadian Tax Journal*, 61:3, 633-670.

²⁴ Perry (1955), Taxes, Tariffs and Subsidies: 368.

²⁵ R.S. Smith (1995), The Personal Income Tax: Average and Marginal Rates in the Post-War Period, *Canadian Tax Journal*, 43, 5: 1056.

Figure 1: Federal Personal Income Tax Revenue, 1917-2017 (2016\$)



For a full list of the sources used to construct this graph, see *The Federal Fiscal History of Canada*: <https://www.fraserinstitute.org/sites/default/files/federal-fiscal-history-canada-1867-2017.pdf>.

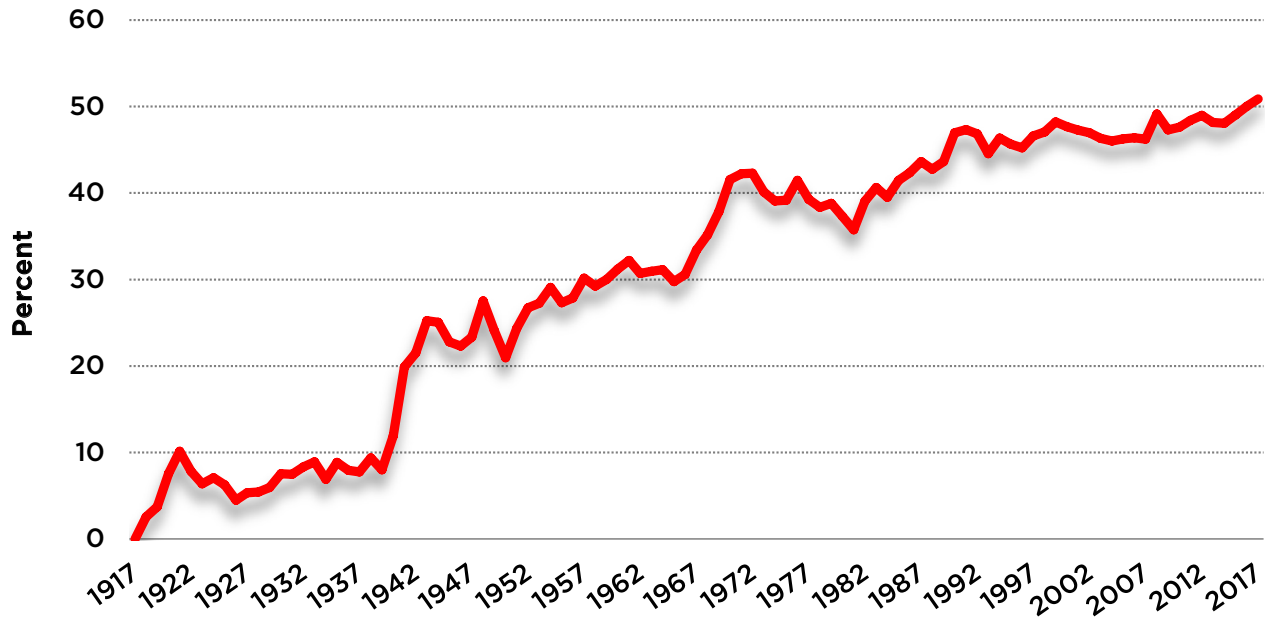
and it reached 68 percent by the early 1990s.²⁶ At present, approximately 75 percent of Canadians file a personal income tax return.²⁷ Many Canadians who don't actually pay income taxes have an incentive to file in order to qualify for refundable tax credits, such as the GST credit.

Figure 1 presents the inflation-adjusted (in \$2016 dollars²⁸) total personal income tax revenue for the federal government. In 1918, total revenue (in

²⁶ J.H. Perry (1984), *Taxation in Canada*, 4th edition, Canadian Tax Paper no. 74, Canadian Tax Foundation: 383; Smith (1995), *The Personal Income Tax*: 1057.

²⁷ The Canada Revenue Agency stated that 26,099,820 returns were filed in 2014. See Canada Revenue Agency, *Income Statistics 2016 (2014 tax year): Preliminary Table 1*, Government of Canada, <http://www.cra-arc.gc.ca/gncy/stts/prlmnry/2014/tbl1-eng.pdf>, as of March 23, 2017.

²⁸ In 2016 dollars deflated using CPI 1914-2015, v41693271 Canada; All-items (2002 = 100). For 2016 and 2017 assuming 2 percent inflation (Statistics Canada (2015), *Table 8-1: Annual average percentage changes for the Consumer Price Index — Major components, not seasonally adjusted Canada*, Government of Canada, <http://www.statcan.gc.ca/pub/62-001-x/2015011/t081-eng.htm>, as of March 28, 2017).

Figure 2: Federal Personal Income Taxes as a Share of Federal Revenues, 1917-2017

For a full list of the sources used to construct this graph, see *The Federal Fiscal History of Canada*: <https://www.fraserinstitute.org/sites/default/files/federal-fiscal-history-canada-1867-2017.pdf>.

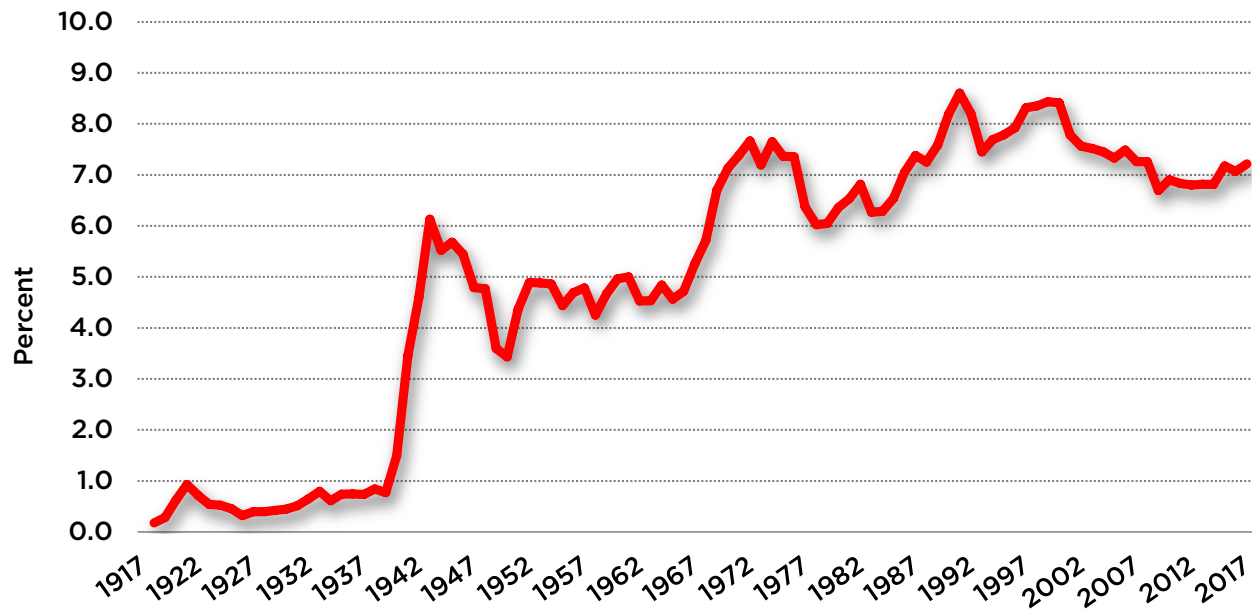
real dollars) from the federal personal income tax amounted to \$116 million whereas by 2017 it is expected to total \$150.7 billion.²⁹ Interestingly, as evidenced by the data in figure 1, the real increases in federal personal income tax revenues don't begin until roughly the mid-1960s, though the foundation for those increases was established during World War II.

In terms of per-person federal personal income taxes, the burden has increased from roughly \$14 per person in 1918 (adjusted for inflation and denoted in 2016 dollars) to roughly \$4,120 in 2017, an almost 300-fold increase.

After a century of changing brackets, rates, and exemptions, along with periodic reforms designed to broaden the base and lower the rates, the importance of the federal personal income tax as a revenue source has steadily grown, as figures 2 and 3 illustrate. As a share of total federal revenue, the personal income tax has grown from 2.6 percent of revenue in 1918 to an

²⁹ \$153.7 billion in nominal terms.

Figure 3: Federal Personal Income Taxes as a Share of the Economy (GDP), 1917-2017



For a full list of the sources used to construct this graph, see *The Federal Fiscal History of Canada*: <https://www.fraserinstitute.org/sites/default/files/federal-fiscal-history-canada-1867-2017.pdf>.

expected 51 percent in 2017. Large increases in the share of federal revenues represented by personal income taxes are evident at the beginning of World War II and the late 1960s, though a steady increase is generally observed across the entire 100-year history of the tax.

Similarly, as a share of the economy (GDP), federal PIT revenue has grown from 0.2 percent in 1918 to an expected 7.2 percent in 2017. The trend in personal income taxes as a share of the economy (figure 3) is quite different than its share of federal revenues (figure 2). For instance, we observe periods in figure 3 where federal personal income taxes are declining as a share of the economy both due to economic circumstances such as recessions and/or through purposeful reductions in tax rates.

It is ironic that a tax that was anathema to federal politicians during the first 50 years after Confederation and that many believe was brought in and sold as a temporary wartime measure has come to be the dominant source of federal government revenue. Indeed, both its creation and its most dramatic

expansion occurred during periods of war.³⁰ While the late 20th century saw a period of reform that resulted in a reduction in the number brackets, a lowering of rates, and a broadening of the base, recent federal government revenue policy has taken the first steps towards both higher rates and more brackets.

³⁰ Peacock and Wiseman argue that the rate of growth of public expenditures is driven by what taxpayers consider to be tolerable levels of taxation and that this tolerance is greater during times of national or social crisis. Thus, the public sector has grown in a step-like fashion of abrupt jumps and long plateaus driven by crises such as war. See Alan T. Peacock and Jack Wiseman (1961), *The Growth of Public Expenditures in the United Kingdom*, Princeton University Press; and D.A.L. Auld and F.C. Miller (1982), *Principles of Public Finance: A Canadian Text*, 2nd edition, Methuen: 74).

Six Budgets that Made Today's Income Tax



by William Watson

McGill University economist and Fraser Institute senior fellow

As noted in the foreword, Adam Smith believed one of the four requirements of a good tax is that it be “certain, and not arbitrary.” The rules governing Canada’s income tax usually have been clear. But from year to year, and decade to decade, the only real certainty about income taxes is that finance ministers never stop tinkering with them. With the new tax barely six months old, the April 1918 budget raised the top rate all the way to 54%³¹ and added a special war surtax that maxed out at 35% of the tax owed. It also introduced exemptions of \$200 (or \$2,732 in \$2016) for each child under age 16. Since then, the course of Canada’s income tax has never run smoothly. This chapter looks at six budgets that, more than most, gave us the tax we have today.

1926

The first is actually four budgets, those brought in by James A. Robb of Huntingdon, Quebec, from 1926 to 1929, boom years for the Canadian economy. Robb was Mackenzie King’s finance minister until his death just days following the October 1929 crash. Robb’s budgets reduced income taxes year after year. “Happily,” he told the Commons in 1926, “our financial and commercial position now enables us to make very substantial reductions in the income taxes.”³² His budget cut taxes in half for most low- and middle-income brack-

³¹ Albeit starting only at \$1 million or \$13.7 million in \$2016.

