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• THE FISCAL LANDSCAPE: PART II — TAX POLICY •

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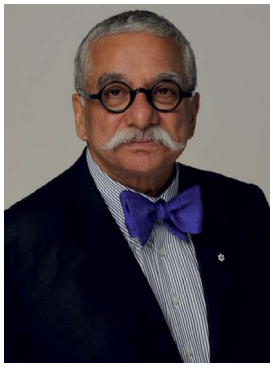

Vern Krishna CM

Tax law is driven by policy. Every rule has an underlying rationale, which is purportedly translated into legislative language in the statute. However, sloppy drafting or interpretation can distort the policy of a rule. Tax policy concerns the efficiency with which we implement transfers of resources from the private to the public sector, and the value and benefit that society derives from the process.

A tax system should raise sufficient revenue to finance government operations. A good tax system, however, is also concerned with the manner in which we collect the revenue. It should be neutral and efficient, fair and equitable, certain, administratively simple and easy to comply with. These are often conflicting goals, and all the more so if we use tax law to implement economic, social, political and cultural objectives. Hence, ultimately, all tax law is a compromise of competing values. Tax policy analysis should evaluate the effectiveness and efficiency of the compromises.

REVENUE GENERATION

The Tax Base

Governments levy income taxes to raise revenues for public purposes. The amount of revenue that a tax system raises for government is a function of a simple mathematical formula:

Revenue = Tax Base x Tax Rate

Alternatively, the amount of income tax that a taxpayer must pay is a function of the same formula:

Tax payable = Tax Base x Tax Rate

Thus, there are only two variables that directly determine the amount of revenue that a tax system

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raises. The formula (tax base x tax rate) is simple, but the interplay between these two variables is not as simple as it appears. The tax base can be manipulated through prohibitions, exemptions, credits and deductions. In Canada, notwithstanding the *Carter Commission's* recommendations in 1966 that a "buck is a buck" and should be taxed as such, we do not have a comprehensive tax base (CTB). Indeed, as we shall see in succeeding chapters, the tax base is riddled with exclusions, exemptions and special reductions that ensure that a buck in not a buck. For example, we tax employment income, business income and capital gains at different rates, which can vary from zero to more than 50 per cent.

The relationship between the tax base and tax rates also influences the manner in which we achieve other non-revenue objectives. For example, the size and character of the tax base and tax rates can affect the fairness of the system, economic efficiency, certainty of tax laws, the costs of compliance, and tax avoidance.

When non-lawyers talk about tax, they usually focus on tax rates. For example, an individual may complain that the top federal tax rate of 33 per cent is too high. However, tax lawyers spend most of their time trying to manipulate the tax base to a lower level. Hence, for example, a tax lawyer would try to reduce the threshold at which an individual's top rate kicks in ($205,842 in 2018) to a lower level, in order to reduce the overall tax bill.

A tax system with a broad tax base is usually simpler, and more certain, than a system with a narrowly constrained base. This is because a broad-based system requires fewer lines of demarcation between classifications of income, expenditures, and exclusions than a narrowly based system. For example, a system that taxes all forms of gains, regardless of their source, requires fewer rules than a system that distinguishes between business income, investment income, and capital gains. Similarly, a system that taxes all forms of capital gains in the same manner will be simpler than one that differentiates between different forms of capital gains that taxes each type at different rates.

The tax base for federal income tax purposes is "taxable income". The provinces can elect to use one of two bases for the purposes of provincial tax: (a) federal "taxable income", or (b) "federal tax payable". The provincial tax for individuals (except in Quebec) piggybacks on the federal tax base. Hence, any changes to the federal taxable base almost invariably affect provincial revenues.

The political interplay between the tax base and rate is also important. Governments do not generally like to raise rates prior to an election, unless the rate increase is on the top 1 per cent of the population. However, they like to lower the rate on the middle class, which has obvious benefits. At the same time, they can broaden the base by eliminating deductions and credits, which has the less obvious advantage of increasing taxes without appearing to do so.

