MOWAT RESEARCH #143 | FEBRUARY 2017

Tax Exemptions for Investment Income

Boon or Bane?

BY PETER S. SPIRO

Mowat Centre
ONTARIO'S VOICE ON PUBLIC POLICY

School of Public Policy & Governance
UNIVERSITY OF TORONTO

Acknowledgements

The author gratefully acknowledges comments and discussion from William Forward, Erich Hartmann and Sunil Johal of the Mowat Centre, and Jonathan Rhys Kesselman of Simon Fraser University, as well as an anonymous reviewer. The author would also like to thank Elaine Stam for her design work on this report.

Author

PETER SPIRO

Peter Spiro has been studying the tax system and its impacts on economic performance for more than thirty years, with a focus on evidence-based econometric analysis. He is one of Canada's most widely quoted experts on tax evasion and the underground economy. He is both an economist and a lawyer, with degrees in economics from the University of Toronto and University of Chicago, and a law degree from Osgoode Hall Law School. He has numerous publications in professional journals on topics in both economics and law. An article he co-authored in the Canadian Tax Journal with J.R. Kesselman was awarded the Douglas J. Sherbaniuk Distinguished Writing Award for "the best writing undertaken for the Canadian Tax Foundation in 2014-15."

Mowat Centre
ONTARIO'S VOICE ON PUBLIC POLICY

The Mowat Centre is an independent public policy think tank located at the School of Public Policy & Governance at the University of Toronto. The Mowat Centre is Ontario's non-partisan, evidence-based voice on public policy. It undertakes collaborative applied policy research, proposes innovative research-driven recommendations, and engages in public dialogue on Canada's most important national issues.

MOWATCENTRE.CA

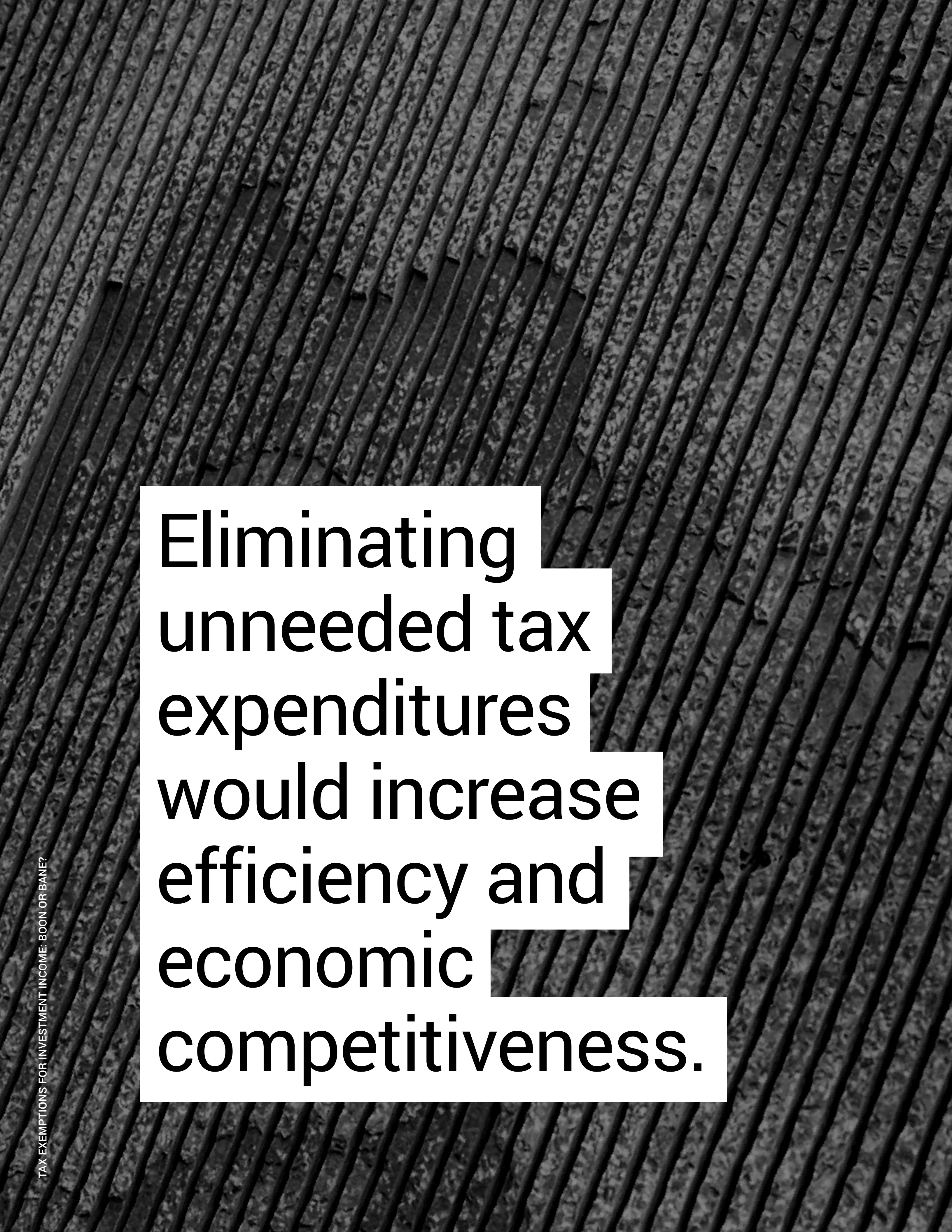
@MOWATCENTRE

439 UNIVERSITY AVENUE
SUITE 2200, TORONTO, ON
M5G 1Y8 CANADA

School of Public Policy & Governance
UNIVERSITY OF TORONTO

 ISBN 978-1-77259-040-1

Contents



Eliminating unneeded tax expenditures would increase efficiency and economic competitiveness.

EXECUTIVE SUMMARY

In its 2016 budget, the Government of Canada announced a comprehensive review of federal tax expenditures. "The objective of the review is to ensure that federal tax expenditures are fair for Canadians, efficient and fiscally responsible." This paper aims to contribute some insights to help guide that analysis.[1]

The Canadian tax system is riddled with tax exemptions and preferences for many different types of income and taxpayer characteristics. These allow people to pay lower rates of tax, or no tax at all, on some types of income. Collectively, they are referred to as "tax expenditures." This paper will focus on the largest category of these tax expenditures – those that affect investment income.

Eliminating unneeded tax expenditures would increase efficiency and economic competitiveness. It would allow a tax system that is fairer across income groups and also fairer in its treatment of different types of income recipients at the same income level. Both types of fairness are important goals of public policy.

Adding up all the preferences for investment income, one finds that the federal government loses about $75 billion of tax revenue per year. That is more than half of all the personal income tax it currently collects. The vast majority of investment income in Canada is either not taxed at all or taxed at lower rates than regular income. Eliminating or reducing these expenditures would permit substantial reductions in the general income tax rates without a loss of revenue.

The bulk of investment income is received by higher-income Canadians, and therefore these preferences favour them. That exacerbates income inequality, which has been a growing policy concern in recent years.

This paper explores the different types of tax preferences for investment income. The key question is whether they can be justified on the ground that they improve economic performance. This analysis finds that the current preferences generally fail to do so. In some instances, there may be problems that create an economic justification for special treatment of investment income, but the current preferences are poorly designed to deal with those problems.

One example is the taxation of capital gains, where half of the income is exempt from tax. It is variously justified on the grounds that it encourages entrepreneurial risk taking, or that it compensates for illusory capital gains that are

1 http://www.fin.gc.ca/access/tt-it/rfte-edff-eng.asp

due to inflation. It does not target either of these well. The aim of avoiding tax on inflationary gains would be better achieved by explicitly exempting the portion of a capital gain that is due to general inflation. To the extent that it does encourage risk taking, it is questionably targeted. It provides just as much of a tax break to Canadians who speculate on foreign stock markets as to those who create new businesses in Canada.

The dividend tax credit allows dividends from large Canadian corporations to be taxed at much lower rates than employment income. The claim is that it is needed to avoid double taxation, as the corporation has already paid taxes on its profits. In fact, many corporations have significant profits that are tax exempt. There is no attempt to verify that the corporation has actually paid tax before giving its shareholders the dividend tax credit. More generally, capital is internationally mobile. Economists believe that this enables large corporations to shift part of the burden of the corporate income tax to their employees or customers. This implies that the dividend tax credit often compensates shareholders where no compensation was needed.

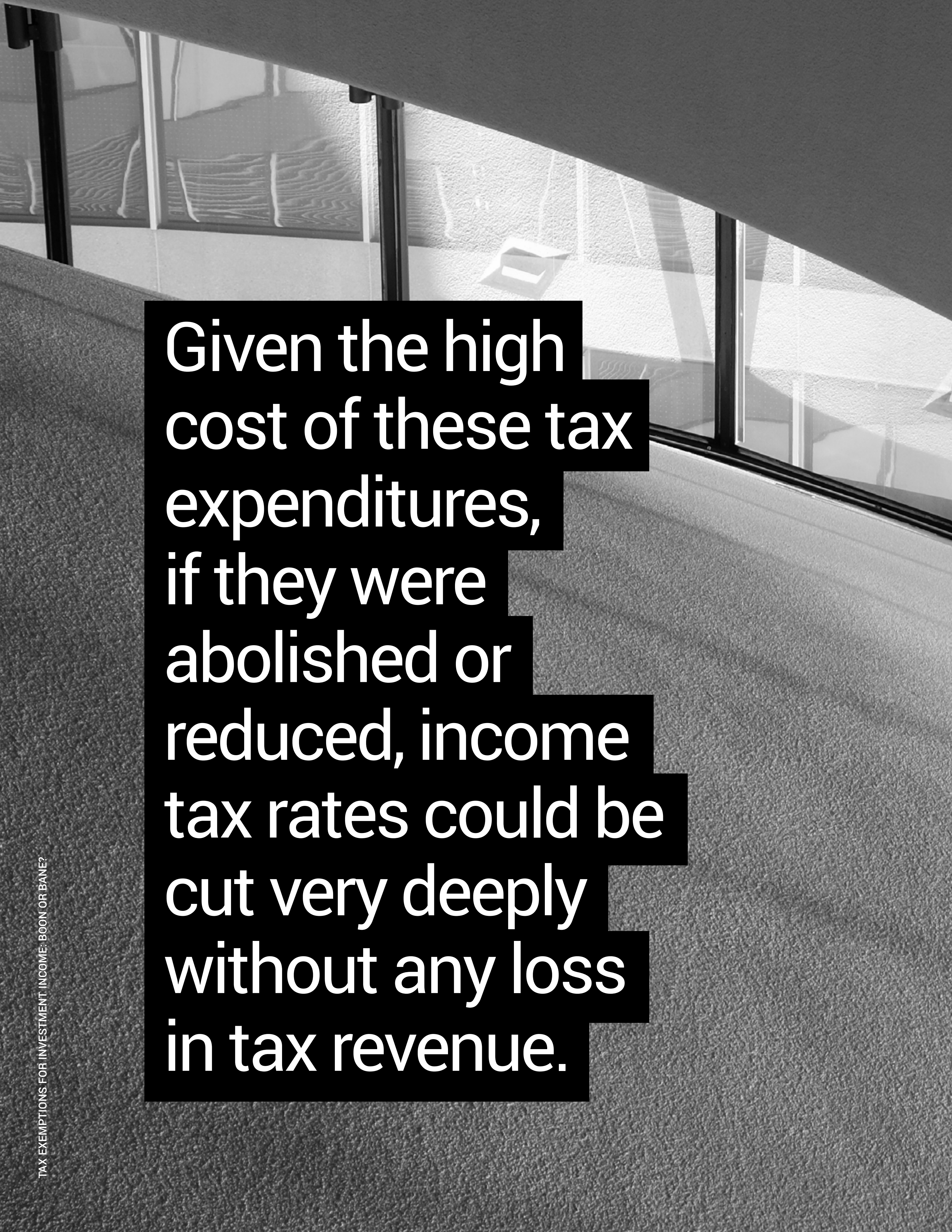
The largest tax preference of all is for money put away for retirement, in Registered Pension Plans and Registered Retirement Savings Plans. At first blush, this might appear to be a justifiable reward to those who are financially prudent and save for the future. The problem is that a large proportion of Canadians do not participate in this type of saving. Therefore, this huge tax expenditure increases the tax burden of those who cannot participate in order to subsidize those who do. It is also likely that it fails in its goal of encouraging more saving. The subsidy to saving provided by the tax system means that those who have a target for future retirement income can achieve it more easily, without saving as much. Therefore, it is possible that these tax preferences have the perverse effect of actually reducing the national savings rate.

Another major tax preference is the lower business tax rate for small corporations. This benefit also flows disproportionately to higher-income people. It appears to encourage a proliferation of businesses that cannot achieve efficiencies of scale. It results in lower overall productivity in the economy.

Taken together, the story is not a pretty one. These tax preferences result in a large loss of tax revenue with little in the way of benefit for the Canadian economy. The loss in revenue forces overall tax rates to be much higher than they would otherwise need to be. That discourages economic activity and encourages tax avoidance and evasion. The tax system would be fairer and more efficient if these tax preferences were scaled back. Given the income tax rate cuts promised in the United States by the new administration, Canada will need to pay attention to tax rate competitiveness. Maximizing efficiency by eliminating unnecessary tax expenditures would help in that effort.

Each one of these topics could be a major paper on its own, and this paper is not intended to provide exhaustive coverage of all the possible variations. The point of this overview is to draw attention to the range of shortcomings of these schemes. In any broad review of tax expenditures, the major investment-related ones covered in this paper – which many consider either structural or sacrosanct – deserve particularly careful scrutiny.

List of Specific Recommendations



Given the high cost of these tax expenditures, if they were abolished or reduced, income tax rates could be cut very deeply without any loss in tax revenue.

1 INTRODUCTION TO THE CONCEPT OF "TAX EXPENDITURES"

The federal government's total revenue from personal income tax in 2016 is estimated to be about $143 billion. Theoretically, this revenue could have been much larger if all types of income were taxed at the standard tax rates. Tax revenue is lost to many different kinds of exemptions, preferences and credits. Some specific types of income are either not taxed at all or taxed at lower rates than regular employment income. This is true of most types of investment income. For example, only half of the income earned through capital gains is taxed.

The income tax revenue lost due to all the different exemptions, preferences and credits is estimated to be about $135 billion in 2016.[2] In the jargon of tax specialists, these exemptions are referred to as "tax preferences" or "tax expenditures." The government never sees this money, as it is deducted by taxpayers before they remit their taxes. The term is intended to draw an analogy with actual spending by the government, because the government can be viewed as deliberately giving up the money through these special exemptions. The bottom line is that it leaves the government with less money to devote to other purposes.[3]

2 This is the author's estimate of what he considers to be genuine discretionary tax expenditures. It excludes "structural items" that are included in the Department of Finance's table of tax expenditures, such as the credit for the Basic Personal Amount, and the transfer of tax points to the provinces.

3 Due to the progressivity of the tax system, simply summing up the individual items, as was done to arrive at the $135 billion figure, no doubt understates the total revenue cost: John Lester, "Managing Tax Expenditures and Government Program Spending," University of Calgary, SPP Research Papers, December 2012, p. 11.

1.1 Income Tax Rates Could be Cut in Half if Tax Expenditures were Abolished

Given the high cost of these tax expenditures, if they were abolished or reduced, income tax rates could be cut very deeply without any loss in tax revenue.

It would be unrealistic to expect that all tax expenditures will be abolished, but even modest reductions could have a significant impact. There is a very large amount of money at stake. If some tax preferences are inefficient, there is a considerable potential for improving the economy by eliminating them. The money saved can either be devoted to reducing overall tax rates, or to increasing spending in high priority areas that may currently be underfunded.

1.2 Most of the Large Tax Expenditures are for Investment Income and Savings

Hundreds of different types of tax revenue losses are itemized in detail by the Department of Finance in its annual *Report on Federal Tax Expenditures*. Some of them represent multi-billion dollar amounts. Many of them are relatively small, costing less than $100 million each per year. Taken together, even the smaller ones add up to a substantial amount, and they are all worthy of careful scrutiny. The large number of these small tax expenditures creates a risk that a review will get bogged down in nickel and dime measures. The greatest focus should be on those where the most money is involved, which is where reforms could have the greatest positive impact.

