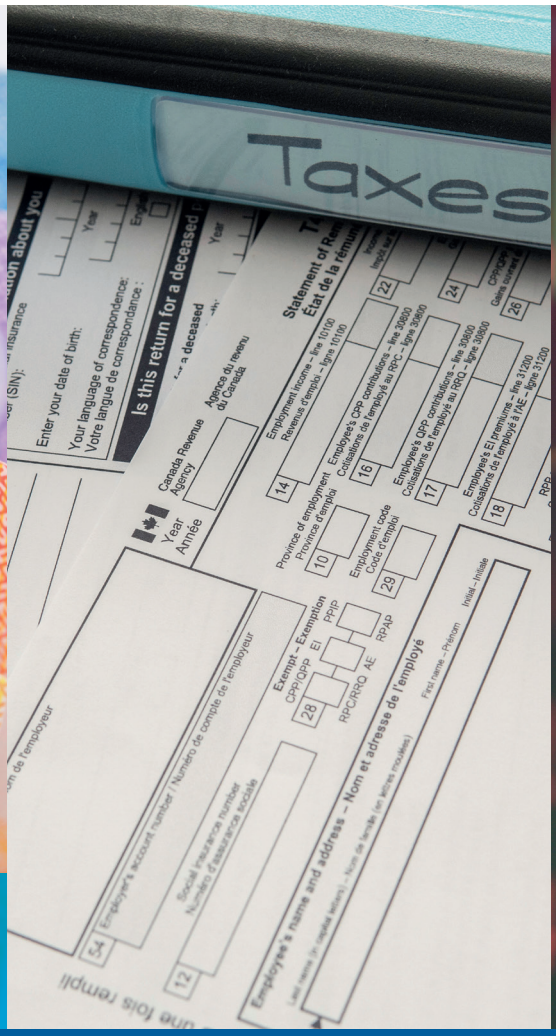
MEI Ideas for a More Prosperous Society



RESEARCH PAPERS

SEPTEMBER 2022

CHOKING HAZARD

THE ADVERSE EFFECTS OF "EAT THE RICH" POLICIES

By Valentin Petkantchin and Nathalie Elgrably-Lévy

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HIGHLIGHTS

The progressivity of the tax system is a widely accepted principle. Already in Ancient Greece, not only did taxation exist, but the idea of having the rich pay more was advanced. Today, despite some 2,500 years of history, the issue of the taxation of the rich remains topical. It may even be more topical than ever.

This Research Paper analyzes four fiscal measures regularly recommended for raising taxes on "the rich." The first three target the "rich" as individual taxpayers, while the 4th targets companies:

1. A 1% wealth tax, levied on fortunes over $10 million
2. An increase in the capital gains inclusion rate from 50% to 75%
3. An increase in the federal income tax rate from 33% to 35% for incomes over $216,000
4. An increase in the federal corporate income tax rate from 15% to 18%

Whatever the definition of the term "rich," such taxation targets the best-performing economic actors on the market, and therefore those who create wealth. Yet since all economic actors respond to incentives, and since taxation constitutes a powerful incentive, it is essential to study the unexpected and undesirable effects (the unintended consequences) of proposed measures, and to insert them into the debate. It is from this angle that this Paper proposes to analyze the four measures listed above. It will draw upon the teachings of economics, and Canadian and international experiences will also shed some empirical light on the matter.

A 1% wealth tax, levied on fortunes over $10 million

This tax is politically alluring since its base is very limited. However, it is difficult to implement as it encounters a multitude of operational obstacles and presents a number of adverse effects that harm society as a whole.

Defining what constitutes taxable wealth, calculating the value of the assets of which it is composed at the *precise moment* when the tax is calculated, and curbing the problems of tax avoidance and capital migration are all obstacles to the implementation and administration of a wealth tax. Indeed, most European countries that had introduced such a tax have abandoned it in recent decades, often for these very reasons. That is the case for Austria, Germany, Sweden, and France, which eliminated it because of the economic harm it caused.

Wealth taxes also have unintended consequences. Because they reduce the profitability of investments, they incentivize rich taxpayers to consume a larger portion of their wealth, and therefore to reduce their saving and their investment in productive activities, which undermines productivity and the progression of living standards. Germany estimated this, observing a potential reduction in economic growth, investment, and employment, as well as lower overall tax revenues.

An increase in the capital gains inclusion rate from 50% to 75%

This measure has several unwanted and harmful repercussions for the economy as a whole. For one thing, it would affect taxpayers of more modest means as well as those with the highest incomes. It would also increase the cost of venture capital, reduce the capacity of SMEs to attract qualified labour, slow the fluidity of capital in the economy, and ultimately compromise productivity growth. In contrast, eliminating this kind of tax is beneficial. In Switzerland, for example, the non-taxability of capital gains allowed for increased real incomes all while maintaining the overall level of tax revenues. Indeed, asked to decide in a referendum in 2021, the Swiss rejected—by a large majority of 65%—an initiative aiming to raise the inclusion rate up to 150%, much like what is proposed these days in Canada.

An increase in the federal income tax rate from 33% to 35% for incomes over $216,000

As income from labour represents 3/4 of the total taxable income of high earners, increasing the income tax rate directly targets those taxpayers who create wealth as employees. This increase would be particularly harmful in the Canadian context, for several reasons. Besides the fact that it

would raise the combined federal-provincial rates, except Saskatchewan's, to or above the psychological threshold of 50%, and several of them above 55%, it risks having a negligible, or even a negative, effect on total tax revenues in Canada, since it would incentivize individuals to modify their behaviour in the labour market. Certain taxpayers could even be tempted to emigrate to a country with a more attractive tax regime, which would affect the future performance of Canadian companies, and thus economic growth and the standard of living of the population.

Based on Canada's experience in 2016, we can extrapolate that increasing the federal income tax rate from 33% to 35% would have a negative impact on total tax revenues when considering combined federal and provincial revenues.

The experience of the United Kingdom provides similar results following its raising of the top income tax rate from 40% to 50% in April 2010. Indeed, the British Treasury revised this rate downward as of 2013.

An increase in the federal corporate income tax rate from 15% to 18%

In theory, such a measure aims to increase taxes on the owners of companies, who are supposed to bear the burden of the higher corporate income tax. The reality, however, is much more nuanced.

For one thing, while it is companies that concretely pay the amounts due for this tax, they can lighten their burden by passing it on to other economic agents, notably shareholders and employees, but also consumers and retires (through their pension funds).

For another thing, by reducing the profitability of Canadian companies, a higher corporate income tax would undermine their international competitiveness. Indeed, a study of 85 countries showed that corporate income taxes have substantial unintended consequences on investment and entrepreneurship, and thus on economic growth.

As this Paper testifies, taxation is a delicate area where governments must act with a great deal of caution. Like nuclear energy that can illuminate cities if it is used properly or destroy them if it is not, taxation can fund public interventions but can also dig an economy's grave.

Thus, any modification of the tax regime must be scrupulously analyzed in order to identify all potential unintended consequences, notably those that would push economic actors to invest less, work less, move, or export their capital and their wealth.

Finally, instead of seeking to increase the tax burden on the rich just because they are rich, the government of Canada should favour initiatives that will improve Canada's international competitive positioning, notably with regard to the United States, and make it more attractive for foreign investment and wealth creation.

INTRODUCTION

Behind its provocative title, this Research Paper analyzes four fiscal measures often considered in order to collect more taxes from "the rich." Whichever way this term is defined, such tax policy systematically targets entrepreneurs and economic actors who have done the best in the marketplace. By penalizing in particular those who create wealth, this selective taxation also gives rise to a number of adverse effects that threaten the prosperity of all Canadians.

Yet these adverse effects are often absent from the public debate.

By analyzing the relevant economic arguments, as well as Canadian and international experience, this study aims to describe these effects, for they deserve to make up an integral part of the debate. The point here is not to "defend the rich"—especially if their wealth was obtained through means other than trade in the service of consumers, innovation, and the creation of prosperity.

