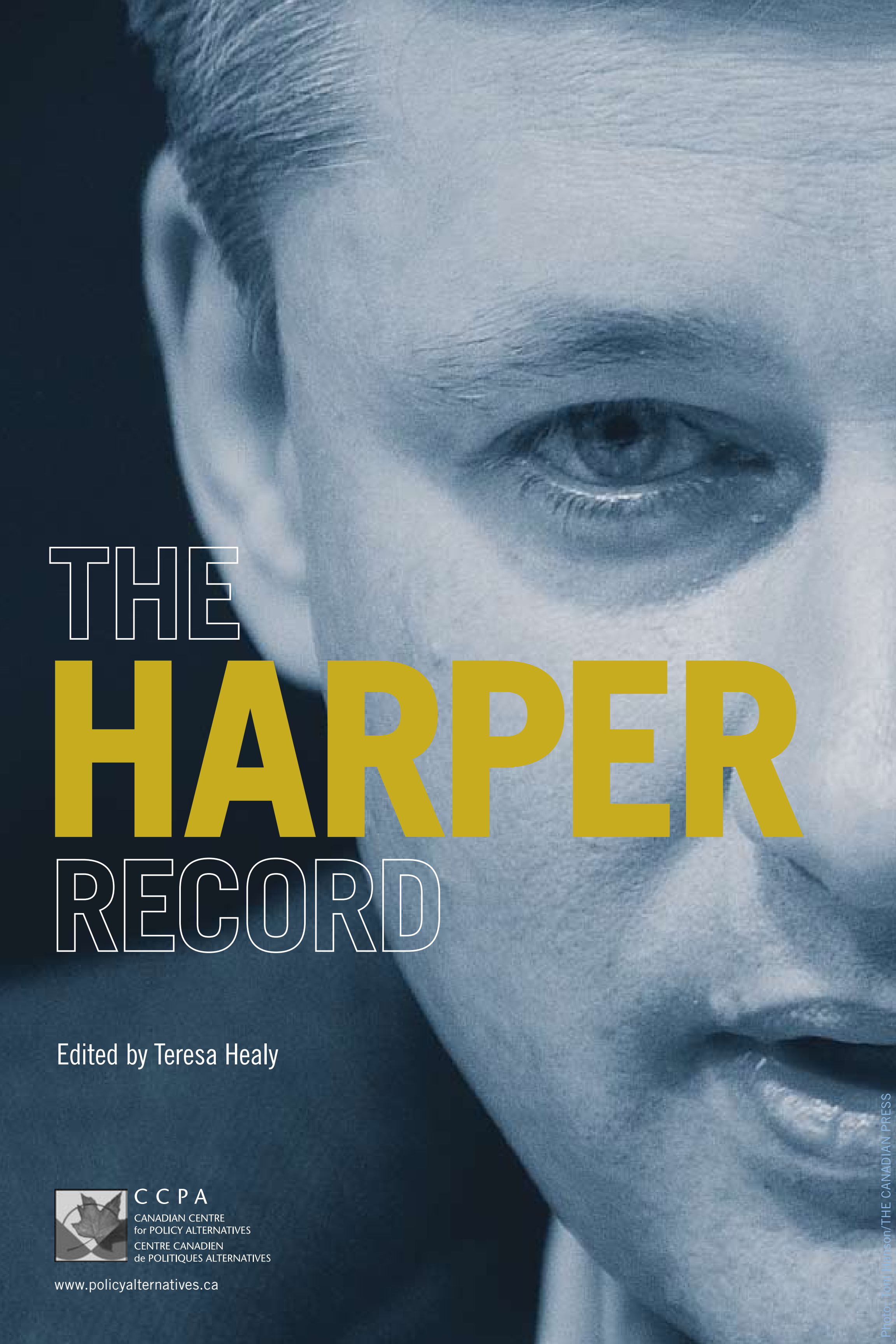

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The Conservative Tax Record

More of the same, or a turn for the worse?

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A PROGRESSIVE TAX system and strong public fiscal capacity are needed to secure a more equal and inclusive society. In Canada, wages and market income are very unequally distributed, but the tax and transfer system redistributes income from the more to the less affluent. Taxes also finance public services — such as health care and education — that benefit all Canadians regardless of income. Countries with relatively high taxes as a share of national income also have higher levels of public social spending and, as a result, have much narrower income and opportunity gaps between rich and poor.