The figures shown in Table 1.1 only reflect the losses in federal government tax revenue. Most provinces have a unified personal income tax system in which federal and provincial income taxes are levied together, and the provincial governments mainly follow the federal policies. Adding on the revenue lost by the provinces would increase these figures by roughly 60 per cent.

This paper will not look at all the tax preferences of the type shown in Table 1.1, but will scrutinize one particular category of them: those exempting or reducing the taxation of income from capital. These total an impressive $75 billion, which represents more than half of annual personal income tax revenue.

There is a particular motivation for focusing on tax preferences for capital. One of the most important economic policy issues of the day is income inequality, which was a major issue in the federal election campaign and a major concern in the 2016 federal budget.

One possible means of redressing the balance would be through redistribution, financed by increasing the top income tax rates. There are concerns about the effects this would have on incentives and tax avoidance. One of the leading researchers on this subject is Michael Veall. He instead suggests “broadening the tax base by eliminating special tax preferences, concentrating

TABLE 1.1
Ten Largest Personal Income Related Tax Preferences

Measure	Federal Tax Revenue Loss, 2016 projections, $ billions
Registered Pension Plans	25.7
Registered Retirement Savings Plans	15.5
Canada Child Tax Benefit	10.7
Canada Pension Plan and Quebec Pension Plan contributions and benefits	9.9
Partial inclusion of capital gains (personal income tax only)	5.8
Exemptions from non-resident withholding tax	5.6
Non-taxation of capital gains on principal residences	5.3
Dividend gross-up and tax credit	4.6
Employment Insurance and Quebec Parental Insurance Plan premiums and benefits	4
Small Business Corporation Tax Deduction	4

Source: Canada Department of Finance, *Report on Federal Tax Expenditures—Concepts, Estimates and Evaluations*, 2016, pp. 30-39.

Canada is currently above the OECD average level for income inequality.

on those that differentially benefit those with high incomes. This approach potentially could find support from across the political spectrum."[4] While such political predictions are always risky, a reform package that eliminates unproductive tax expenditures, while reducing tax rates at all income levels, ought to find broad support.

There is considerable evidence that tax preferences for capital increase inequality, because the benefits flow disproportionately to the top 10 per cent and 1 per cent of income earners. This contribution to inequality is even harder to justify if they fail to achieve their purported economic objectives.[5]

Table 1.2 looks at the share of the benefit of selected tax preferences for capital that went to benefit the top 1% of tax filers, who had 11.7% of all the income in Canada.

TABLE 1.2
Research on the Distribution of Tax Preferences for Investment Income

Item	Percentage of the tax revenue loss that goes to tax filers in the top 1%
Employee stock option deduction	100
Partial inclusion of capital gains	87
Lifetime capital gains exemption	80
Dividend tax credit	46
Registered retirement savings plans	15

Source: Brian Murphy, Mike Veall, and Michael Wolfson, "Top-End Progressivity and Federal Tax Preferences in Canada: Estimates from Personal Income Tax Data," *Canadian Tax Journal*, (2015) 63:3, 661-88,Table 1. These figures are based on data from the 2011 tax year.

The figures in Table 1.2 only report the benefits for the top 1%. That category has attracted the most attention in recent policy discussions. However, we should also be concerned about benefits that flow disproportionately to the top 10% or the top 20%. If this table was stated in terms of the top 10 per cent, then a much larger percentage of the RRSP benefit would have been evident.

4 Michael R. Veall, "Top income shares in Canada: recent trends and policy implications," (2013), *Canadian Journal of Economics*, Vol. 45, No. 4, 1247-72, p. 1262.
5 Concerns about the capital gains and dividend preferences similar to those expressed here were noted in a different context by Robin Boadway and Jean-François Tremblay, "Corporate Tax Reform: Issues and Prospects for Canada," Mowat Research No. 88, 2014.

TABLE 1.3
Distribution of Income Among Tax Filers, 2014 Tax Year

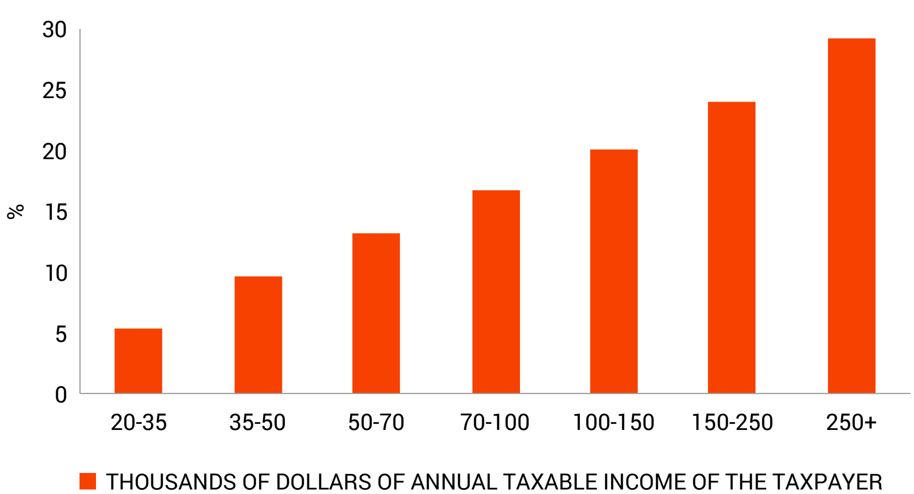
	Assessed Income Range						
	$20,000-34,999	$35,000-49,999	$50,000-69,999	$70,000-99,999	$100,000-150,000	$150,000-250,000	$250,000+
Per cent of total number of returns	19.1	15.5	13.0	10.4	5.4	2.1	1.0
Per cent of Total income assessed	11.0	14.0	16.5	18.6	13.7	8.2	11.0
Per cent of Taxable dividends	2.7	6.3	9.5	13.9	15.6	15.5	35.5
Per cent of Taxable capital gains	3.3	4.6	6.4	9.4	10.8	13.1	50.5

Source: Author's calculations from Canada Revenue Agency, *Preliminary Income Statistics—2016 Edition*, 2014 taxation year (http://www.cra-arc.gc.ca/gncy/stts/prlmnry/2014/menu-eng.html#h18), Table 2, "All Returns by Total Income Class."

Table 1.3 provides a broader description of the general distribution of taxable investment income. Investment income is very heavily weighted towards the upper end of the income distribution.

Figure 1 is particularly noteworthy. It reports combined federal and provincial personal income tax paid by each group, as a percentage of its assessed income. In 2014, the average tax rate paid by the top 1 per cent (with annual incomes over $250,000) was about 29 per cent. That reflects access to preferential rates for investment income. The average income for tax filers in this group was $532,000; the bulk of it would otherwise have been subject to the top marginal tax rate, which was close to 50 per cent in some provinces. The top 1 per cent collectively had income of $134 billion. It may not be feasible to bring their effective rate up to 50 per cent, but if they had paid even an extra ten percentage points of tax, that would have represented a significant addition to government revenue. Canada's income tax system is progressive, but not as progressive as one might expect based on the published tax rates for ordinary income.

FIGURE 1
Actual Income Tax Paid as % of Assessed Income, by Income Group



Source: Calculated from Canada Revenue Agency, Preliminary Income Statistics - 2016 Edition, for 2014 taxation year.

This paper is not seeking to argue that the only aim of tax policy is to achieve greater income equality. There is some optimal level of income equality (however hard that is to determine empirically), and beyond that point greater tax progressivity is counterproductive. However, Canada is currently above the OECD average level for income inequality, and its tax system contributes less than average to reducing inequality.[6] Inequality increased considerably more in Canada than in most other countries in recent years.[7]

In the context of tax expenditures, one of the desirable goals is greater transparency and increasing our understanding of how much they contribute to inequality. Tax expenditures have a tendency to undermine progressivity by stealth. One cynical student of the subject has suggested that "tax expenditures are often the outcome of the poorly informed few legislating for the less informed many in circumstances where the accountability of legislators is severely impeded."[8] Higher-income people are opinion-leaders, and adept at funding research and lobbying government departments to support policies that benefit them.

Top marginal income tax rates have the appearance of being high, but this is partly window-dressing, as much of the top-end income legally avoids it.[9] There are economic costs resulting from the distortions in economic activity that occur due to vastly different incentives for economic activities of equal value. For example, there is a greater incentive to self-employment, which can take advantage of more of these preferences. There are some top-end earners who, because of the nature of their positions, cannot avail themselves of all these preferences, so the current system is unfair even within the top 1 per cent. Equal treatment of all types of income would be fairer, and it would allow the top marginal tax rate to be made considerably lower without any loss in tax revenue.

One could suggest that the federal tax expenditures report ought to include information that quantifies the effect of each tax expenditure on income inequality or the progressivity of the tax system. The methodology to do so already exists in research that describes how an overall index of income tax progressivity can be constructed for a country.[10] Using that framework, the tax expenditures report ought to state for each expenditure how much Canada's index of progressivity would change if that particular expenditure was eliminated.

RECOMMENDATION #1

The federal Tax Expenditures Report should calculate an overall index of tax progressivity and quantify how much each expenditure contributes to it.

6 OECD, Divided We Stand: Why Inequality Keeps Rising, 2011. "An Overview of Growing Income
Inequalities in OECD Countries: Main Findings," Figure 9.
7 Ibid., Table A1.1.
8 Burton, Mark, "Capturing Contemporary 'Democracy': The Shortcomings of Australian Tax Expenditure Management and their Ideological Foundations." In Lisa Philipps, Neil Brooks and Jinyan Li, eds., *Tax Expenditures: State of the Art* (Toronto: Canadian Tax Foundation, 2011), at 6:24.
9 Figure 1 above actually overstates average tax rates for higher income earners when computing the average tax rates relative to assessed income. Assessed income omits the excluded half of capital gains, so that the reported average tax rates overstate the true rates relative to a more inclusive measure of income for top earners.

10 Gerlinde Verbist and Francesco Figari, "The redistributive effect and progressivity of taxes revisited: An International Comparison across the European Union," GINI Discussion Paper 88, August 2013, www.gini-research.org.

2 THE MULTIPLE GOALS OF TAX POLICY: FAIRNESS AND ECONOMIC EFFICIENCY

The first and most obvious goal of taxation is to raise revenue to pay for public services, but in a modern economy there are important supplementary goals. The sources and types of taxation have major impacts on the after-tax incomes of different individuals and on their incentives to contribute to the economy.

Taxes in a modern economy generally rise along with the income earned by the person who is taxed. A tax that rises with income may have undesirable effects. The person who earns income is forced to share the gains with the government. As a result, she may not devote as much effort to earning additional income. She may devote more of her effort to schemes aimed at avoiding tax, and may enter into outright evasion by working in the underground economy or hiding income in offshore tax havens.

By contrast, taxes that are unrelated to income do not have a disincentive effect. However, they are generally considered to be unfair because they are much less affordable for low and middle income people.

Most economists believe that the overall tax rate affects the incentives to work. In that case, tax preferences for investment may have an adverse effect because they force the tax rate for employment income to be higher than otherwise. For example, tax rates in Canada have raised worries about a brain drain of higher-income skilled workers.[11] Tax expenditures are generally counterproductive to good incentives, because they require the general income tax rate that affects skilled salaries to be higher. While tax expenditures for investment benefit higher-income people, the problem is that they only provide that benefit selectively. Only those higher-income people who choose to participate in the particular types of investments that are favoured benefit. That creates skewed incentives.

The effect of income tax rates on mobile high tech workers may become a matter of increased concern for Canada if the United States proceeds to cut its income tax rates further. To preserve competitiveness, a greater focus on cutting tax expenditures in order to be able to afford a lower overall income tax rate might be desirable. On the other hand, the new administration in the

11 Gary L Hunt and Richard Mueller, "Fiscal Policy, Returns to Skills, and Canada-US Migration: Evidence from the Late 1990s." *Canadian Public Policy*, Vol. 39, No. 1, March 2013. As studies of this type show, there is some evidence that rising tax rates have an impact, but the overall effect is not large. Tax rates matter, but the opponents of progressive taxation tend to exaggerate their importance. Many key workers in the high tech economy are relatively young, and have few assets. Even if they fall into a high income category, they will be less affected by the tax rates on investment income than older people with large accumulations of wealth.

United States is also following a policy of being unfriendly to immigrants, and therefore the net effect on Canada's ability to attract or retain internationally mobile workers might be minimal.

2.1 Progressive Income Taxation as an Instrument of Fairness

Modern income taxation has progressive rates, meaning that the percentage of income that is taxed rises as income gets higher. The Canadian personal income tax system has a number of tax brackets with rising tax rates to achieve this result. For example, in Table 2.1 we see that a person earning $50,000 per year from employment pays tax of about 30 cents on an additional dollar of income earned, while a person earning $200,000 per year pays 53 cents of tax on each additional dollar.

However, we see in the same table that, if the person earning $200,000 manages to get his additional income as a capital gain instead of from employment, he will only pay 26 cents on each additional dollar of income. All of a sudden, he is paying less tax than the low-income person who works at a job, possibly doing hard physical labour in unpleasant conditions -- which is something that people earning $200,000 rarely do.

Capital gains can occur in any situation where a person sells an asset for more than he bought it. Capital gains can be made in the stock market, bond market, or the real estate market. A person may sell a business he owned and realize a gain. But in order to earn capital gains, one has to have capital to invest. Higher-income people who have more discretionary income and savings to use for this purpose are therefore much more prone to earning capital gains.

This paper will have much more to say about this issue later. First, we will take a brief segue to explore the reasons why most analysts believe that progressive taxation -- which aims to take more from the rich than the poor -- is fair.

The higher-income person probably does not want to pay a higher rate of tax, but it is arguably fair that he do so. A high income person finds it easier to pay for the basic necessities of life

TABLE 2.1

Combined federal and provincial marginal income tax rates in Ontario, 2016

Taxable Income	Rate for Employment or Interest Income	Effective Rate for Capital Gains	Effective Rate for Eligible Canadian Dividends
first $41,536	20.05%	10.03%	-6.86%
over $41,536 up to $45,282	24.15%	12.08%	-1.20%
over $45,282 up to $73,145	29.65%	14.83%	6.39%
over $73,145 up to $83,075	31.48%	15.74%	8.92%
over $83,075 up to $86,176	33.89%	16.95%	12.24%
over $86,176 up to $90,563	37.91%	18.95%	17.79%
over $90,563 up to $140,388	43.41%	21.70%	25.38%
over $140,388 up to $150,000	46.41%	23.20%	29.52%
over $150,000 up to $200,000	47.97%	23.98%	31.67%
over $200,000 up to $220,000	51.97%	25.98%	37.19%
over $220,000	53.53%	26.76%	39.34%

Source: http://www.taxtips.ca/taxrates/on.htm while still having plenty left over for luxuries, and therefore does not have as much need for the additional money.

A higher-income person who dislikes this type of taxation may argue that he deserves to keep his higher income rather than sharing it with others through higher tax rates: he earned it by working harder, being smarter, more creative, devoting more years to education, etc. In short, he makes a greater contribution to the economy and society. There is some merit to this argument up to a point, and most would agree that greater effort deserves to be rewarded. However, where income disparities become very large, the argument becomes less compelling.

The people who earn the most money do so because of the legal institutions of modern society. The richest people are the ones who own intangibles such as financial instruments and intellectual property in brand names, trademarks and inventions. These only have value because of the societal enforcement of complex property rights. Since all income depends on these social relationships, nobody has a right to complain that a redistributive tax policy mandated by a democratically elected government is "unfair" or "confiscatory."

The argument that higher tax rates discourage entrepreneurship and innovation has some merit, but it can be overstated. Opponents of progressive taxation frequently exaggerate the impact of lower taxes on incentives.[12] Many innovators are not motivated primarily by money, and some innovations are more the result of luck than great effort. The greatest fortunes are usually made by people with a substantial element of luck. They were in the right place at the right time, and not really that much smarter than the next best person. If Mark Zuckerberg had not developed Facebook, there would have been something almost as good in Myspace. This phenomenon has been described as the "Winner Takes All" aspect of the modern economy. The person who comes out on top by making a small improvement reaps disproportionately large rewards.[13] It is the consequence of mass communications in a huge market. Many of the people who enjoy high incomes as corporate or financial executives are reaping the spillovers from this trend.