By penalizing in particular those who create wealth, selective taxation gives rise to a number of adverse effects that threaten the prosperity of all Canadians.

The four measures analyzed resurface regularly in the news and in economic debates. They are the following, with the first three targeting the "rich" as individual taxpayers, and the fourth targeting companies:

1. A 1% wealth tax, levied on fortunes over $10 million
2. An increase in the capital gains inclusion rate from 50% to 75%
3. An increase in the federal income tax rate from 33% to 35% for incomes over $216,000
4. An increase in the federal corporate income tax rate from 15% to 18%

What adverse effects would such fiscal measures have on the Canadian economy as a whole? What do national and international experience have to teach us about their consequences?

This Research Paper analyzes each of these four measures following a similar structure, namely:

- The presentation of the measure from a historical perspective
- An analysis of the economic arguments and the mechanisms by which adverse effects are disseminated, notably through distortions and incentives created in the economy by the new fiscal measures
- A study of the empirical arguments illustrating the effects of each new measure:
  - Examples and potential lessons from the Canadian experience
  - International examples and comparisons
- The proposal of recommendations based on the analysis of the tax in question, as the case may be, in order to promote the creation of wealth and prosperity in Canada

The Research Paper has one chapter devoted to each measure.

CHAPTER 1

Wealth Taxes Lead to Poverty

One of the measures to "eat" the rich consists of taxing their fortunes (capital and assets), in the form of a wealth tax. The idea of imposing such a tax recurs regularly in the public debate in Canada. For example, during the most recent election campaign, it was proposed to tax all net wealth above $10 million at a rate of 1%.[1]

This is a politically seductive tax, since it would in theory only apply to some tens of thousands of households (75,000 households according to a recent estimate),[2] namely those having accumulated the largest fortunes in Canada.

However, not only would this tax be difficult to implement and administer, but it would also have a number of adverse effects that make it a "lose-lose" fiscal measure for society as a whole.

1.1 "Wealth" Is Difficult to Define, Evaluate, and Tax

According to the OECD, a wealth tax is a tax on "movable and immovable property, net of debt."[3] Even though the term "wealth" is a common one, it is not easy to define precisely for tax purposes. What should be included? For example, must the value of a household's principal residence be taken into account, or that of durable consumer goods like cars and boats, or the value of works of art, jewelry, and other collectible items? What about the value of productive capital, machines, or the assets of sole proprietorships?

Defining taxable wealth, in order to determine precisely what the fiscal calculation will be based on, is thus a first practical obstacle to the implementation of a wealth tax. Generally, even though exemptions for assets like those enumerated above are sometimes granted, the tax basically covers cash, financial assets like stocks and bonds, business capital, real estate, and high-value assets like boats, collector cars, and works of art.[4] Total debts are then deducted from the total value of these assets. The tax is therefore applied to total *net* wealth. In the case of the Canadian proposal, any net wealth above $10 million would thus be taxed annually at the rate of 1%.

Yet such a tax is calculated and must be paid regardless of income earned by the taxpayer during the year. The amount of tax to be paid can thus easily exceed one's annual income, in which case one must sell a portion of one's assets in order to cover the tax payment, a situation that is rare in the context of existing taxes.[5]

Even though the term "wealth" is a common one, it is not easy to define precisely for tax purposes.

The implementation of a wealth tax would also face a whole series of operational difficulties, which can be costly to resolve.

- First, the value of the assets that make up the fortune must be determined at the *precise moment* when the tax is calculated. While it is relatively easy to estimate the value of corporate shares listed on a stock market at a given date by looking at their market price (even though this requires abstracting away the normal fluctuations on financial markets), it is more complicated to estimate the value of real estate (in the absence of a sale or transaction), or of corporate shares not listed on a stock market. As opposed to income, wealth has proven difficult to measure.[6]
- Second, should only the wealth held domestically be included, or should this be expanded to include the wealth the taxpayer holds all around the world? In the latter case, the fiscal administration costs are generally far higher if taxpayers do not declare the existence of such foreign

1. New Democratic Party, *Ready for Better - NDP 2021 commitments*, 2021, p. 114.
2. Alex Hemingway, "Robust wealth tax could raise $363B over 10 years," Policy Note, September 14, 2014.
3. OECD Tax Policy Studies, *The Role and Design of Net Wealth Taxes in the OECD*, 2018, p. 16.
4. Michelle Scott, "Wealth Tax," *Investopedia*, May 8, 2022.
5. Jack M. Mintz and James E. Pesando, "Wealth Taxation in Canada: An Introduction," *Canadian Public Policy*, Vol. 17, No. 3, September 1991, p. 229.
6. Marcus Drometer *et al.*, "Wealth and Inheritance Taxation: An Overview and Country Comparison," *ifo DICE Report*, 2018, Vol. 16, No. 2, p. 45.

assets. In general, taxpayers are encouraged to minimize the value of their fortunes, and the tax collector has to deploy considerable resources to obtain a more precise evaluation of the wealth to be taxed.[7]

- Finally, if exemptions are granted, "rich" taxpayers will be tempted to transfer a portion of their taxable assets into those types of assets that are exempt, thus reducing the tax's ability to generate the tax revenues the authorities expect. Another form of avoidance that impacts tax revenues consists of taxpayers simply transferring their assets, and even their tax residence, abroad, thereby putting their fortunes out of reach of the wealth tax.[8]

International experience confirms that the implementation and administration of a wealth tax are particularly expensive for the tax authorities because of these obstacles (see the case of France, below).

International Experience

The difficulties of implementing and administering a wealth tax are illustrated by international experience. For example, most European countries that had implemented such a tax have eliminated it in recent decades, notably for the reasons mentioned above.[9]

A CD Howe Institute report summarizes the change in this regard:

> Two decades ago, one-half of OECD member countries had some type of annual wealth tax, but many have discontinued it. [...] In those few nations that continue to have a wealth tax, its proceeds have decreased over time. [...] Our argument against wealth taxation is over and above the substantial administrative challenges in measurement, collection and coverage for annual wealth taxes. These alone are enough to raise red flags about wealth taxation.[10]

7. Philip Cross, *Does Canada Need a Wealth Tax?* Fraser Institute, October 15, 2020, p. 16.

8. Allan D. Viard, "Wealth Taxation: An Overview of the Issues," American Enterprise Institute, October 15, 2019, p. 189.

9. Robin Boadway and Pierre Pestieau, "Over the Top: Why an Annual Wealth Tax for Canada is Unnecessary," CD Howe Institute, June 2019, p. 3.

10. *Idem.*

As another recent study pointed out, the elimination of the tax in various countries was "generally motivated by administration and compliance difficulties, undesired behavioral responses such as emigration, and disappointing revenue yields."[11]

Most European countries that had implemented a wealth tax have eliminated it in recent decades.

The main reasons given for the elimination of the wealth tax were the following:

- **Austria:** The tax was abolished in 1993 "due to the high administrative costs that accrued in the data collection process and because of the economic burden the wealth tax meant to Austrian enterprises."[12]
- **Germany:** The tax was eliminated in 1997 as it was deemed unconstitutional, but in addition to this, "[o]ne evident reason was the comparatively small tax revenue that it yielded (only 0.8% of total tax revenues) and the weak enforcement given the high administrative costs of implementing it."[13]
- **France:** The Solidarity Wealth Tax (ISF) was created in 1989.[14] It led to considerable tax evasion and was eliminated in 2017.[15] It has been estimated that 510 wealthy households left the country each year over a 33-year period. The migration of capital was evaluated at between 143 billion and 200 billion euros (constant 2015 euros).[16]
- **Sweden:** The wealth tax was abolished in 2006. One of the main criticisms was that "the wealth tax spurred tax avoidance and evasion, especially in the form of capital flight to offshore tax havens."[17]

11. Allan D. Viard, *op. cit.*, footnote 8, p. 181.

12. Marcus Drometer *et al.*, *op. cit.*, footnote 6, p. 49.

13. *Idem.*

14. Philippe Crevel and Sarah Le Gouez, "L'ISF, l'histoire agitée d'un impôt à fort ressort médiatique," Le cercle de l'épargne, September 2017, p. 2.