³² Hansard (1926), *Parliament of Canada: Debates of the House of Commons*, Library of Parliament. <http://parl.canadiana.ca/> (p. 2449).

ets and by a third for the top bracket. Of a further 10% reduction the following year, Robb said, “Thus, moneys which otherwise would come into the public coffers are released for the use of the individual; the development of the country is encouraged; the cost of production in our industries is reduced and avenues for an increase of business are created.”³³ Today’s taxpayer rights groups couldn’t have said it better. Robb’s budgets established the precedent, not always ignored by his successors, that good economic times can allow for income tax cuts. On the other hand, if ever the “war income tax” were to have been eliminated, it would have been in the boom times of the late 1920s, and it wasn’t.

1943

The next truly transformative budget was that from 1943, with its theme of “work and save.” In it, Finance Minister J.L. Ilsley, a Liberal from Nova Scotia, introduced tax withholding. His first three wartime budgets had raised tax rates high. The first bracket rate was now 30% and top marginal rates were 96% for families and 98% for individuals. Many Canadians were having trouble building enough saving into their budgets to pay the taxes they owed on their previous year’s income. Ilsley’s remedy was “pay-as-you-earn”: employers would remit income tax as the income was earned. This created a problem for the tax year 1943, however. With people dipping into their current earnings to pay their 1942 taxes, and with Ottawa trawling the same earnings to withhold 1943’s taxes, something had to give. The solution was a retroactive 50% cut for the tax year 1942. Unlike James Robb’s big cuts, however, it didn’t actually reduce federal revenues, the loss being more than made up by advancing payment of 1943 taxes. Canadians have been paying as they earn ever since.

1971

The next major structural change came in 1971, with the implementation of many recommendations of the Royal Commission on Taxation, which had been commissioned by the Diefenbaker government in 1962 and had reported in 1966. The headline synopsis of the six-volume report of the “Carter Commission”—it had been chaired by Toronto accountant Kenneth Carter—was “a buck is a buck is a buck,”³⁴ meaning that all additions to a taxpayer’s purchas-

³³ *Hansard*, 1927: 394.

³⁴ After Gertrude Stein’s “a rose is a rose is a rose.”

ing power should be taxed at the same marginal rate. The practical implication was that capital gains, which had never been taxed, should be included as income. Doing so would allow a reduction in income tax rates, which the Commission recommended should not exceed 50%: “We think there is a psychological barrier to greater effort, saving and profitable investment when the state can take more than one half of the potential gain.”³⁵ Thus Carter’s real mantra, one most tax economists regularly chant, was: “broaden the base, lower the rates.” It fell to pipe-smoking Liberal Finance Minister J. Edgar Benson of Kingston to implement the Carter reforms. After a government white paper in 1969 and then extended lobbying and public consultation, the budget eventually included only one-half of capital gains in income, though it did lower top rates. As it often does, tax theory ran into the brick wall of political reality.

1973

In his second budget as finance minister, John Turner, MP for Ottawa-Carleton, introduced full indexing of the income tax system, both the exemptions and the brackets, thus placing Canada, as he said, among “a very select group of countries which have eliminated the hidden revenues accruing to governments through the effect of inflation on a progressive tax system.”³⁶ Year-on-year inflation was “only” six percent when Turner spoke, but would be in double-digits by the next tax year, when indexing came into effect. The great virtue of indexing is that any increase in real tax rates must be legislated; it doesn’t occur by stealth as rising prices push people into higher brackets even though their real incomes haven’t changed.

1981

The 1981 budget of Finance Minister Allan MacEachen, MP for Cape Breton Highlands-Canso, was an important marker in a negative way.³⁷ It proposed dozens of base-broadening reforms, including taxing various employee bene-

³⁵ Royal Commission on Taxation (1966), *Taxation of Income: Part A, Taxation of Individuals and Families*, volume 3, Queen’s Printer, Government of Canada, <http://publications.gc.ca/pub?id=9.699804&sl=0> (p. 163).

³⁶ Hansard, 1973: 1435.

³⁷ For a good account, see Christina McCall and Stephen Clarkson (1994), *Trudeau and Our Times. Volume 2: The Heroic Delusion*, McClelland and Stewart: 229–40.

fits, and its rationale was impeccable: “A cutback of tax preferences will permit a lowering of tax rates... [which] will improve the incentives to work, save and invest ... [and] reduce the tendency for taxpayers to devote wasteful effort and money in finding artful ways of avoiding tax.”³⁸ But it did so essentially by surprise, without preparing the ground. The resulting opposition, much of it from business lobbies—which “crowded Ottawa-bound planes with their representatives as winter set in”³⁹—led to the unwinding over the next few months of many of its 150 proposed tax measures. The long-term result was, for all practical purposes, the end of the tradition of budget secrecy. Subsequent governments have made sure to float flotillas of trial balloons and pre-budget leaks before attempting any potentially controversial change.

1987

Partly inspired by, and partly reacting to, tax reform in the United States, the fourth budget of Conservative Finance Minister Michael Wilson, MP for Etobicoke Centre, began a Canadian tax reform that eventually included the transition from the Manufacturer’s Sales Tax to the Goods and Services Tax. “The central objective of tax reform,” Mr. Wilson said, “is to reduce tax rates... To get tax rates down we must reduce tax preferences and broaden the tax base. A wide range of specific tax preferences, of primary benefit to corporations and upper-income earners [will] be eliminated, reduced or modified right across the system.”⁴⁰

The major reforms to the income tax were a reduction in the number of brackets from 10 to three, a reduction in tax rates (though temporary surtaxes to achieve budget balance delayed their effect), and the conversion of many deductions to tax credits, either refundable or non-refundable. As Mr. Wilson explained, “Exemptions favour those in higher income brackets. A tax credit, on the other hand, provides the same dollar benefit to taxpayers regardless of their income level.”⁴¹ Having relief vary across tax brackets may well be a problem if exemptions from tax are regarded as social policy delivered through the tax system. On the other hand, if society decides certain activities or sources of income should be exempt from tax, then it is obvious and in fact

³⁸ Budget speech, Hansard, 1981: 12722.

³⁹ John English (2009), *Just Watch Me: The Life of Pierre Elliott Trudeau 1968-2000*, Alfred A. Knopf Canada: 541.

⁴⁰ Hansard, 1987: 3578.

⁴¹ Hansard, 1987: 3578.

just that people paying a greater tax on these activities or incomes will experience a greater reduction in tax. Unfortunately, that point of view essentially disappeared from Canadian policy discussions with Mr. Wilson's abandonment of it.

There have been other important income tax changes since 1987, of course. In two budgets in 2000, Paul Martin lowered the middle and bottom rates modestly and raised bracket thresholds. Conservative Jim Flaherty's 2008 budget introduced the Tax-Free Savings Account, the mirror image of the Registered Retirement Savings Plan (RRSP). Bill Morneau's 2016 budget reduced the middle rate and reversed a two-decade trend to lower top rates by introducing a fourth bracket for those with taxable income of \$200,000 or more. But we haven't had truly transformative change in a while. Perhaps it's time.

Canada's Competitiveness Problem with the Personal Income Tax



by Robert P. Murphy

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and

Milagros Palacios

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As explained in a couple of the historical essays included elsewhere in this volume, in 1917 Canada's political leaders were worried about what the introduction of a personal income tax would mean for the nation's international competitiveness and its continued ability to attract investment and people. As Canada recognizes the 100th anniversary of the introduction of the personal income tax, it is crucial to understand just how uncompetitive Canada has become with respect to the personal income tax.

Both economic theory and empirical research suggest that high income tax rates distort incentives and impede economic growth. Some Canadians might believe—erroneously—that their income tax burden is relatively light because the top federal tax rate is quite competitive with other peer countries. However, the 2013 study *The Economic Costs of Increased Marginal Tax Rates in Canada*,⁴² found that focusing merely on the top federal rate is misleading, because the Canadian provinces also impose relatively high tax rates. Once the authors adjusted for this factor, they observed that its high income tax rates make Canada uncompetitive compared with many states south of the border.

⁴² Robert P. Murphy, Jason Clemens, and Niels Veldhuis (2013), *The Economic Costs of Increased Marginal Tax Rates in Canada*, Studies in Budget and Tax Policy, The Fraser Institute, <https://www.fraserinstitute.org/sites/default/files/economic-costs-of-increased-marginal-tax-rates-in-canada.pdf>.

Why marginal income tax rates matter

When the public thinks about the burden of government taxation, they usually have in mind how much revenue—perhaps as a share of GDP—is transferred from households and businesses to the government. Although this is certainly an important metric, economists are also concerned with the economic damage done when the tax structure changes people's behaviour. If a tax discourages individuals from engaging in a mutually beneficial transaction, then it has “hurt the economy” in the sense that an opportunity to make people better off has been missed. In the extreme, we can imagine a draconian tax that virtually wipes out a particular market; such a tax would yield little revenue (because there would be little activity left to tax), but it would obviously be harmful to anyone who had previously bought or sold in the market.

Because individuals make decisions “on the margin,” economists focus on the marginal income tax rate that individuals face. In other words, the tax rate of their current income bracket is the relevant parameter that influences whether individuals will work longer hours or take more risk.

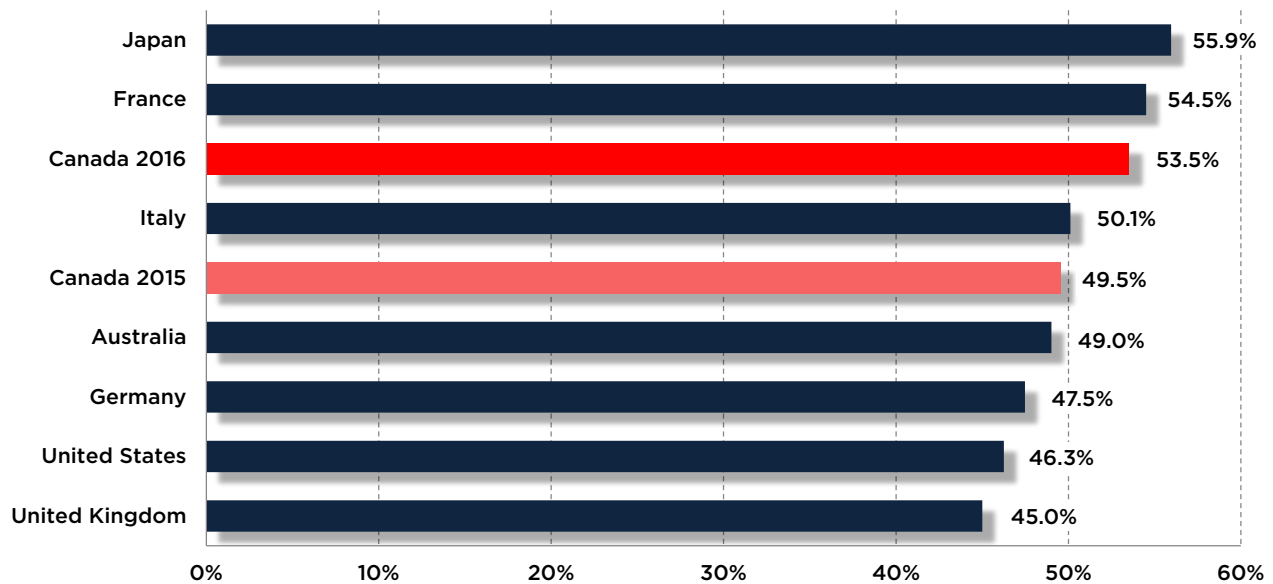
Now we see the potential downside to a “progressive” income tax, which imposes higher rates on higher income. Although the obvious appeal of such a system is that it concentrates taxation on those members of society who can most afford it, a huge drawback of progressive taxation is that it discourages economic activity more than does a tax system with more uniform or “flatter” rates.