Competitive markets are efficient at delivering most goods and services that consumers want, according to standard economic theory. However, economic theory does not pretend that the distribution of income that results from market forces is fair in any objective sense, nor is the market economy efficient at delivering social goods and services. Social goods such as education and health care have a greater long-term societal benefit than individuals are capable of paying for them in the short term.

While severe over-taxation might kill the golden goose, failing to adequately redistribute income can also have negative economic effects. Worsening inequality can contribute to health problems, crime and lack of education. It creates a waste of human potential that has a measurable negative impact on economic growth.[14] If social conditions deteriorate due to inequality, it can lead to a more violent and turbulent society with greater risks for all. Good social policy is also good economic policy.

12 Peter S. Spiro, "Overselling the Economic Efficiency Gains from Shifting the Tax Mix towards Consumption Taxes," *Public Finance and Management*, forthcoming.

13 Robert H. Frank, *Success and Luck: Good Fortune and the Myth of Meritocracy*, Princeton University Press, 2016

14 Several econometric studies have found that income inequality undermines long-term growth. For a review, see Era Dabla-Norris, Kalpana Kochhar, Frantisek Ricka, Nujin Suphaphiphat, and Evridiki Tsounta, "Causes and Consequences of Income Inequality: A Global Perspective," International Monetary Fund Study Note 15/13, 2015.

2.2 Exempting Investment Income Undermines the Fairness of the Tax System

Some economists have argued that investment income from capital should not be taxed at all, or at much lower rates than employment income.[15] One argument is that, in the absence of special treatment, investment income is overtaxed .

On this view, a person earns income by the sweat of his brow and pays income tax on it. If he chooses to save some of this income (meaning that he postpones consuming the fruits of his labour), and earns investment income on it, he should not be required to pay tax again. If he is taxed on his investment returns, this argument points out, he ends up paying more tax than his imprudent neighbour who spent it all and therefore has no investment income. Viewed that way, a tax on investment income penalizes thrift and prudence. The investment return is not really income, on this view, but a compensation for the loss of enjoyment that the saver suffered by delaying his spending. Hence, it would be wrong to tax it.

Those who take this position generally argue that taxing the return to savings discourages saving, and therefore leads to less money being available for investment in productive enterprises. If this is true, long-run economic growth becomes lower than it would otherwise have been.

A variant of this argument states that only consumer spending should be taxed, and no income of any kind should be taxed. Thus, any portion of earned income that is saved would be exempt from tax, until such time as its owner actually consumes some part of his wealth.

15 For a discussion, see "Long-term reflection: the examination of a dual income tax system," *Final Report of the Québec Taxation Review Committee*, 2015, p. 95ff.

It is implied by those who advocate taxing only consumer spending that everybody has an equal opportunity to earn increased future income simply by saving today. This is only true in abstract theoretical models. In reality, it is belied by actual experience, when one looks at the interest rate that can be obtained on "safe investments" such as GICs. Historically, real interest rates on low-risk forms of savings have usually been quite low (and have been zero or negative in the years since the 2008 financial crisis). The stock market, in the long-run, produces higher rates of return, but even the safest mutual funds are subject to large short-term volatility. Small savers may feel that they cannot afford that risk, and therefore end up with very low returns.

Large differences in investment income result from the greater ability of some people to earn extraordinarily high investment returns. A failure to tax those returns, or to tax them at lower rates, has the potential to seriously undermine the progressivity of the tax system.[16]

The investment returns achieved by different individuals are sometimes determined by a combination of skill and luck, but some have argued that the game is fixed. This has been noted, particularly with respect to stock options, by Roger Martin, former Dean of the University of Toronto's business school.[17] He suggests that stock options, rather than being an effective

16 A type of dual taxation has been introduced in Scandinavia. However, those countries started with a much more even distribution of wealth than we have in Canada. It is questionable whether an attempt to graft that approach onto the very different starting point of the Canadian tax system would achieve a similar outcome.
17 Roger L. Martin, Fixing the Game, Harvard Business Review Press, 2011; Roger Martin, "The Fundamental Problem with Stock-Based Compensation" [Winter 2003] *Rotman Management* 7-9.

incentive for good performance, are subject to manipulation and encourage executives of large corporations to act contrary to the interests of shareholders.

For people in lucrative business positions, such as executives compensated with stock options, the distinction between primary income from work versus secondary income from investment returns is quite blurred. These forms of compensation often make the difference between people becoming rich or not. Leaving these winnings untaxed would further increase the inequality of wealth.

Even when we consider arm's-length investments such as RRSPs and TFSAs, the rates of return on different portfolios may vary substantially. The ability to earn a high rate of return through superior skill (or luck) may lead to large differences in what is available to different individuals for retirement.[18] This has been eloquently stated by Rhys Kesselman:

> *... the standard distinction between labour and capital incomes is spurious. Almost all supernormal returns conventionally attributed to capital in fact reflect the individual's characteristics and thus are more properly viewed as the product of labour-type inputs. Supernormal returns in business and investment reflect not only good luck or pure rents but also the input of effort, experience, ingenuity, perseverance, vision, social skills, connections, and special knowledge by the individual -- all aspects of labour rather than capital per se. This issue also arises with the returns on financial and tangible assets-such as publicly traded securities, real estate, and collectibles. Thus, the persistent supernormal returns earned by some individuals are reflective not of capital per se but rather personal attributes.*[19]

The argument for taxing these returns through progressive taxation is just as strong as the argument for taxing differences in employment income through progressive taxation. If we apply progressively higher tax rates to the earnings from skill at working as a computer programmer or teacher, there is no reason not to similarly tax the earnings from skill in making financial investments.

While severe over-taxation might kill the golden goose, failing to adequately redistribute income can also have negative economic effects.

Of course, some of the people who currently earn large amounts of investment income received their wealth through inheritance. To suggest that investment income should not be taxed because its original source was already taxed once many generations ago would lead to very inequitable outcomes that strongly favour the rich.

18 This is a particularly strong objection to the TFSA, where these above normal returns will not be taxed even when they are withdrawn. This point was noted by Benjamin Alarie "Assessing Tax-Free Savings Accounts—Promises and Pressures," *Canadian Tax Journal* (2009) vol. 57, no 3, 504 - 32.

19 J.R. Kesselman, "Reconciling Equity and Efficiency," forthcoming, *Canadian Income Tax Centennial Symposium*, Canadian Tax Foundation, 2016.

2.3 Do Taxes on Investment Income Affect the Amount that Individuals Save?

The other key argument for lower taxation on investment returns is the claim that it encourages people to save more. This is based on the notion that if you increase the reward for something, people will do more of it. In fact, there are occasional exceptions to that rule, and saving may well be one of them.[20]

Economic theory is unable to predict what will happen after the net (after-tax) rate of return from investment income is increased. It cannot predict whether people will decide to save more or less because of it. It may vary from situation to situation, depending on the way people value enjoyment today versus enjoyment in the future, and how they set goals for the future. For example, many people have a specific target level of income that they want to achieve during retirement. For such a person, an increase in the after-tax rate of return on investment through a tax cut would reduce the need for saving.

This point is far from academic, as the current environment of low rates of return demonstrates. Financial planning experts have been at pains to point out to people that they have to save more to compensate for the lower rates of return due to the low interest rates of the past several years.[21] This would be equally good advice if net rates of return changed due to taxation.

There are very complex interactions involved, and empirical researchers have been unable to answer the question of what effect taxation has on savings. A major literature survey by a leading expert on the subject, running to over 100 pages, was forced to conclude that very little can be said on the subject with confidence: "One cannot review the voluminous literature on taxation and saving without being somewhat humbled by the enormous difficulty of learning anything useful about even the most basic empirical questions."[22]

A more recent review of the subject for the Mirrlees Commission in the United Kingdom found that "it is unlikely that changes in interest rates due to preferential taxation, or other movements in interest rates, will cause big changes in the level of saving."[23]

Another criticism of the proposal to tax only consumption is that the boundaries of consumption are not easy to define, particularly for wealthy people.[24] The prestige and power that come with wealth are themselves a source

20 In the technical terms of supply and demand theory, this is a case where the income effect from a price change is greater than the substitution effect.

21 A good example is David A. Dodge, Alexandre Laurin and Colin Busby, "The Piggy Bank Index: Matching Canadians' Saving Rates to Their Retirement Dreams," (2010), Toronto, C.D. Howe Institute E-Brief. The authors calculate the percentage of income that individuals need to save in order to achieve a comfortable retirement. As a corollary, if the after-tax rate of return was reduced due to a higher income tax rate, the required savings rate would increase.

22 B. Douglas Bernheim, "Taxation and Saving." NBER Working Paper no. 7061, 1999. Published in the *Handbook of Public Economics*, A. J. Auerbach & M. Feldstein (ed.), pages 1173-1249 Elsevier, 2002. For a Canadian perspective, see J.R. Kesselman, "Québec Income Taxation and Incentives for Household Savings," study for the Québec Taxation Review Committee, 2014, http://www.examenfiscalite.gouv.qc.ca/fileadmin/user_upload/etudes/Kesselman.pdf

23 Orazio P. Attanasio and Matthew Wakefield, "The effects on consumption and saving of taxing asset returns," (2008). Prepared for the Report of a Commission on Reforming the Tax System for the 21st Century, Chaired by Sir James Mirrlees.

24 Alvin C. Warren, Jr., "Fairness and a Consumption-Type or Cash Flow Personal Income Tax," (1975) 88:5 *Harvard Law Review*, pp. 931-946; Reuven S. Avi-Yonah, "Risk, Rents, and Regressivity: Why the United States Needs Both an Income Tax and a VAT," (2004) 105:13 Tax Notes, 1651-66. On the distributional effects of the sales tax in Canada, see Luc Godbout and Suzie St-Cerny (2011) "Are Consumption Taxes Regressive in Quebec?" (2011) 59:3 Canadian Tax Journal, 463-93. These authors find that the GST is not regressive towards the low end, but only because of the substantial low income credits that have been provided along with it.Its greatest impact is on middle income earners.

of enjoyment. For example, there is the political influence that comes from tax-deductible political donations and the honours and naming rights that come with donations to universities and other institutions.[25] Senior executives of companies have control over tax-deductible business expenses that confer substantial consumption benefits (luxurious office space, executive jets, business meetings in interesting travel destinations). Tax laws have attempted to restrict the scope of these by limiting business deductions for entertainment and meals, but with mixed success. A typical consumption tax hits middle income people, but leaves larger proportions of the consumption of the wealthy untaxed.

25 Empirical studies have found the prestige from public donations to be an important incentive: Y. Mochimaru and W.T. Harbaugh, "What Do Donations Buy? A Model of Philanthropy Based on Prestige and Warm Glow," (1998), 67:2 *Journal of Public Economics*, 269-84.

3 ONLY HALF OF CAPITAL GAINS IS TAXED

3.1 Background to the Special Treatment of Capital Gains

There is a cluster of related capital gains exemptions. It represents an annual tax revenue reduction of $6 billion on untaxed gains from the sale of investments such as stocks and real estate in personal income tax returns. Another $5 billion is lost through the complete exemption of capital gains on principle residences. There is an additional $6 billion of lost revenue on capital gains earned by corporations, some of which will eventually flow to individuals through dividends. About $1.4 billion of revenue is lost in the lifetime exemption for the sale of small businesses and farms.[26] Employee stock options based on capital gains cost almost $1 billion per year. Capital gains flow overwhelmingly to people in the top 1 per cent of the income distribution.

For much of its history, Canada did not tax any capital gains at all. There was a misconception that it was not really income, but only a fortuitous change in value, and values could fluctuate either upward or downward. The Carter Commission[27] report of 1966, a landmark in Canada's tax policy development, pointed out the fallacy in this view, and recommended taxing capital gains the same as regular income. As a compromise, eventually fifty per cent of capital gains was taxed beginning in 1972.

A big problem in taxing one kind of income at a much lower rate is the temptation it creates for tax avoidance. It encourages socially unproductive effort aimed at tax minimization by schemes that attempt to re-label regular income as capital gains. It leads to enforcement problems and litigation between taxpayers and the Minister of National Revenue. One of the leading reference works on Canadian income tax law points out that the distinction between capital gains and other income "has created more case law than any other issue under the Act."[28]

The economic arguments that have been advanced to justify this special treatment of capital gains do not stand up to close scrutiny. One argument is that successful investors ought to be encouraged to take their winnings and reinvest in the next big thing, rather than being discouraged from selling because their accumulated gains would be taxed. This is part of a general argument that some investments are particularly risky, and the tax system should compensate to encourage them.

26 Much of these gain is in turn due to accumulated income sheltered under the Small Business Deduction for small corporations.
27 Report of the Royal Commission on Taxation (Ottawa, 1966).

28 Peter W. Hogg, Joanne E. Magee and Jinyan Li, *Principles of Canadian Income Tax Law* (Toronto: Carswell, 2013), p. 317.

Even if these arguments were valid in a closed economy, in the modern world where Canadians invest around the world, there may often be little economic benefit to Canada from this risk taking. The current approach treats all types of capital gains the same. There is no distinction made between short-term speculation in real estate, which may actually be harmful to the economy, versus genuine entrepreneurial investments in innovative technology. There may be a plausible argument for a special treatment of capital gains in some contexts, but the current system makes no attempt to optimize the benefits.

There is a view that compensation needs to be given to shareholders because the corporation has paid corporate income tax, and this justifies a lower capital gains tax on stocks. [29] This is also countered by the open economy concept. Canada is a small country on the world stage, and it is a reasonable approximation to assume that the real after-tax cost of capital for corporations in Canada is determined by world market conditions. Therefore, much of the cost of the corporate tax is passed on by corporations to either employees or customers. Shareholders do not deserve to be compensated by a lower capital gains tax. This is discussed in greater depth in section 4.1 below, dealing with the dividend tax credit.

There are some situations in which capital gains may genuinely deserve different treatment from other income. However, there are many different types of capital gain, and a one-size policy does not fit all of them well. There are more efficient ways to deal with the special circumstances of capital gains than an across-the-board 50 per cent reduction for every type of capital gain.

As ownership of capital assets outside tax sheltered vehicles (RRSPs, pension funds, TFSAs) is disproportionately in the hands of higher-income people, tax preferences in the personal income tax system for capital gains tend to undermine the progressivity of the tax system.

RECOMMENDATION #2

Replace the general exemption of half of capital gains with targeted measures that deal with specific problems that result from taxing capital gains.

3.2 Inflation is not a Valid Argument for a General Exemption of Capital Gains

One of the strongest arguments for a lower rate of taxation on capital gains applies to assets held for a long period of time. For these assets, part of the gain is illusory. It is merely part of a general increase in prices due to general inflation in the economy.

Price inflation in recent years has not been very high compared to what was experienced in the 1970s and 1980s. The Bank of Canada has set a target for an annual rate of general inflation in the Consumer Price Index (CPI) of 2 per cent per year. It has established a reliable track record of meeting that target on average. Even at that modest inflation rate, the average level of prices doubles every 35 years once compounding is taken into account. Therefore, general inflation can have a significant impact on assets held over long periods of time.

29 Heather Kerr, Ken McKenzie and Jack Mintz, eds., *Tax Policy in Canada* (Toronto: Canadian Tax Foundation, 2012), p. 6:18.

The solution is to exempt the portion of capital gains that is due to inflation and then tax the real increase at the normal tax rate.

It would be hard to argue that it is fair to tax illusory gains that are not real gains. However, an arbitrary 50 per cent reduction in the taxation of capital gains is not a proper response to the problem. Currently, the same low rate of capital gains tax is applied to a capital gain on an asset sold after three months as one sold after 30 years. In the former, there would be virtually no inflation, while in the case of the latter, nearly all of the gain might be due to inflation. The seller of the short-term asset is seriously over-compensated, while the seller of the long-term asset may be under-compensated. It is possible that all of the "capital gain" on a long-term asset is due to inflation, and there is no real gain. Indeed, after the effect of inflation is factored out, there might be a loss in real terms.