15. Valérie Mazuir, "IFI, le nouvel ISF version Macron," *Les Echos*, September 30, 2019.

16. Gaël Campan, "Wealth Taxes End Up Hurting Main Street," MEI, Economic Note, July 16, 2020, p. 3.

17. Daniel Waldenström, "Inheritance and Wealth Taxation in Sweden," Institut ifo, Vol. 16, No. 2, 2018, p. 9.

A recent American report that took an in-depth look at the challenges related to a wealth tax concluded that it "generates a swarm of avoidance and does a lot of economic damage per dollar raised. That is why most of Europe has abandoned wealth taxes and the United States has not imposed one."[18]

Indeed, wealth taxes are not just difficult to implement; they also have substantial adverse effects on economic growth. And anything that limits economic growth necessarily affects society as a whole.

1.2 Reduced Savings, Investment, and Growth

The implementation of a wealth tax has a direct impact on investment in the economy, as it automatically reduces its rate of return (see Box 1-1).

Investment and saving being two facets of the same phenomenon, a drop in the return on investment reduces the demand for loanable funds, which in turn reduces the return on saving. As saving becomes less attractive, wealthy taxpayers are encouraged to consume a larger portion of their fortunes, and therefore reduce their savings and investments in productive activities because "[i]f you consume money fast rather than invest it, you save a bundle of wealth taxes."[19]

Estimates of Economic Losses: The German Example

As in Canada, the idea of a wealth tax resurfaced in the public debate in Germany a few years ago. An estimate of the economic consequences of introducing such a tax was presented in 2018 in a report prepared for the Federal Ministry for Economic Affairs and Energy.[20]

The report has the merit of quantifying the overall impact of different wealth tax implementation scenarios, including the impact on several economic indicators, as well as on *total* tax revenues, and not just those generated by the new tax.

It is worth emphasizing the importance of considering the tax system in a holistic manner. The sums collected by a tax constitute an amount of money that will be neither spent nor saved nor invested. Since these alternative uses themselves also generate tax revenues and additional economic activity that would in turn entail tax revenues, it is imperative to carry out a comprehensive analysis of the effects of a tax measure, in the short term and also in the longer term.

For example, a wealth tax of 0.8% (starting at 1 million euros for single filers and 2 million euros for couples) would result, according to the model estimate, in a decrease of around 5% in GDP (after 8 years), a drop of over 10% in investment, and a reduction of over 40% in household saving[21] (see Table 1-2).

Reduced investment negatively affects the productivity of labour in the economy and in the end is a drag on economic growth.

Moreover, although it was estimated that the wealth tax would generate over 18 billion euros a year in the short term (and 14 billion euros in the long term), it would entail a reduction in revenues from other taxes, such as the income tax and the capital gains tax. The total fiscal loss of a wealth tax would thus represent over 31 billion euros a year in the long term (see Table 1-3), without even taking into account the administrative costs that such a tax would require.[22]

The authors of the report conclude in the following terms:

> [O]ur analysis demonstrates that a wealth tax can have a notable adverse impact on economic activity, reducing economic growth, investment and employment. As a result, the burden of a wealth tax is practically borne by every citizen, even if the wealth tax is designed to target only the wealthiest individuals in society, via high tax-free allowances, for instance. Moreover, the introduction of a wealth tax in the form considered in our analysis would actually

18. John H. Cochrane, "Wealth and Taxes," Cato Institute, Tax and Budget Bulletin, February 25, 2020, p. 6.

19. *Ibid.*, p. 7.

20. Clemens Fuest *et al.*, "The Economic Effects of a Wealth Tax in Germany," *Ifo DICE Report*, Ifo Institute, Vol. 16, June 2018.

21. *Ibid.*, pp. 24-25.

22. *Ibid.*, p. 25.

Box 1-1

Wealth Taxes and Savings

For purposes of illustration, suppose someone invests $100,000 for their retirement. If the investment generates a net rate of return (after taxes) of 4%, the taxpayer would have $480,102 after 40 years. However, if this same total amount is subject to a 1% wealth tax each year, the taxpayer will have a third less ($321,175) and the rate of return would fall by more than a quarter, to below 3%. A 2% wealth tax would reduce the final amount by more than 55%, while the rate of return would be reduced by more than half, to 1.9% rather than 4% without the tax (see Table 1-1).

Thus, "[t]he effect on incentives for young people to save for their retirement, for example, can be dramatic"[1] following the implementation of a wealth tax.

Table 1-1

Investment, rate of return, and wealth tax (40 years)

Amount invested	Rate of return	Amount available	With 1% tax	Rate of return with 1% tax	With 2% tax	Rate of return with 2% tax
$100,000	4.0%	$480,102	$321,175	3.0%	$213,982	1.9%

Therefore, even at an apparently low rate like 1%, a wealth tax has a serious impact on the long-term rate of return not only of retirement savings but also of any investment. Reduced investment in turn negatively affects the productivity of labour in the economy—with wages tending to stagnate as a result—and in the end is a drag on economic growth.

1. Adam Stuart and Helen Miller, "The economic arguments for and against a wealth tax," *Fiscal Studies*, Vol. 42, Nos. 3-4, October 25, 2021, p. 465.

> lead to a decline in total tax revenue, as the revenue gains from a wealth tax are notably lower than the decline in revenues from other taxes, especially the labour income tax and the sales tax.[23]

A recent Fraser Institute study echoes this. In the Canadian context, a small reduction in saving, investment, and GDP would suffice to entail a reduction in tax revenue that would exceed the expected revenues from the wealth tax.[24]

A simulation of the impact of implementing a wealth tax is all the more important given that Canada's economy is small and open, as tax expert Jack Mintz was already pointing out in the early 1990s:

> Canada is a small open economy. As is the case with income taxes, a small open economy may find it difficult to impose taxes on

23. *Ibid*., p. 26.

24. Philip Cross, *op. cit*., footnote 7, p. 26.

Table 1-2

Estimate of the economic impact of implementing a wealth tax in Germany	
Economic indicator	**0.8% wealth tax scenario (starting at 1 million euros for single filers and 2 million euros for couples)**
Gross domestic product (GDP)	-5.1%
Production	-5.2%
Investment	-10.3%
Employment	-2.1%
Household consumption	-4.1%
Household saving	-41.3%
Household wealth	-24.7%

Source: Clemens Fuest *et al.*, "The Economic Effects of a Wealth Tax in Germany," *Ifo DICE Report*, Ifo Institute, Vol. 16, June 2018, p. 25.

Table 1-3

Estimate of the fiscal consequences of implementing a wealth tax in Germany	
Sources of tax revenue	**Billions of euros**
Wealth tax	€14.74
Other tax revenue	- €46.10
Income tax (wages)	- €22.13
Value added tax	- €12.76
Corporate income tax	- €6.78
Capital gains tax	- €4.39
Net	- €31.36

Source: Clemens Fuest *et al.*, "The Economic Effects of a Wealth Tax in Germany," *Ifo DICE Report*, Ifo Institute, Vol. 16, June 2018, p. 25.

> wealth in a world where global capital markets are increasingly integrated. Tax theory suggests that the efficient rate of a tax on a good or factor decreases in value, the more responsive is the consumption of the good or the use of the factor to changes in the tax rate. In a small open economy, the optimal rate of tax on a perfectly mobile good or factor is zero. If wealth is highly mobile, efficiency considerations would indicate that it not be taxed.[25]

These arguments remain valid in the current context, with capital just as mobile as it was 30 years ago, if not more so.

A small reduction in saving, investment, and GDP would suffice to entail a reduction in tax revenue that would exceed the expected revenues from the wealth tax.

25. Jack M. Mintz and James E. Pesando, *op. cit.*, footnote 5, pp. 227-236.

CHAPTER 2

No Gain from a Higher Inclusion Rate

Capital gains earned by individual taxpayers[26] are often presented as being a source of income for the rich alone.[27] Proposing to increase the taxation of such gains—in whichever form—thus logically resurfaces in the public debate when ways of taxing the rich are discussed.

