

## *Comments on the Paper by Robin W. Boadway and Harry M. Kitchen*

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—Alan M. Schwartz\*

In a presentation that I found to be most comprehensive, Robin Boadway and Harry Kitchen have identified the objectives of tax reform, addressed some possible reforms that could achieve those objectives, and discussed a number of underlying issues. I would like to comment on those objectives and issues from the perspective of a tax practitioner who advises high-rate taxpayers.

First, it may be instructive to remember that Canada introduced income tax in 1917 as a “temporary measure” to finance the country’s World War I effort. The base rate was 4 percent and there was a “super tax” of 2 percent levied on all incomes between \$6,000 and \$10,000. In addition, there was a separate tax on playing cards.

In 1998, the combined federal and provincial top marginal rates varied from a low of 45.6 percent in Alberta to a high of 54.17 percent in British Columbia. In Ontario, at the first bracket of \$29,590 of taxable income, the combined federal and provincial rate in 1998 was 41.65 percent. At an income level of \$62,193, the combined marginal rate was 50.29 percent.

This is a far cry from the 6 percent maximum rate in 1917. In fact, according to a recent book by Joel Emes and Michael Walker,<sup>1</sup> the total tax bill of the average Canadian family in dollar terms has increased by 1,286 percent since 1961. The total tax bill now accounts for more of the average Canadian’s budget than shelter, food, and clothing combined. How did we get there? The 1987 tax reform was supposed to create a fairer tax system. The base was to be broadened, preferences dramatically reduced, and rates reduced to about 45 percent. For those who did not dabble in tax shelters, these changes were supposed to result in less taxes. What happened? Not all the blame can be laid at the door of the federal government. The provinces invaded the territory and introduced rates that resulted in combined rates of almost 56 percent. Then the federal government added the 3 percent and 5 percent surtax. The aftermath of the 1987 tax reform was the worst of all possible worlds from the perspective of the

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<sup>1</sup> Joel Emes and Michael Walker, *Tax Facts 11* (Vancouver: The Fraser Institute, 1999).

taxpayer—a broad base and high rates. Taxpayers feel they have been had and, as a result, have suffered a loss of confidence and trust in government.

Moreover, according to Emes and Walker, income taxes represent less than half of the average total tax bill. Other taxes, ranging from sales to motor vehicle to property taxes, account for over 63 percent of the total tax bill.

Against that background, let us examine some of the objectives and issues identified by Boadway and Kitchen.

### COMPETITIVENESS

Boadway and Kitchen say that it is mandatory that our tax system facilitate the ability of Canadians to compete. In their view, this means

1) that all productive activities must be treated on a par—that is, we can no longer give preferential tax rates to certain industries such as the manufacturing and the resource sectors; and

2) tax rates must not be so onerous that mobile labour and firms are induced to move abroad.

Point 1 raises several questions. First, is it a correct policy decision for Canada not to favour certain sectors, such as the resource industry, having regard to the importance of our natural resources to our economic well-being? Should we not be playing to our strength?

Second, is it naive to think that we can have a tax system without preferences? As a political matter, would this government or any government have the political will to resist the pressure that would be exerted by the mining industry and all derivative industries that service the mining sector if the tax preference were removed? If the example of the pressure exerted by the insurance industry, and, in particular, insurance salesmen, on the government to keep the banks out of the insurance business is any indication, one must seriously doubt whether any government would adopt an industry-neutral tax policy.

Turning to point 2, it seems fair to conclude that, by comparison with US rates, our top combined marginal rate is too high and it kicks in at far too low a threshold. What incentive is there for our young engineers and scientists to stay here when they find themselves in the highest tax bracket straight out of school? As Boadway and Kitchen say, “Even labour, especially highly skilled, is able to move among countries more readily.”<sup>2</sup> If our tax rates are too high in comparative terms, companies will move to more favourable jurisdictions as long as the underlying infrastructure is available. We have seen many companies move from Vancouver to Seattle. We can learn a lot by emulating Ireland, which has become a vibrant centre attracting software and high technology companies by reducing taxes.

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<sup>2</sup>Robin W. Boadway and Harry M. Kitchen, “Personal Income Tax Reform in a Broader Context,” in this issue of the journal, 566-602, at 569.

There was a lot of fanfare when Alberta introduced a flat tax in the last budget. Because our top rate kicks in at such a low threshold, one could say that we already have a flat tax in Canada, except that it is at a 50 percent rate, rather than the 20 to 25 percent rate generally proposed for flat tax systems.