Tax Rates

The second element in determining government revenues is the rate that one applies to the tax base. The term "tax rate" is ambiguous and leads to misunderstandings in discussions about taxes. In theory, if we ignore behavioral responses to tax rates, a rate of 40 per cent will produce a greater amount of revenue than a tax rate of 20 per cent. However, we cannot ignore behavioural responses to rate changes. A reduction in tax rates may actually stimulate economic growth and enhances overall revenues, which, in turn, will lead to additional tax revenues.

Hence, we must consider three different tax rates, marginal, average, and effective, to determine their ultimate effect on taxes raised and taxes paid.

(i) Marginal rates

The marginal tax rate is the level of tax that applies to the next dollar of taxable income.

Marginal rates are the key to tax planning. As marginal rates rise, the total tax payable increases by a rate that is more than proportional to the increase in income.

For example, the following are the five federal marginal rates on taxable income for individuals in 2018:

Taxable Income	Federal Rate (%)
On first $46,605	15.0
On next $46,603	20.5
On next $51,281	26.0
On next $61,353	29.0
Over $205,842	33.0

Hence, for example, if Harry earns $30,000 taxable income, he would pay basic federal tax at a marginal rate of 15 per cent. In contrast, if Janice earns taxable income of more than $205,842, she would have a federal marginal rate of 33 per cent, but would pay that percentage only on her income over that amount.

The marginal rate is important in tax planning because it tells us how much more tax a taxpayer will pay as income increases, and how much he or she will save in taxes as income falls. Thus, marginal rates tell us the tax cost or tax benefit of the *next* transaction, which is what concerns tax lawyers and bankers.

For example, an individual with a 33per cent marginal rate will save tax at that rate if she contributes to a registered pension plan, and reduces her current taxable income. If she is taxed at a lower marginal rate (say 26 per cent) when she retires, she will save tax in the long run. Hence, she saves 7 per cent in the long run. Additionally, she will defer her current tax liability to a later date, which is another form of saving.

(ii) Average rates

The average tax rate tells us the tax rate payable on the taxpayer's *entire* income. Hence, it measures the total tax burden of the taxpayer. We obtain the "average rate" of tax by dividing the total tax payable by the tax base. If Jane earns $25,000 and pays $3,750 tax, her average tax rate is 15 per cent. This is the rate that people implicitly refer to when they complain that their taxes are too high, or that their neighbour's taxes are too low.

The average rate reflects the weighted average of all of the marginal tax rates. Hence, by definition, an individual's average rate of tax is usually lower than his or her marginal rate. For example, the average federal tax rate of an individual who earns taxable

income of $30,000 is $4,500, that is, 15 per cent. In this case, the average and the marginal rates are equal because only one federal marginal rate (15 per cent) applies to all of the income. However, if Janice earned taxable income of $250,000 in 2018, she would pay (before credits) federal tax of $62,242, which makes her average rate of tax 25 per cent — that is, 8 per cent lower than her federal marginal rate of 33 per cent.

Progressive and Average Rates (2018)

	Jane	Janice
Taxable Income	$25,000	$250,000
First Bracket: 15%	$3750	$6,991
On next $46,603: 20.5%		$9,554
On next $51,281: 26%		$13,333
On next $61,353: 29%		$17,792
On next $44,158: 33%		$14,572
Total Tax	$3750	$62,242
Average Tax Rate Total Tax /Taxable Income	15%	25%

In a flat tax system, the average rate is equal to the marginal rate. For example, if the flat tax rate is 26 per cent, an individual who earns $1,000,000 would pay $260,000 in tax. An individual who earns $100,000 would pay $26,000. Both individuals would have also have the same marginal rate of 26 per cent. This form of flat (proportional) taxation is politically controversial as being "unfair", but there are serious arguments on both sides.