In recent years, Canada's rising corporate profits and worsening personal-income inequality have been amplified by lower, less progressive taxes and reduced social spending.[1] As a share of Gross Domestic Product (GDP), pre-tax corporate profits rose from 8% in the 1990s to above 13% since 2004. After-tax corporate profits doubled from 5% in the 1990s to 10% since 2004. The richest 1% of taxpayers increased their share of total pre-tax income from 8.6% to 12.2% between 1992 and 2004.[2] An important Statistics Canada report that carefully documents the rise of after-tax family income inequality finds that, between 1996 and 2004, the main driver was changes to the tax/transfer system.[3]

This chapter examines the federal corporate and personal tax cuts implemented since 2000, evaluates recent Conservative restructuring of the personal tax system, and compares the Liberal and Conservative records on taxation.

Corporate tax cuts

Budget 2000 cut the general corporate income tax rate from 28% to 21%. Budget 2003 extended this cut to resource companies and began phasing-out the corporate capital tax. Budget 2005 proposed to eliminate the corporate surtax by 2008 and to further cut the general rate from 21% to 19% by 2010. The NDP, which then held the balance of power in Parliament, re-negotiated the Budget to delete these corporate tax cuts and to invest the revenues retained in public programs. Notwithstanding its arrangement with the NDP, the Liberal government used the 2005 Economic and Fiscal Update to reinstate the corporate tax cuts originally proposed in the Budget and to eliminate the federal capital tax in 2006, two years ahead of schedule.

In Budget 2006, the Conservative government confirmed the corporate income tax cuts from the 2005 Update, reduced the small business rate to 11% by 2009, and made more profits eligible for this preferential rate. The October 2006 Tax Fairness Plan pledged a general rate of 18.5% by 2011. However, the relentless campaign for more corporate tax cuts ignored these sharp reductions. In June 2007, for example, *The Globe and Mail's* Report on Business ran the following headline: "Taxes are Falling, but Not Here."

In September 2007, Jack Mintz moved the goalposts again by calling for a combined federal/provincial corporate tax rate of "roughly 20%".[4] The following month's federal Economic Statement proposed a combined rate of 25%. The Government of Canada pledged to cut its own rate to 15% by 2012 and is asking provincial governments to cut their rates to 10%. The federal small-business rate dropped to 11% in 2008, a year ahead of schedule.

Lower corporate taxes are supposedly needed to make Canada internationally competitive. However, when the Conservatives took power in 2006, combined federal/provincial corporate tax rates were already well below the U.S. average, among the lower half of G-7 countries, and only two percentage points above the world average.[5] Nevertheless, the

Conservatives decided to cut federal corporate tax rates by seven percentage points.

KPMG's 2008 *Competitive Alternatives* report constructed an index of corporate income taxes, other business taxes and employer payroll taxes for 10 countries. Based on tax rates announced for the coming decade, KPMG concluded that Canada will be tied with the Netherlands for the second-lowest business taxes. Only Mexico will have (slightly) lower business taxes. The other G-7 countries and Australia will have significantly higher business taxes than Canada.[6]

These huge corporate tax cuts have not stimulated additional investment. As a Statistics Canada paper observes, "Over much of the last decade, corporations as a whole have been posting record profits. Meanwhile, business fixed capital investment has been relatively sluggish in recent years."[7] Similarly, TD Bank notes that the ratio of business investment to profits has fallen to an all-time low.[8]

Gross investment by private corporations currently equals about 10% of GDP, only slightly above the level that it has consistently averaged since the 1960s. In other words, gross investment (which includes depreciation) approximately equals after-tax profits (which exclude depreciation). Historically, non-financial corporations took out loans and sold stock to fund investment in excess of internally-generated funds. Corporate tax cuts have contributed to a reversal of this pattern. Today, non-financial corporations lend surplus funds to households and "issuance of common stock by Canadian companies has turned negative for the first time since the 1960s."[9] The C.D. Howe Institute, an organization committed to tax cuts, argues that Canada has comparatively high marginal effective tax rates (METRS) on capital. In calculating this measure, the Institute excludes local business taxes, which are particularly low in Canada, and research and development tax incentives, which are particularly generous here. It includes inventories, which Canadian tax-accounting rules subject to a particularly high METR. However, fixed capital such as machinery and equipment is what matters most for productivity and economic growth.

