



Policy paper number 1:

**Bringing Balance and Fairness
to Canada's Tax System**

November 28, 2011

Dear friend

When I launched my campaign to be leader of the New Democratic Party of Canada, I said the key goal of the NDP national government we will elect in 2015 should (and must) be to build a more equal Canada.

To do so, we must introduce measures to address income inequality.

In recent years, in part because of deliberate government policy, more and more income and wealth has been concentrated in the hands of the wealthiest Canadians. Most middle and working families have not enjoyed a real increase in their income in many years. Income inequality is now as bad as it was in the late 1920s.

One of the ways that Liberal and Conservative governments have contributed to this is through fiscally unsustainable and socially irresponsible decisions about the Canadian tax system. As I will argue below, some \$18 billion will be spent every year by Ottawa on tax benefits for profitable corporations and wealthy individuals – recipients who need help the least.

In my view, as one of many steps we must take to build a more equal Canada, these funds should be redeployed to more productive purposes that will promote prosperity and equality – priorities like green jobs, health care, education and training, public transport, public and cooperative housing, and poverty reduction.

In the notes that follow, I offer my views about our tax system, and then I make some specific proposals:

I propose a new federal income tax bracket of 35% on incomes in excess of \$250,000;

I propose a new and better approach to taxes on capital gains and stock options;

And I propose that Stephen Harper's spending on tax cuts for profitable corporations be phased out.

I'll have more to say in the remaining months of this leadership campaign on many issues – all, fundamentally, about how I believe our government should work to create a more equal Canada. But let's begin with this topic – some practical first steps to address one of the worst things Liberal and Conservative governments have done in the recent past – the direct assault on our collective ability to build a better Canada, by the perversion of our tax system into an instrument that wastes billions of dollars creating more inequality.

All the best,
Brian Topp

Part 1: Back to basics: why do we have taxes anyway?

Taxation has become the third rail in Canadian politics. The only time we ever hear our current political leaders utter the word “tax,” it’s immediately followed with “cut.” That has to change.

Tax phobia has come to dominate politics in this country. We have lost track of why we have a tax system in the first place: to pay for things that we as a society have decided to do together rather than individually.

Some of those things are naturally public, because they cannot be divided up into pieces and purchased through a market; examples include national defence, international relations, criminal justice and police and fire protection.

Some involve an activity that is incompatible with a market-based approach. Programs like Old Age Security fit into this category, as their purpose is to counteract the unequal distribution of income resulting from market forces.

Some of those things should be provided publicly for economic reasons, as it would be far too inefficient to do it privately: streets, roads, bridges and highways, for example.

Some should be public because they benefit society as a whole, not just those who use the service. Public transit is a good example. The benefits of public transit, include reduced congestion on roads and better air quality, are shared among all of us.

Some services are public because we want to make sure that their benefits are distributed more equitably across society. For example, Canadians have a profound belief that elementary and secondary education should be distributed equitably, not on the basis of ability to pay.

The choices we make about taxation have impacts beyond the basic need to sustainably fund public services. Perhaps the most important of these other purposes is to redistribute income. Market forces tend to distribute income unequally. One of the roles of the tax system is to recognize differences in Canadian families’ ability to pay: higher taxes are levied on people with more, and lower taxes on people with less.

Income taxes, because they increase as a share of income as the payer’s income rises, have the most powerful redistributive effect. Taxes on consumption and sales also have a redistributive effect when combined with the public services they pay for.

All of which to say – “taxes” are a tool we use as a society to pool our efforts and to accomplish many important things together. When Conservatives demonize taxes, they are seeking to strip Canadians of this tool, and of its benefits. They’ve had it all their own way for many years. Look at the results. It’s time for a different and better approach.

Part 2: Basic objectives for our tax system, and how it measures up

The primary purpose of our tax system is to generate the revenue we need to pay for the services that we have decided to provide publicly. Over the long term, our tax system needs to be big enough to pay for the level of public services we have chosen.

This may seem an obvious point, but it is largely absent from public debate these days.

We hear constantly from conservatives that we can cut taxes without hurting public services. They don't really mean that; what they really mean is that if taxes are cut, governments will be forced to balance the books by cutting or privatizing public services.

The second most important role for the tax system is to increase equality: to redistribute income from those with greater resources to those with fewer.

In recent years, our national tax system has failed to deliver on this role; in fact, it has moved in the opposite direction. Changes in Canada's income tax system, both in the design of the system itself, and in its size relative to other sources of public revenue, have actually reinforced, rather than offset, the powerful trend towards greater inequality. Rates of tax paid by Canadians in the highest-income 1% of the population have dropped dramatically.¹

The third critical issue to consider in our tax system is its fairness, and in particular, Canadians' perceptions of its fairness.

There are two key elements to tax fairness.