Currently, for various reasons, only half of capital gains earned are taxable. In the fiscal jargon, this corresponds to an inclusion rate of 50%.[28] Increasing this rate is one of the measures raised in the public debate in Canada with a view to making the "rich" pay more.

For example, increasing the inclusion rate to 75% was proposed in order to more heavily tax capital gains. Among other things, this measure would target the profits earned by entrepreneurs when they sell their assets (stocks, bonds, and real estate).[29]

There are several aspects of capital gains taxation that deserve to be highlighted:

- *The gains of taxpayers with relatively modest earnings would also be taxed.* Of course, the taxpayers with the highest incomes would be affected, but they would not be the only ones; less well-off taxpayers would also be penalized by increasing the taxation of capital gains (see Section 2.1).
- *There would be a negative economic impact* on the cost and the mobility of Canadian capital, as well as on entrepreneurship (see Section 2.2).
- *The tax competitiveness of Canada (and of Canadian provinces) would be weakened.* The ability to attract foreign investment and to compete with other jurisdictions in North America and elsewhere in the world would be reduced if the inclusion rate were raised to 75% (and even more so if it climbed to 100%). Reduced investment would have an effect on productivity, future economic growth, and ultimately, the salaries and standard of living of all Canadians (see Section 2.3).

2.1 Capital Gains: Just a Rich Person's Game?

In Canada as elsewhere in the world, the public debate is focused on the fact that the way capital gains are taxed essentially benefits the "rich," or even the "ultra-rich" (for example, the top 1% of income earners).

The "rich" are not the only taxpayers to earn capital gains and pay taxes on them in Canada.

Yet in a market economy, it is natural for entrepreneurs who do well and create wealth, and hence those who successfully multiply their invested capital, to be (over)represented among capital gains earners. This is notably the case when entrepreneurs sell their businesses in order to retire, or when they sell a start-up after having played the role of angel investor, and they withdraw their venture capital.

Nonetheless, the "rich" are not the only taxpayers to earn capital gains and pay taxes on them in Canada.

Indeed, the figures often put forward in this regard are misleading. The public debate is often focused on the share of the 1% of taxpayers with the highest incomes, including capital gains. For instance, one can read such statistics as: "[t]he top 1.1 per cent of all returns filed in 2017, with incomes above $250,000, reported $20.2 billion or 55 per cent of all capital gains."[30]

To be sure, wealthy investors earn capital gains, which is to be expected in a market economy since they create wealth. However, they are not

26. In Canada, capital gains taxes are paid by individual taxpayers as well as by companies. Only the first type of taxation is examined here.

27. Rhys Kesselman, "Getting the facts straight on capital gains tax," *Financial Post*, February 4, 2021.

28. Valentin Petkantchin and Olivier Rancourt, "The Capital Gains Tax and Inflation: How to Favour Investment and Prosperity," MEI, Economic Note, April 14, 2022.

29. Nick Boisvert, "How the main federal parties plan to tax the wealthy," CBC News, September 16, 2021.

30. Rhys Kesselman, *op. cit.*, footnote 27.

Table 2-1

Distribution of capital gains, by income bracket, with and without including taxable capital gains, Canada, 2018

	Value of capital gains				Number of taxpayers				
Income bracket	Share WITH capital gains		Share WITHOUT capital gains		Share WITH capital gains		Share WITHOUT capital gains		
	Millions of $	Share	Millions of $	Share	1,000s	Share	1,000s	Share	% of all taxpayers
50K or less	1,988	5%	12,625	34%	1,160	40%	1,386	48%	4.9%
50K-100K	3,700	10%	8,831	24%	962	33%	921	32%	3.2%
100K-250K	7,125	19%	7,783	21%	612	21%	494	17%	1.7%
250K or +	24,717	66%	8,109	22%	182	6%	114	4%	0.4%
Total	37,530	100%	37,348	100%	2,916	100%	2,916	100%	10.3%

Source: Tommy Gagné-Dubé *et al.*, "Policy Forum : La concentration réelle des gains en capital au Canada — Une analyse longitudinale," *Canadian Tax Journal*, Vol. 69, No. 4, 2021, p. 1198.

the only ones. Taxpayers with average or more modest incomes can also earn such gains, for example on the occasion of an unusual occurrence such as the sale of a business, the fruit of a lifetime of saving, investment, and labour, with a view to retiring. In order to know which types of taxpayers are actually affected by this tax, the exceptional "jump" in income bracket caused by a capital gain needs to be excluded.

Nearly half (48%) of taxpayers who realized capital gains in 2018 are in the $50,000 or less income bracket if the exceptional income from the gain that year is excluded.

Tax experts from the University of Sherbrooke's Taxation and Public Finances Chair (CRRP) carried out this exercise for 2018, as can be seen in Table 2-1, notably the columns that exclude taxable capital gains.

This table features the kinds of figures often put forward in the public debate (in the "Value of capital gains/Share WITH capital gains" columns): Taxpayers in the top 1%, approximately equivalent to those earning $250,000 or more, did indeed realize gains of $24.7 billion, or two-thirds (66%) of the $37.5 billion in total taxed capital gains in 2018.

However, if we take into account the exceptional nature of capital gains as a source of income, the share earned by taxpayers in the top 1% is cut in three, and represents just $8.1 billion, or 22% of the total. More surprising still: nearly half of taxpayers (48%—see the "Number of taxpayers/Share WITHOUT capital gains" columns in Table 2-1) who realized capital gains in 2018 are in the $50,000 or less income bracket if the exceptional income from the gain that year is excluded.

The share rises to 80% if we include taxpayers who earn less than $100,000. The gains of those earning $50,000 or less total $12.6 billion, and for those earning less than $100,000, the gains total $21.5 billion, which is 55% more and 165% more, respectively,

than the gains of those earning over $250,000, which total $8.1 billion.[31]

Contrary to taxpayers in the top 1% who can more easily afford a more burdensome taxation of capital gains, these less affluent taxpayers—who declare taxable capital gains on average around once every 15 years[32]—would certainly find themselves hard-hit by an increase in the inclusion rate to 75%, and even more by an increase to 100%.

Increasing the inclusion rate to 75% would make the economy less innovative and less dynamic, ultimately affecting economic growth, productivity, and wages.

Other studies find similar results,[33] namely that a significant portion of taxpayers affected by the capital gains tax are not among the richest 1%. In wanting to "make the rich pay," advocates of increasing the inclusion rate in fact also risk punishing many middle-class taxpayers, and those of more modest incomes, as these will be affected right along with the rich.

2.2 Impact on the Cost and the Mobility of Capital, and on Entrepreneurship

It is especially SMEs and start-ups—generally the most dynamic elements in an economy—that would be penalized by an increase in the inclusion rate.

Indeed, the main direct consequences of increasing capital gains taxation would be:

- *Increasing the cost of venture capital and discouraging entrepreneurship* – Like a sales tax that raises the cost of goods and services, the capital gains tax impacts the transfer of businesses, as the tax is due upon the resale of capital invested in the SME or start-up.

  Indeed, in anticipation of the tax to be paid, investors demand a higher return to invest in these companies. This has the effect of making the funds used by SMEs and start-ups rarer, increasing their cost and discouraging entrepreneurship.