The proper way to deal with this problem would be to make an explicit calculation of the portion of the gain that is due to inflation, and then tax the real increase at the normal tax rate. It is not as if the *Income Tax Act* is unaware of the existence of the CPI. The Income Tax Act refers to the CPI in a number of places, and uses it to automatically adjust various items, such as tax brackets.[30]

30 In sections 117.1, 122.51, and 146. In the first of these, it recites the legal source of the CPI, "as published by Statistics Canada under the authority of the *Statistics Act*."

Administratively, there would not be any difficulty in implementing such indexing. Schedule 3 in the T1 tax return already requires the taxpayer to fill in the year of acquisition of the capital asset whose disposition is being reported. Most people now use software to prepare tax returns, and it would be a simple matter for such programs to automatically calculate the value adjusted for inflation.

The historic cost base of the asset would be multiplied by an inflation factor to arrive at a new current-dollar cost base.[31] The difference between it and the proceeds of disposition would represent the actual capital gain (or loss) on that asset. Once inflation has been taken into account, it would be reasonable to make all of the real gain taxable at the regular income tax rate.[32]

It would be a simple matter to amend section 38 of the *Income Tax Act* to define taxable capital gains to include only real gains:

Capital gains shall be calculated using the following formula:

> *Taxable capital gains = A x B - C*
>
> *where A is the adjusted cost base, B is the Consumer Price Index in the year of disposition divided by the Consumer Price Index in the year of acquisition, and C is the proceeds of disposition, and the Consumer Price Index is as defined in section 117.1.*

Nobody could seriously suggest that this would significantly increase the complexity of the tax system. It is a very simple formula compared to some of the brain twisters that already exist in

31 Multiplying the original purchase price by inflation since the year of acquisition is the way to convert the gain so that it is expressed in dollars of the current year.
32 A similar conclusion was reached in the *Final Report of the Québec Taxation Review Committee*, 2015, Recommendation 24, p. 91.

the *Income Tax Act*. The concept of indexation for inflation is widely familiar to taxpayers. It already applies in many spheres of financial life, such as the indexation of public pensions and, in the tax code itself, the indexation of the basic exemption, the brackets, and various contribution limits.

RECOMMENDATION #3

Use indexation to exempt increases in asset values that merely compensate for general price inflation.

3.3 A General Exemption is not an Efficient way to Encourage Entrepreneurship

It is often argued that a lower capital gains tax rate encourages entrepreneurial initiative and economic growth. This justification is quite tenuous. Even if there are a few spheres in which it may have merit, it fails to justify giving a lower capital gains tax rate for every kind of investment.

The argument is deficient on a variety of grounds, both practical and analytic. As with the inflation justification, a general lowering of the capital gains tax rate is a remarkably blunt instrument for the purported objective. Moreover, it is also questionable in terms of its economic logic, as it is far from certain whether a lower inclusion rate actually encourages risk taking.[33]

The partial inclusion of capital gains means that only half of losses are deductible. If somebody is risk averse (as many investors are believed to be) the partial inclusion is actually something that discourages risk taking. Being risk averse means that the investor subjectively suffers more from a loss of $1000 than he has enjoyment from a gain of $1000. Therefore, the inability to fully deduct the loss will be viewed as a greater disadvantage than the ability to pay tax on only half the gain. Where people are risk averse, they only pursue opportunities when the probability of gain is perceived to be higher than the probability of loss. The partial inclusion is likely to discourage risk taking.

Even if a lower rate of capital gains tax succeeded in encouraging risk taking, it would not create a justification for a general lowering of capital gains, including those on speculative investments in foreign stock markets. Measures targeted at entrepreneurs who start companies that invest in the Canadian economy would achieve the incentive objective at a much lower cost in foregone revenue.

RECOMMENDATION #4

Capital gains incentives should be restricted to categories that encourage new business investment in the Canadian economy.

3.4 The Lock-In Effect

One frequently heard argument for reducing the capital gains tax rate is that it may actually yield more tax revenue. The basis for this claim is that capital gains are only taxed on realization, which is when the asset is sold. It is suggested that this makes owners with paper profits reluctant to sell, and the asset becomes “locked in.”

33 Taxation of Capital Gains of Individuals, OECD Tax Policy Studies No. 14, 2006, pp. 16-18. They suggest that the effect of partial inclusion on risk taking is at best ambiguous, and is more likely to diminish it.

The owners of assets with accrued gains can avoid the tax by continuing to hold them and refusing to realize the gains:

Ironically, the argument that the capital gains tax is needed to raise revenue is perverse. Evidence from the United States demonstrates clearly that lower capital gains taxation rates raise total revenue in the short run because lower tax rates induce the sale of appreciated assets and bring in more tax payments.[34]

Such claims are probably exaggerated. They are usually based on looking at changes over a short period of time following a change in the tax rate. That inevitably leads to bunching. The longer term change in annual revenue, even if it remains positive, would be considerably lower. The revenue impact may in fact be negative in the longer term even though there was a short-term positive impact.

A secondary and related argument is the hypothesis that the "lock-in" effect on owners of appreciated assets, who hold on to them in order to avoid capital gains tax, creates inefficiencies in the allocation of capital:

> *[T]he capital gains tax introduces inefficiencies of its own because it encourages the owners of capital to hold on to it, even if more profitable investment opportunities are available. This lock-in effect depends on owners' investment horizons and the difference between actual and alternative returns. While there are no estimates of the size of the efficiency loss due to the lock-in effect, there is no doubt that it is substantial.*[35]

In fact, it is unlikely that there is any adverse economic effect on the allocation of capital from the lock-in for general stock market investments. The price at which the appreciated stock is being held is determined in an efficient market. Those who are bidding for it do so because they expect the rate of return on it to be at least as high as the next best alternative. Therefore, if more profitable investment opportunities are available elsewhere, those opportunities will not go begging for capital.

The people who were lucky and long ago bought stocks that have had a huge rate of appreciation, such as Apple or Google, might prefer to diversify by selling some part of their portfolio. This would make them happier, but it is unlikely to have any material effect on the overall efficiency of the global economy. These examples are used because Canadians are currently allowed the same low inclusion rate for capital gains on foreign stock as on stocks of Canadian companies. Even if there was an economic efficiency loss if sales of such stocks are discouraged, it would not be occurring in Canada. The Canadian government should not be so altruistic that it devotes tax expenditure dollars to improving economic efficiency in other countries.

There may be a few specific areas where the lock-in effect undermines efficient economic use of assets. It would be better to deal with these through a specific rollover exemption, as discussed in the next section.

34 Herbert G. Grubel, *Unlocking Canadian Capital: The Case for Capital Gains Tax Reform* (Vancouver: Fraser Institute, 2000), p. ix.
35 *ibid.*, p. x.

3.5 Rollover Provisions are a Better Way to Alleviate Lock-In

There is a legitimate argument that some forms of lock-in may be economically harmful. The best way to deal with these is through targeted permission for tax-free “rollovers.” Such a rollover allows a taxpayer to sell an asset without reporting any capital gain if the money is reinvested in assets of a similar type within a specified period of time

The tax code already has some rollover provisions for replacement property in section 44. These rollover provisions are currently of limited application. One permitted category consists of assets such as equipment used in an operating business. If these are sold and replaced with similar assets, no capital gain is recorded. Capital gains on such assets would in any event be unusual. Another rollover provision applies to assets such as buildings or land that are disposed of involuntarily, either because of destruction or legal expropriation.

It is suggested that broadening the right to use rollover provisions to other areas where it is economically appropriate would be more efficient than a broad capital gains exemption.

Lock-in effects could have harmful impacts in some specific situations where it is desirable that ownership should move freely within the economy. That can apply to actual tangible property, such as buildings or land, where it may be desirable that it move easily from one use to another.

It may also apply in some specific cases to investments in new companies by venture capitalists. There are some people who specialize in the risky business of investing in new ventures. They develop a special expertise in being able to evaluate new prospects. Once they have successfully nurtured a company that can be passed on to regular, risk-averse investors, it is desirable for this to happen. It frees up the capital of the venture investors, for potential use in new venture capital investments. In such cases, it would be desirable to allow rollovers to happen tax free if the money is reinvested in an asset of the same type. The Income Tax regulations would be used to define the appropriate categories, analogously to what is now done in other parts of the tax system.

Extending rollover provisions to real estate investments could have beneficial economic effects. For example, in tight real estate markets such as Toronto and Vancouver, a substantial portion of the rental apartment stock consists of condos owned by real estate investors. Investors who bought in the past and have substantial accrued capital gains would be reluctant to sell because of the tax impact. This tends to distort the market, as it limits the supply for purchasers in established neighbourhoods that are in high demand. If the investors could take their profits and continue to defer the tax, on the condition that they reinvest in a new location, it might alleviate these distortions.

Real estate is depreciable property, and a significant part of the lock-in effect that discourages re-sales is due to recapture of depreciation. Currently, Regulation 1101 does not permit a taxpayer to put all rental property into one class. That would also have to be amended in addition to the capital gains rollover when replacement property is acquired.

It should also be noted that enhancing the tax deferral for rental real estate is likely to help offset another type of imbalance. Principal residences are exempt from capital gains tax for their owners (in addition to the implicit rent being exempt). The strong tax preferences for home ownership have been questioned as an area of excessive tax expenditure.[36] By comparison, people who rent their housing are disadvantaged by the tax system. Long tax deferrals are ordinarily not justified, but in this example extending a tax advantage to those who invest in the provision of rental housing would serve to reduce the existing imbalance that favours home ownership.

RECOMMENDATION #5

Where realization of capital gains has a clear economic benefit, offer rollover exemptions for those who reinvest their gains.

3.6 Retention of Corporate Earnings

Most profitable public corporations pay some dividends, but they generally pay out only a portion of their net profits in this form. The average corporation keeps about 50 per cent of its after-tax profits as retained earnings, [37] which it reinvests in its own operations or sometimes uses to diversify by buying other businesses. This money retained each year (assuming it is used wisely) increases the value of the corporation, and is generally recognized by the market in the form of a higher stock price.

When an investor sells these stocks, the appreciation in the price of the stock is taxed as a capital gain. The retained earnings accumulated within the company, which would otherwise have become dividends (and taxed as such), are thereby converted into a capital gain which is taxed even more preferentially than dividends. It does not represent a true capital gain. It is a flaw in the Income Tax Act's definition of capital gains that it allows people to count this as capital gains. It misinterprets something that is merely an accumulation of earnings as a capital gain. The fact that this capital gain is not taxed until the stock is sold brings in the compounding advantage noted above, and magnifies the benefit for the investors compared to income that is paid out in the form of dividends.

Table 3.1 provides a simple numerical example of the difference this can make. Company A retains all its earnings and reinvests them in the company. Company B pays out all its earnings to the investor, who pays income tax on the dividends.[38] Both companies earn net profits that represent a 10 per cent rate of return on their equity. The investor buys $100 of shares in Year 1, and sells after 10 years, paying capital gains tax. The net after-tax value from Company A is $199.20, compared to only $151.70 from Company B.

36 It should be observed that a majority of Canadians are homeowners, and for most of them the home is their largest asset. This creates a resistance to any reform that would reduce these preferences that is a whole order of magnitude greater than for other areas of taxation. A possible compromise would be to limit the principle residence exemption to those sellers who use the proceeds to buy a different residence.

37 This is the average from 2000 to 2015. It is volatile over the business cycle. It averaged about 60 per cent in the years prior to the 2008 financial crisis, but has been lower since then. Data are from Cansim Table 380-0078, "Undistributed corporation profits."

38 At an effective rate of 29.5 per cent, taking into account the dividend tax credit. This is the actual current marginal rate for high income Ontario taxpayers, http://www.taxtips.ca/taxrates/on.htm.

TABLE 3.1

Example of investment return on a $100 investment due to different retained earnings policies

Year	Company A	Company B
1	110.0	107.0
2	121.0	114.5
3	133.1	122.6
4	146.4	131.3
5	161.1	140.5
6	177.2	150.4
7	194.9	161.0
8	214.4	172.4
9	235.8	184.5
10	259.4	197.5
Proceeds when shares are sold, paying Capital Gains Tax in year 10	$199.2	$151.7

Note: Company A retains all earnings, while Company B pays all its earnings out as dividends, which the individual reinvests in its shares.

One possible way to deal with this issue would be to amend the *Income Tax Act* to require some minimum payout of net corporate profits, in the form of a combination of cash dividends and stock dividends.[39] It would be at the discretion of the corporation to decide what percentage of it was in cash and what percentage in the form of stock dividends.

Stock dividends are taxed in the same way as cash dividends.[40] Taxing these dividends would not create a cash flow problem for the taxpayer, because if desired there can be a standing order with the brokerage firms to sell a portion of the stock dividend as it is received. The virtue of a stock dividend, from the viewpoint of the paying company, is that it does not impair its access to capital for re-investment purposes if it genuinely has a good use for the funds.

An even more radical alternative would be to amend the *Income Tax Act* so that the retained profits are deemed to have been received by the shareholders. In terms of the underlying reality, there would be no difference between the two approaches. However, psychologically the latter approach might appear harsher to individuals, as they would be taxed on income that they have not explicitly received.

Perhaps the greatest challenge surrounding this issue would be in dealing with competition among alternative forms of investment. There are three classes of investments that are relevant: publicly traded corporations, Canadian small business corporations, and international corporations.

The Canadian government cannot order foreign companies to pay stock dividends to their Canadian shareholders. The simplest solution would be to impose a higher tax rate on the capital gains on stocks of foreign companies to equalize the benefits. Whatever is the inclusion rate for capital gains on stocks of Canadian companies, the capital gains on those of foreign companies could be made higher.

RECOMMENDATION #6

Review the current policy of allowing shareholders to defer recognition of income from corporate retained earnings until the shares are sold.

39 There have been concerns about “dead capital,” articulated most famously by former Bank of Canada Governor Mark Carney. That is a very complex and specialized topic, and not everybody is convinced that it is a problem. It is conceivable that changes in taxation could have a beneficial impact, and it is something that should be explored.

40 Section 248(1) defines “dividend” to include a stock dividend, and therefore they are taxed like any other dividends. Stock dividends are discussed in Interpretation Bulletin IT-88R2. They are valued based on the increase in paid-up capital of the corporation that is associated with them. The proposal I am making here would, in effect, be a requirement that the paid up capital per existing share is not allowed to rise. New shares would have to be issued to match any retained earnings to prevent the value per existing share from rising.

3.7 Lifetime Capital Gains Exemption for Small Business

The Lifetime Capital Gains Exemption (LCGE) on the sale of a small business corporation represents a tax expenditure of close to half a billion dollars per year.[41] It is one of many tax advantages enjoyed by small businesses. It has been suggested by some that this group is well situated to have a disproportionate political influence: "Small businesses are a major source of candidates and financial and organizational support for local constituency associations."[42]

Lobby groups like to promote small business as the lifeblood of the economy, touting its role in job creation. However, economists have questioned the veracity of these claims. The jobs created tend to be lower paying, and many small businesses have short life spans, so net job creation by small business is much less than gross job creation.[43]

> The problem with the LCGE is that it ultimately rewards those that grow a business slowly over a period of decades just as much as dynamic entrepreneurs who create rapidly growing businesses.