Marginal tax rates are not the appropriate measure of international competitiveness. An investor deciding where to locate a facility is concerned about the investment's total tax liability (i.e., the average tax rate), not the tax on the last dollar invested (i.e., the marginal rate).

Even if METRs were the appropriate measure, across-the-board CIT cuts are not a cost-effective way of reducing METRs. Finance Canada's Budget Plan 2007 indicated that its permanent Capital Cost Allowance (CCA) changes, which are projected to cost $145 million in 2008, will reduce Canada's METR almost as much as the Budget 2006 CIT cuts, which are projected to cost $3 billion in 2008.

Budget 2007 also introduced a temporary accelerated CCA for manufacturers at a cost of $1.3 billion over three years. The C.D. Howe Institute recently revealed that this measure, along with similarly targeted provincial incentives, dramatically reduced Canada's overall METR on capital from 37% in 2006 to 31% in 2007.[10] Not surprisingly, measures tied to new investment have relatively more effect at the margin.

The U.S. government taxes American corporations on a worldwide basis. Profits from the Canadian subsidiaries of American corporations repatriated to the U.S. are subject to American tax minus credits for Canadian tax paid. Therefore, if effective tax rates are lower in Canada than in the U.S., American-controlled corporations pay the difference back to the U.S. government. Japan and the United Kingdom also tax their corporations on a worldwide basis. Further CIT rate reductions and/or targeted tax incentives could simply transfer revenues from the Canadian treasury to foreign treasuries.

Canadian rates are well below American rates, but only the U.S. federal rate applies to profits repatriated from Canada. Clearly, the U.S. federal rate already exceeds the overall Canadian rate in lower-tax provinces. Any further CIT cuts could cause most Canadian subsidiaries of American corporations to pay U.S. tax.

Personal tax cuts

The 2000 Budget and Economic Statement cut personal tax rates from 29% to 26% on income from $61,000 to $100,000, from 24% to 22% on income from $30,000 to $61,000, and from 17% to 16% on income under $30,000. Then Finance Minister Paul Martin also eliminated the 5% high-income surtax and reduced the proportion of capital gains subject to tax from 75% to 50%. Taxable capital gains (outside of tax-exempt pension plans and RRSPs) are overwhelmingly concentrated in the hands of the very affluent. Mackenzie calculates that about one-third of the value of the 2000 income tax cuts went to the richest 5% of taxpayers.[11]

By enabling provincial governments to set their own rates and brackets instead of setting provincial taxes as a percentage of federal taxes, Martin also facilitated inequitable provincial tax changes. For example, Alberta implemented a flat tax and New Brunswick has proposed one.[12] Murphy, Roberts and Wolfson calculate that the federal-provincial effective tax rate for the richest 0.01% of taxpayers (with average incomes of $5.9 million in 2004) fell from 42% to 31% between 1992 and 2004.[13]

The 2005 Economic and Fiscal Update proposed to cut the bottom income tax rate to 15% immediately, as well as to cut the middle two rates by 1% and raise the threshold for the highest rate to $200,000 by 2010. The Liberals also promised to raise the basic personal credit to $10,000 and to institute a modest employment tax credit.

In the 2005–06 federal election, the Conservatives campaigned on cutting the GST from 7% to 6% immediately, and to 5% within five years. Their other major personal-tax promise was to exempt "reinvested" capital gains from taxation *(Stand Up for Canada, January 2006).* The first Conservative budget cut the GST to 6%, raised the basic personal credit to $10,000, and cut the lowest income tax rate to 15.5% in 2006 and 15% in 2007. Budget 2006 also introduced several new non-refundable tax credits, including an employment tax credit similar to the one promised by the Liberals and a child tax credit worth up to $300 per child under 18 at an annual cost of $1.5 billion. Most progressives believe the money would have been better spent on improving the targeted refundable child tax credit.

In November 2006, the Conservative government unveiled an economic strategy (*Advantage Canada: Building a Strong Economy for Canadians, November 2006)* that unsurprisingly gave pride of place to establishing "Canada's Tax Advantage" and called for "lower taxes for all Canadians and the lowest tax rate on new investment in the G-7." Even Conservative politicians are usually somewhat coy about cutting taxes for the very affluent, but *Advantage Canada* went beyond the populist promise of tax cuts for all Canadians embodied in the headline-grabbing pledge to cut the GST. It clearly called for lower marginal and effective tax rates on the "highly skilled" — described as those making more than $120,000 per year. It is worth noting that the text and chart in the paper on the need for lower taxes for "highly skilled workers" were almost identical to those found in the Liberals' 2005 *Economic and Fiscal Update*.