  For example, if angel investors are penalized each time they want to withdraw their venture capital when they invest in Canada, fewer of them will want to do so. Also, capital will be less mobile to be withdrawn from start-ups in order to be reinvested in new projects that promise greater returns (a form of "lock-in" effect—see below). At the same time, it will be more difficult for SMEs and start-ups with new, innovative projects to find the funds they need to finance their growth in the Canadian market.[34]

- *Making it more difficult for start-ups and SMEs to attract skilled labour* – These companies have trouble competing with large, well-established companies in terms of salaries. To attract skilled workers, SMEs and start-ups often use forms of remuneration tied to results, such as stock options. Greater taxation of capital gains means that a larger portion of the increased value of these stocks would go to the taxman instead of remunerating a company's leader and executives. The tax thus makes it more complicated for start-ups and SMEs to attract talent.[35]

- *Reducing the efficiency of capital allocation and flow in the economy* ("lock-in" effect) – If taxation hits the transfer of capital, then capital will tend to be transferred less often. This situation is problematic when the transfer is justified on grounds of efficiency, but is avoided for reasons of taxation. The tax thus reduces the mobility of capital, thereby keeping it in inefficient and relatively less productive contexts when it would have been preferable to direct it toward uses with greater added value:

31. See the "Value of capital gains/Share WITHOUT capital gains" columns in Table 2-1.

32. Tommy Gagné-Dubé, *et al.*, "Policy Forum : La concentration réelle des gains en capital au Canada — Une analyse longitudinale," *Canadian Tax Journal*, Vol. 69, No. 4, 2021, p. 1205.

33. Alex Whalen and Jason Clemens, "Correcting Common Misunderstandings about Capital Gains Taxes," Fraser Institute, January 2021, p. 9; Alexandre Laurin, "Tracking Capital Gains: Not Just for the Rich," C.D. Howe Institute, October 14, 2021.

34. Lora Dimitrova and Sapnoti Eswar, *Capital Gains Tax, Venture Capital, and Innovation in Start-ups*, November 13, 2019, p. 7.

35. Niels Veldhuis, Keith Godin, and Jason Clemens, *The Economic Costs of Capital Gains Taxes*, Fraser Institute, February 2007, p. 16.

> This is due simply to the fact that when investors have incentives to keep scarce capital in a particular investment longer than they otherwise would, this situation prevents that capital from being reallocated to better, more productive uses. Less productive uses of capital mean overall returns to capital are lowered, which affects the strength of the economy as a whole.[36]

The tax has a particularly negative effect on the flow and mobility of venture capital in the economy, whereas it would be better for it to be highly mobile. If an idea or investment project proves to be a dead end, its funding needs to be rapidly stopped and the capital reallocated elsewhere. With a high level of taxation, venture capital therefore becomes relatively rarer, and innovative projects have more trouble locating funding. In order to find it, entrepreneurs need to look abroad in order to carry out their innovative and potentially wealth creating ideas, as highlighted by a study on the economic costs of this type of taxation.[37]

Increasing the capital gains tax by hiking the inclusion rate to 75% would make the economy less innovative and less dynamic, ultimately affecting economic growth, productivity, and wages in the country.[38]

The authors of a study on the economic costs of this tax conclude, on this topic:

> Capital gains taxes make capital investments more expensive and therefore less investment occurs. Less capital has a number of negative consequences including decreasing the productivity of Canadian workers and ultimately lowering Canadian living standards. [...] Capital gains taxes reduce the return that entrepreneurs and investors receive from the sale of a business. This diminishes the reward for entrepreneurial risk-taking and reduces the number of entrepreneurs and the investors that support them. The result is lower levels of economic growth and job creation.[39]

2.3 Lower Fiscal Competitiveness

An increase in the inclusion rate automatically means an increase in the effective capital gains tax rate. For example, in the case of Quebec, with a top federal-provincial tax rate of 53.31%, an inclusion rate of 50% is equivalent to an effective rate of 26.655%. This rate would climb to 39.98% with 75% inclusion, and to 53.31% with total (or 100%) inclusion.

A 75% inclusion rate would give Canada the third highest capital gains tax rate among OECD countries.

Since countries apply diverse and varied provisions to the different kinds of capital gains, it is difficult to present a precise comprehensive evaluation of Canada's international competitiveness. Nonetheless, a simple comparison of the general regime, without exemptions, of capital gains on the sale of listed stocks held for the long term allows the competitiveness of Canada and of the provinces to be situated. As can be seen in Table 2-2, a 75% inclusion rate would give Canada the third highest capital gains tax rate. If the inclusion rate were increased to 100%, Canada would have the heaviest capital gains tax burden, far ahead of Denmark.

2.4 The Swiss Lesson

The case of Switzerland is interesting in more than one regard when it comes to capital gains taxation.

For one thing, it is one of the countries where capital gains on securities for individuals are now exempt from taxation.

36. Tommy Gagné-Dubé, *et al.*, *op. cit.*, footnote 32, p. 3.

37. Jason Clemens, Charles Lammam, and Matthew Lo, *The Economic Costs of Capital Gains Taxes in Canada,* Fraser Institute, October 2014, p. 7.

38. Daniel J. Mitchell, "The Overwhelming Case Against Capital Gains Taxation," *Forbes*, November 7, 2014.

39. Jason Clemens, Charles Lammam, and Matthew Lo, *op. cit.*, footnote 37, pp. 6-8.

Table 2-2

Top capital gains tax rate* in OECD countries, April 2021		
Rank	**Country**	**Top CGT rate (%)**
((1))	**Canada (100%)[1]**	**53.31%**
1	Denmark	42.00
2	Chile	40.00
((3))	**Canada (75%)[2]**	**39.98%**
3	Finland	34.00
4	France	34.00
5	Ireland	33.00
6	Norway	31.68
7	Netherlands	31.00
8	Sweden	30.00
9	United States	29.20
10	Israel	28.00
11	Portugal	28.00
12	Austria	27.50
13	**Canada (50%)**	**26.65%**
14	Germany	26.38
15	Italy	26.00
16	Spain	26.00
17	Australia	23.50
18	Iceland	22.00
19	Japan	20.32
20	Estonia	20.00
21	Latvia	20.00
22	Lithuania	20.00
23	United Kingdom	20.00
24	Poland	19.00
25	Greece	15.00
26	Hungary	15.00
27	Colombia	10.00
28	Mexico	10.00
29	Belgium	0.00
30	Czech Republic	0.00
31	Korea	0.00
32	Luxembourg	0.00
33	New Zealand	0.00
34	Slovakia	0.00
35	Slovenia	0.00
36	Switzerland	0.00
37	Turkey	0.00

Source: Authors' calculations. Daniel Bunn and Elke Asen, "Savings and Investment: The Tax Treatment of Stock and Retirement Accounts in the OECD," Tax Foundation, May 2021, p. 9.
*Gains on stocks held for the long term and without majority ownership (exemptions and tax surcharges included)
[1] With 100% inclusion rate; [2] with 75% inclusion rate (based on top personal income tax rate of 53.31% for Quebec).

However, in the 1990s, several cantons (the equivalent of Canadian provinces) still had such a tax, while others had already eliminated it.[40]

One study analyzed the impact of the elimination of the tax in 8 cantons between 1986 and 1990. The study found an increase in real income in the long term. Also, thanks notably to this increase in real income (and in the other taxes that depend on it), the cantons' tax revenue was not negatively impacted.

The Swiss Federal Council concluded that an "increase in taxation would reduce [...] the amount of economically available capital per worker, thus notably depressing salaries."

According to the authors of the study:

> The data presented [...] suggest that abolishing the capital gains tax has had positive and economically significant effects on the level of real income in the cantons. [...] [It] has had no statistically negative effect on real tax revenues. This result is due to the fact that the increases in real income caused by abolishing the tax caused a corresponding increase in other tax revenues, which replaced those lost through abolishing the capital gains tax.[41]

For another thing, since the early 2000s,[42] several referendum initiatives have aimed to implement a tax on all capital gains, like current policy proposals in Canada. The most recent initiative put to a referendum took place in September 2021. Entitled "Alléger les impôts sur les salaires, imposer équitablement le capital" (Reducing taxes on salaries, taxing capital equitably) and also known as "Initiative 99%," this initiative was rejected by the Swiss population, with 65% voting against it and 35% voting in favour.[43]

This initiative proposed to introduce an inclusion rate on income from capital for individuals, including for capital gains on securities, of 150% above a certain threshold (100,000 Swiss francs) and of 100% below this threshold, compared to the current total exemption.[44] The proposal was the equivalent of an increase in the inclusion rate from 0% to 100%, and to 150% above the threshold.