The most serious problem is the effect on overall economic efficiency and growth in the standard of living. As explained further in section 8.1 below, small businesses lack economies of scale and usually do not have access to the latest technology and equipment. Therefore their average productivity is low.[44] The tax breaks effectively subsidize their higher costs and make it possible for small businesses to represent a large share of the economy.[45]

Another issue with the LCGE is that the requirements to qualify are not very stringent. In order to claim the LCGE, the company is required to have been involved in active business activity for two years prior to the sale. Individuals who have deferred income accumulated in a corporation from activities that would not otherwise qualify (e.g., investment or professional income) can use their capital to purchase a safe operating business, such as a franchised coffee shop, and then re-sell it two years later, effectively converting their previous earnings into a tax-free capital gain. The generosity of this scheme is considerably increased by allowing the business ownership to be split among members of a family, so that a couple with two children may be able to convert more than $3 million free of tax.[46]

41 Canada Department of Finance, *supra* note 2.
42 Geoffrey E. Hale, *Uneasy Partnership: The Politics of Business and Government in Canada* (Toronto: University of Toronto Press Higher Education, 2006), p. 92.
43 Erin Weir, "Small Business and Jobs," Progressive Economic Forum, 2009, http://www.progressive-economics.ca/2009/08/31/small-business-and-jobs/; Anne-Marie Rollin, "Measures of Employment Turnover post 2000: Gross Employment Gains and Losses Versus Net Employment Change," *Statistics Canada Economic Insights*, Catalogue no. 11-626-X, 2012.
44 Research has found that the proliferation of small scale business accounts for a large proportion of the productivity gap between Canada and the United States. e.g., "The impact of Canada's firm-size disadvantage on the labour productivity gap between Canada and the United States," *Statistics Canada Daily*, Wednesday, January 8, 2014, http://www.statcan.gc.ca/daily-quotidien/140108/dq140108a-eng.htm
45 Duanjie Chen and Jack Mintz, "Small Business Taxation: Revamping Incentives to Encourage Growth," School of Public Policy, University of Calgary, *SPP Studies*, Volume 4, Issue 7, May 2011.
46 This would require shrewd advance tax planning, such as distributing the shares before they had appreciated, having the spouse purchase them at fair market value, and ensuring that children have reached the age of 18 prior to the disposition.

The LCGE may be intended as a reward for entrepreneurship, aimed at encouraging people to undertake risks by the prospect of a large reward at the end. The problem with the LCGE is that it ultimately rewards those that grow a business slowly over a period of decades just as much as dynamic entrepreneurs who create rapidly growing businesses.

Public policy ought to be targeted more at encouraging the creation of innovative, dynamic firms that grow rapidly. As noted by analysts at the OECD, other countries have adopted alternative measures that are aimed at rewarding dynamic companies rather than routine service businesses: "If it is felt that there is a compelling economic case for at least partially exempting capital gains taxation on investing in high-growth companies, it may be preferable to replace the LCGE by a measure along the lines of that in the United States, which provides a 100% reduction in capital gains tax for shares issued by small businesses ... when they become public companies."[47]

RECOMMENDATION #7

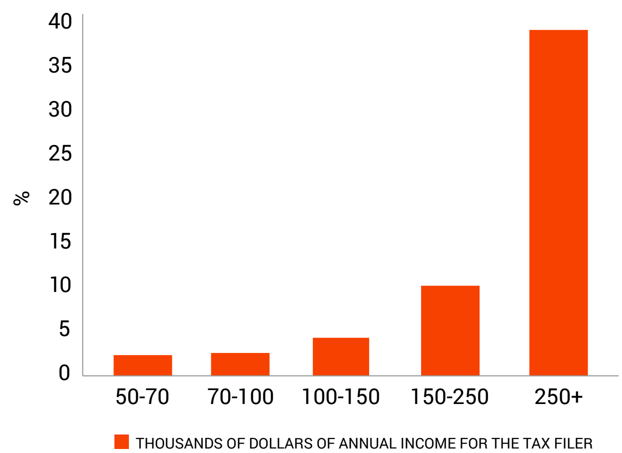
Redesign the Lifetime Capital Gains Exemption so that it encourages more dynamic growth by small businesses.

3.8 Conclusion: A General Exemption is a Blunt Instrument that Misses its Target

The most cogent argument for special treatment of capital gains applies to long-term assets, where a substantial part or even all of the apparent capital gain is due to inflation. However, responding to this problem with an across-the-board low capital gains tax rate is the wrong way to do it. Indexing capital gains for inflation is an administratively simple and much more appropriate way to deal with the problem.

FIGURE 2

Capital Gains Income as % of Employment Income by Income Group

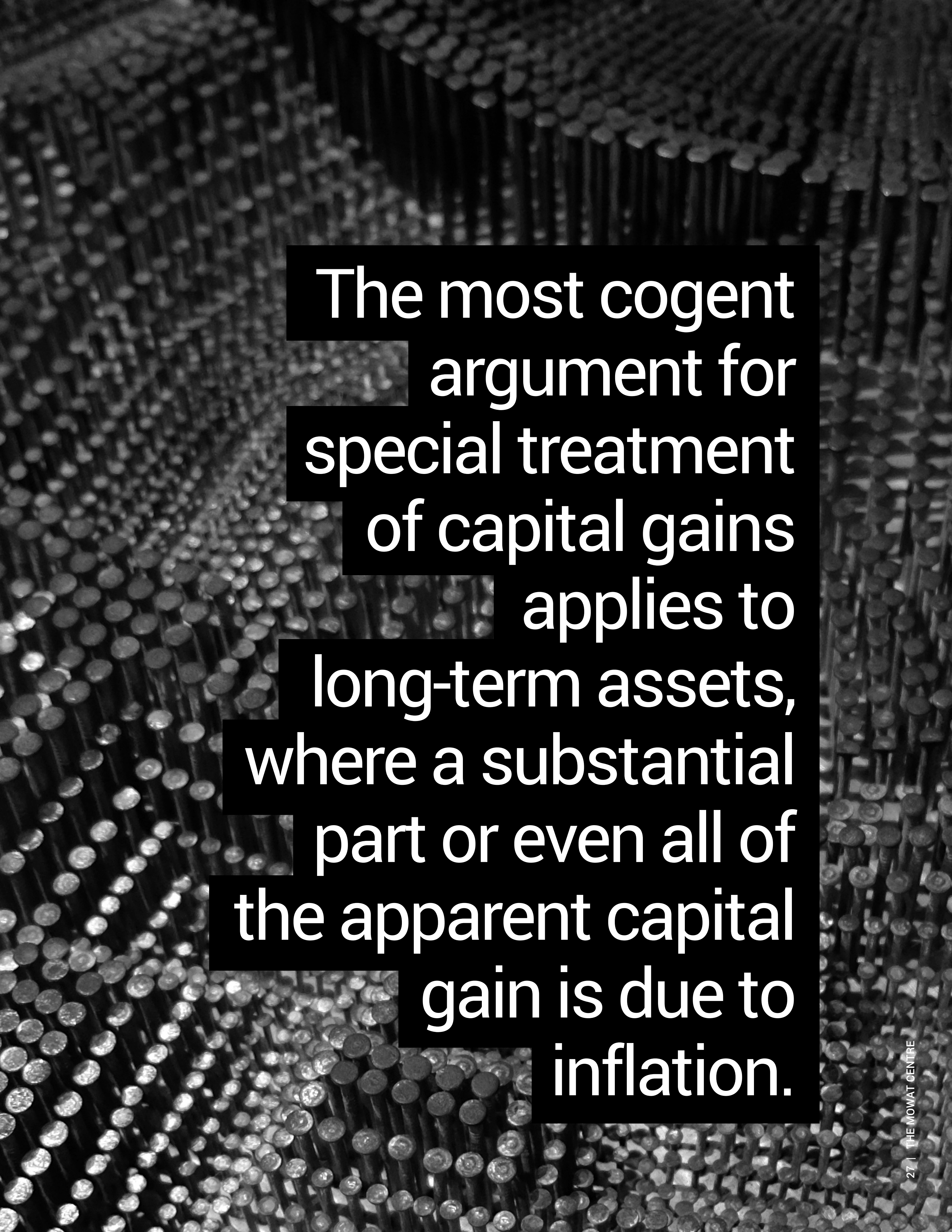


Source: Calculated from Canada Revenue Agency, Preliminary Income Statistics - 2016 Edition, for 2014 taxation year.

Taking care of inflationary gains would probably also resolve a substantial part of the concern about lock-in. An expanded use of rollovers could alleviate problems for other types of capital assets where lock-in might otherwise prevent capital from going to its most efficient use within the Canadian economy.

If these specific measures are taken, the remaining arguments provide little justification for the current low inclusion rate on capital gains. Increasing that rate would improve both the equity and efficiency of Canada's tax system.

47 *OECD Economic Surveys: Canada*, 2016, p. 148.



The most cogent argument for special treatment of capital gains applies to long-term assets, where a substantial part or even all of the apparent capital gain is due to inflation.

4 THE DIVIDEND TAX CREDIT

Taxpayers who receive eligible dividends[48] (generally, any dividends from publicly traded Canadian corporations) may claim a credit that substantially reduces the personal tax payable on this income. It is often claimed that this dividend tax credit (DTC) is needed to avoid double taxation. The argument is that the corporation has already paid corporate income tax on the income out of which it pays the dividends. The credit is therefore supposedly an offset to prevent this income from being taxed twice. As will be discussed below, there are good reasons to believe that the logic behind this is faulty. No such relief is necessary, and it leads to distortions in investment decisions and reduces the fairness of the tax system.

The federal tax revenue given up due to the DTC totals about $5 billion per year. The reason why it is not an even larger amount is that the majority of Canadians who own stocks, directly or indirectly, do so in tax sheltered instruments such as registered pension plans and RRSPs where there is no direct tax on dividends at all. However, when these funds are withdrawn, the portion that was earned as dividends does not get any special tax treatment at all, and is fully taxed as regular income.

That is an example of one of the distortions in decision making that results from the DTC. For unsheltered investments, stocks have a substantial advantage relative to bonds, as the after-tax yield from dividends becomes higher even if the pre-tax yield is the same on both. However, once these investments are held inside an RRSP, there is no difference. Based on the arguments presented below, it is appropriate that there be no difference. However, that does not justify the unfairness inherent in the current inconsistent tax treatment of the same assets in different environments.

48 Generally, any dividends from publicly traded Canadian corporations.

4.1 Unnecessary as a Compensation for Corporate Tax

The idea that compensation is needed to offset the tax already paid by a corporation has an appealing elementary logic to it. However, taxation is one area where economic analysis that is limited to simple arithmetic often leads to mistaken conclusions. It is important to understand that the person who sends the tax payment to the government is not always the one who actually bears the cost of it. They may be able to pass it on to some other party who has weaker power in the market. This is particularly relevant in the case of large corporations.

The capital of large corporations is very mobile globally, and goes to wherever it can get the highest return.[49] If a country has some

49 By contrast, the capital going into small businesses is typically local rather than being internationally mobile. A valid argument may exist for the dividend tax credit as an offset to corporate tax for small business corporations. However, as noted elsewhere, small businesses already benefit from a surfeit of tax preferences of their own.

impediment to earnings, such as a higher corporate tax rate, the capital will tend to stay away until other factors adjust to offset the impediment. Capital moves easily across international borders, while consumers, workers, and land do not. The adjustments will consist of a combination of changes, depending on relative bargaining power: prices being increased for consumers, and/or wages being reduced for workers, and/or rents being reduced for the owners of immobile property rights.[50]

The movement of capital into or out of the country continues until the after-tax rates of return (adjusted for risk) in Canada are made equal to the global norm. As noted by Robin Boadway, "evidence suggests that the corporate tax is largely shifted to labour, so giving credit to shareholders for it is largely a windfall."[51]

This effect is reinforced by the way shares are traded. Corporate shares traded on stock markets are extremely liquid, and the markets are global. Shares of Canadian companies are bought and sold by investors from all over the world, and some of the largest Canadian companies are even listed on foreign stock exchanges.

The prices of corporate shares reflect all relevant information, including the taxes paid by those corporations that affect their after-tax income. If a company happens to do a lot of its business in a country that has an above-average corporate tax rate, that was already factored into the price of the shares when the investor bought it. The price of the shares was marked down as much as it needed to be in order to leave the shareholder's rate of return unaffected by the corporate tax.[52] No compensation is required.

A large proportion of Canadian shares is owned by foreign investors and by Canadian pension funds. These investors are **not** entitled to receive the DTC. They would not buy Canadian shares if Canadian corporate taxes had the effect of reducing the rate of return that they receive.

The most widely used measure of valuation in the stock market is the price/earnings ratio (P/E). This expresses the market price of the stock as a ratio of the net (after-tax) earnings per share of the company. If P/E ratios were systematically higher in Canada because taxes had reduced net earnings, then one could say that Canadian investors are getting a worse deal, and they need a DTC to compensate them. In fact, the prices of shares are set in the market to keep the P/E ratio competitive. Empirical studies find that Canadian P/E ratios are similar to those of comparable stocks in other countries.[53] No compensation through a DTC is necessary.

Another indicator that the double taxation justification is fallacious is seen in the fact that the DTC is given indiscriminately to the dividends of any Canadian company. There is no attempt in the tax code to link the credit to the amount of tax actually paid by the company. [54] In fact, a

50 Rents exist more broadly than simply rents of land. They exist in connection with any property right that has a localized value inside Canada's borders, including property rights in intangibles such as monopolistic power. That is one reason why the corporate income tax remains an important taxing tool in spite of capital itself being highly mobile.

51 Robin Boadway, "Piecemeal Tax Reform Ideas for Canada—Lessons from Principles and Practice," Canadian Tax Journal (2014) 62:4, 1029 - 59, p. 1052.

52 As noted above, the share price may need to adjust only a little, or not at all, if other factors such as wages in that country have fallen to offset the higher corporate tax rate. The point is that, if any adjustment at the first stage was blocked, it will be remedied in the stock market.

53 Gerald Garvey and Ron Giammarino, "Ownership Restrictions and the Value of Canadian Bank Stocks," Research Paper Prepared for the Task Force on the Future of the Canadian Financial Services Sector, 1998. They found that P/E ratios for Canadian bank stocks were as high as those in the US. Richard Deaves, Peter Miu and Barry White, "Canadian stock market multiples and their predictive content," *International Review of Economics and Finance* 17 (2008) 457–466 is a comprehensive econometric analysis of the determinants of Canada P/E ratios, in which corporate tax rates play no role.

54 Boadway, *supra* note 51, p. 1036.

company can be eligible for the DTC even though it may actually not have paid any Canadian corporate income tax at all. For example, a Canadian headquartered company can receive dividends from a foreign subsidiary without paying any Canadian tax.[55] It can then pay these funds out to its Canadian shareholders, who still receive the DTC.

The implication of these capital market fundamentals is that Canadian individuals who own shares are not impacted by Canadian corporate taxes. The DTC they receive compensates them for something for which no compensation was required. It is essentially a windfall for the investors who own eligible stocks.[56]

4.2 Discouragement of International Diversification

The DTC encourages Canadians who own stocks outside registered plans to be undiversified and own a larger percentage of Canadian stocks than they would otherwise. Where Canadian individuals hold stocks outside RRSPs, more than 80 per cent are those of Canadian companies.[57] Canadian stocks represent a very small proportion of the world market. The Canadian economy is resource based, and many major modern industries have little representation on Canadian stock markets. Therefore, it would make sense for Canadian investors to diversify and hold only a smaller proportion of their assets in Canadian stocks.

It is those with the very highest incomes who have significant amounts of taxable dividend income and therefore benefit the most from this tax credit.

Canadian taxable investors are much more heavily invested in Canadian stocks than would otherwise appear prudent. One likely explanation is the DTC, which makes investing in Canadian dividend paying stocks much more attractive than comparable foreign stocks.

This appears to be a throwback to a historical period of economic nationalism, when foreign investment was actively discouraged by government policy. That policy no longer exists, but it remains preserved as a fossil in the DTC.

55 Foreign earnings by Canadian corporations represent a substantial share of net after-tax profits reported in Canada. See Peter S. Spiro, "Can a Dividend Tax Credit Be Justified in a Small Open Economy?" 2013, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2268791, note 34.
56 It appears from the evidence of P/E ratios that it does remain a windfall for the relatively limited pool of taxable Canadian investors. There are not enough of them to bid up the price of eligible Canadian stocks and fully capitalize the benefit.
57 See Spiro, *supra* note 55, Table 3. As this table shows, there is also a considerable degree of "home bias" even by pension funds that are not affected by the DTC. However, the degree of bias is much larger for unsheltered personal investments.