Advantage Canada also called for reduced savings on savings and investment income, including capital gains. High taxes on high earners and investors were seen as disincentives to work and savings. These claims have been routinely made in recent federal Budgets introduced by Liberals and Conservatives alike, even though the consensus of the academic literature is that high tax rates on the rich have very little impact on their work effort or savings.[14]

Budget 2007 promised to devote all future interest savings from debt repayment to reducing personal income taxes. Budget 2008 cut the GST to 5%, well ahead of schedule. Lowering the GST by two percentage points will cost over $12 billion per year of foregone revenues, eliminating much of the underlying federal government surplus. As a result, the 2008–09 Budget is now widely believed to be barely in balance.

While derided by right-wing economists as an inefficient tax cut in terms of increasing those all-important incentives to work and invest, the GST cut has resulted in tax savings across the income spectrum, with the largest proportional impacts among middle income groups. (The poor usually pay a bit less than average in GST since they spend more than average on tax-exempt essentials such as food and shelter, and receive the GST credit, while the very affluent tend to save rather than spend a significant proportion of income.) Most progressives believe that the small tax savings dispersed across the tax-paying public would have been better directed to child care, urban and environmental infrastructure, or other programs. However, no major opposition party has endorsed the idea of restoring one or two points to the GST to rebuild the lost fiscal capacity.

New directions in personal taxation

The Conservatives have also undertaken three initiatives which, while not having major fiscal implications to date, could gradually change the overall personal tax system moving forward. There has been at least tentative movement to shifting to a family-based income tax system; and to further exempting investment income from tax through Tax Free Savings Accounts. The Conservatives also introduced a Working Income Tax Benefit, as promised by the Liberals, which could grow to significance over time.

Finance Minister Jim Flaherty has made pension income divisible between spouses for tax purposes. As documented by the Caledon Institute, this initiative "will provide windfall benefits to some of the wealthiest seniors, only modest benefits to middle-income seniors, and nothing at all to the poorest of Canada's elderly."[15]

Flaherty has also mused about making all income divisible for tax purposes. This proposal would cost about $5 billion and would be similarly inequitable. By definition, single parents, unattached individuals, and families without income would not be eligible.

Because the spousal tax credit already equals the basic personal credit, couples could take advantage of income-splitting only if one spouse is in a higher tax bracket than the other. In other words, at least one spouse would have to be making more than $37,000 annually. If both spouses make less than this amount, they could not benefit from income-splitting.

By far the greatest gains would accrue to rich people whose spouses stay home. For example, a single-earner family with an income of $240,000 or more would retain an extra $9,000 in unpaid federal tax.[16]

In 2004, taxpayers making more than $250,000 declared $11 billion in capital gains, or 43% of the total amount of taxable capital gains income, and $6 billion or 36% of all dividend income. Most of the rest is declared by those with much higher than average incomes of more than $100,000 per year. Other investment income such as interest income is a bit more widely distributed, especially among seniors, but the essential reality is that very few middle- and lower-income individuals and families have significant savings and investments outside of tax-sheltered pension plans and RRSPs. (In fact, only about one in four private sector workers now has an employer pension plan, and most ordinary Canadians have only contributed a small amount of their allowable savings to an RRSP.) Lighter taxation of investment income — like the Liberal government's cut in the inclusion rate for capital gains and increases in the contribution limits for tax-sheltered RRSPs — thus overwhelmingly benefit very-high-income individuals and families, and reduce the progressivity of the personal income tax (itself the only progressive element of our tax system).

The 2006 Conservative election campaign promised to eliminate capital gains tax on the sale of assets when the proceeds are reinvested was likely dropped (or perhaps just deferred) due to the cost and complexities of implementation. Instead, the 2008 Budget introduced Tax Free Savings Accounts (TFSAs) which will likely prove a Trojan Horse, initially innocuous, but dangerous in the long-term as the hidden reality emerges.

From age 18, anyone will be able to save up to $5,000 per year (roughly indexed to inflation) in a TFSA. Any money removed can be re-contributed as savings room accumulates, so the total limit in 10 years will be $50,000 plus any inflation adjustment. All income earned in TFSAs, as in RRSPs, will be exempt from taxes. While contributions will not be tax-deductible, there will be no taxes on withdrawals.