According to one study, the proposal would have had several negative effects, notably:

- During business succession:

  > If the initiative is accepted, the net proceeds from the transfer would fall by between 26% and 49% compared to the current regime. [...] To maintain net proceeds at the current regime's level, the obvious solution for entrepreneurs is to increase the sale prices of their companies. To do so, the increases must be between 39% and 107%. It thus falls to buyers to finance the higher sale prices, for example by borrowing more.
  >
  > The consequence of such an increased sale price: a buyer must take money out of the company to finance a higher purchase price, perhaps by massively increasing the company's debt. Sooner or later, the company will be deprived of substantial funds and its capacity to invest and to create jobs will suffer. Globally, the Swiss economy will be severely weakened and become less attractive. The initiative affects family structures in particular.[45]

- During the sale of a start-up:

  > There too, the 99% initiative has weighty consequences: the proceeds from a sale by

40. Peter Kugler and Carlos Lenz, "Capital Gains Taxation: Evidence from Switzerland," in Herbert G. Grubel (ed.), *International Evidence on the Effects of Having No Capital Gains Taxes,* Fraser Institute, 2001, p. 59.

41. *Ibid*., pp. 60-64.

42. Confédération Suisse, Droits politiques, Objets soumis au référendum facultatif, Répertoire chronologique des demandes de référendum, Arrêté fédéral concernant l'initiative populaire "en vue de l'harmonisation fiscale, d'une imposition plus forte de la richesse et du dégrèvement des bas revenus (Initiative pour l'impôt sur la richesse)," consulted on June 3, 2022.

43. Confédération Suisse, Droits politiques, Objets soumis au référendum facultatif, Répertoire chronologique des demandes de référendum, Arrêté fédéral relatif à l'initiative populaire "Alléger les impôts sur les salaires, imposer équitablement le capital," consulted on June 2, 2022.

44. Confédération Suisse, Département fédéral des finances, Context Sidebar, Initiative populaire "Alléger les impôts sur les salaires, imposer équitablement le capital," (initiative 99 %), consulted on June 2, 2022.

45. Author's translation. Economiesuisse, "Résumé," TaxPartner Taxand, 2021, p. 2.

> the founder fall by between 28% and 52%. To offset this erosion, a start-up's sale price would need to be raised by between 39% and 107%.
>
> Thus, the initiative would undermine the attractiveness of our economy as a place to set up a new business.[46]

The Swiss Federal Council—which recommended the rejection of the initiative when the people and the cantons voted—concluded that an "increase in taxation would reduce the attractiveness of Switzerland for people whose capital generates substantial income, would have negative effects on the incentives to amass a fortune, and as a result, would reduce in the medium term the amount of economically available capital per worker, thus notably depressing salaries."[47]

Any proposal that aimed to increase the capital gains tax by raising the inclusion rate should be evaluated as carefully in Canada as it was in Switzerland.

Any proposal that aimed to increase the capital gains tax by raising the inclusion rate should be evaluated as carefully in Canada as it was in Switzerland.

46. Author's translation. *Idem*.

47. Author's translation. Confédération suisse, *Message concernant l'initiative populaire "Alléger les impôts sur les salaires, imposer équitablement le capital*," March 6, 2020, p. 2707.

CHAPTER 3

Hiking Rates Reduces Revenues

The idea of collecting more in income taxes from those who earn the most—whether the top 10% or just the top 1% of high-income earners—also resurfaces regularly in the public debate in Canada. Thus, during the 2021 federal election campaign, it was proposed to raise the top federal income tax rate from 33% to 35%[48] for income above $216,511.

While in theory, this would apply to all types of income, work income (salaries) would be particularly affected by such a hike. Indeed, although one might think that the rich get a larger share of their income from capital, in reality, work income represents 3/4 of the total taxable income of high earners.[49]

Thus, an increased income tax rate would weigh heavily on the taxpayers who create wealth as employees. They receive salaries in exchange for their contribution to economic growth and prosperity, which benefit all Canadians, today and tomorrow.

An increase in the top federal rate from 33% to 35% would be particularly harmful in the current Canadian context of anemic growth, for several reasons:

- *Historical context*: The increased tax rate would follow the substantial increase announced by the government of Canada in 2016, as well as provincial hikes, which currently push combined top federal-provincial rates above the 50% threshold in most provinces.[50] In Quebec, for instance, it is already 53.3%.
- *Fiscal impact*: The rate hike may well have a negligible, or even negative, effect on total tax revenues in Canada, namely those that combine federal and provincial revenues.
- *Reduced Canadian tax competitiveness*: The rate hike would position Canada's provinces among the least attractive industrialized countries in terms of drawing both international talent and the companies that use that talent.
- *Negative impact on economic growth*: The rate hike also runs the risk of undermining economic growth.

3.1 Historical Context: One Hike Too Many?

Canada had kept its top federal rate steady for almost three decades. But a new rate hike would come only a few years after the already considerable hike that was announced in 2016 and that raised the rate from 29% to 33% (see Figure 3-1).

Like the federal government, several provinces have also increased their rates in recent years.[51] A new hike of the top federal rate would push top combined federal-provincial rates, except Saskatchewan's, to or above the 50% threshold, and several of them above 55% (see Table 3-1).

A new hike of the top federal rate would push top combined federal-provincial rates above the 55% threshold in several provinces.

An increase in the top federal rate from 33% to 35% would increase the proportion of the salaries earned by taxpayers that are siphoned off into public coffers, a proportion which at the margin is already higher in most provinces than the proportion they receive in remuneration for their efforts. In other words, taxpayers would be even more inclined to reduce their activities, as the taxman leaves less than half of what they earn in their pockets. It's a situation that former NDP leader Thomas Mulcair described in these terms even before the 2016 increase: "Several provinces are now at the 50 per cent rate. Beyond that, you're not talking taxation; you're talking confiscation."[52]

48. Jamie Golombek, "How the major parties' proposed tax changes will affect your wallet," *Financial Post,* September 10, 2021.

49. Philip Gross, *Should Upper-Income Canadians Pay More Income Tax?* Fraser Institute, 2020, p. 15.

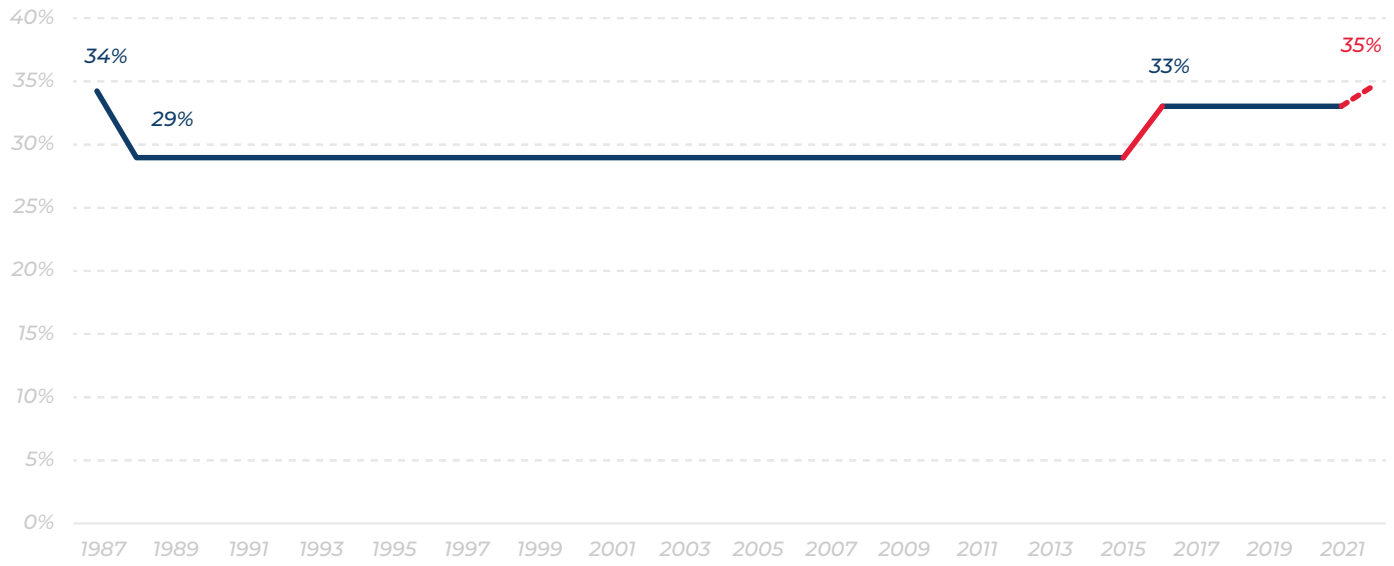
50. Jamie Golombek, *op. cit.*, footnote 48.