4.3 Historical Background to the DTC

Dividends received from corporations became taxable in Canada in 1926, and did not receive any special treatment in the personal income tax for many years after that. This became more problematic when income tax rates rose sharply in the post-war period, as capital gains were not taxed at all. It "created incentives among shareholders to accumulate profits in corporations, convert these profits to capital gains, and thus avoid personal taxation and achieve the tax-free realization of income."[58] This was a particularly significant problem in the case of closely held corporations, where the shareholders had direct control over dividend policy.[59]

The logical response to the problem might have been to introduce a capital gains tax. In contrast to Canada, the US has had a capital gains tax ever since 1913, and the taxation of dividends did not receive any special treatment until 2003. Canada did not introduce a capital gains tax until 1972. Instead, in 1949 a 10 per cent DTC was introduced for dividends received from Canadian corporations.

In the earliest incarnations of tax expenditure analysis in the 1970s and early 1980s, the Department of Finance referred to the DTC as a tax expenditure, on the grounds that its design was very different from a fully integrated corporate tax. There was no attempt to match the amount of DTC received on a particular stock with the amount of tax paid by the company. Some companies may benefit from special deductions that leave them free of corporate income tax, but in spite of that their shareholders get the same DTC as everybody else.

In a 1977 report, the Department of Finance stated that a "proposed enrichment of the DTC was not intended to provide greater relief from the double taxation of corporate income, but to attract increased investment in Canadian equity securities." This view of a nationalistic purpose for the DTC appeared as late as 1992 in Department of Finance documents.[60]

Today, the Department of Finance labels the DTC a structural component of the tax system, rather than as a tax expenditure. The Department of Finance's Tax Expenditures report does provide figures for the revenue foregone due to the DTC. It is described as structural "because its purpose is to reduce or eliminate the double taxation of income earned by corporations and distributed to individuals through dividends."[61]

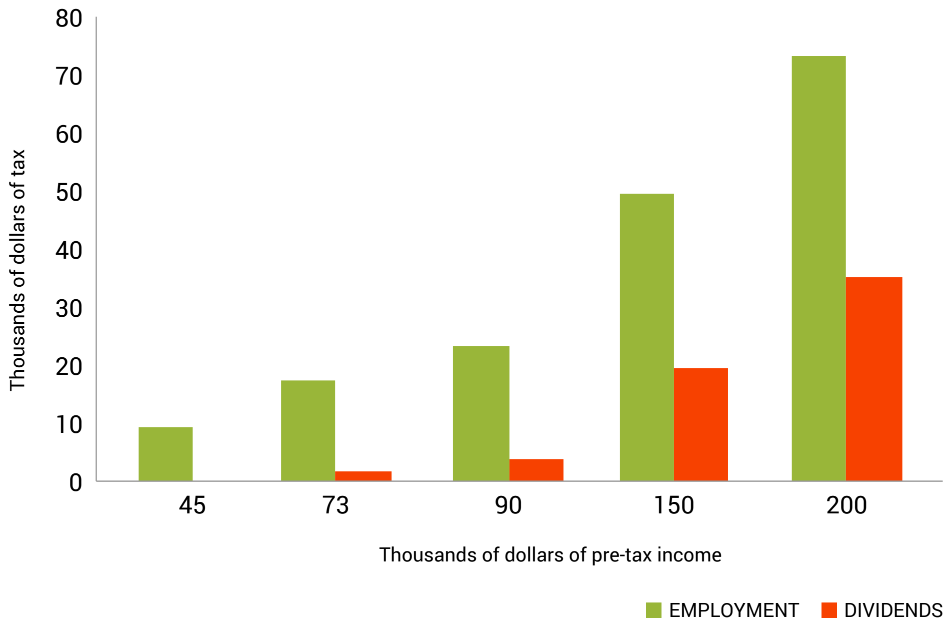
It is clear that the DTC and the capital gains tax on corporate stock are interrelated. If the DTC was eliminated, while the current capital gains tax exemption was kept in place, the latter would create a means of avoiding taxes on dividends. Companies could reduce dividends and keep more retained earnings, which would result in greater capital gains for the shareholders when the stocks were sold. Therefore, reform in both of these areas has to be carried out in a consistent manner.

58 Glenn P. Jenkins, "The role and economic implications of the Canadian dividend tax credit," Ottawa : Economic Council of Canada, 1986, p. 1.
59 Tim Edgar, "Integration Canadian Style: Comments on the Dividend Tax Credit and the Recommendation of the Ontario Fair Tax Commission," (1994) 9(16) *Tax Notes International* 1231-1254, p. 1233.

60 Tim Edgar, "Distress Preferred Shares and Small Business Development Bonds: A Tax Expenditure Analysis," (1994a), 42 *Canadian Tax Journal*, No. 3, 659 at 671.
61 Canada Department of Finance, *Tax Expenditures and Evaluations 2012*, p. 9.

FIGURE 3

More tax paid on employment income than the same income from dividends



Source: Author's calculation based on the tax rates in Table 1.2

4.4 Beneficiaries of the DTC

It is those with the very highest incomes who have significant amounts of taxable dividend income, as seen in Table 1.3 above. They therefore get the largest benefit from the DTC. It is another tax expenditure that significantly undermines the progressivity of the tax system.

The DTC makes possible the earning of high incomes at below normal tax rates. For example, a person earning between $150,000 and $200,000 from employment income pays a 48 per cent income tax rate on the last dollar of income (combined federal and Ontario taxes). By contrast, a person whose only source of income is from dividends can earn this much and pay a tax rate of only 31.7 per cent on the last dollar.

The unequal treatment would be considered unfair even if dividend income did not happen to be concentrated in the hands of higher-income people. It violates the basic principle that people with the same amounts of income should pay the same amount of tax.

Consider two people with identical amounts of gross income, e.g., $80,000. A, who gets his income by working will have after-tax income of $60,350. B, who gets his income from dividends, will end up with after-tax income of $77,600.

In comparing fairness among individuals with very different sources of income, it is pointless to consider antecedent factors that might have affected the level of income they are receiving. There is always an endless list of economic factors that might have made A's income higher than B's, or vice versa. The bottom line is that we have two people with the same gross income, but very different after-tax income because of a tax preference that is available to only one of them. As suggested above, there is really not a good economic justification for the DTC, and therefore nothing to justify the differences in after-tax incomes that arise from it.

RECOMMENDATION #8

Reduce or eliminate the DTC for large corporations in conjunction with capital gains tax recommendations.

5 WITHHOLDING TAXES

Withholding taxes are taxes that are charged on earnings of foreign investors in Canada. As a result of a web of treaties with other countries, much of the investment income earned by foreign investors in Canada is not taxed by Canadian governments. The annual revenue given up due to this is about $5 billion.

It might be thought that this is a benefit to the foreign investors. If so, it would increase their incentive to invest in Canada and therefore provide a benefit to the Canadian economy. This is the position taken by Jack Mintz, who suggested criteria for applying a benefit/cost evaluation:

> *From Canada's perspective, the economic cost of withholding taxes is that they inhibit the efficiency of its capital market, US foreign direct investment in Canada, and the efficiency and competitiveness of Canadian-based multinationals. The benefit of withholding taxes is that they shore up government revenues. A key element of any economic evaluation of withholding taxes is the degree to which they are credited. When fully credited, they have little impact on investment, except for compliance costs.*[62]

These are reasonable criteria, but it is questionable whether they would justify the very generous exemptions that have been permitted in recent years. Many foreign countries, and the United States in particular, tax their citizens on their world-wide income. The home government might have given its citizens a credit for the tax that they had to pay to Canada. In such a situation, the lack of a withholding tax may result in Canada losing revenue that just goes to a foreign government instead.

In some cases, the primary beneficiaries may be Canadian investors in foreign assets. These treaties are reciprocal. Canada exempts foreign investors in exchange for their governments exempting Canadians. Canada may or may not succeed in subsequently taxing the foreign income of its own citizens. If the foreign asset is held in a tax sheltered instrument, the effect of the treaty may be that the Canadian investor pays no tax to any government, at least until the asset is divested.

62 Jack M. Mintz, "Withholding Taxes on Income Paid to Nonresidents: Removing a Canadian-US Border Irritant," C.D. Howe Institute Backgrounder, 2001, pp. 6-7.

Many of the tax treaties are with tiny countries such as Barbados, whose citizens are too few (and too poor) to have significant investments in Canada. The benefit of the treaty is for Canadian taxpayers. Wealthy Canadian investors may park their foreign investments in offshore trusts in tax havens. These are legal, and if certain requirements are met they are not liable to Canadian tax.[63]

RECOMMENDATION #9

Review tax treaties and withholding tax policies to better understand the net revenue cost and the economic benefits, if any.

63 Occasionally, taxpayers make mistakes and run afoul of the rules. In that case, these offshore trusts become taxable in Canada, as in *Fundy Settlement v. Canada*, 2012 SCC 14, [2012] 1 S.C.R. 520.

6 TAX FREE SAVINGS ACCOUNTS

Canadian Tax Free Savings Accounts (TFSAs) have only existed since 2009. However, similar schemes have existed for longer periods in the United States and United Kingdom, which helps predict future trends in Canada.

The promoters of TFSAs have argued that they are of benefit to lower income people. However, lower income people do not have the savings capacity to accumulate significant amounts of money in these or any other savings instrument. The Conservative government had increased the annual contribution limit to $10,000 per year as of 2015, while the succeeding Liberal government reduced it back to $5,500 for 2016 and the following years. Analysis by J.R. Kesselman finds that, even at this lower level, the benefits are heavily weighted towards higher-income people. He observed that "barely 1 out of 15 Canadians eligible to have a TFSA utilized the maximum available contribution limit in 2013, and the rate has undoubtedly declined further by 2015." [64]

Kesselman went on to observe that "the highest-income TFSA holders are the ones with the most to gain from increasing the contribution limit. The behavioural patterns support the hypothesis that TFSA contributions come largely from shifting of taxable assets rather than new saving."[65]

64 Jonathan Rhys Kesselman, "Tax-Free Savings Accounts: Expanding, Restricting, or Refining?" Canadian Tax Journal (2015) 63:4, 905 - 45, p. 921.
65 *Ibid.*, p. 924.

Benjamin Alarie cites a United States study of Roth IRA's, which are quite similar in design to TFSAs. This found that "the richest 10 per cent receives about 55 per cent of the tax benefits."[66]

The amount accumulated in TFSAs started out small, and therefore the initial tax revenue loss is modest.[67] However, projections indicate that it will become a major source of tax revenue loss over the long term. Therefore, further review of this type of tax shelter is in order. One possible option is a lifetime cap on the total that may be accumulated in a TFSA.

There is one outstanding policy problem that needs particular attention. Based on current legislation, TFSA withdrawals will not be taken into account in testing the eligibility of a person for social support programs that are aimed at lower income people. If that were maintained, it could lead to the bizarre situation that a person who is a TFSA millionaire could qualify for income support programs aimed at those below the poverty line.

66 Alarie, *supra* note 18, p. 509.
67 However, there are reports that even over a short period, a few individuals have managed to accumulate over $1 million in a TFSA: http://business.financialpost.com/personal-finance/tfsa/this-bay-st-trader-managed-to-amass-1-25-million-in-his-tfsa-now-the-taxman-wants-to-know-how?__lsa=3fe9-c8bd

Proponents of TFSAs have sold the concept as a way to allow lower income people to save for the future, without facing a penalty from the clawback of social benefits as a result of this saving. That may sound quite laudable and altruistic, but it is rooted in a fallacy. It presupposes that there is one group of low-income people who are imprudent, and another that is prudent and saves for the future. Most of the time, the reality is that the people who saved were able to do so because they had higher incomes at some point in their lives, rather than because they are more virtuous. Given that there is a limited budget for social benefits, it makes sense to allocate it based on actual need rather than dubious judgments about which lower income people are more virtuous. If one finds two retired people, each with $15,000 of pension income, but one with $200,000 saved up in a TFSA and the other with none, it does not make sense to give both of them the same social benefits. Nevertheless, that would be the result of the current legislation.

It is unlikely that such a policy would be sustained as the absurdities multiply in the long term. It may not appear to be an urgent matter at the present time, but delaying the inevitable is not a good policy. It would be preferable for governments to develop a more sustainable policy in advance and embed it in legislation, rather than having to do it retroactively.

RECOMMENDATION #10

Retain a low limit on the maximum contribution to TFSAs.

RECOMMENDATION #11

Announce a sustainable policy regarding the effect of TFSA withdrawals on the eligibility for social benefits.

While the amount accumulated in TFSAs started out small, they are projected to become a major source of tax revenue loss over the long term.

7 TAX PREFERENCES FOR RETIREMENT SAVINGS

7.1 The Most Expensive Tax Preference of Them All

This is the largest category of tax preferences by far. At first blush, it may seem churlish to question them. After all, what could be more meritorious than people who are prudent and save for their retirement? The tax system encourages this saving in two ways. First of all, the income put aside for retirement is exempt from the usual income tax when it is originally earned. On top of that, the interest, dividends and capital gains that these savings earn in the decades leading up to retirement are also exempt from income tax. No tax is payable until income is withdrawn from the plan. As a result, the nest egg grows much faster. For any given amount of saving, the amount available in retirement will be much larger due to these tax exemptions.

Canada's tax expenditures for retirement saving are considerably more generous than the international norm. They are almost twice as large, relative to tax revenue, as in the United States.[68] This loss of tax revenue forces overall income tax rates to be higher. It erodes competitiveness, particular when it comes to attracting internationally mobile high tech workers. They tend to be younger and place less value on the distant future benefits conferred on them by these tax expenditures.

It is sometimes thought that schemes such as RRSPs reflect mainly a deferral of taxes, as tax is eventually paid when the funds are withdrawn. However, investment returns compound within the plan free of tax for many years. Given the "time value of money," this represents a large cost to the public purse on a discounted present value basis.[69]

As illustrated by the fable of the ant and grasshopper, society generally considers it fair that those who save will have more when they retire. The question, however, is just how much more they should have. The problem is

68 OECD (2010), *Tax Expenditures in OECD Countries*, OECD Publishing, Paris, Table II.31, p. 226.

69 This requires complex calculations, and it is sensitive to assumptions about rates of return on investments. It was undertaken by the Department of Finance in the 2003 Tax Expenditures report in a special study entitled "Long-Run Projections of the Tax Expenditure on Retirement Savings." This study estimated that the combined value of the tax expenditure for RPPs and RRSPs in 2001 was $13.7 billion, or 1.25 per cent of GDP. That would be much higher than the simple figures based on annual deductions that appears in the regular Tax Expenditures report, as in Table 1 above.

that the distribution of the benefits from these tax exemptions is quite uneven. Two-thirds of Canadian workers do not have employer pension plans, and the vast majority do not have significant RRSP savings either. Yes, people only get this benefit if they are prudent and they save, but some people are in a better position to save than others by virtue of the higher incomes they enjoy prior to retirement. This results in a situation where the people who save can retire comfortably, taking cruises and spending winters in warm climates, while others barely scrape by.

These tax preferences make it easier to save for retirement for those who would have saved anyway, who are primarily in the top deciles of income. Therefore, these programs exacerbate inequality. This issue can be related back to the discussion earlier, about whether saving as opposed to consumption should receive a more favourable tax treatment. As observed above, it is not really an issue of the taxation of saving per se. The pure return to saving (as measured by the interest rate on low-risk deposits such as savings bonds and GICs) is quite low. Exempting this type of basic interest income from taxation would be a relatively inexpensive tax expenditure.

The tax expenditures that currently exist particularly benefit those who have access to financial acumen and manage to earn much higher rates of return. As observed by Rhys Kesselman, there is no justification for exempting these "supernormal" investment returns from taxation.[70] Income is income, and a buck is a buck. There does not appear to be a convincing reason to treat one kind of income more favourably than another.

The only universal form of tax-assisted savings is the Canada Pension Plan, which currently provides a very modest pension of about $7000 per year for the average recipient. The people who are close to the poverty line and have no other resources receive an additional taxpayer-funded benefit in the form of the Guaranteed Income Supplement (GIS). Somebody with $7000 of CPP would have a total income of about $19,000 from CPP, Old Age Security (OAS), and GIS.[71] That provides a very meagre standard of living.