Besides the textbook theory, we have empirical studies documenting that taxation really does matter. For example, in 2010, Christina and David Romer⁴³ studied several periods in US history and estimated that a tax increase of 1 percent of GDP reduces output by roughly 2 to 3 percent. In 1996, Eric Engen and Jonathan Skinner⁴⁴ reviewed more than 20 studies of the United States and other countries, and concluded that “a major tax reform reducing all marginal rates by 5 percentage points, and average tax rates by 2.5 percentage points, is predicted to increase long-term growth rates by between 0.2 and 0.3 percentage points.”

⁴³ Christina D. Romer and David H. Romer (2010), The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks, *American Economic Review* 100, 3 (June): 763–801, <http://emlab.berkeley.edu/~dromer/papers/RomerandRomerAERJune2010.pdf>, as of March 14, 2017.

⁴⁴ Eric Engen and Jonathan Skinner (1996), Taxation and Economic Growth, *National Tax Journal* 49, 4 (December): 617–42.

Figure 1: Top Combined Statutory Marginal Income Tax Rates in Selected OECD Countries, 2015



Notes:

1) The highest combined statutory personal income tax rate that is applied on earned income, taking into account that some personal income taxes may be deductible from the base of other personal income taxes, but before any other tax deductions. The top statutory tax rates are the combined central and sub-central governments' rates.

2) For countries with sub-central and/or local personal income tax rates, the OECD calculates the combined rate by either taking an average of the sub-central/local rates or selecting a jurisdiction that the OECD considers representative. In Canada's case, the "representative" jurisdiction is Ontario and it is Detroit, Michigan for the US.

Sources: OECD.Stat (2016), *Top Statutory Personal Income Tax Rate and Top Marginal Tax Rates for Employees (Table I.7)*, http://stats.oecd.org/Index.aspx?DataSetCode=TABLE_I1, as of April 1, 2017; calculations by authors.

How Canada ranks against peer countries

In light of the significance of marginal income tax rates for economic behaviour, it is important to consider Canada's standing against similar countries. Figure 1 combines national and sub-national personal income tax rates for the G7 countries plus Australia, which is often compared to Canada given the two countries' economic, cultural, and historical similarities. For Canada, Ontario's provincial tax rate is used as a proxy for the provinces and for the United States, Michigan is used.

Table 1: Top Statutory Marginal Income Tax Rate, Provincial, Federal, and Combined, 2016

Province	Top provincial rate	Top federal rate	Combined top rate
British Columbia	14.70	33.00	47.70
Alberta	15.00	33.00	48.00
Saskatchewan	15.00	33.00	48.00
Manitoba	17.40	33.00	50.40
Ontario	20.53	33.00	53.53
Quebec	25.75	27.56	53.31
New Brunswick	20.30	33.00	53.30
Nova Scotia	21.00	33.00	54.00
Prince Edward Island	18.37	33.00	51.37
Newfoundland & Labrador	16.80	33.00	49.80

Notes:

(1) Personal income tax rates include surtaxes where applicable.

(2) The federal personal income tax rate is lower in Quebec due to the Quebec Abatement, which is applied because Quebec has opted out of various federal programs. For more information, see <http://www.fin.gc.ca/fedprov/altpay-eng.asp>.

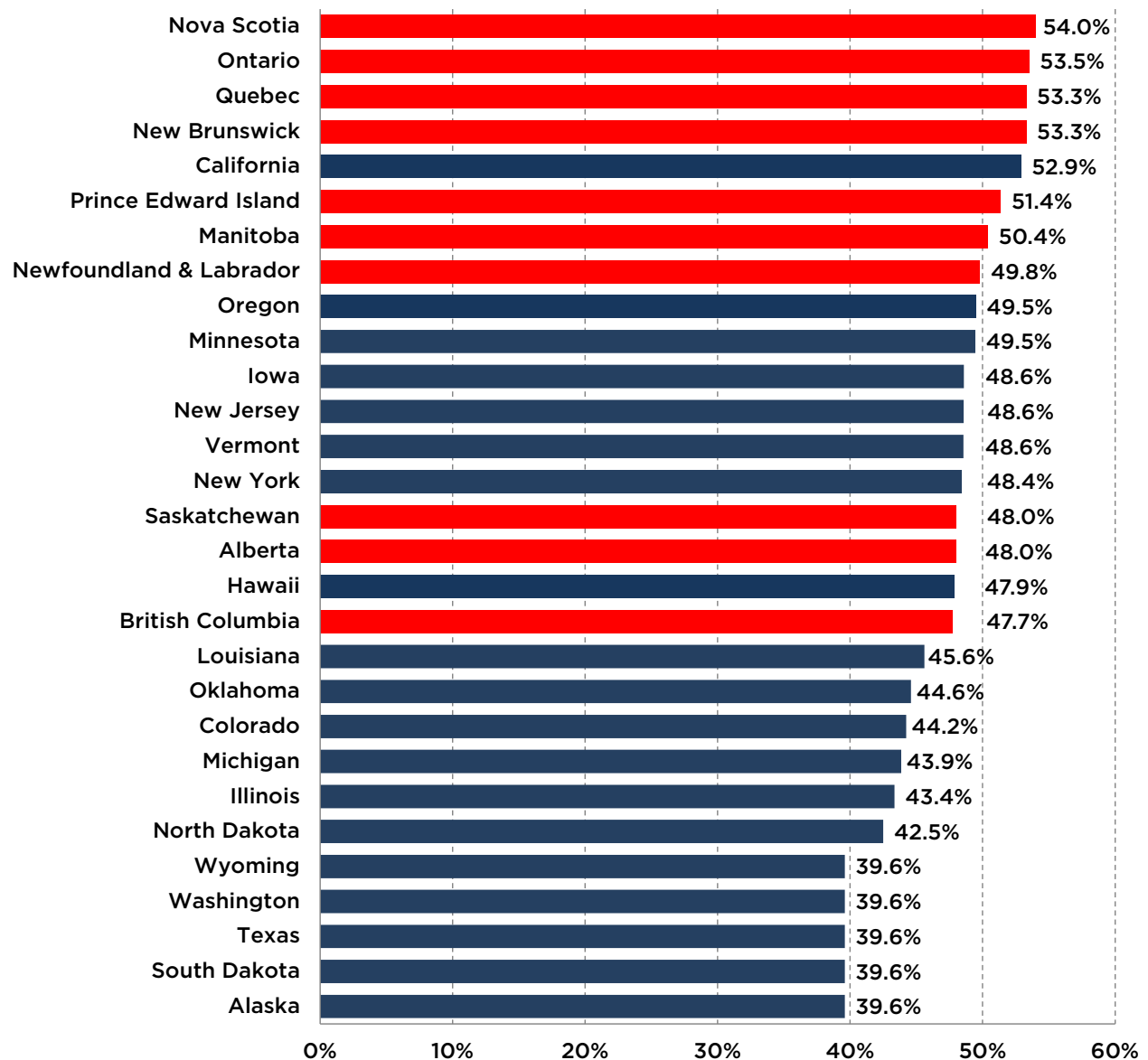
Sources: Canada Revenue Agency [CRA] (2016), *Canadian Income Tax Rates for Individuals – Current and Previous Years*, Government of Canada, <http://www.cra-arc.gc.ca/tx/ndvdl/fq/txrts-eng.html>; Revenu Quebec (2016), *Income Tax Rates*, Government of Quebec, <http://www.revenuquebec.ca/en/citoyen/situation/nouvel-arrivant/regime-fiscal-du-quebec/taux-imposition.aspx>, as of November 10, 2016; and calculations by authors.

As figure 1 illustrates, as of 2015 Canada had a middle-of-the-road top marginal personal income tax rate compared to the rest of the G7 and Australia. Specifically, at 49.5 percent, Canada's rate was higher than in the UK, the US, Germany, and Australia, but lower than the top marginal tax rate in Japan, France, and Italy.

In 2015, the federal government announced an increase in the top federal personal income tax rate to 33 percent effective in 2016, which meant that the top marginal rate increased to 53.5 percent (2016), making it higher than Italy's top personal income tax rate.

It is important to understand the provincial variations in tax rates. As table 1 indicates, the combined federal-provincial top tax rates provide a large

Figure 2: Top Combined Statutory Marginal Income Tax Rate in Canadian Provinces and Selected US States, 2016



Notes:

(1) Personal income tax rates include surtaxes where applicable. Quebec's tax rate is adjusted for the federal abatement.

2) For US states, local income taxes are excluded.

Sources: CRA (2016); Revenu Quebec (2016); Nicole Kaeding (2016), *State Individual Income Tax Rates and Brackets for 2016*, Tax Foundation, <http://taxfoundation.org/article/state-individual-income-tax-rates-and-brackets-2016>; Kyle Pomerleau (2015), *2016 Tax Brackets*. Tax Foundation, <http://taxfoundation.org/article/2016-tax-brackets>; and calculations by authors.

one-two punch to take-home income for Canadians. In Nova Scotia, a whopping 21 percent more is taken at the provincial level, yielding a combined top income tax rate of 54 percent. Note that Quebec has the highest provincial tax rate, but the federal abatement means that the combined burden is lower in Quebec than in Ontario or Nova Scotia.

To be fair, we should acknowledge that in Canada, more governmental functions (especially education) are handled at the provincial level than is typical in other peer countries. Consequently, the Canadian pattern of relatively low federal tax rates coupled with relatively high provincial tax rates is not, by itself, problematic.

In order to assess the true burden in the various provinces in Canada compared to their US state peers, we have ranked all of the Canadian provinces and the US states according to their combined federal and provincial/state top income tax rates.

Figure 2 reveals that the *total* marginal personal income tax rate in Canadian provinces is relatively high, compared to the typical US state. Note that figure 2 presents just selected US states for simplicity's sake, but its underlying data use all states and provinces. The figure focuses on states that are high tax, border Canada, or are oil-producing. In particular, in a ranking of the provinces and states by their combined top tax rates, seven out of the top eight are Canadian provinces, with only California joining them.