The first is a rate structure that reasonably reflects differences in the ability to pay of individual taxpayers. As a taxpayer's income increases, so does his or her ability to pay tax on incremental amounts of income. Marginal tax rates should increase with income, reflecting ability to pay. Today, tax rates are virtually flat, with very little difference in tax rates from middle-income to the stratosphere occupied by the highest income Canadians.

The other key element of tax fairness is how taxpayers in similar economic circumstances are treated.

In recent years the unfairness in the system has become unacceptable. Many decisions have contributed to this, but the most important one is the gap that has opened up between tax rates on employment income and rates on income from capital.

For example, income from capital gains is now taxed at half the rate paid on income from employment, as is income from cashing in stock options – a favourite form of compensation for top executives. To make matters worse, the benefits from these provisions do *not* apply to the earnings of retirement savings (RRSPs, RRIFs and pension plans), where most Canadians' financial investments are held.

Meanwhile, rates of tax on corporate profits are plunging, as Canada storms to the front of the pack in the race to the bottom in corporate taxation.

While many of the changes that have undermined the fairness and revenue raising capacity of Canada's tax system have taken place gradually, two major changes stand out: first, the initiative by former Finance Minister Paul Martin in the early 2000s to cut the tax rate on capital gains by one third, from 75% of the rate of tax on normal income to 50% of that rate; and second, the decision, initially by the Liberals and subsequently taken to an extreme by the Harper Government, to leap into the lead in the race to the bottom in corporate income tax rates.

Let's be very clear: ***the Liberal government's capital gains tax cut was the most regressive single tax change in Canadian political history.*** Because 62% of taxable capital gains in Canada are reported by the highest-income 3% of Canadian taxpayers, more than 60% of the benefit from that tax cut goes to that small group of individuals – to the tune of almost a billion dollars in 2008.²

Corporate taxes cuts are no better. There is no evidence that spending on corporate income tax rate cuts has done anything for our economy, or created a single job. The big winners from corporate tax cuts were, and continue to be, financial institutions and the resource sector -- the sectors of our economy that need help the least.

Part 3: Specific ideas for a better tax system

It took Liberal and conservative governments a long time to bring us to where we are today. It will take time to turn things around. But I believe progress can be made in the term of the next Parliament. Here are four proposals to that end:

(1) My first proposal: modernize the rate structure for personal income tax

Income inequality in Canada has grown dramatically in the past 20 years. That fact, and the threat it poses to the most fundamental values in our society, is finally now part of the public debate in Canada, and indeed throughout the western world.

The median effective tax rate paid by the highest income 0.01% of Canadians declined by 10% over the past two decades, while the median rate paid by the bottom 95% dropped by barely 1%.³

Our personal income tax system must be modernized to reflect the reality of soaring incomes at the top of the income scale and the fact that the very wealthy are rapidly leaving the rest of us behind.

The first step in restoring fairness to Canada's personal income tax system is to end the free ride for Canada's highest-income 1% by introducing a higher marginal tax rate on income in excess of \$250,000.

I propose a new 35% rate on income in excess of \$250,000.

This new rate would cut spending on tax cuts for the wealthiest among us by about \$3 billion – funds that would then be available for productive investment.⁴

(2) My second proposal: modernize the treatment of capital gains

It is simply not fair that income earned from employment should be taxed at more than twice the rate of unearned income from capital gains. And the questions raised by this preferential treatment become more difficult to explain away when one takes into account the fact that income from capital gains inside retirement savings – where the vast majority of Canadians hold most of their financial investments – doesn't qualify for that special treatment.

With two important caveats, capital gains should be taxed as ordinary income – 100% of this form of income should be recognized – and not be discounted by 50%.

Here is a first caveat – it is fair for capital gains to be protected from inflation.

To reflect the only legitimate objection to full taxation – that the portion of a gain in value just reflects inflation – the base value from which capital gains are calculated should be indexed to inflation. That would have the additional benefit of favouring long holding periods over quick flips.

For a hold period of 10 years, indexing would produce the same result as the 75% inclusion rate that was policy in Canada until the early 2000s. For holding periods of more than 10 years, the effective rate of tax would be lower than it was. The proceeds from speculative quick flips would be taxed at full rates.

Here is a second caveat -- this change in tax treatment would not apply to the sale of our homes, small businesses or farms.

Our homes are ordinary Canadians' biggest asset, where the vast majority of our savings go. This proposal would retain this important support to Canadians ability to save. Current exemptions from capital gains taxation – principal residences and the first \$750,000 in gains from the sale of small business and farm assets – would remain the same.

Overall, this modernization would cut spending on tax benefits for the highest-income Canadians by approximately \$1.5 billion, and cut a further \$2.2 billion in spending on the corporate tax side – funds that would then be available for productive investment.⁵

(3) My third proposal: modernize the treatment of stock options

One of the most popular ways of rewarding Canada's highest paid CEOs is through the granting of stock options – the right to buy shares of a company at a pre-determined price, which can be exercised over time in the future as the value of the shares increases.