A modest tax exemption for some savings income makes some sense. Anti-poverty activists have long noted and deplored the fact that saving by many older lower-income workers approaching retirement is punished, since income from savings is clawed back from the income-tested Guaranteed Income Supplement to Old Age Security after they turn 65. This could be remedied by exempting modest savings from social program clawbacks.

At the other end of the income spectrum, however, the very affluent can and do accumulate investments above and beyond their pension and RRSP savings, and would be in a position to invest $5,000 each and every year in a TFSA. Over 20 years, a couple who maximized contributions and earned income at a 5% rate within this vehicle could accumulate a non-taxable fund of well over $300,000, and earn untaxed investment income in excess of $7,500 a year. If the scheme becomes a permanent feature of our tax system, more and more investment income will be stored in TFSAs, and the loss of revenue for Ottawa in a "mature" system will likely be far more than the $3 billion per year estimated in the Budget. And the financial industry will have a new vehicle to sell and on which to collect fees.

It is worth noting that Jack Mintz, former president of the C.D. Howe Institute and a huge fan of Tax-Free Savings Accounts, suggests essentially the same thing in the April 4, 2008 issue of *Canadian Business Magazine*:

> Flaherty was able to bring in a substantial tax reform at little fiscal cost to the government for the next few years. The real cost will be down the road, when many seniors will have untaxed investment income sheltered in the TFSA. Of course, someone else will be in power by then, and Flaherty's new account will make life a lot tougher for tax-and-spend governments in the future.

The Conservatives introduced a small Working Income Tax Benefit (WITB) in the 2007 Budget, worth a maximum of $500 for single persons earning between $5,500 and $9,500, with lesser amounts for those just below and just above these limits. The maximum rises to $1,000 for couples and single parents. Such a measure, almost identical in design, had been put forward for discussion purposes in the 2005 (Liberal) Economic and Fiscal Update. The hopes of some social advocates that the WITB would be ramped up over time, on the model of the Canada Child Tax Benefit, were dashed when the 2008 Budget failed to implement any increase.

While income supplementation of very low wages can indeed help people leave social assistance for paid work and raise the incomes of the working poor, such schemes, according to the OECD, have the potential to function as a subsidy to low-wage employers unless they are twinned with a decent minimum wage floor.[17] Yet the Conservatives have failed to act on the recent recommendation of the Federal Labour Standards Review that the federal minimum wage should be reinstated at $10 per hour.

Conclusion

Has the Conservative tax record been more of the same or a turn for the worse? On corporate taxes, it has clearly been more of the same. Indeed, the first round of Conservative corporate tax cuts were taken directly from the previous Liberal government's 2005 Budget and Fiscal Update. The new Liberal leader, Stéphane Dion, has committed to slash corporate taxes "deeper than the Conservatives."[18] His Green Shift proposal includes cutting the federal corporate tax rate to 14% from the Conservative government's proposed rate of 15%.

On personal taxes, the Conservatives have pursued a different approach than their Liberal predecessors. However, it is debatable whether this approach constitutes a turn for the worse. The Conservative focus on cutting the GST has distributed tax savings more equitably than proposed Liberal income tax cuts. On the eve of electoral defeat, the previous Liberal government promised to reduce the 22% rate to 21%, reduce the 26% rate to 25%, and raise the threshold for the 29% top income tax rate from $116,000 to $200,000 in 2010, at an annual cost of $2.7 billion in lost revenue. Dion's Green Shift revives the first two of these proposals. To date at least, the Conservative approach has been to direct modest income tax savings to a broad spectrum of "ordinary working Canadians" rather than to higher-income earners.

The Conservatives have also pursued some new directions in personal income taxation. While the Working Income Tax Benefit is a modestly progressive initiative, income-splitting and TFSAs are definitely turns for the worse. However, the leading parliamentary advocate of expanded income-splitting, MP Garth Turner, is now a member of the Liberal caucus. There is some continuity between Liberal initiatives to shelter investment income from tax, such as higher ceilings on RRSP contributions and lower inclusion rates for capital gains, and TFSAs.