### **DIVIDEND TAX CREDIT AND THE MINTZ COMMITTEE'S SUGGESTION OF A CDT**

The Technical Committee on Business Taxation ("the Mintz committee") expressed serious concern about the existing dividend tax credit system.<sup>3</sup> The credit is available whether or not corporate tax has been paid on the income from which the dividend is paid. The committee therefore recommended a corporation distribution tax (CDT), which would ensure "funding" of the dividend tax credit by the payment of corporate tax at least equal to the amount of the credit. My initial reaction to this suggestion was strongly in favour since the proposal was accompanied by a recommendation to eliminate part IV.1 and part VI.1 tax.

On reflection, however, the Mintz committee's proposal has some drawbacks. There are basically two reasons why a corporation may not pay tax (apart from the fact that the corporation may be unprofitable). First, some corporations enjoy certain tax deductions as incentives. The Mintz committee's response is that industrial policies and resulting tax preferences should not be declared through the tax system. Boadway and Kitchen present the counterargument that the delivery of incentives through a tax system involves a minimum of administrative cost and discretion. I am inclined to accept the counterargument and avoid a system that would create a whole new bureaucracy and introduce a level of uncertainty as to whether a grant would be forthcoming and further uncertainty as to how long it would take to obtain the grant.

The second reason a corporation often pays no tax is that it receives its income from its international operations. The Mintz committee recommended that the existing "exempt income" system be maintained. Accordingly, for these two reasons, I am inclined to reject the concept of the CDT, particularly since it will result in significant additional complexity.

### **THE FAMILY AS A TAX UNIT**

The minister of finance has asked the all-party Commons finance committee to hold hearings and recommend measures for improving government support for families. This issue is a hot potato, politically and emotionally. My fear is that the government will come up with a reform package that will treat the "stay-at-home-parent" family the same as the "two-wage-earner" family. However, the result will be that the two-wage-earner family will pay more tax than before, and there will be no benefit to the stay-at-home-parent family.

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<sup>3</sup> See Canada, *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, April 1998), 7.9-7.11.

This is what occurred when wives receiving child support payments complained about having to include the amount received for child support in income. Under the old system, the tax saving enjoyed by the husband payer was often greater than the tax payable by the recipient wife because he was in a higher tax bracket. Thus, there was less tax payable and therefore more money available for child support. By moving to a no deduction/no income inclusion system, the wife was no better off because the amount awarded to her or agreed to be paid to her was reduced to reflect the fact that there was no deduction to the payer and no income inclusion to the recipient. However, the government was better off, because it had eliminated the tax arbitrage formerly associated with child support payments.

### **DEDUCTIONS VERSUS CREDITS**

The 1987 tax reform introduced a change from personal tax deductions to a credit system. It was considered unfair in a progressive tax system that persons in the higher tax brackets should receive a larger tax benefit than those in the lower brackets. A deduction of \$100 was worth more money to someone paying tax at the 55 percent rate than someone at the 30 percent rate. With the move to a credit system, each taxpayer received the same absolute tax benefit in terms of taxes saved. However, the credit (with the exception of that for charitable donations) was calculated on the basis of the 17 percent lowest tax rate. Here there was equality, but again the winner was the government.

This approach strikes me, as it does Boadway and Kitchen, as ill conceived. Put simply, it means that income/revenue should be taxed at differential progressive rates based on income level, but that deductions should be treated equally regardless of income level.

### **CONCLUSION**

On balance, I agree with Boadway and Kitchen that our personal tax system is sound and does not require a major overhaul. What is required is a return to the underlying thrust of the 1987 tax reform—less taxes through a broader base and lower rates; that is, rates that are competitive with those of other countries.

On a micro basis, an aspect that cries out for change is the rule that requires capital gains to be included in income but allows the deduction of capital losses only against capital gains, rather than against income generally. Fairness requires symmetrical treatment.

Another area of concern to taxpayers is reform of the registered retirement savings plan system. Most Canadians of the post-war generation have grave doubts that the Canada Pension Plan will provide them with very much, if anything, by way of retirement income. Given the high tax rates and the cost of housing and other living expenses in Canada, at the same time they have serious concerns about their ability to fund their retirement. With a much longer life expectancy, they anticipate a lengthy retirement period.

Finally, I would like to add a comment on the simplification of tax law. I agree with the Mintz committee that it is unrealistic to expect that our tax system can be simple. However, I suggest that there is a tendency among tax legislators to be overly zealous in preventing tax leakage. They introduce exceedingly complex provisions into the Income Tax Act, often without considering that the amount of leakage does not justify the complexity being added. The best example is the application in 1987 of the term preferred share rules to a share that is otherwise a taxable preferred share. This change was made because of an unwarranted fear that companies would issue preference shares in modest amounts to take advantage of the \$500,000 exemption for taxable preferred shares. I suggest that tax legislators should always ask themselves, before they enact a complex provision, "Is the game worth the candle?"