Canada uses progressive marginal rates, where the rate of tax increases as income rises. The rate starts at 15 per cent, and then rises in steps to 20.5 per cent, 26 per cent, 29 per cent, and, finally, to 33 per cent. An individual pays tax on the first bracket of income at 15 per cent, 20.5 per cent on the second bracket, 26 per cent on the third bracket, 29 per cent on the fourth bracket, and 33 per cent on the fifth bracket. The marginal tax rate is always equal to the individual's highest tax bracket.

The marginal rate is the key to tax planning because it measures the amount of tax or benefit resulting from a decision or change. For example, in decisions involving buy or lease, agreements to enter a new contract or pay damages to exit an old one, we calculate the tax cost or benefit at the margin for engaging in the activity.

Example

Assume the following simplified marginal rate structure:

Taxable Income	Tax Rate
$0 - $50,000	10%
Over $50,000	10% on the first $50,000, and 40% above that amount.

Amanda earns $60,000 and has $5,000 in savings, which she wants to invest in a financial instrument that will return $5,000 and pay an additional $1,000 interest at the end of one year. Without the investment, Amanda will owe $9,000 in taxes — that is, $5,000 on the first bracket, and $4,000 on the second bracket.

The $1,000 of investment income will be taxed at 40 per cent because Amanda is in the second bracket. Hence, her total tax bill will rise to $9,400. She will retain only $600 net of taxes from her investment. Thus, her after-tax rate of return is 12 per cent — that is, $600 divided by $5,000. The marginal rate of tax times the increment in income gives us the result without having to recalculate her entire tax liability.

At the same time, Amanda's average rate of tax after the investment is 15 per cent — that is, $9,400 divided by $61,000. However, since, the average rate of tax merely reflects her total tax burden, she will not find the rate of tax helpful in making her investment decision. She should make her decision using her marginal tax rate, which reflects her incremental cost or savings.

(iii) Effective rates

The "effective rate" of tax is the total tax payable divided by *net income* for tax purposes, before exclusions, credits, and exemptions. For example, since only one-half of capital gains are taxable as

income, the effective tax rate on capital gains is only one-half of the taxpayer's marginal rate. For certain exempt capital gains, the effective rate is zero [section 110.6].

In the above example, assume that an individual has income of $210,000, including $60,000 of capital gains in the year. By excluding one-half of the capital gains from taxable income, the individual reduces her taxable income by $30,000. The individual's effective federal tax rate is the actual tax payable divided by her "real" net income of $210,000.

Effective tax rates are a yardstick for comparing taxes between individuals, and between different countries. Every exemption and credit reduces the tax base, which, in effect, lowers the effective tax rate. Thus, one can broaden the tax base and lower the tax rate to promote fairness and achieve economic efficiency.

Example

Assume that Country A taxes net income at 40 per cent whereas Country B taxes net income at 35 per cent. On the surface, it appears that Country A has higher tax rates. If, however, Country A allows generous deductions for depreciation, or interest, expenses in computing income that Country B does not permit, the effective rate of tax in Country A may actually be lower than in Country B. For example, the deduction for mortgage interest and property taxes is a significant difference between Canadian and American tax burdens on similar amounts of income.

In political terms, however, raising top marginal rates is more impressive than adjusting effective tax rates, and gives the impression that the government is hitting the rich (the so-called 1 per cent) hardest, which appeals to the remaining 99 per cent (including the 30 per cent who do not pay taxes at all. Conversely, eliminating an exemption or credit is a subtle way of increasing taxes, because it increases the effective rate of tax, but without adjusting rates. This is a useful technique to raise money from middle income individuals.

PROVINCIAL TAXES

The provinces apply tax as a percentage of the federal taxable income or tax payable. A taxpayer's total tax liability is the aggregate of his federal *and* provincial taxes payable. Provincial rate schedules vary between provinces. Hence, depending upon their province of residence, Canadian residents pay differential taxes on identical amounts of income.