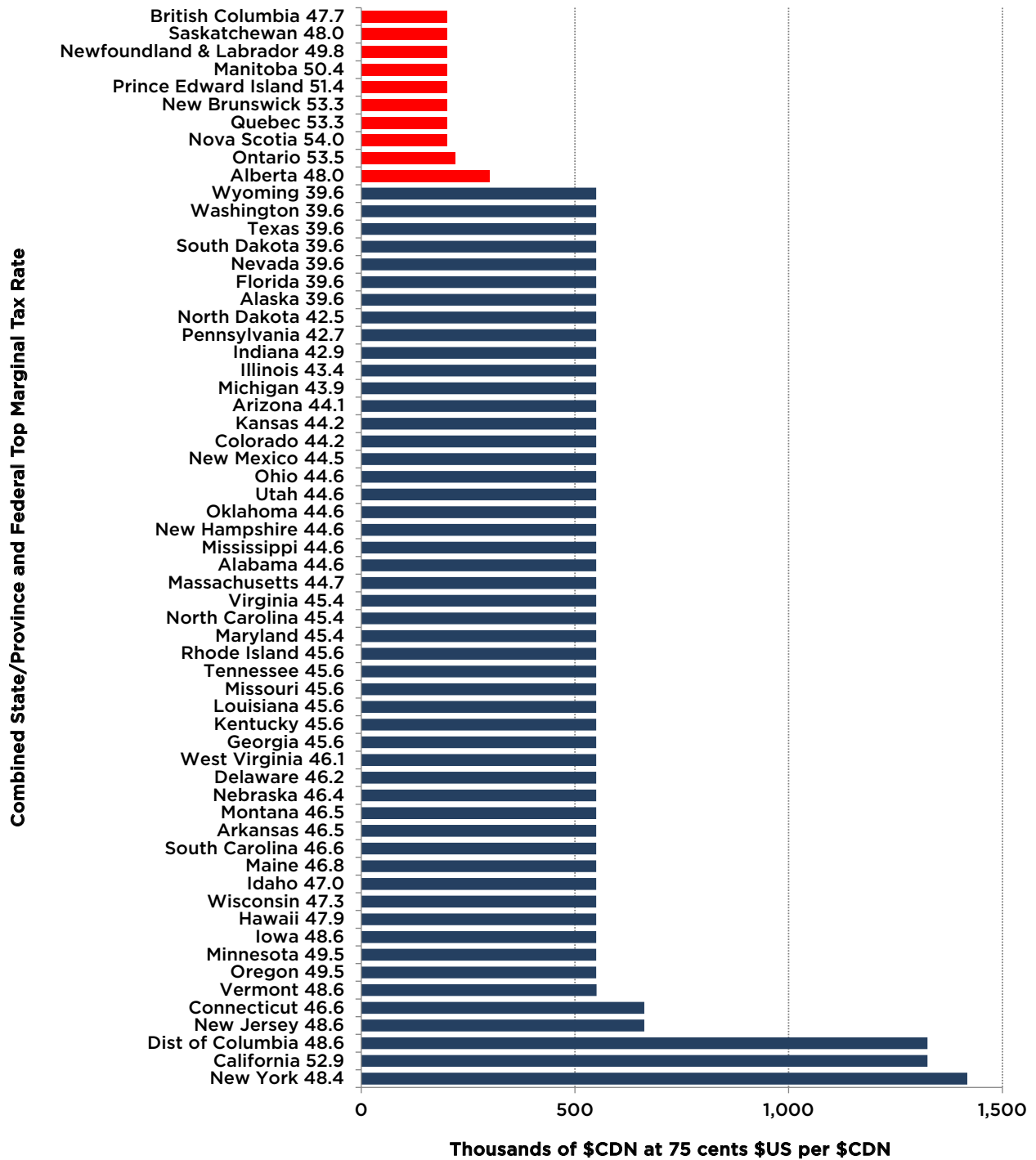
Another way of putting the matter is to consider British Columbia, which has the lowest combined top personal income tax rate of any province. Yet even though BC is the most competitive jurisdiction in Canada, 42 of the US states have a lower combined income tax rate than British Columbia.

But wait, it's worse. By merely comparing the (combined) top personal income tax rates, we are understating how much heavier the Canadian burden really is. This is because the top rate kicks in at a lower income threshold in Canadian provinces, compared to US states.

As figure 3 indicates, the Canadian provinces apply their top marginal income tax rates on people earning much lower incomes than in the United States. For example, in Alberta the top income tax rate kicks in at \$300,000 and above; in Ontario the threshold is \$220,000; and for the other provinces the top tax rate applies to any income above \$200,000. In contrast, the threshold is much higher in US states. Many of the states have a top threshold (in Canadian dollars and for single filers) of about \$550,000. Further, an admittedly "high tax" state like New York only applies its top rate to incomes above \$1.4 million.

Simply put, the combined federal-provincial personal income tax burden on Canadians is higher in *any* province than it is in the overwhelming majority

Figure 3: Taxable Income Where Top Rate Starts, 2016



Note: The state and federal tax brackets correspond to the single filer.

Sources: CRA (2016); Revenu Quebec (2016); Nicole Kaeding (2016); Kyle Pomerleau (2015); Bank of Canada (2016). *Year Average of Exchange Rates*, <http://www.bankofcanada.ca/stats/assets/pdf/nraa-2016-en.pdf>; and calculations by authors.

of US states. Furthermore, the threshold at which these top rates are applied is much lower in Canada, meaning that the disparity in tax burdens is even larger than the rates alone would suggest.

Conclusion

Both economic theory and empirical analysis indicate that high marginal income tax rates distort behaviour in harmful ways and in particular reduce economic growth. Although a superficial consideration of income tax rates levied at the federal (or central) government level makes Canada appear competitive against other G7 countries, once we account for the relatively high burden of provincial income tax rates, Canada's edge evaporates. Specifically, as of 2016, the combined federal-provincial tax rate in the lightest-taxed province of British Columbia (at 47.7 percent) was higher than the analogous figure for 42 of the 50 US states. Furthermore, the income threshold at which the top rates apply is far lower in Canada than in the US, posing further problems for Canadian competitiveness.

Especially as the United States embarks on major tax reform under the new Trump Administration—which may very well combine income tax rate reductions with other features—Canadian provinces and the federal government should consider measures to make their jurisdictions more tax competitive.

Compliance Costs and Complexity in Canada's Personal Income Tax



by François Vaillancourt
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Université de Montréal*
and
Charles Lammam
*Director of fiscal studies, Fraser Institute*⁴⁵



It is clear that much has changed since the personal income tax (PIT) was first introduced in 1917. Governments now rely significantly more on this revenue source than they did then. For instance, the federal government now relies on the PIT for approximately half of its total revenue, up from 2.6 percent in 1918 (see Di Matteo's essay in this volume). In 2015/16, the federal government alone collected \$145 billion in PIT.⁴⁶ This is on top of the over \$90 billion in PIT revenue collectively collected by the provinces (various provincial public accounts; authors' calculations).

However, the PIT imposes significant costs beyond the tax dollars extracted by governments. An important cost is that incurred by individuals and families to comply with the tax code. This essay discusses this hidden cost of the PIT and how an increasingly complex tax code can lead to higher compliance costs.

⁴⁵ The authors would like to thank Hugh MacIntyre and Feixue Ren, Fraser Institute analysts, for their assistance.

⁴⁶ Canada, Receiver General for Canada (2016). *Public Accounts 2015/16*. Ministry of Public Works and Government Services.

Compliance costs

Complying with Canada's personal income tax system imposes costs on Canadian households. For instance, some Canadians pay directly for services that assist with tax preparation and tax planning (i.e., tax preparers, accountants, and lawyers). Others purchase computer software to help them wade through the tax code.

But in addition to these direct costs, Canadians also incur indirect costs, namely, the financial value of the time it takes to understand the tax rules, compile the relevant materials, and complete the tax forms. All told, the latest available estimates show that Canadians spent nearly \$7 billion complying with the personal income tax system in 2012.⁴⁷ These costs are not trivial. They represent about \$501 per Canadian household. Put differently, each individual tax filer incurs, on average, \$217 in total compliance costs.⁴⁸

These costs, which are incurred simply to comply with various tax rules, do not add any productive capacity to the economy. They do not go towards building new factories or purchasing new machinery, nor do they improve our human capital through investments in education or training. And compliance costs certainly do not improve our lives by increasing our incomes. In fact, complying with the tax code means Canadians have less money and time available to spend on the things they care about, including leisure, work, and family and friends.

Another related issue that is too often ignored is that the relative burden of compliance costs falls disproportionately on lower-income Canadians. While the average dollar cost of complying with the tax code increases as one's income increases, the real burden of such costs is measured as a share of one's

⁴⁷ Speer, Sean, Milagros Palacios, Marco Lugo, and François Vaillancourt (2014), *The Cost to Canadians of Complying with Personal Income Taxes*, The Fraser Institute, <https://www.fraserinstitute.org/sites/default/files/cost-to-canadians-of-complying-with-personal-income-taxes.pdf>, as of March 23, 2017. This cost estimate is mainly for the personal income tax but also includes some payroll taxes (EI, CPP, and QPP).

⁴⁸ Governments also incur costs to administer taxes, including the cost of collecting taxes, maintaining records, and managing appeals and investigations at the federal, provincial, and municipal levels. These costs are in addition to those for compliance. In 2011, governments in Canada collectively spent an extra \$6.6 billion to administer the tax system (see François Vaillancourt, Édison Roy César, and Maria Silvia Barros (2013), *The Compliance and Administrative Costs of Taxation in Canada*, The Fraser Institute, <https://www.fraserinstitute.org/sites/default/files/compliance-and-administrative-costs-of-taxation-in-canada-2013.pdf>, as of March 23, 2017).

income. Using this measure, lower-income Canadians pay the highest share of their income to comply with the tax code⁴⁹

Tax complexity

The complexity of the personal income tax system is partly what drives compliance costs. In recent years, Canada's tax system has become more complex across a host of different measures⁵⁰

For evidence of this, there is perhaps no better place to look than the evolution of the Income Tax Act, the legislation governing personal and corporate income taxes. Since it was introduced 100 years ago, the Act has become increasingly longer and denser. A growing web of complicated rules has made it more difficult for ordinary Canadians to understand and more costly to comply with.

For instance, when the Act was established in 1917, it contained 3,999 words. A century later, in 2016, the number of words had increased by over 1 million to 1,029,042. For every one word in the Act in 1917, there were 257 words 99 years later. Not surprisingly, the Act's page count has also increased dramatically. After standardizing the font, margins, and page size, the Act has grown from just six pages in 1917 to 1,412 pages in 2016.⁵¹ The extra 1,400 pages is certainly a contributing factor to the significant compliance costs delineated above.⁵²

⁴⁹ Specifically, low-income Canadians dedicate 3.3 percent of their income to tax compliance compared to 0.3 percent for high-income earners (Speer et al., 2014, *The Cost to Canadians*).

⁵⁰ François Vaillancourt, Charles Lammam, Feixue Ren, and Marylène Roy (2016), *Measuring Personal Income Tax Complexity in Canada*, The Fraser Institute, <https://www.fraserinstitute.org/sites/default/files/measuring-tax-complexity-in-canada.pdf>, as of March 23, 2017.

⁵¹ For consistency, the calculations exclude the following from the 1917 and 2016 versions of the Act: cover page, table of contents, schedule/appendix, official status of consolidation disclaimer, the French text, page numbers, and notes in the margin. The page size and font is the default setting of Word 2010. Specifically, the font size is 11 point. The margins are one inch on each side and the page size is standard letter (8.5 inches by 11 inches).