51. Ben Eisen, Milagros Palacios, and Nathaniel Li, *No Free Lunch for the 99 Percent: Estimating Revenue Effects from Taxes on Top Earners*, Fraser Institute, April 2022, p. 2.

52. Aaron Wherry, "Thomas Mulcair versus taxes," *Maclean's*, August 8, 2013.

Figure 3-1

Evolution of the top federal personal income tax rate, with proposed hike to 35%



Sources: Library of Parliament, Economics and Finance, "Personal Income Taxes in Canada: Revenue, Rates and Rationale," October 18, 2021.

3.2 Negative Impact on Provincial Government Revenues and on Total Tax Revenues

Both economic theory and Canadian and international experience confirm that taxpayers with the highest incomes modify their behaviour in predictable ways following an increase in the top personal income tax rate. These behaviours limit the tax revenues that can be expected by governments and negatively affect economic growth for the following reasons:[53]

- Rate hikes push the most productive entrepreneurs to make less of an effort to increase their incomes. On the contrary, they will prefer to devote more time to non-market and less productive activities, thus negatively impacting both tax revenues and economic growth.

Additional budget revenues following rate increases often prove lower than expected. If the tax base shrinks significantly, revenues could even fall.

- Rate hikes encourage taxpayers to change the kind of income they earn, or the moment of taxation (for instance by transforming salaries into potential capital gains to be realized in the future); this negatively impacts tax revenues.
- If it is deemed especially confiscatory, the hike could push taxpayers to leave Canada, or not to move here. The attraction of the country for international talents would thus be reduced, which would affect the future economic performance of Canadian companies.

53. Alexandre Laurin, "Unhappy Returns: A Preliminary Estimate of Taxpayers Responsiveness to the 2016 Top Tax Rate Hike," CD Howe Institute, September 27, 2018, p. 2.

Table 3-1

Top combined personal income tax rates by province, with federal rate hike

	2021			Scenario, 35% federal rate
	Provincial rate	Federal rate	Combined rate	Combined rate
British Columbia	20.50%	33.00%	53.50%	55.50%
Alberta	15.00%	33.00%	48.00%	50.00%
Saskatchewan	14.50%	33.00%	47.50%	49.50%
Manitoba	17.40%	33.00%	50.40%	52.40%
Ontario	20.53%	33.00%	53.53%	55.53%
Quebec	25.75%	27.56%	53.31%	55.31%
New Brunswick	20.30%	33.00%	53.30%	55.30%
Nova Scotia	21.00%	33.00%	54.00%	56.00%
Prince Edward Island	18.37%	33.00%	51.37%	53.37%
Newfoundland & Labrador	18.30%	33.00%	51.30%	53.30%

Note: The federal rate is lower in Quebec than in the other provinces because Quebec has withdrawn from several federal programs.
Source: Authors' calculations. Ben Eisen, Milagros Palacios, and Nathaniel Li, *No Free Lunch for the 99 Percent: Estimating Revenue Effects from Taxes on Top Earners*, Fraser Institute, April 2022, p. 3.

As illustrated by Canadian and international experience, high-income taxpayers generally have high elasticity of taxable income (ETI—see Table 3-2). A high ETI means that with each tax rate increase, the tax base shrinks considerably, as taxpayers modify their behaviour and reconsider their decisions.

Thus, because of all the economic reactions of "rich" workers, anticipated additional budget revenues following personal income tax rate increases often prove lower than expected. In fact, if the tax base shrinks significantly, tax revenues could even fall. Given what was observed following the 2016 rate hike, such a risk should be taken seriously in the Canadian context.

3.3 The 2016 Canadian Experience

The 2016 increase of the top federal rate from 29% to 33% is a real-life experience that can help us estimate the economic and fiscal impact of a new hike from 33% to 35%.

Empirical research suggests that this hike had, at best, a negligible effect on combined federal-provincial tax revenues; at worst, the rate increase effectively reduced total tax revenues.

As one study summarized:

> [I]ndependent analyses found that taxpayers' responsiveness was sufficiently high that the 2016 increase in the upper-income marginal tax rate produced little if any increase in overall government revenue in Canada.[54]

The 2016 increase of the top federal rate from 29% to 33% had, at best, a negligible effect on combined federal-provincial tax revenues.

A recent Fraser Institute report, based on the 2016 hike, concluded that increasing the top federal rate by one percentage point would result in around $244 million of additional federal tax revenues,[55] after taxpayers' reactions are taken into account. Under these conditions, a two percentage-point increase from 33% to 35% would

54. Ben Eisen, Milagros Palacios, and Nathaniel Li, *op. cit.*, footnote 51, pp. 5 and 7.

55. *Ibid.*, p. 12.

Table 3-2

Evaluation of elasticity of taxable income (ETI) following the 2016 top federal rate hike

Reference	ETI estimate*	Conclusion
Laurin (2018)	0.56	"[T]he tax hike would likely have yielded Ottawa about $1.2 billion – a small fraction of the more than $3 billion the hike would have yielded without the behavioural response, and $0.8 billion lower than budgeted. [...] The federal hike likely cost provincial treasuries about $1.3 billion in personal income tax revenues in 2016. Since the provincial losses exceed the $1.2 billion federal gains, the hike was a revenue loser on a national scale."
Ferede (2019)	-0.50	"[A] one percentage-point increase in the top federal personal income tax rate is associated with a reduction of total taxable income by about 0.50 percent. [...] [T]he tax rate would yield some additional revenue for the first nine years. In the long-term, paradoxically, the federal government stands to gain less revenue through the tax rate increase than it would without any tax rate change owing to the shrinkage of taxable income."
Smart and Uguccioni (2019)	0.50	"[O]ur estimates suggest the rate increase results in a tax base that is $5.5 billion smaller than it would otherwise be. This results in a loss in federal tax revenues of about $1.7 billion through the behavioural effect, leaving at net increase in federal revenues of just under $1 billion. At the same time, however, shrinkage in the shared tax base reduced provincial tax revenues by an additional $1.0 billion, leaving combined federal and provincial revenue essentially unchanged from a four percentage-point tax increase. Put somewhat differently, we conclude that top income tax rates are currently very close to their revenue-maximizing levels, so that rate changes have only negligible impacts on revenues."

* In response to the variation in the net-of-tax rate, except for Ferede (2019) where it is in response of the variation of the tax rate itself.
Sources: Alexandre Laurin, "Unhappy Returns: A Preliminary Estimate of Taxpayers Responsiveness to the 2016 Top Tax Rate Hike," CD Howe Institute, September 27, 2018, p. 6; Ergete Ferede, *The Revenue Effects Of Tax Rate Increases On High-Income Earners*, Fraser Institute, 2019, p. ii; Michael Smart and James Uguccioni, "Estimating taxpayer responses to top tax reforms," National Tax Association, Vol. 112, June 8, 2019, p. 23.

generate around $488 million more for federal government coffers.

However, the negative fiscal impact of this hike on the tax revenues of the provinces must also be taken into account. In this regard, the report concluded in the following terms:

> These revenue gains are largely counteracted by the negative effect of tax externalities to the province, because the provinces will suffer reduced taxable-income bases without any compensating rise in their tax rates. In fact, a one-percentage point increase to the top federal PIT rate would reduce provincial government tax revenues by $350 million. *As a result, we estimate that a loss of aggregate government revenue of $106 million would be caused by the increase of one percentage point to the top federal PIT rate.*[56]

56. *Ibid.*, emphasis added.