NEUTRALITY

Neutrality means that a tax system should not draw artificial distinctions between identical transactions merely on the basis of their legal form or source. Thus, neutrality implies a level playing field that does not favour or unfairly discriminate against taxpayers merely on the basis of their choice of entities, or relationships, to structure their business and personal transactions. For example, in a perfectly neutral system, the tax consequences would be the same regardless of whether an individual earned income personally or through a corporation.

In fact, the Canadian tax system is far from neutral, and invites behavioral responses from taxpayers who are often motivated purely by tax considerations. This is inevitable. Taxpayers faced with choices respond to the system and attempt to minimize their tax burden. To do otherwise would be irrational. For example, in 2018, a Canadian-controlled private corporation pays federal tax at a rate of 10 per cent on the first $500,000 of its active business income. The rate is scheduled to drop to 9 per cent in 2019. In contrast, an individual in the top bracket would pay federal tax at a marginal rate of 33 per cent on the same amount of income. Since the reduced rate of tax is not available to individuals, the system favours the corporate form of business. Taxpayers respond to this systemic bias, which is an intrinsic part of the tax system, by opting to conduct their Canadian businesses through the corporate form in order to save tax. Hence, professionals, such as, doctors and lawyers often use professional corporations for tax purposes.

EFFICIENCY

The efficient allocation of resources to maximize production and economic growth is an important policy of the tax system. A policy is efficient if it promotes the optimal allocation of capital. A tax system can distort economic efficiency and capital flows by causing persons to make business decisions solely on tax considerations. Thus, we should evaluate tax measures intended to stimulate or encourage economic activities based on their cost effectiveness in the light of the objectives of the provision.

Similarly, in the international arena, tax provisions can distort economic decisions and cause a non-optimal allocation of capital. The principle of capital export or international neutrality, for example, suggests that a taxpayer's choice between investing at home or abroad should not be affected by the pattern of taxation. A Canadian corporate tax rate that is significantly higher than international norms stimulates export of capital and jobs to countries with lower rates in order to enhance domestic after-tax returns. For example, if Canada taxes the Royal Bank of Canada (RBC) at 30 per cent on its Canadian income and the United Kingdom taxes its U.K. profits at 25 per cent, the tax system will be neutral only if it taxes RBC at a net rate (after foreign credits) of 5 per cent on its foreign income.

FAIRNESS AND EQUITY

A tax system must be fair. An unfair system of taxation stimulates blatant tax avoidance and evasion. Thus, we speak of tax equity as a system that treats similarly situated taxpayers in a similar manner (horizontal equity) and promotes a fair distribution of income (vertical equity). That said, however, it is not always easy to settle upon a common understanding of what is "fair", which is a judgement based on social, political and moral values.

Horizontal and Vertical Equity

(i) Horizontal Equity

Most people agree that taxpayers in similar financial circumstances should pay similar amounts of tax. At its simplest level, an individual who earns $100,000 from employment should be taxed at the same rate as an individual who earns $100,000 from rental income. We refer to this aspect of fairness as horizontal equity: equal treatment of those with equal ability to pay.

However, the accurate measurement of "income" or tax base is integral to the fairness of the tax system. For example, consider two individuals, Jane and Harry, both in a 50 per cent tax bracket. Jane earns $150,000 as a public servant in government; Harry is employed in the private sector, earns $100,000 in salary, but also gets free accommodation valued at $50,000. The principle of horizontal equity requires that we tax both Jane and Harry in a similar manner because they earn equal amounts of economic income, albeit in different forms. They have the same tax base. But what if Jane trades off $10,000 of her salary in exchange for her employer providing on-site child care services that previously cost her $20,000 (after-tax) a year? Should Jane be taxed on $140,000, $150,000, $160,000 or $180,000?

(ii) Vertical Equity

Equity also requires that we recognize a taxpayer's ability to pay, which may be quite different from the taxpayer's "income" in an accounting sense. Assume, for example, that Harry, a single father with four infant children, looks after his elderly mother who suffers from an expensive and chronic disease. Jane is single, in good health, and spends her money on sailing. Thus, taxpayers with the same numerical income may have different capacities to pay tax. Vertical equity suggests that we recognize these personal elements in the taxpayer's "ability to pay" to pay tax.