⁵² Measuring the growth in the size of tax legislation has limitations. Both Joel Slemrod (2005), *The Etiology of Tax Complexity: Evidence from US State Income Tax Systems*, *Public Finance Review* 33 (3): 279–299, and Caroline Turnbull-Hall and Richard Thomas (2012), *Length of Legislation as a Measure of Complexity*, Office of Tax Simplification, Government of United Kingdom, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/193496/ots_length_legislation_paper.pdf, as of March 23,

Table 1: Growth in complexity of Canada's Income Tax Act, 1917 to 2016

Measure	1917	2016	Increase	Growth (times)
Words	3,999	1,029,042	1,025,043	257
Pages	6	1,412	1,406	235

Notes:

*For consistency, the calculations exclude the following from the 1917 and 2016 versions of the Act: cover page, table of contents, schedule/appendix, official status of consolidation disclaimer, the French text, page numbers, and notes in the margin.

*The page size and font is the default setting of Word 2010. Specifically, the font is calibre size 11. The margins are one inch on each side and the page size is standard letter (8.5 inch by 11 inch).

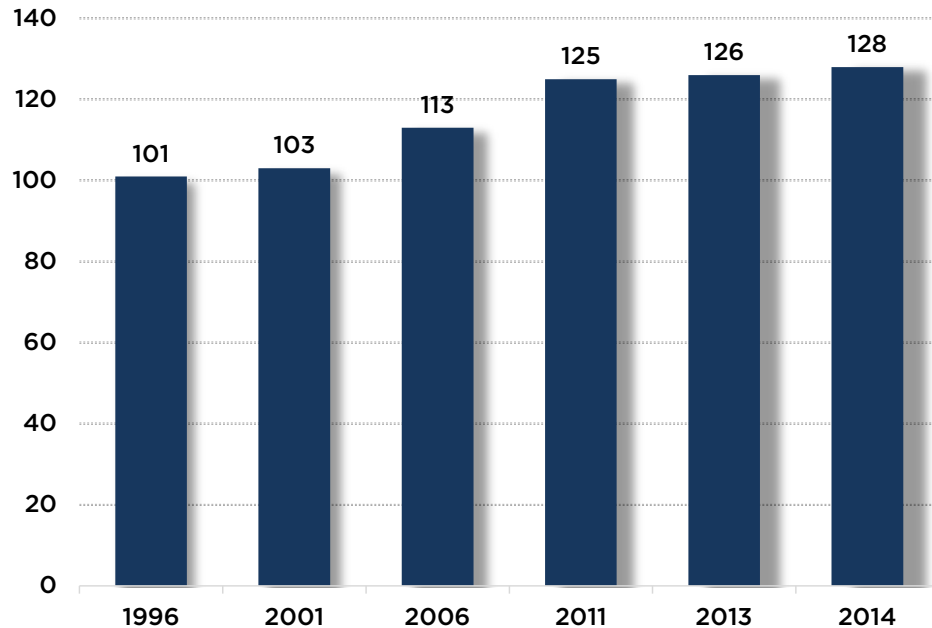
Sources: Pontifex (1918); Canada, Department of Finance (2017); calculations by authors.

One main source of the tax system's complexity is the long list of tax credits, deductions, and other special preferences (known as "tax expenditures"), which has grown in recent years. For instance, the number of federal tax expenditures in the personal income tax system (excluding corporate and sales taxes) is now well over 100 and covers a wide range of activities such as donating to a political party, or volunteering as a firefighter, or buying a home for the first time. From 1996 to 2014, the federal government added 27 personal tax expenditures for a total of 128. That's a 27 percent increase in the span of just 18 years.

Claiming a tax credit or deduction typically requires a tax filer to maintain receipts or fill out additional forms in order to be eligible. It can require various calculations to sum up different types of spending over the course of the year or income earned in different jurisdictions. Sometimes people feel the need to hire a tax professional so that they don't miss any possible tax benefits. These are some of the reasons that claiming tax expenditures can contribute to higher tax compliance costs. In fact, a recent analysis found that after controlling for different factors such as age, gender, and income, Canadian tax-filers

2017, note that longer legislation or text in an information booklet may reduce complexity if, for example, it allows the use of plain English (i.e., simpler language), or covers various possible types of taxpayers. In addition, it is important, where feasible, to carefully distinguish and separate out non-tax related aspects from the documents (such as income support delivered through the tax system) to truly gauge tax complexity.

Figure 1: Number of Federal Personal Income Tax Expenditures in Canada, Selected Years, 1996-2014



Notes:

- 1) The number of personal income tax expenditures includes every tax expenditure included in the Department of Finance's annual *Tax Expenditures and Evaluations* report. It excludes the sub-expenditures and the "Supplementary information: present-value of tax-assisted retirement savings plans."
- 2) The "Reclassification of flow-through shares" is considered to be one tax expenditure, even though this tax expenditure is listed as a sub-category of "Deduction of resource-related expenditure."
- 3) Data are based on the latest information available for the estimates of the number and cost of tax expenditures. For data prior to 1990, the Department of Finance's 1985 report is the source. Data may vary by report.

Sources: Department of Finance (various years); calculations by authors.

who used at least one of the 10 tax measures examined spent, on average, 20.3 percent more on tax compliance than those who didn't use any of them.⁵³

Consider also the growth in complexity that has occurred in the administrative documents associated with the personal income tax system. The total number of lines in tax forms is a reasonable indicator of growing complexity.

⁵³ Speer et al., 2014, *The Cost to Canadians*.

The number of lines in the federal income tax form has increased from just 23 in 1917, to 328 in 2015. That's 305 more lines since the PIT was first introduced.

There are, of course, other factors that add to the tax system's complexity, including the number of tax rates and differing treatment for different types of income. But regardless of the specific indicator, it is clear that Canada's PIT system is now much more complicated than it was 100 years ago. Each new tax law, credit, line, or rate can add to the complexity of the tax system. And the more complex the system, the more difficult—and often more costly—that system is to navigate.

Simplification is the solution

Broadly speaking, to lower compliance costs Canadian governments could reduce or eliminate tax policies that add complexity to the personal income tax system. For instance, getting rid of ineffective credits, deductions, and other special tax provisions would not only simplify the personal income tax system, it would create room to broadly lower personal income tax rates.⁵⁴ In the absence of reform, Canadians will continue to bear high costs to comply with our personal income tax system. Unfortunately, while often called for, meaningful tax simplification has yet to occur in Canada.⁵⁵

⁵⁴ Charles Lammam, Joel Emes, Jason Clemens, and Niels Veldhuis (2015), *Reforming Federal Personal Income Taxes: A Pro-Growth Plan for Canada*, The Fraser Institute, <https://www.fraserinstitute.org/sites/default/files/reforming-federal-personal-income-taxes.pdf>, as of March 23, 2017.

⁵⁵ François Vaillancourt and Richard Bird (2016), Tax Simplification in Canada: A Journey Not Yet Mapped, in S. James, A. Sawyer, and T. Budak, eds., *The Complexity of Tax Simplification* (Palgrave Macmillan): 70–94.

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The High Cost of Raising Revenue through the Personal Income Tax



by Bev Dahlby

Research director and distinguished fellow, School of Public Policy, University of Calgary

The personal income tax (PIT) is the single largest source of revenue for Canadian governments, but it also has a major impact on the level and growth of personal income. The PIT influences a wide range of important economic decisions that individuals make, such as hours of work, location of employment, retirement dates, acquisition of education and training, occupation choice, risk taking, entrepreneurship, and savings. All of these decisions affect the amount and types of income generated in the economy.

When governments raise the PIT rates, both direct and indirect costs are imposed on the private sector. The direct cost is the additional PIT that taxpayers have to pay. The indirect cost is the loss of income-generating activities arising from the taxpayers' responses to the tax rate increases. The marginal cost of public funds (MCF) measures both the direct and indirect costs to society in raising an additional dollar of tax revenue through a tax rate increase. In the absence of other distortions in the economy, such as monopolies or pollution, the cost of raising an additional dollar of tax revenue is normally more than a dollar because of the additional welfare loss arising from further distorting decisions that affect the size of the economic pie.⁵⁶

The MCF can help inform tax policy decisions. By indicating which are the highest and which the lowest cost sources of tax revenue, the MCF can reveal the direction for revenue neutral changes in the tax mix that would

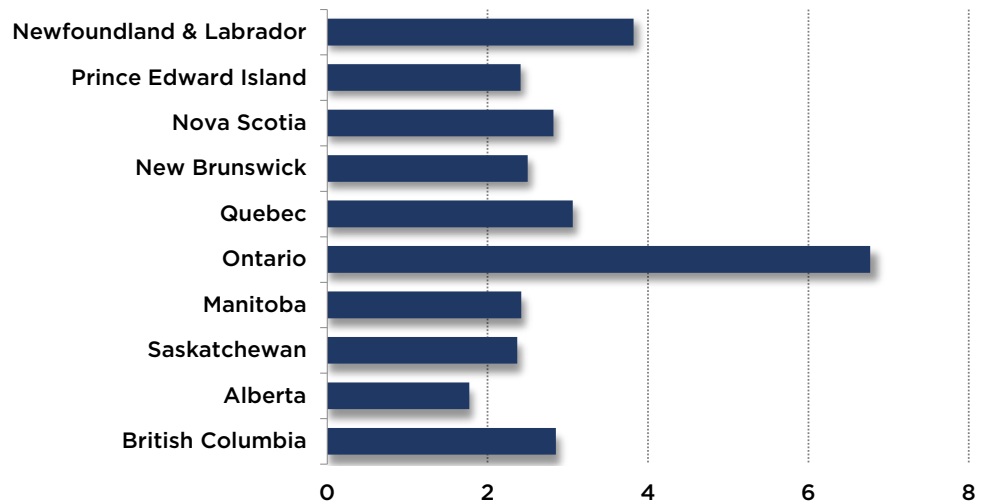
⁵⁶ The MCF does not include the various governments' administrative costs of levying, and the private sector's cost of complying, with the PIT. The administrative and compliance costs are relatively fixed and would not significantly affect the marginal cost of raising an additional dollar of tax revenue. (See also the essay by François Vaillancourt and Charles Lammam in this volume.)

lower the total cost to society of raising a given amount of tax revenue. It can also be used in cost-benefit analyses of public expenditure programs because the benefit from an additional dollar spent on a program should be greater than the cost of financing it through the tax system. As we will see, the MCF of the personal income tax can be very high. In Ontario, our estimates show that it is more than \$6 per \$1 of revenue raised. With costs this high, marginal public expenditures would have to bring very high value to justify raising extra income tax revenues to pay for them. No other province has so high a marginal cost of funds, though in every province the MCF exceeds \$2 per \$1 raised: to the direct cost of taxation has to be added more than another full dollar of indirect cost.