One of the reasons why stock options are so popular as a form of executive compensation is that stock option income is taxed as half the rate of ordinary wages and salaries. In effect, by taxing the proceeds of options at half rates, Canadians are subsidizing the incomes of the richest of the rich in this country.

Income from cashing in stock options should be taxed at full rates, abolishing a tax benefit for the wealthiest that cost the federal treasury \$750 million in 2008.⁶

(4) My fourth proposal: a return to a moderate approach on corporate income taxation

Governments at both the national and provincial levels have made big cuts to corporate tax rates. Canada's corporate income tax rates are now substantially below those of our closest competitors in the United States.

This process began under the Liberals, and has continued under the Conservatives. When the Harper cuts are fully implemented, Canada's corporate tax rate will be 15%; the US rate is currently 34.2%.

Even on its own terms, this race to the bottom doesn't make sense. Former Statistics Canada head Munir Sheikh has pointed out lower Canadian taxes on corporations that pay US tax just reduces the credit they get for Canadian taxes on their US tax returns. In effect, for the large number of companies in Canada whose parent companies pay tax in the US, Canada's low corporate tax rates just transfer money from Canadians to the US Treasury.⁷

The argument that general tax measures, including lower tax rates, provide a valuable stimulus to investment has been called into question by a study of Canada's tax credits for research and development released in October 2011 which concluded that our system is poorly-targeted, ineffective and wasteful.⁸

Support for corporate investment should be targeted and delivered in a form that enables government to establish clear expectations and objectives that can form the basis for effective accountability.

Under Harper's plan, the corporate income tax rate will drop from 16.5% to 15% on January 1, 2012.

That cut should be rescinded. Thereafter, corporate income tax rates should be increased by 1.5% each year until they reach the rate of 22.12% that applied before the Harper Conservatives jumped into the race to the bottom in corporate taxation.

Once fully implemented, restoring the integrity of Canada's corporate tax system in this way would redeploy some \$11 billion to more productive purposes, based on the Parliamentary Budget Office's estimate of corporate tax revenue in 2013-14.⁹

In Conclusion: A modern and effective tax system that helps build greater equality

Taken together, the measures I propose in this paper would, when fully implemented, reallocate some \$18 billion a year from tax benefits given to people who don't need them, to more productive uses.

That would make a substantial contribution to Canada's public services and to the nation's fiscal health. Just as important, it would help restore Canadians' confidence in the fairness of our tax system. That confidence has been shaken by decades of tax cuts whose primary beneficiaries are the wealthiest Canadian individuals and corporations -- and in particular, by a response to the worldwide recession that calls on Canadians to sacrifice public services on which they depend and on which Canada depends for a prosperous and secure future, while the government persists with a pointless and ridiculously costly program of corporate tax cuts and giveaways to those who need them least.

We all benefit from public services. Canadians know these services aren't free, and they are prepared to pay the taxes needed to support them. But they will not do so if the tax system is lacking in credibility and fairness – and is instead itself creating greater inequality.

One of the most important things the current generation of Canadians must leave to future generations is the capacity to pay for public services and investments they will need to face many key challenges.

Aiming, above all, to build a more equal society, one practical step at a time.

¹ Brian Murphy, Paul Roberts and Michael Wolfson “High-income Canadians”, Perspectives, Statistics Canada, September 2007 Cat. 75-001-XIE

² Calculations from “Income Statistics 2010 – 2008 Tax Year” Basic Table 2A, Canada Revenue Agency.

³ Brian Murphy, Paul Roberts and Michael Wolfson “High-income Canadians”, Perspectives, Statistics Canada, September 2007 Cat. 75-001-XIE

⁴ Calculations from “Income Statistics 2010 – 2008 Tax Year” Basic Table 2A, Canada Revenue Agency.

⁵ Calculations from “Income Statistics 2010 – 2008 Tax Year” Basic Table 2A, Canada Revenue Agency and Tax Expenditures and Evaluations 2010”, Department of Finance, Government of Canada, December 2010. <http://www.fin.gc.ca/taxexp-depfisc/2010/taxexp1001-eng.asp>

⁶ Calculations from “Tax Expenditures and Evaluations 2010”, Department of Finance, Government of Canada, December 2010. <http://www.fin.gc.ca/taxexp-depfisc/2010/taxexp1001-eng.asp>

⁷ Munir Sheikh, “A Canada-US tax gap means a Canada-US tax transfer”, Globe and Mail, 20 April 2011.

⁸ “Innovation Canada: A Call To Action”, Expert Panel Report, Review of Federal Support for Research and Development, Government of Canada, October 2011.

⁹ Calculations based on estimates in “Fiscal Transparency: Parliament and the Expenditure Management System, Analysis of Government Responses to a Motion of the House of Commons Standing Committee on Finance”, Table 7, Parliamentary Budget Office, Parliament of Canada, February 25, 2011