There is general agreement that individuals with higher incomes should pay "more tax" than individuals with lower incomes. Most people will agree that an individual who earns $100,000 in a year should pay more tax than an individual who earns $30,000. This principle of vertical equity, which is based on the theory that a taxpayer should pay according to his or her ability to pay, does not, in itself, provide a ready answer to the more difficult question: *how much*

more should the rich pay than the poor? For example, the lowest federal tax rate is 15 per cent on taxable income up to $46,605 and 33 per cent on taxable income exceeding $205,842 [2018]. Is this increase in marginal tax rates equitable? In technical terms, what is the optimum slope of the tax rate curve? This is as much a political as an economic question.

In assessing ability to pay, should we tax individuals or as part of a family unit? Comprehensive family taxation would address the inequities of unequal tax burdens on families in similar financial circumstances.

For example, consider the situation of two families. In Family A, both spouses (partners) work and bring in $100,000 each, for a joint family income of $200,000. Their federal and provincial (Ontario) tax in 2018 would be $24,626 each, for a total family tax burden of $49,252 on a combined taxable base of $200,000. In Family B, only one spouse works in the market place and brings in $200,000, whilst the other spouse is at home with the children. Their total tax burden in the same year would be $70,481. Family B has a tax burden that is $21,229 more than Family A, which has the same family income.

The disparity of tax burdens between the two families creates an incentive to devise arrangements for income splitting between family members. For example, in certain limited circumstances, it is possible to create a corporation and split business income between spouses if each has contributed capital to the corporation and extracts the income as dividends from the corporation. However, effective 2018, the federal government imposed severe restrictions on income splitting share capital structures and dividend payments. The legislation is complex, and the rules are littered with ambiguities, which will lead, inevitably, to prolonged litigation.

Thus, horizontal and vertical equity are closely related. A fair tax base is as important as fair tax rates in achieving equity. However, allowing Family B to split income between the two spouses so as to pay the same amount as Family A is difficult to implement for political reasons. The Carter Commission (1966) recommended the family unit as the taxable base to implement comprehensive family taxation.

PROPORTIONAL TAX RATES

In a proportional or flat rate system, we would tax the entire taxable base at a constant rate. For example, if three taxpayers A, B and C with taxable incomes of $20,000, $40,000 and $60,000 respectively are each taxed at a flat rate of 17 per cent, they would pay taxes commensurately proportionate with their income as follows:

Taxpayer	Taxable Income	Tax	Rate (%)
A	$20,000	$3,400	17
B	$40,000	$6,800	17
C	$60,000	$10,200	17

The total tax revenue collected would be $20,400.

Thus, in a proportional rate system, higher income levels bear a heavier tax burden. In the above example, C pays three times, and B pays twice, the total tax that A would pay. The description “flat tax” refers to the shape of the line when plotted on a graph that displays the tax rate on the vertical axis and income on the horizontal axis. A true flat tax takes the same percentage of everyone’s income — a family with twice the income of another must pay twice the tax.

Proportional taxes can have built-in progression if the statute exempts certain forms of income from tax. For example, if we exempt the first $10,000 of income from tax, and then levy tax at a flat rate of 20 per cent, the individual’s average rate of tax will get progressively higher with income. At $20,000 income, the individual would pay $2,000 tax, with an average rate of 10 per cent. At $50,000 income, an individual would pay $8,000 tax, for an average of 16 per cent.

Sales and consumption taxes (such as the GST and HST) are generally levied as proportional taxes — that is, at a flat rate applied to all sales, regardless of the amount expended. The shape of the tax rate curve should not be confused with the incidence of the tax burden. The HST, for example, is a flat tax on consumption, but has a regressive effect when measured against income. It takes a higher percentage of income from lower income

levels than it does from higher income levels. *All* flat taxes (for example, gasoline, airline, alcohol, tobacco, entertainment, gaming and fishing, excise, environmental, energy, etc.) on use or consumption have a regressive incidence when measured against income. Indeed, the tobacco tax is probably the most regressive of all taxes because more poor people tend to smoke cigarettes than do upper income individuals.