Several factors affect the magnitude of the MCF for any tax. Tax bases that are very tax sensitive have a higher MCF. If the taxpayer can readily shift activity away from a tax base, there is a greater distortion in the allocation of resources when its tax rate is increased, and the MCF for that tax base will be higher. A measure of the tax sensitivity of a tax base is the percentage reduction in the tax base from a one percentage point increase in its tax rate. This parameter is called the (own) semi-elasticity of the tax base, and it is a negative number because of the inverse relation between a tax base and the tax rate that is applied to it. In addition, the interaction between tax bases can affect the size of the welfare loss from a tax increase. For example, an increase in the PIT rate, by lowering a taxpayer's disposable income, will normally lead to a reduction in the consumption of goods and services that are taxed under a general sales tax, leading to a larger welfare loss per dollar of total tax revenue generated from the PIT rate increase. This interaction can be measured by the percentage change in the sales tax base when the PIT rate is increased by one percentage point, known as the cross semi-elasticity of the tax bases. Another factor that affects the size of the MCF is the tax rate itself. Generally speaking, the higher the tax rate the higher the MCF because the welfare loss from taxation depends on the size of the tax wedge, the gap between the pre- and post-tax returns on an investment, or the gap between the before and the after-tax wage rates that workers receive. Finally, taxes that generate more tax revenue will have a higher MCF because distortions in the larger tax bases have a larger impact on economic activity and represent larger efficiency losses.

Given estimates of the semi-elasticities of the tax bases, the tax rates, and the shares of tax revenues generated by different taxes, it is possible to calculate the taxes' MCFs. Here I will present some estimates of the MCFs for provincial personal income taxes based on the econometric estimates of the long-run tax sensitivities of the aggregate PIT bases found in Ferede and Dahlby (2016). That study found that the average own semi-elasticity of the

Figure 1: The Marginal Cost of Public Funds from a Provincial PIT Rate Increase in 2017



Calculations based on E. Ferede and B. Dahlby (2016), *The Costliest Tax of All: Raising Revenue through Corporate Tax Hikes Can Be Counter-Productive for the Provinces*, SPP Research Papers 9, 11 (March), <https://www.policyschool.ca/wp-content/uploads/2016/05/estimating-tax-base-ferede-dahlby.pdf>, as of March 22, 2017.

provincial PIT bases is -3.5, implying that a one percentage point increase in the top provincial marginal income tax rate reduces a province's PIT base by an average of 3.5 percent. Quebec's PIT base has the lowest tax sensitivity, with semi-elasticity of -2.62, perhaps because of lower population mobility than in other provinces. Interestingly, British Columbia has the most tax sensitive PIT base with a semi elasticity of -4.42.

Figure 1 shows the estimates of the marginal cost of raising an additional dollar of tax revenue through an increase in the top provincial marginal tax rate in each of the 10 provinces based on their projected 2017 tax rates.⁵⁷

⁵⁷ Calculations based on E. Ferede and B. Dahlby (2016), *The Costliest Tax of All: Raising Revenue through Corporate Tax Hikes Can Be Counter-Productive for the Provinces*, SPP Research Papers 9, 11 (March), <https://www.policyschool.ca/wp-content/uploads/2016/05/estimating-tax-base-ferede-dahlby.pdf>, as of March 22, 2017. For technical reasons, it was not possible to calculate the semi-elasticity of the PIT for Nova Scotia so the calculation in figure 1 for Nova Scotia is based on the estimated semi-elasticity in B. Dahlby and E. Ferede (2012), *The Effects of Tax Rate Changes on Tax Bases and the Marginal Cost of Public Funds for Canadian Provincial Governments*, *International Tax and Public Finance* 19: 844–883.

Ontario has the highest MCF for a PIT rate increase: raising an additional dollar of PIT revenue costs the private sector \$6.77. The MCF in Ontario is high because it has one of the highest top marginal PIT rates, 20.53 percent, on top of the federal rate of 33 percent, and a relatively sensitive PIT base with a semi-elasticity of -4.15. Note that while British Columbia has the lowest top provincial marginal income tax rate, 14.7 percent, it has a higher MCF than Alberta, 2.85 versus 1.77, even though Alberta's top marginal rate is slightly higher at 15 percent. This is because, as previously noted, the econometric evidence indicates BC has the most tax sensitive PIT base, though it's not clear why BC's PIT base is so sensitive. There is an important lesson to draw from this—we should not simply judge a province's "tax competitiveness" based on how its tax rates compare with other provinces because tax base sensitivity varies between provinces, and a province such as BC with a relatively low tax rate, can nonetheless have a very costly tax system.

The Ferede and Dahlby (2016) study does not estimate the MCF of the federal PIT. Although not strictly comparable with provincial MCFs for 2017 shown in figure 1, the MCF for the federal PIT was 1.30 in the Baylor and Beauséjour (2004, Table 4) study and 1.17 in the Dahlby and Ferede (2012, Table 6A) study.⁵⁸ These estimates of the MCF for the federal PIT are lower than those for the provincial PITs because provincial PIT increases create incentives to shift income-generating activities across provincial borders, an option not available at the federal level.

The estimates of the MCFs in all of the provinces except Alberta exceed \$2 for every additional dollar of PIT revenue, indicating that the indirect cost of raising an additional dollar of PIT revenue is more than the additional amount the taxpayer pays. However, the studies by Dahlby and Ferede (2012) and Ferede and Dahlby (2016) indicate that provincial corporate income taxes have even higher MCFs, and are more costly sources of tax revenue than the PIT. On the other hand, provincial sales taxes generally have lower MCFs than the PIT. Tax reforms that shift more of the tax burden from provincial corporate income taxes to provincial sales taxes, or even to the provincial PITs, would improve provincial economic performance. And much of the benefit of lower corporate income taxes would accrue to workers, offsetting con-

⁵⁸ The Baylor and Beauséjour (2004) estimate was derived from a computable general equilibrium model, calibrated to data for the 1996-98 period (see M. Baylor and L. Beauséjour (2004), *Taxation and Economic Efficiency: Results from a Canadian CGE Model* (Working Paper 2004-10), Ottawa: Department of Finance, <http://www.fin.gc.ca/pub/pdfs/wp2004-10e.pdf>, and the Dahlby and Ferede (2012) study calculated the federal MCF for 2006 based on an econometric estimate of the responsiveness of the provincial PIT tax bases to a federal PIT rate increase.

cerns about the distributional effects of these changes in the tax mix, because recent studies by Ebrahimi and Vaillancourt (2016) and McKenzie and Ferde (forthcoming)⁵⁹ have shown that workers' wages and salaries increase when provincial CIT rates are reduced.

⁵⁹ P. Ebrahimi and F. Vaillancourt (2016), *The Effect of Corporate Income and Payroll Taxes on the Wages of Canadian Workers*, The Fraser Institute, <https://www.fraserinstitute.org/sites/default/files/effect-of-corporate-income-and-payroll-taxes-on-wages-of-canadian-workers.pdf>, as of March 22, 2017; and K. McKenzie and E. Ferde (forthcoming), *The Incidence of the Corporate Income Tax on Wages: Evidence from Canadian Provinces*, SPP Research Papers, School of Public Policy, University of Calgary.

Personal Income Taxes and the Capital Gains Tax



by Herbert Grubel
Professor emeritus, Simon Fraser University
and
Jason Clemens
Fraser Institute executive vice-president



Numerous studies⁶⁰ have demonstrated the high costs imposed on economies that maintain capital gains taxes, particularly those such as Canada that are relatively small and trade-oriented. The source of these costs is that capital gains taxes have especially strong effects on entrepreneurship, the foundation for successful, thriving economies.⁶¹ But why include an essay on capital gains taxes in a series dedicated to understanding Canada's personal income tax in its 100th year?

Until 1972, capital gains were not taxed. For Canada's first 105 years, we avoided taxing capital in part because as a small, developing country, we understood the need to attract investment. When the capital gains tax was introduced in January 1972, it was based on personal income tax rates. Thus,

⁶⁰ For a discussion of capital gains taxes and their adverse economic impact, see Herbert Grubel, ed. (2000), *Unlocking Canadian Capital: The Case for Capital Gains Tax Reform*, Fraser Institute, <https://www.fraserinstitute.org/sites/default/files/UnlockingCanadianCapital.pdf>, as of March 22, 2017; and Niels Veldhuis, Keith Godin, and Jason Clemens (2007), *The Economic Costs of Capital Gains Taxes*, The Fraser Institute, <https://www.fraserinstitute.org/sites/default/files/EconomicCostsCapitalGainsTax.pdf>, as of March 22, 2017.

⁶¹ Jason Clemens, Joel Emes, and Niels Veldhuis (2015), *Entrepreneurship, Demographics, and Capital Gains Tax Reform*, The Fraser Institute, <https://www.fraserinstitute.org/sites/default/files/entrepreneurship-demographics-and-capital-gains-tax-reform.pdf>, as of March 22, 2017.

Table 1: Combined Federal-Provincial Capital Gains Tax Rate, 2010 vs. 2016

	2010	2016	Change
BC	21.85	23.85	9.2%
AB	19.50	24.00	23.1%
SK	22.00	24.00	9.1%
MB	23.20	25.20	8.6%
ON	23.20	26.76	15.3%
QC	24.11	26.65	10.6%
NB	21.65	26.65	23.1%
NS	25.00	27.00	8.0%
PEI	23.69	25.69	8.4%
NF	21.15	24.90	17.7%
Federal-only	14.50	16.50	13.8%

Notes:

- (a) Tax rates include surtaxes where applicable.
- (b) Quebec tax rate is adjusted for Quebec Abatement.

Source: Canada Revenue Agency (CRA), 2016.

when personal income tax rates change, so too does the taxation of capital gains.

A capital gain (or loss) occurs when an asset such as a stock or ownership in a business is sold for more (or less) than it was purchased for originally. A portion of the gain—50 percent under current rules—is included in the person's regular income. This means that the effective capital gains tax rate is half of the top personal income tax rate. Principal residences and certain types of investments in Canada are exempt from capital gains.

Capital gains taxes are, unfortunately, on the rise in Canada because various provinces, and most recently the federal government, have all increased their personal income tax rates. Table 1 summarizes the increase in the applicable capital gains tax rates, by province, between 2010 and 2016. It shows the top combined federal-provincial personal income tax rate adjusted to reflect that only half of a capital gain is included in personal income. The increases in the capital gains tax range from a low of 8.0 percent in Nova Scotia to a high of 23.1 percent in Alberta and New Brunswick.

The defenders of capital gains taxes claim that such taxes are needed to improve economic efficiency, achieve a fairer income distribution, and raise revenue. All three arguments are flawed.⁶²

The efficiency rationale

The efficiency rationale is that owners of capital will have an incentive to shift income from employment, which is taxed at normal income tax rates, to businesses or other entities in order to enjoy lower or even no taxes. Economists worry about both the resources lost to the tax planning needed to achieve these shifts and the potential for inefficient levels of capital within firms, which would lower the overall returns to capital. Both of these effects would lower overall economic growth.

While these arguments may make sense conceptually, they do not coincide with the experiences of countries that have no capital gains taxes. If concerns about loss of efficiency due to the absence of capital gains taxes were valid, then such costs would be apparent in countries such as Switzerland, New Zealand, and Hong Kong, which impose no capital gains taxes. However, studies of these countries have consistently shown that such costs are immaterial.⁶³

This argument also seems to misunderstand that the owners of financial assets, land, and real estate, the appreciation of which represents the vast bulk of all capital gains, have virtually no ability to make the shifts in income discussed above—from employment income to other forms. Only the owners of small businesses have any real opportunity to avoid capital gains taxes. Again, the evidence from countries with no capital gains taxes suggests that this problem is minor.