There is a general view that private saving has a broader societal fiscal benefit, and therefore it should be encouraged. Those who accumulate significant private savings do not require financial assistance from the state, as do those who have very low incomes and therefore receive the GIS. However, the subsidy to saving ends up going primarily to those who would in any case have higher post-retirement incomes, and would never have been in danger of requiring social assistance.

A significant debate has played out about this over the last several years. The reason that CPP benefits are so low is that only 25 per cent of income is replaced by it (and capped at a low limit), as compared to a typical 70 per cent in employer paid pension plans. The Ontario government took the position that the CPP ought to be enhanced to replace a larger proportion of income. Precisely because of the factors driving growing income inequality among workers in recent years, there is a risk of a greater degree of senior poverty in coming decades.

70 *Supra*, note 19.

71 http://www.esdc.gc.ca/en/cpp/oas/payments/tab1_19.page

The critics of CPP expansion like to say that there is no crisis, which is true. Prudent policy, of course, does not wait for a crisis to develop. When there is sufficient evidence of a future risk, policy ought to be changed in order to prevent a crisis from developing.

Those who oppose CPP expansion emphasize the relatively good position of current seniors. Unfortunately, that does not take into account factors pointing to greater problems in the future.[72] The seniors who are already retired are the ones who worked during a relatively strong period of industrial development. Their peak periods of saving included years of unusually high real interest rates in the 1980s and 1990s that enabled them to accumulate more assets. The current workforce, which represents future retirees, consists of a larger proportion of people with precarious employment, with a smaller portion of them covered by employer-provided pension plans, exacerbated by lower rates of return on their private savings.

For current Canadian retirees, less than 40 per cent of their income comes from public pensions or transfers. That is quite low by international standards, where the average among the advanced OECD countries is about 60 per cent.[73]

Given the risks, it may be reasonable for the government to adopt a more paternalistic stance and require an expanded amount of saving for retirement through a public pension plan such as the CPP. If there is a risk that a significant number of people will under-save, it is reasonable to counter this by forcing them to save more while they are working. That is preferable to forcing future taxpayers to provide financial support for them when they can no longer work.[74]

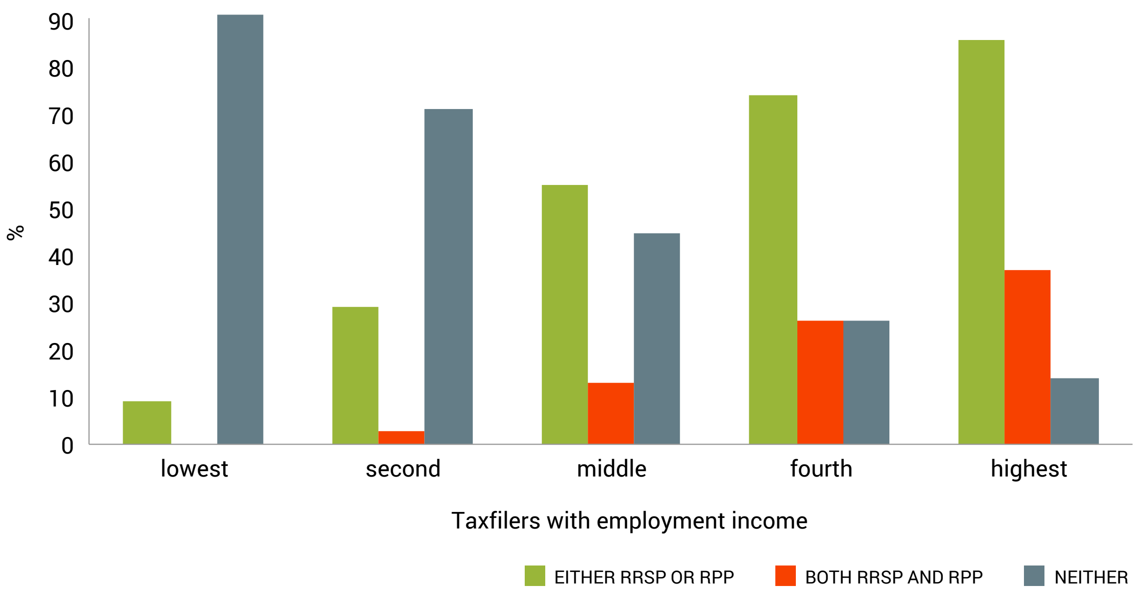
In the context of a discussion of tax expenditures, the key point to make is that the preferences for retirement are the largest among the tax expenditures. Excluding the CPP, they total $40 billion per year. Retirement contributions are capped (the maximum allowed RRSP contribution in 2017 is about $26,000) and that limits the benefit for very high income people. Nevertheless, the percentage of people who manage to take advantage of these preferences rises with income. Higher-income people, including those in the top quintile of income earners, take considerably greater advantage of these programs than lower and middle income people.

72 Richard Shillington, "An Analysis of the Economic Circumstances of Canadian Seniors," Broadbent Institute, February 2016; Keith Ambachtsheer, "Is the New Canada Pension Plan Expansion Based on Myths or Facts?" July 2016, http://kpa-advisory.com/policy-papers; for further discussion of the benefits of CPP expansion, see J.R. Kesselman, "Expanding Canada Pension Plan Retirement Benefits: Assessing Big CPP Proposals," *SPP Research Papers*, University of Calgary, School of Public Policy, 2010.
73 OECD, *Pensions at a Glance 2013*, Figure 2.4. http://dx.doi.org/10.1787/pension_glance-2013-en

74 Support for low income seniors increases demands for a variety of public spending programs in addition to explicit income support to alleviate poverty.

7.2 Most of the Benefit Flows to a Minority of the Population

FIGURE 4
Participation in private retirement saving by income quintile



Source: Karim Moussaly, "Participation in Private Retirement Savings Plans, 1997 to 2008," Statistics Canada, 2010, Table 7, data for 2008.

It is a relatively small segment of the population that benefits from this major tax preference. Less than one-third of the Canadian labour force is a member of a registered pension plan (see Figure 5). The proportion is somewhat higher for employees, but it is important to factor in the growing proportion of Canada's workforce that is self-employed. RRSPs exist as an alternative for the self-employed, but in fact many people have neither an RRSP nor an RPP (see Figure 4). In the highest income quintile, 40 per cent of taxpayers have both an RRSP and an RPP.[75]

Among middle income Canadians with employment income, almost half has neither an employer pension nor participates in an RRSP.[76] Of those who have RRSPs, the amount of contributions is often too little to provide significant retirement income. Even among the half of the population that participates, the benefits are heavily weighted towards the upper end of the income range.

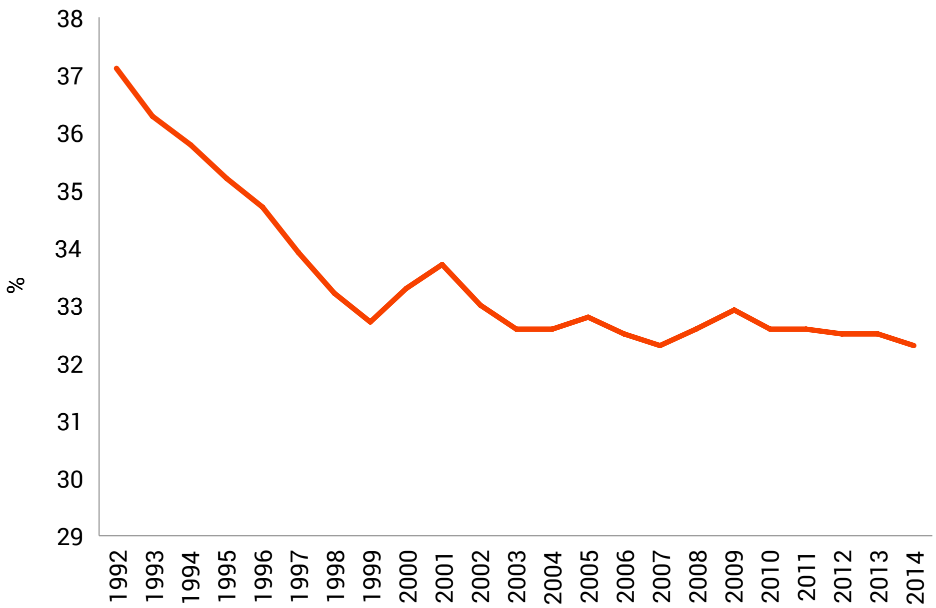
The very uneven distribution of this tax benefit should be a concern from the viewpoint of the fairness of the tax system. It is not enough to say that anyone with employment income is legally

75 In total, of those with RPPs, slightly over half also have RRSPs: Derek Messacar, "Do Workplace Pensions Crowd Out Other Retirement Savings? Evidence from Canadian Tax Records" 2015, Statistics Canada, Analytical Studies Branch Research Paper Series, Catalogue no. 11F0019M, No. 371, Table 2. RPP contributions by an individual reduce RRSP contribution room, so the combined contribution has an upper limit.

76 Karim Moussaly, "Participation in Private Retirement Savings Plans, 1997 to 2008," Statistics Canada, Catalogue no. 13F0026M, no. 1, 2010, Table 7, data for the middle quintile of those with employment income, 2008. Even for the prime savings rate age groups (those in the middle income quintile aged 35 to 64), about 40 per cent contributed to neither an RPP nor an RRSP (Table 9).

FIGURE 5

Less than one third of the labour force belongs to an employer pension plan



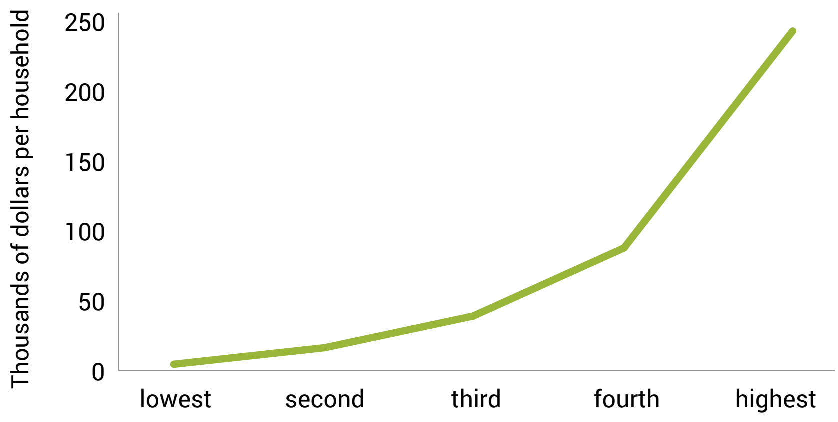
Source: Statistics Canada, Table 280-0016, Registered pension plans (RPPs).

entitled to make RRSP contributions, and the people who fail to do so have only themselves to blame. The government appears to believe that retirement saving is such an important goal that it deserves a very large subsidy. Where so many people are unable to take advantage of this subsidy, different policies should be considered.

Fairness would be enhanced by providing a subsidy only for the type of retirement saving that is universal, namely the CPP and OAS.[77] If there is to be a subsidy for retirement income, it is arguably fairer to focus it more on those with greater need, by expanding the tax-funded OAS. The OAS currently has an annual value of $6840. That is a very modest amount compared to the tax expenditure subsidy to retirement income received by those in the top quintile or decile. It is true that maximum contributions to RPPs and RRSPs are capped, but in absolute dollar terms the privately sourced retirement income received by people at or near the contribution ceiling is much higher than the tax-funded OAS benefit received by lower income people. To justify the current subsidies for retirement savings to those in the top deciles, one needs to demonstrate that they confer a broad economic benefit -- a positive externality. However, as discussed in the next section, the evidence tends to suggest that they do not have a positive impact on the national savings rate.

77 Some critics have suggested that the planned increases in CPP premiums may put a burden on lower income individuals, but the Working Income Tax Benefit has been enhanced to alleviate this.

FIGURE 6
Value of RRSP Assets by net worth quintile



Source: Statistics Canada, Table 205-0003 Survey of Financial Security (SFS), 2012

7.3 Subsidizing Retirement Plans May Actually Reduce Savings

In addition to the important issue of fairness, there is the deeper question of whether the subsidy given to RPPs and RRSPs ought to exist at all.[78] Is such a large tax expenditure to support retirement saving justifiable?

It was observed above that the economic literature is ambiguous about how the tax rate on investment income affects the incentive to save. With something as specific as saving to replace income in retirement, it is more than likely that many people have a specific target in mind. It is therefore quite possible that the subsidy provided to retirement saving actually leads to a lower amount of total saving. People can achieve their desired target level of pension income by putting aside a smaller amount each year when they are working, because the amount saved and the investment return on it are not taxed. If one takes a view that a higher national rate of saving is desirable, because it supports more real capital investment, then this is a perverse policy.

A major study on this subject was undertaken by researchers at the OECD. They pointed out that the popularity or high take-up rate of these retirement schemes is not evidence that they are successful in increasing overall savings;

In order for such tax incentives to achieve their stated goal of increasing or encouraging saving, it must be the case that the saving level responds positively to an increase in the net rate of return. If that has to be the case, the funds going into such accounts need to have come from individuals reducing their consumption levels as opposed to simply moving money from one form of saving to another. As a result the simple size and take-up of such schemes is not an indicator of their effectiveness as a policy instrument in increasing personal and household saving. Instead the evaluation of their success is somewhat more complicated, as it should consider what the same households that are

78 Research has not found a noticeable positive impact of RRSPs on the savings rate: John Burbidge, Deborah Fretz, Michael R. Veall, “Canadian and American Saving Rates and the Role of RRSPs,” *Canadian Public Policy*, Vol. 24, No. 2 (Jun., 1998), pp. 259-263; See also Kesselman, supra note 22.

taking up these schemes would have saved in their absence. Moreover, if one is interested in the effect of these schemes on national rather than personal savings, one has also to consider the implications for government saving that is affected through the reduced tax liabilities implied by these schemes.[79]

To answer this question, they looked in considerable detail at the savings flows of households. For example, to evaluate the effect of IRAs in the United States, they looked for changes in household consumption as reported in the Consumer Expenditure Survey. Detailed analysis of these data failed to find an increase in saving:

The coefficient on new contributors is not significantly different from zero in any of the specifications that we report. Furthermore, in most specifications the point estimates are positive rather than negative. According to these results, therefore, we can resoundingly reject the hypothesis that IRAs create new saving: consumers who start contributing to one do not seem to be reducing their consumption.... the evidence from the two tests presented is remarkably consistent, making them credible. Second, the contributions of the IRA legislation to new saving is minimal.[80]

The overall conclusion of this research was that "at the most, only relatively small fractions of the funds going into tax-advantaged savings vehicles can be considered to be "new" saving. As such, the best interpretation of the evidence is that such policies are expensive ways of encouraging savings."[81]

79 Orazio P. Attanasio, James Banks and Matthew Wakefield, "Effectiveness of Tax Incentives to Boost Retirement Saving," *OECD Economic Studies* No. 39, 2004/2. This study used data from the United States and the United Kingdom, but those countries are sufficiently similar to Canada that its findings are likely to be applicable here.
80 *Ibid*, pp. 151-152 and 155.
81 *Ibid.*, p. 166.

The implication of this view is that it might be more efficient to significantly curtail or even eliminate these subsidies for retirement saving, and use the money instead to lower the overall income tax rate and enrich public pension plans. An expansion of mandatory public pension plans is more likely to increase overall savings, if that is the goal of policy. Critics of public pensions often argue that this goal will be frustrated, as individuals respond by reducing their private savings rate when public pensions are increased. That may be true for those who were already saving. However, if there is a significant segment of the population that has low private saving, forced saving would cause an overall net increase in savings. It would imply that a broad public pension plan has a greater potential to increase the national savings rate than the current tax incentives.