The real policy issue is not whether a tax is regressive, but whether the incidence and degree of regressively of a tax properly reflects the economic and social values of society. If it does not, how should we rectify the situation — through direct rebates or tax credits?

PROGRESSIVE TAXATION

Most Canadians agree with the principle that individuals with higher incomes should pay more tax than individuals who earn less. The underlying premise is that higher income individuals have a greater ability to pay taxes and, therefore, it is fair that they pay more tax. But how much more is "fair"? The difficulty is that many believe that a tax system is fair if it taxes the other person.

Canada has a progressive tax system. The adjective "progressive" refers not to the quality of our Byzantine tax law, but to the aspect of our system by which the marginal rate of tax increases at various levels of taxable income. Thus, a person who earns taxable income of $210,000 pays not only more tax in absolute dollars than an individual who earns $45,000, but the rate of federal tax progresses from 15 per cent to 33 per cent as taxable income rises.

We justify progressivity on the principle that an individual's ability (though not enthusiasm) to pay tax increases as his or her income rises. This assumption, however, only starts the debate. Approximately one-third of Canadian taxpayers (of which there were approximately 27 million in 2015 did not pay any income tax at all. The non-payers filed tax returns primarily to receive benefits paid out as income redistribution under the HST and child-tax benefits.

Progressivism kicks in at about the $50,000 income level and accelerates thereafter until it peaks at the top federal marginal rate of 33 per cent, which works out to approximately 53.5 per cent in combined federal and provincial (Ontario) taxes [2018]. Thus, contrary to popular opinion, the rich in Canada do pay substantial taxes. However, there is no consensus, and likely never will be, on the meaning of "fair" in taxation.

Certainty and Simplicity

A good tax system is one that can be administered economically and should not impose unreasonable compliance costs on taxpayers. The more complex a tax system, the higher the compliance costs. Thus, a good system is one that is certain and simple.

A tax system must be certain so that taxpayers can plan their affairs and business transactions secure in the knowledge that the consequences that attach to the transactions are predictable. On the other hand, business transactions in a complex economy are inherently uncertain and some degree of complexity is inevitable.

A tax system should also be simple. This is particularly important in the case of personal taxes, where the majority of individuals should be able to comply with the law without being put to unnecessary professional fees for expert advice.

Compromise of Values

Tax law is a compromise between competing values. Tax policy objectives of revenue generation, neutrality, efficiency, fairness and administrative feasibility pull in different directions. At any required level of revenues, a neutral tax system will generally be less complex than one that has multiple distinctions between classes of taxpayers and types of income. However, a neutral system will also be less sensitive to the objective of fairness, which implies distinctions based on ability to pay.

For example, income taxes are levied both on individuals and on corporations at different rates. This creates two tensions. First, there is an incentive

to choose the form of organization that attracts the lowest rate of tax. As previously noted, there is a substantial difference between taxes imposed on Canadian corporate small business and the top marginal rate of tax on individuals. This makes it attractive to use the corporate form which makes the system less neutral, but is intended to stimulate economic activity.

Second, the corporate tax results in economic double taxation of income, once at the corporate level, and then again at the personal shareholder level when net profits are distributed. Double taxation is inefficient and unfair to taxpayers. The mechanism to minimize double taxation through shareholder credits for corporate taxes makes the system fairer, but also more complex.

In addition to raising sufficient revenues for public spending, a tax system should also consider the mode of raising the revenue to ensure that it is "fair", efficient and facilitate administrative compliance with the law. These are often conflicting goals, and all the more so if we use tax law to implement economic, social, political and cultural objectives. Hence, ultimately, all tax law is a compromise of competing values. Tax policy analysis should evaluate the effectiveness and efficiency of the compromises.

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