It is also critical to consider the costs of “locked-in capital,” which capital gains tax proponents seem to ignore. The “lock-in” effect stops capital from

⁶² See Grubel, ed. (2000), *Unlocking Canadian Capital*; Herbert Grubel, ed. (2001), *International Evidence on the Effects of Having No Capital Gains Taxes*, The Fraser Institute, <https://www.fraserinstitute.org/sites/default/files/IntlEvidenceNoCapitalGainsTaxTable.pdf>, as of March 22, 2017; and Herbert Grubel (2001), Why There Should Be No Capital Gains Tax, in Herbert Grubel, ed., *Tax Reform in Canada: Our Path to Greater Prosperity*, The Fraser Institute: 139–161, <https://www.fraserinstitute.org/sites/default/files/TaxReforminCanadaCapitalGains.pdf>, as of March 22, 2017.

⁶³ Grubel, ed. (2001), *International Evidence*; Charles Lammam and Jason Clemens, eds. (2014), *Capital Gains Tax Reform in Canada: Lessons from Abroad*, The Fraser Institute, <https://www.fraserinstitute.org/sites/default/files/capital-gains-tax-reform-in-Canada.pdf>, as of March 22, 2017.

moving to other investment opportunities with higher returns because of the punitive nature of the capital gains tax. In other words, capital gains taxes create a barrier to capital by locking it in and preventing it from flowing to its highest end use. Former Federal Reserve Chairman Alan Greenspan, in testimony before the US Senate Committee on Banking, Housing, and Urban Affairs in February 1997,⁶⁴ was clear about the net costs of capital gains taxes:

... the major impact (of capital gains taxation) is to impede entrepreneurial activity and capital formation. While all taxes impede economic growth to one extent or another, the capital gains tax is at the far end of the scale... the appropriate capital gains tax rate [is] zero.⁶⁵

Fairer income distribution

The second argument from proponents of capital gains taxes is that such gains accrue mainly to those with high incomes. Taxing capital gains, therefore, results in a more equal distribution of income. However, in Canada, most who pay the capital gains tax have modest incomes in years prior to and after they realize those gains. For many, the capital gain is an infrequent or even one-time event, such as happens from the sale of a business. Canadians with consistently high incomes paid only about a quarter of all the capital gains taxes collected.

The fairness argument is further flawed by the fact that historically, much of the increase in the value of assets has been due to inflation. Under these conditions, the taxation of realized capital gains results in a tax on the real value of the assets, which unfairly taxes property rather income.⁶⁶

⁶⁴ *Testimony of Chairman Alan Greenspan: The Federal Reserve's Semiannual Monetary Policy Report Before the Committee on Banking, Housing, and Urban Affairs*, US Senate (February 26, 1997), Federal Reserve Board, <https://www.federalreserve.gov/boarddocs/hh/1997/february/testimony.htm>, as of March 22, 2017. The quote is taken from the question period after completion of the formal testimony.

⁶⁵ Grubel, ed. (2000), *Unlocking Canadian Capital*: 25.

⁶⁶ At the very least, indexing of capital appreciation should be considered to ensure that inflationary gains are not taxed.

Source of revenue

The final argument used to support the capital gains tax is that it is an important source of revenue. Unfortunately, the federal government does not regularly report revenue from capital gains taxes since it appears as part of the overall personal income tax revenues. However, in 2011, the Institute formally requested that data and was able to determine that the federal government collected about \$2.8 billion, or roughly 1.1 percent of total federal revenues, from capital gains taxes.⁶⁷ More important than the amount of revenue raised, though, is that the tax decreases the total revenue raised through personal income and value-added taxes. This is due to the inefficiencies that the capital gains tax causes, which reduce economic growth and, with it, taxable personal income.

This point is driven home by an analogy, which considers the economy to be like a fruit-bearing tree. The taxation of income is equivalent to the government claiming a part of the fruit harvest, allowing the tree to grow and produce larger harvests in later years. Capital gains taxation is equivalent to trimming the annual increase in tree branches on which the fruit grows so that the size of future harvests is reduced correspondingly.

Studies looking at the effects of variations in the capital gains taxation rate have produced results with important implications for politicians and policy makers. When the rate is increased, wealth holders postpone the realization of capital gains and pay fewer taxes than had been projected. When rates are decreased, wealth holders increase the realization of capital gains and tax revenues rise by more than expected. In the longer run, the real economic effects of the tax are the reduction of economic growth and living standards, as discussed above.

The preceding summary has shown how capital gains taxation lowers economic growth and ultimately living standards in Canada. Furthermore, the key justifications used for taxing capital gains are not only not compelling, but in at least one case, are simply incorrect. Canada benefitted from not taxing capital gains for most of its history and like other countries, including Switzerland, New Zealand, and Hong Kong, would again benefit from returning to a capital gains tax rate of zero.

⁶⁷ Jason Clemens, Charles Lamman, and Matthew Lo (2014), *Economic Costs of Capital Gains Taxes in Canada*, in Herbert Grubel, ed., *Capital Gains Tax Reform in Canada: Lessons from Abroad*, The Fraser Institute, <https://www.fraserinstitute.org/sites/default/files/economic-costs-of-capital-gains-taxes-in-canada-chpt.pdf>, as of March 22, 2017.

A Modern Personal Tax on Consumed Income



by Jack M. Mintz

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At the time the ten-page Income War Tax Act was promulgated in Canada 100 years ago, the underlying principle was to tax Canadians on their “annual net gain, profit or gratuity”; capital gains from holding property would be exempt. However, 100 years later, this “annual income” approach is no longer appropriate. Consumption is now a more reliable tax base on which to promote economic growth and fairness.

The notion of taxing annual income was debatable, even in 1917. In response to a question on the taxation of real estate, Sir Thomas White, then finance minister, responded:

Two men, let us say, are employed by the Bank of Montreal, and each draws a salary of \$10,000. One of these men has no outside property at all; he spends the entire \$10,000 upon himself and his family. Clearly he is assessable for \$10,000, which is his income. The other man spends only \$1,500 or \$2,000 upon himself and his family—he has a smaller family—and with the balance of the money speculates in stocks or pays taxes upon property which he holds and which gives him no return. Would anybody seriously argue that the first man should be taxed upon \$10,000, and that the other man should not be taxed at all, or should be taxed only upon \$2,000 or \$3,000?⁶⁸

The 1917 tax was developed with the aim of taxing annual income, as Sir Thomas White makes clear. It was broadened in 1972 to tax capital gains based on the 1967 Carter Commission principle that a “buck is a buck is a

⁶⁸ *Hansard*, September 20, 1917: 28.

buck.”⁶⁹ Applying a corporate income tax to ensure that any retained profits do not escape taxation was a hallmark of Canadian tax policy even going back to 1917.⁷⁰

Given the high personal and family exemptions in the 1917 version of the income tax only 2% of Canadians actually paid it. Today, however, the income tax is much more important, bringing in more than \$300 billion in federal and provincial revenues (15% of GDP). Almost every Canadian files—either to pay tax or receive refundable credits. The tax, therefore, can have far-reaching impacts on economic activity by discouraging work effort, entrepreneurship, investment, savings, risk-taking, and ultimately, economic growth.

Given concerns with economic growth, the original intent to tax annual income, whether saved or not, became increasingly challenged. A new approach to personal taxation was developed in the late 1970s, based on the principle that only consumed income—income minus saving—should be taxed.⁷¹ The notion of taxing consumed income rather than annual income became an acceptable alternative among many experts.⁷² No longer was annual income necessarily regarded as the appropriate base to measure a person's well-being. Instead, consumption could be viewed as a better measure.

A tax on consumed income also reduces the economic cost of taxation. Under an annual income tax, savers pay more tax than consumers over time or, to put it in other words, future consumption is taxed more heavily than current consumption. With a consumption tax, present and future consumption are treated the same.

Consider the example of a consumer and saver with the same earnings. Under an annual income tax, the consumer pays tax only once when income is earned. A saver pays tax not only on the earnings that year but also on the investment income received from saved earnings in the future, resulting in the saver paying more tax than the consumer over time.

⁶⁹ Canada (1966), *Report of the Royal Commission on Taxation* (The Carter Commission report), Ottawa: Queen's Printer.

⁷⁰ Canada, *Report of the Royal Commission*: 16.

⁷¹ United States (1977), *Blueprints for Basic Tax Reform*. Department of the Treasury, <https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Blueprints-1977.pdf>, as of March 6, 2017; and James Meade (1978), *The Structure and Reform of Direct Taxation*, London: Institute of Fiscal Studies, <https://www.ifs.org.uk/docs/meade.pdf>, as of March 6, 2017.

⁷² The principle was also endorsed in Mirrlees et al. (2011), *Tax by Design. The Mirrlees Review: Reforming the Tax System for the 21st Century*, Institute for Fiscal Studies, <http://www.ifs.org.uk/docs/taxbydesign.pdf>, as of March 6, 2017.

Savings is simply consumption deferred to a later time. A dollar saved today is equal in time value to the dollar plus any return on savings received later. Going back to the above quote, Sir Thomas White could have argued that a person should not be taxed on saved income but on the disposal of his or her property and accumulated income consumed at a later time.

Consumption taxes are also simpler to apply in today's modern world. The essence of consumption taxation is to exempt the so-called normal return on assets, which is the minimum return that savers require to willingly postpone their consumption to the future. By expensing rather than depreciating capital, the investor is provided the equivalent time value of depreciation and financing costs incurred to hold capital. Simplification is further achieved since capital income does not need to be adjusted for inflation. Some complexities in the taxation of international income are also avoided since interest is no longer tax-deductible.

The consumed income approach is consistent with the tax treatment of pension and retirement savings accounts. Taxpayers could deduct their savings from the tax base and pay tax only on account withdrawals (though no tax would be applied to investment income earned in an account). It is also consistent with the notion of simply exempting the return on savings since the tax value of the deduction for savings would be equal to the time value of tax paid on future account withdrawals (which is consistent with the principal-residence exemption, a lifetime capital gains exemption, and Tax-Free Savings Accounts). In fact, Canada could move to a full-fledged consumed income tax by simply removing existing limits on investments in registered assets. This would not only make the income tax fair by removing the double tax on savings, but also provide significant economic benefits by encouraging investment and risk-taking.

To ensure that the consumed income tax cannot be avoided, a business consumption tax would also be imposed, replacing the current corporate income tax. Businesses would deduct investment expenditures from their tax base and pay tax on asset disposals. For both households and businesses, the cost of borrowed funds would not be deductible since the return on savings would not be taxed.

An alternative consumption tax is, of course, the value-added tax (the federal Goods and Services Tax or the federal-provincial Harmonized Sales Tax, based on the invoice-credit method). Value-added—the difference between sales revenues and input purchases from other businesses—is similar to a consumed income tax in that it only taxes consumption. It could also be levied as a “business value tax” that applies to the revenues net of purchases

from other businesses, with or without wage deductibility and with or without border adjustments for exports and imports.

Those who defend the taxation of capital income argue that because the rich save more than the poor, it is only fair to tax the return to savings. There is also the argument that wealth confers economic and political power. While these arguments have some validity, they are really based on other considerations. Instead of taxing capital income, one could, however, apply the consumption principle to the taxation of estate transfers since giving money to heirs is a form of consumption.