Of course, a critical test of tax policy is how much revenue it generates to finance important public priorities. Table 1 shows federal revenues overall and by source as a share of the economy (GDP). This is a more useful measure of major changes than dollar amounts, since seemingly large tax changes measured in terms of dollars often turn out to trivial as a share of the economy. Revenue changes, of course, reflect

TABLE 1 *Federal expenditures and revenues (% of GDP)*

	Actual 1993–94	1997–98	2005–06	2006–07
	(Liberal Government)			(Conservative Government)
Program expenditures	16.8	13.0	12.7	13.0
Total revenues	17.0	13.0	16.2	16.3
of which				
Tax revenues	12.8	14.6	13.5	13.7
Personal Income Tax	7.6	8.5	7.5	7.6
Goods and Services Tax	2.2	2.2	2.4	2.2
Corporate Income Tax	1.3	2.4	2.3	2.6

		Forecast 2007–08	2008–09	2009–10	2010–11
Program expenditures	A	13.2	13.1	13.2	13.1
	B	12.0	12.0	12.0	11.9
Total revenues	A	16.0	15.3	15.3	15.2
of which	B	14.8	14.7	14.6	14.4
Tax revenues	A	13.4	12.8	12.8	
Personal Income Tax	A	7.4	7.5	7.6	
Goods and Services Tax	A	2.0	1.7	1.7	
Corporate Income Tax	A	2.8	2.3	2.2	

NOTES Forecast A is from the 2008 (Conservative) Budget. Forecast B is from the (Liberal) November 2005 Economic Statement.
SOURCES Budget Plan 2008. Table 5.4. p. 201, Table 5.5 p. 205; November 2005 Economic and Fiscal Update. Table 1.4. p. 15; Department of Finance Fiscal Reference Tables. September 2007. Tables 3 and 4.

the interaction of the tax structure and the state of the economy, but the period considered has been (until very recently) one of fairly steady economic expansion and buoyant federal revenues. Data are provided for 1993–94 when the Liberals took office; 1997–98, when the federal deficit was eliminated and surpluses began to emerge; 2005–06, the last year of the Liberal government; 2006–07, the first fiscal year of the Conservative government, and for 2007–08 through 2010–11. For these latter years, the Table provides the current fiscal forecast from the 2008 Budget and that of the November 2005 Economic Statement, reflecting the Liberal agenda forecast forward.

Looking first at the Liberal period, the federal revenue share of GDP fell, by a significant two percentage points of GDP from the high point in 1997–98, though by a more modest 0.7 percentage points of GDP over their entire term. In the Conservative period, the revenue share is forecast to fall by 1.1 percentage points of GDP from 2006–07 to 2010–11. Over this period, the Liberals had anticipated an even greater decline of federal revenues as a share of GDP, a total of 1.9 percentage points. Given that one percent of GDP today is equivalent to $15.6 billion, this amounts to a very large difference in fiscal capacity. While the two percentage-point cut to the GST has, in itself, clearly cut federal fiscal capacity moving forward, the fact remains that federal revenues in 2010–11 are now forecast to be significantly higher than was the case under the last Liberal fiscal plan.

It is also interesting to note that total program expenditures as a share of GDP have been and are forecast to remain almost constant as a share of GDP, while the Liberal period saw a very sharp cut of 4.1 percentage points in the deficit-cutting period to 1997–98 (by far the largest reduction of any OECD country in recent years), and a further modest decline of 0.3 percentage points thereafter. There have, of course, been shifts in spending under the Conservatives — notably to transfers to the provinces and security spending, and away from federal social programs — and their spending priorities have not matched progressive priorities as registered in the CCPA's Alternative Federal Budgets.

Much of the decline in revenues under the Liberals was accounted for by lower Employment Insurance premiums and lower excise taxes. The personal income tax share of GDP, however, was cut from a high of 8.5% in 1997–98 to just 7.5% in 2005–06 (at a cost of roughly $15 billion per year in annual revenues), and was expected to fall further due to the tax cut package in the 2005 Economic Statement.

The impact of the Martin personal income tax cuts of 2000 on revenues were considerable, even though they were offset in significant part by the fact that most of the income gains of the past decade went to high-income earners in correspondingly relatively high tax brackets.

While taxes on the affluent have fallen as a proportion of income, they still pay higher than average effective tax rates.

Conservative tax cuts have reduced the Canadian tax system's capacity to redistribute wealth and raise revenue for public purposes. On the whole, this approach represents a continuation of previous Liberal policy.