If research establishes that this is a legitimate national policy goal, a legislated policy creating a compulsory minimum level of retirement saving could be set. That could be achieved either by compulsory contributions to an expanded Canada Pension Plan or to alternative compulsory private plans.[82] In spite of massive tax incentives, it appears that savings rates have fallen to fairly low levels.[83] This suggests that if policy intervention really is needed in this area, it would make more sense to use some form of

82 The latter is the Australian approach, recommended by Stephen Kirchner and Charles Lammam, "Lessons for Ontario and Canada from Forced Retirement Saving Mandates in Australia," Fraser Research Bulletin, August 2015. However, research suggests that private retail investing is costly and earns substandard returns: Juhani T. Linnainmaa, Brian T. Melzer, and Alessandro Previtero "Costly Financial Advice: Conflicts of Interest or Misguided Beliefs?" Working Paper, University of Chicago, Booth School of Business, faculty.chicagobooth.edu/juhani.linnainmaa/MisguidedBeliefs.pdf
83 Some argue that Statistics Canada's savings rate is inaccurate, e.g., Malcolm Hamilton, "Do Canadians Save Too Little? Reports of undersaving by Canadians for retirement are exaggerated." C.D. Howe Institute Commentary No. 428, 2015. However, Hamilton's critique is based on including the asset value of housing, which is not counted by Statistics Canada. It can be countered that equity in owner-occupied homes is not readily convertible to spendable cash (there are many problems with reverse mortgages).

It would make more sense to use some form of compulsory saving rather than dangle the carrot of a large subsidy that is very expensive and has limited effectiveness.

compulsory saving rather than dangle the carrot of a large subsidy that is very expensive and has limited effectiveness.

It should be observed that the 2016 federal-provincial agreement will lead to only a modest expansion of the CPP. The income replacement level will be increased to one-third of eligible earnings, compared to 25 per cent currently, while the upper earnings limit will be increased by 14 per cent.[84] Steps to expand that further in future years may be justifiable. Of course, even this modest expansion met considerable resistance, and came about through Ontario's threat to set up its own compulsory public pension plan. Consensus about reform in this area is difficult to achieve. In spite of that, it is desirable to continue to think about further reform and set long-term goals.

If the current subsidies for saving were replaced with lower general tax rates, the tax system would be more efficient and less prone to avoidance and evasion. The income tax a person pays does not confer any direct benefit on that person, and therefore a high rate of income tax serves as an incentive to tax avoidance and evasion. By contrast, the future pension that a person receives is directly related to the CPP premiums paid while working. A forward-looking person does not view these premiums as a tax, and would have little or no incentive to evade them.[85]

A system that replaces unproductive subsidies for retirement saving with lower general tax rates would help improve incentives in the tax system. It would also eliminate the unfairness inherent in the current situation, where mainly higher-income taxpayers receive subsidies for savings that they would likely have undertaken even without the incentive.

The general income tax rate reductions made possible by the money saved from reducing tax expenditures would leave people with more disposable income, available for them to spend or save as they see fit. It is likely that people who are concerned about their future well-being would save more as a result of these general tax rate reductions, coupled with reduced opportunities to earn untaxed income on investments.

It is unrealistic to think that the current programs could be reformed quickly. A huge financial infrastructure has developed based on the current regime. Millions of Canadians have made their retirement and savings plans based on the expectation that these schemes would be available indefinitely. Suddenly eliminating these tax preferences would be a major shock, and could not be justified given the expectations that have been created.

A possible compromise would be to gradually reduce the tax expenditures in this area. The allowable contributions to these plans could be reduced over the long term. For example, currently 18 per cent of employment income

84 http://www.fin.gc.ca/n16/data/16-113_3-eng.asp

85 One cannot rule out the possibility that some individuals would still try to evade CPP premiums. This could be either because they are irrational, or because they believe that the promise to pay a future pension is unreliable. Nevertheless, the overall incentive to evade is much lower than for the income tax.

may be contributed to an RRSP, (with an upper limit of $25,370 in 2016). That could be gradually reduced, perhaps at a rate of 1 per cent per year, until some desirable target level is reached.

More research needs to be done in this critical area to determine what is being achieved by these large subsidies for retirement savings. There is currently a major OECD research project underway to examine the question of whether it is "better to use tax incentives to increase contributions into private pensions or is it better instead to withhold those tax incentives and increase public pensions instead?"[86]

This is quite a complex question, and precise research answers may be difficult to come by. Nevertheless, given the amount of money devoted to these subsidies for retirement savings, it is certainly worth making a greater effort to understand their effects.

RECOMMENDATION #12

Review tax expenditures for retirement savings to ensure that the benefits are equitably distributed.

RECOMMENDATION #13

Undertake a benefit-cost analysis to determine whether tax expenditures to subsidize retirement savings should be curtailed, using the revenue to reduce overall income tax rates and/or increase tax-funded public pensions for low-income Canadians.

86 OECD Project on Financial Incentives and Retirement Savings, Project Outline 2014-2016, http://www.oecd.org/finance/private-pensions/fiscal-incentives-retirement-savings.htm

If the current subsidies for saving were replaced with lower general tax rates, the tax system would be more progressive, efficient and less prone to avoidance and evasion.

8 THE PREFERENTIAL TAX RATE FOR SMALL BUSINESS CORPORATIONS

The "Small Business Deduction" (SBD) is a tax preference that has broad ramifications. On the one hand, it is an aspect of business taxation, and affects the relative competitiveness of different types of businesses. On the other hand, since a small corporation's profits feed directly into the income of its owner, it will also has significant impacts on income distribution and the fairness of the personal income tax system.

The SBD is technically not a personal income tax preference, but in practice it has much the same effect. The SBD makes employment through a small corporation a tempting alternative to earning regular employment income. It is listed as a $4 billion reduction in corporate income tax. In reality, if it did not exist, some people who are currently self-employed would have chosen instead to be employees. Therefore, the SBD indirectly reduces the government's personal income tax revenue.

Both the federal and provincial governments provide a preferential, lower corporate tax rate for the profits of small corporations. Unusually, this is a tax expenditure where most provincial governments outdo the generosity of the federal government.

The federal rate of tax for large corporations is 15 per cent, and this is reduced by a relatively modest 4.5 percentage points, to 10.5 per cent on the first $500,000 of net income of Canadian Controlled Private Corporations (CCPCs). That is enough, at the federal level, to represent a tax revenue loss of over $4 billion.

The Ontario government's tax rate on the incomes of large corporations is 11.5 per cent. This is reduced by 7 percentage points, to 4.5 per cent, for small corporations. Therefore, the provincial government's tax expenditure in this area is about 50 per cent larger than the federal government's.

8.1 Proliferation of Businesses at an Inefficient Scale Undermines Productivity

The potential for the SBD to reduce economic efficiency has long been a concern of policy analysts. A major review of the corporate tax system undertaken for the Minister of Finance in 1997 noted the risk that this tax rate differential "encourages the growth of small corporations at the expense of large businesses for reasons other than the economic advantages that small enterprises may bring to the economy."[87] Nevertheless, the committee issuing this report stopped short of encouraging the abolition of the preference. It limited its recommendations

87 Report of the Technical Committee on Business Taxation, Ottawa, 1997, p. 3.4. This committee is often referred to as the "Mintz Committee" after the economist who headed it.

to targeting more of the advantage to small firms with higher levels of investment and employment.[88]

Does the economy gain anything from the large tax expenditure represented by the SBD? The tax breaks tempt some people to go into business who might not otherwise have done so. Canada has one of the most generous tax regimes for small business in the developed world, as observed by analysts at the OECD: "Preferential tax rates for small companies are found in only 11 out of the 34 OECD member countries.... Thresholds for withdrawing small company tax preferences are much lower in most other countries with such arrangements than in Canada."[89]

This has increased the share of the economy that is occupied by the small business sector. Most small businesses are in the service sector. If nothing else, the proliferation of small businesses does increase the range of choice available to consumers, beyond the homogenized offerings available from mega-corporations. That diversity has some societal value, but it probably cannot justify the steep economic costs.

It is sometimes argued that small businesses are important for job creation, but unfortunately the average quality of jobs and the pay in those jobs is sub-standard. A disproportionate share of small business jobs is at minimum wage. The proportion of minimum wage jobs is largest in firms with fewer than 20 employees, and is roughly double the rate found in large firms.[90]

Small businesses are usually less productive than their larger counterparts, because they are too small to achieve economies of scale in use of equipment and technology. In consequence, they can usually only afford to pay lower wages to their employees. In-depth studies by Statistics Canada have found that the average productivity (output per hour worked) in small businesses is only about half of what it is in large businesses. The share of the economy occupied by small businesses is greater in Canada than in the United States. This explains about two-thirds of the productivity gap between Canada and the United States.[91]

An economic argument can be made that new, dynamic small firms that may lead to innovation are worthy of some special incentives. That would suggest providing time limited tax reductions for the first few years of a corporation's life, rather than an indiscriminate permanent tax reduction for all small firms.[92] Even as far as job creation is concerned, "it is younger firms, especially start-ups, that contribute disproportionately to net job creation, not small firms once firm age is controlled for."[93]

88 Ibid., p. 5.10.
89 *OECD Economic Surveys: Canada* 2016, p. 134.
90 "Minimum Wage," *Perspectives on Labour and Income, Statistics Canada*, March 2010, Table 7.

91 John R. Baldwin, Danny Leung, and Luke Rispoli, "Canada–United States Labour Productivity Gap Across Firm Size Classes," *The Canadian Productivity Review*, January 2014
92 The *Final Report of the Québec Taxation Review Committee*, 2015, also proposes eliminating their current small business deduction, and replacing it with a "growth premium," which is a lower tax rate over an intermediate income interval (Recommendation 18, p. 75). It is questionable whether this would be sufficient to achieve the goal of encouraging significantly greater growth incentives.
93 *OECD Economic Surveys:* Canada 2016, p. 117.

8.2 Disproportionate Share of the Benefits Flows to Upper Income Groups

There is a very large number of small corporations in Canada. Out of a total of about 2.05 million corporations filing tax returns in 2010, 1.95 million were Canadian Controlled Private Corporations (CCPCs).[94]

Small corporations account for a surprisingly large proportion of total corporate income in Canada. Out of a total of $386 billion of corporate net income, about $156 billion of this was earned by CCPCs.[95] That works out to an average of only $80,000 per CCPC. While the majority have relatively low levels of income, but there is also a significant number of them that reach the $500,000 level of income which is the maximum that qualifies for the low small business rate.[96] This is not surprising, as high income professionals such as physicians are now allowed to incorporate. As a result, taking into account the profits earned within small corporations results in a nearly 40 percent increase in the total incomes of the top 1 percent of income earners.[97]

One of the main benefits of incorporation for the business owner is the access that it gives to income splitting. One aspect of this is splitting income among different members of the owner's family, to reduce the total amount of tax paid.[98] The other aspect is the owner splitting income between the corporation and herself as an individual. The owner can choose not to take all her available income out as salary or dividends. She can choose instead to shelter the earnings within the corporation to postpone paying personal income tax. She might ultimately be able to transform it into a capital gain if the earnings are retained inside the corporation until the business is sold. This would allow it to be taxed at either half the personal tax rate, or no tax at all if it qualifies for the LCGE.

This income splitting opportunity with private corporations makes it more complicated for analysts to study the distribution of income in Canada. Previous analysis has relied on information from individual income tax returns. However, the personal income tax return of somebody who owns a private corporation can significantly understate her true income.

Economists have only recently attempted to overcome the data problems. A major new study using a large database has correlated the tax returns of individuals with the returns of the corporations that they control. This study found that CCPCs are disproportionately owned by individuals in the top 5 per cent of incomes, and "top income shares are significantly higher when CCPC incomes are included."[99]

Jack Mintz has observed that "roughly 60% of the value of the SBD accrues to households earning more than $200,000 a year."[100] He notes that "the favourable tax treatment of small businesses enables many wealthy Canadians to pay little or no personal income tax."[101]

94 Michael Wolfson, Mike Veall, Neil Brooks, and Brian Murphy, "Piercing the Veil: Private Corporations and the Income of the Affluent," *Canadian Tax Journal* (2016) 64:1, 1 - 30, p. 26.
95 Ibid., p. 27.
96 Finance Canada, *Tax Expenditures and Evaluations 2013*, "Taxation of Small Businesses in Canada," Chart 5.
97 Wolfson et al, supra note 93, Table A3.
98 Michael Wolfson and Scott Legree, "Private Companies, Professionals, and Income Splitting— Recent Canadian Experience," *Canadian Tax Journal* (2015) 63:3, 717 - 37. These authors conservatively estimate a tax revenue loss of about $500 million in 2011 due to this type of income splitting, pp. 729-30.
99 Michael Wolfson, Mike Veall, Neil Brooks, and Brian Murphy, "Piercing the Veil: Private Corporations and the Income of the Affluent," *Canadian Tax Journal* (2016) 64:1, 1 - 30, p. 2.
100 Jack Mintz, "An Agenda for Corporate Tax Reform in Canada," Canadian Council of Chief Executives, September 2015, p. 18.
101 Ibid., p. 3.

All of this suggests that the SBD fails on two fronts. It supports the proliferation of economically inefficient businesses. In addition, it worsens inequality in the distribution of income.

Canada is a significant outlier in this field, with taxation of small businesses being considerably more generous than the international norm. The previous Conservative government had enacted legislation to schedule further reductions in the federal small business corporate rate, to take it even lower, to 9 per cent by 2019. That is something that the new Liberal government decided to rescind in its first budget. It limited the scheduled cut to half a per cent, down from 11 per cent in 2015 to 10.5 per cent in 2016. As a result, the government was accused of breaking an election promise.[102] Given the desire to please all interest groups during an election campaign, it is not surprising that a government might make some promises in the heat of the moment that appear unwise on further reflection.

When one takes into account political forces, this would appear to be a particularly challenging area for reform. However, other democratic countries have managed to avoid such large preferences for small business, and it is not clear why the preferences should be so unusually large in Canada. The United Kingdom, with an electoral system identical to Canada's, eliminated its small business tax preference in 2015.[103]

As with the subsidies for retirement savings, the small business subsidy is not something that one could envision eliminating over the short term. A large number of Canadians have made business decisions and long-range plans based on the expectation that the small business preference would be a part of the tax system. One could suggest phasing out these preferences over the long term, by gradually increasing the small business rate to match or at least come closer to the general corporate tax rate.

RECOMMENDATION #14

Gradually reduce the difference in tax rates between large and small corporations.

102 http://www.cfib-fcei.ca/english/article/8230-2016-federal-budget-breaks-election-promise-to-small-business.html

103 Admittedly, it was not done by increasing the small business rate. In 2010, the UK's small business corporate rate had been 21 per cent, compared to a general rate of 28 per cent. As of 2015, this was reduced to an identical 20 per cent for all corporations. In Ontario, by comparison, the combined federal-provincial small business corporate tax rate is 15 per cent.

9 MOVING FORWARD TOWARDS LONG-TERM REFORM

Canada's personal income tax system has grown piecemeal, rather than in a coherent or consistent manner. In some instances, lobbying by interest groups that benefit from particular tax expenditures may have played a role in their implementation, to the detriment of broader economic interests. The electorate, and indeed most politicians, may not understand the impacts of these tax expenditures sufficiently well to provide a balanced debate about them.

The policy makers who designed the tax expenditures may have had good intentions in trying to fix a perceived problem in the tax system. However, the global economic landscape is very different than it was when many of the largest tax expenditures for investment income were enacted. There is much greater global integration in investment markets. That alone is sufficient reason to carefully review the desirability of the current tax expenditures in this area.

This paper argues that substantial reform is desirable. However, it recognizes that the major tax expenditures have become deeply embedded in the system. Many taxpayers have made long-term plans based on the expectation that they will remain in place. It would be unfair to suddenly withdraw them, and politically unrealistic to suggest that this could be done.

It is, however, realistic to suggest gradual changes over the long term. Scrutiny of the flaws in the economic logic of the existing tax preferences is an important step in this process. Gradual, incremental changes to the tax expenditures could make them significantly fairer and more efficient than their current design. It should also be borne in mind that many of the tax expenditures for investment income are interrelated. Care has to be taken to ensure that the reforms in different areas proceed on a consistent basis and do not create new distortions.

Accurate analysis of the benefits and costs of these tax expenditures is important going forward. There is frequently pressure to further expand and enrich the existing tax expenditures, as in the recent example of the federal SBD. Even where the political will does not exist to roll back existing preferences, an intelligent debate should make it possible to avoid expanding them where that would further undermine the efficiency or fairness of the tax system.

The global economic landscape is very different than it was when many of the largest tax expenditures for investment income were enacted.