Obviously, a significant share of the tax base would be lost if capital income were to be exempt (a bequest tax would be unlikely to make up the revenue loss). One could adjust marginal personal tax rates and low-income tax credits to make up for revenue losses and achieve redistributive objectives. There might be some limit to how much marginal tax rates can be increased, however, since they could distort work decisions. A better alternative would be for the government to resort to other taxes and user fees or reduce program spending rather than impede economic growth by taxing the return to investment and saving.

To a large extent, many Canadians are already taxed on a consumption basis as all their savings are in housing and retirement accounts from which the investment returns are exempt. There is no reason not to go further to unleash entrepreneurship, investment, and risk-taking, even if doing so would run contrary to current Canadian public policy trends.

The Case for Federal Personal Income Tax Reform



by Charles Lammam
Director of fiscal studies, The Fraser Institute
and
Niels Veldhuis
President, The Fraser Institute



On the 100th anniversary of the federal personal income tax (PIT), the federal government would be wise to consider reforming personal income taxes by eliminating several “tax expenditures” (tax credits, deductions, and other special treatments) and using the revenues to fund broad-based reductions in marginal income tax rates. While some of the reasons underpinning the case for tax reform are discussed elsewhere in this essay series, they bear repeating.

Why tax reform now?

Canada’s economic performance has been sluggish for many years and is projected to remain modest for the foreseeable term. A tax reform plan that improves incentives to work, save, invest, and undertake entrepreneurial activities can help enhance economic growth. Indeed, a large body of research shows that broad-based reductions in marginal tax rates have beneficial economic effects.⁷³ One US study, for instance, finds that a 1 percentage-point

⁷³ See, Robert P. Murphy, Jason Clemens, and Niels Veldhuis (2013), *The Economic Costs of Increased Marginal Tax Rates in Canada*, The Fraser Institute, <https://www.fraserinstitute.org/sites/default/files/economic-costs-of-increased-marginal-tax-rates-in-canada.pdf>, as of March 22, 2017, and B. Dahlby elsewhere in this volume. The economics research is clear that marginal tax rates play an important role in influencing whether people engage in productive economic activity (Murphy et al., 2013). While there is some debate about the extent to which marginal tax rates influence individual decisions, there is general agreement about the adverse economic effects of high and increasing marginal tax rates.

cut in the average personal income tax rate raises real GDP per capita by 1.4 percent in the first quarter of the reforms and by up to 1.8 percent after three quarters.⁷⁴ This type of economic boost could be a powerful shot in the arm for the Canadian economy.

Past federal governments of different political persuasions, both Liberals and Conservatives, have made the case for lowering marginal tax rates based on the potential for economic gain. In 2005, then-Prime Minister Paul Martin's economic plan, *A Plan for Growth and Prosperity*, stated that: "Lower personal taxes would ... provide greater rewards and incentives for middle- and high income Canadians to work, save and invest."⁷⁵ Former Prime Minister Stephen Harper's 2006 plan, *Advantage Canada*, also stressed that "Canada needs lower personal income tax rates to encourage more Canadians to realize their full potential."⁷⁶

Yet, despite what appears to be political consensus, there has been almost no progress in making the federal personal income tax system more competitive and part of a pro-growth agenda. In fact, the federal and many provincial governments have raised marginal tax rates recently, particularly on the country's highly skilled and educated workers, including entrepreneurs and business professionals.⁷⁷ The current federal government, for instance, created a new top personal income tax rate of 33 percent (see table 1), a four percentage point hike over the previous top rate of 29 percent. Several provincial governments have also raised their top tax rate in recent years.

⁷⁴ Karel Mertens, and Morten O. Ravn (2012), The Dynamic Effects of Personal and Corporate Income Tax Changes in the United States, *American Economic Review* 103, 4 (June): 1212–1247.

⁷⁵ See Canada, Department of Finance (2005), *A Plan for Growth and Prosperity*, Government of Canada, p. 130.

⁷⁶ See Canada, Department of Finance (2006), *Advantage Canada*, Government of Canada, p. 46. The fourth paper in this volume by William Watson on six budgets that made the PIT shows that the tax reforms of 1971 and 1987 were also based on the principle of broadening the tax base by eliminating tax expenditures and using the revenues generated to finance cuts in marginal rates.

⁷⁷ High personal income tax rates not only discourage people from working hard, expanding their skills, investing, and being entrepreneurial, they also make it difficult for Canada to attract and retain highly-skilled workers. See Charles Lammam and Hugh MacIntyre (2016, March 24), Don't Think Top Talent Responds to Higher Tax Rates? Think Again... , Web commentary, The Fraser Institute, <https://www.fraserinstitute.org/article/dont-think-top-talent-responds-to-higher-tax-rates-think-again>, as of March 22, 2017.

Table 1: Federal Personal Income Tax Rates, 2014 and 2017

2014		2017	
Income threshold	Tax rate	Income threshold	Tax rate
\$11,139 – \$43,953	15.0%	\$11,635 – \$45,916	15.0%
\$43,954 – \$87,907	22.0%	\$45,917 – \$91,831	20.5%
\$87,908 – \$136,270	26.0%	\$91,832 – \$142,353	26.0%
\$136,271 +	29.0%	\$142,354 – \$202,800	29.0%
		\$202,801 +	33.0%

Source: Canada Revenue Agency (2017), Canada – Federal 2016 and 2017 Tax Brackets and Marginal Tax Rates, *TaxTips*, 2017, <http://www.taxtips.ca/taxrates/canada.htm>.

As a result, Canada’s combined federal-provincial tax rates, which were already uncompetitive internationally, have become even less so.⁷⁸ The competitive pressures on Canada to enact significant personal income tax reform will intensify in coming years, especially if the United States enacts its own PIT reform, which is possible under the new Trump administration.

An additional reason why Canada is due for fundamental PIT reform relates to the complexity of the personal tax system and the opportunity for simplification. The current personal income tax system has grown increasingly complex over the years and now consumes considerable resources in the form of compliance costs.⁷⁹

⁷⁸ Murphy, Clemens, and Veldhuis (2013), *The Economic Costs of Increased Marginal Tax Rates in Canada*; and Charles Lammam, Hugh MacIntyre, Feixue Ren, Ben Eisen, and Milagros Palacios (2016), *Canada’s Rising Personal Tax Rates and Falling Tax Competitiveness*, The Fraser Institute, <https://www.fraserinstitute.org/sites/default/files/canadas-rising-personal-tax-rates-and-falling-tax-competitiveness.pdf>, as of March 22, 2017.

⁷⁹ See Sean Speer, Milagros Palacios, Marco Lugo, and François Vaillancourt (2014), *The Cost to Canadians of Complying with Personal Income Taxes*, The Fraser Institute, <https://www.fraserinstitute.org/sites/default/files/cost-to-canadians-of-complying-with-personal-income-taxes.pdf>, as of March 22, 2017; François Vaillancourt, Charles Lammam, Feixue Ren, and Marylène Roy (2016), *Measuring Personal Income Tax Complexity in Canada*, The Fraser Institute, <https://www.fraserinstitute.org/sites/default/files/measuring->

One of the main sources of the tax system's complexity is the proliferation of credits, deductions, and other special preferences (known as "tax expenditures"). While tax expenditures can reduce an individual's tax bill, they add to the cost of compliance because claiming a tax credit or deduction requires keeping records, ensuring eligibility, and perhaps hiring an accountant to ensure one does not miss out on any tax benefits. And the economic bang of tax expenditures is low, as they provide few behavioural incentives related to work, saving, investment, or entrepreneurship. Instead, tax expenditures simply subsidize behaviour that taxpayers would likely have undertaken anyway. More concerning, however, is that they narrow the tax base, resulting in higher marginal rates. The consequence is a less efficient, uncompetitive personal income tax system.

Opportunity for simplification and pro-growth tax reform

The proliferation of tax expenditures underlines the opportunity for reform. In its 2016 budget, the current federal government criticized the growing number of tax expenditures and launched a formal review. Specifically, the budget stated:

... the Government remains committed to ensuring federal tax expenditures are fair for Canadians, efficient and fiscally responsible. Individuals and businesses have expressed concerns related to the efficiency and fairness of the tax system, and how the increasing number of tax expenditures has made the federal tax system more complex. In the coming year, the Government will undertake a review of the tax system to determine whether it works well for Canadians, with a view to eliminating poorly targeted and inefficient tax measures.⁸⁰

Although the government is to be commended for seeking to eliminate some tax expenditures, it should use its review as an opportunity to reform taxes—concurrently reducing tax rates broadly—not to generate more rev-

[personal-income-tax-complexity-in-canada.pdf](#), as of March 22, 2017; and the sixth paper in this volume by Vaillancourt and Lammam.

⁸⁰ Canada, Department of Finance (2016), *Budget 2016—Growing the Middle Class*, Government of Canada: 211.

venues and raise the tax burden on Canadians. Indeed, eliminating a large number of tax expenditures would broaden the tax base and allow the government to use the resulting resources to lower marginal tax rates. Such tax reform would simplify the system and lead to a less distortionary personal income tax regime, laying the foundation for more rapid economic growth.

A Fraser Institute study published in 2015 provides a detailed blueprint for federal personal tax reform.⁸¹ While the federal PIT system has changed since the study was published, the basic approach is relevant and can serve as a guide for reform.

The analysis started with the fact that tax expenditures cost the federal government approximately \$124 billion in lost revenue in 2013/14, close to the \$130 billion the government was collecting annually in personal income taxes. Of the \$124 billion in annual tax expenditures, Lammam et al. (2015) identified 68 for removal, including the Children's Arts and Fitness Tax Credits, the Public Transit Tax Credit, and the Labour-Sponsored Venture Capital Corporations Credit, to name a few.⁸² The total savings from eliminating the 68 tax expenditures would have been \$20.2 billion.

At the time of study, there were four federal personal income tax brackets (see table 1). Since then, the second lowest rate was reduced from 22% to 20.5% and the government added a new top rate of 33%. Nonetheless, what could the elimination of \$20.2 billion in tax expenditures have meant for the PIT?

It would have allowed the federal government to completely scrap the two middle rates (22% and 26%). An overwhelming majority of Canadians could have faced a single 15% marginal tax rate, while only a small minority—roughly 2% of tax filers—would have faced the higher rate of 29%. Had the top rate of 29% been kept at its 2014 income threshold, this tax reform package, when fully implemented, would have cost \$21.4 billion (in static terms, without accounting for the behavioural changes that would ensue from lower marginal tax rates).

Although the federal PIT system has changed since these options were developed, they demonstrate what a simple, pro-growth tax reform plan could look like. On its 100th anniversary, now is the right time to undertake serious and structural reforms of the federal PIT system.

⁸¹ See Charles Lammam, Joel Emes, Jason Clemens, and Niels Veldhuis (2015), *Reforming Federal Personal Income Taxes: A Pro-Growth Plan for Canada*, The Fraser Institute, <https://www.fraserinstitute.org/sites/default/files/reforming-federal-personal-income-taxes.pdf>, as of March 22, 2017.

⁸² The last two federal budgets have eliminated the first two of these tax credits.

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