This is therefore clearly a measure that, in the name of punishing the rich, would lead to a *lose-lose* result, with an estimated loss of around $212 million a year (for a two percentage-point increase) for the federal and provincial governments combined.

This is a measure that would lead to a *lose-lose* result, with an estimated loss of around $212 million a year for the federal and provincial governments combined.

3.4 International Experience: The Case of the United Kingdom

The experience of the United Kingdom in the years from 2010 to 2013 is also instructive. After having remained stable for several decades at 40%, the top personal income tax rate was increased to

50% in April 2010.[57] Like the Canadian proposal, the new rate targeted the 1% of taxpayers with the highest incomes, some 300,000 households.[58]

The new hike was supposed to generate around £2.5 billion in additional revenues for public coffers.[59] However, because taxpayers modified their behaviour—notably working less and rearranging their incomes—the HMRC (Her Majesty's Revenue & Customs) estimated that the new 50% rate generated just £1 billion or less.[60] It was not ruled out that the effect might actually be nonexistent, which is to say that the income tax rate hike simply generated no additional revenues when total tax revenues are considered together.[61]

Faced with this underwhelming impact, the rate was lowered from 50% to 45% in 2013,[62] a decrease which was justified in these terms by the treasury minister at the time:

> That HMRC report, laid before the House, set out thorough and compelling evidence on the impact of the 50p rate. It showed that the rate was uncompetitive, distortive and inefficient. Not only did it not raise much revenue, but it could even have cost the Exchequer money when the indirect impacts on other taxes were taken into account. This Government were not prepared to maintain a rate of income tax that was both ineffective at raising money and that left us with the highest statutory rate of income tax in the G20, so we acted, in the interests of the country, and the top rate of tax will fall to 45p from April this year. This will see our top rate of tax drop below that of Australia, Germany, Japan and Canada, which will send a signal to businesses taking decisions on investment and location that the UK is a competitive environment.[63]

3.5 Canada Compares Poorly on the World Stage

Canada competes with other countries internationally to attract highly skilled labour, as well as companies' foreign investment that depends on this kind of labour.

In the UK, it was not ruled out that the income tax rate hike simply generated no additional revenues when total tax revenues are considered together.

However, with a federal rate of 35%, if we look at the top combined personal income tax rate, Canadian provinces compare quite unfavourably[64] to American states[65] (see Figure 3-2). Canada, for its part, fares poorly in a comparison of 38 OECD countries, languishing in 34th place among the most heavily taxed countries (see Figure 3-3).

A recent Fraser Institute report summed up the negative effects of increasing top personal income tax rates as follows:[66]

> [H]igher tax rates generally have the effect of reducing the size of the tax base to which they are applied. In the case of increased rates of taxation on personal income, the tax base may shrink because of a reduction in taxable personal income reported at the levels at which higher rates are applied. This can be the result of reductions in economic activity resulting in less earned income, through changes in tax strategies, and other forms of legal and illegal tax avoidance. This reduction in the size of the tax base can either partially or entirely offset the revenue gains from a higher rate.

57. UK Government, *The Exchequer effect of the 50 per cent additional rate of income tax*, March 2012, p. 22.

58. *Ibid.*, pp. 12-13.

59. *Ibid.*, p. 2.

60. *Ibid.*

61. *Ibid.*

62. Antony Seely, *Income tax: the additional 50p rate,* House of Commons Library, Briefing Paper No. 249, September 26, 2018, p. 24.

63. *Ibid.*, p. 35.

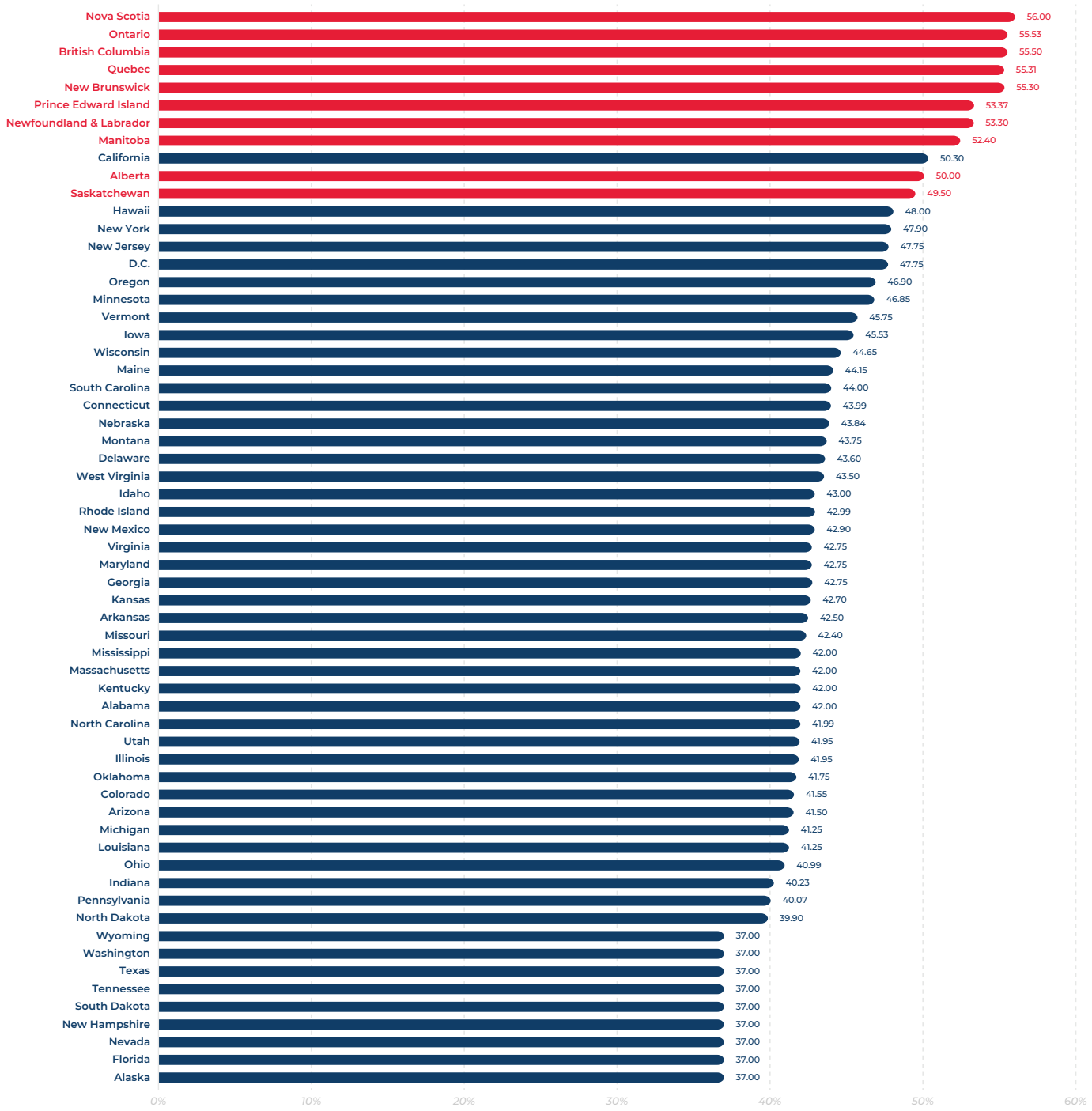
64. Such comparisons remain difficult from an economic point of view because of different social protection in the different countries, notably with regard to health coverage: In Canada, this is funded by taxes, while in the United States and in other countries, such as France and Switzerland, taxpayers must make payroll tax contributions, or pay health insurance premiums, in addition to their income taxes.

65. Not only are the statutory rates higher in Canada, but the income brackets to which they are applied are generally lower than in the United States.

66. Ben Eisen, Milagros Palacios, and Nathaniel Li, *op. cit.*, footnote 51, pp. 4-5.

Figure 3-2

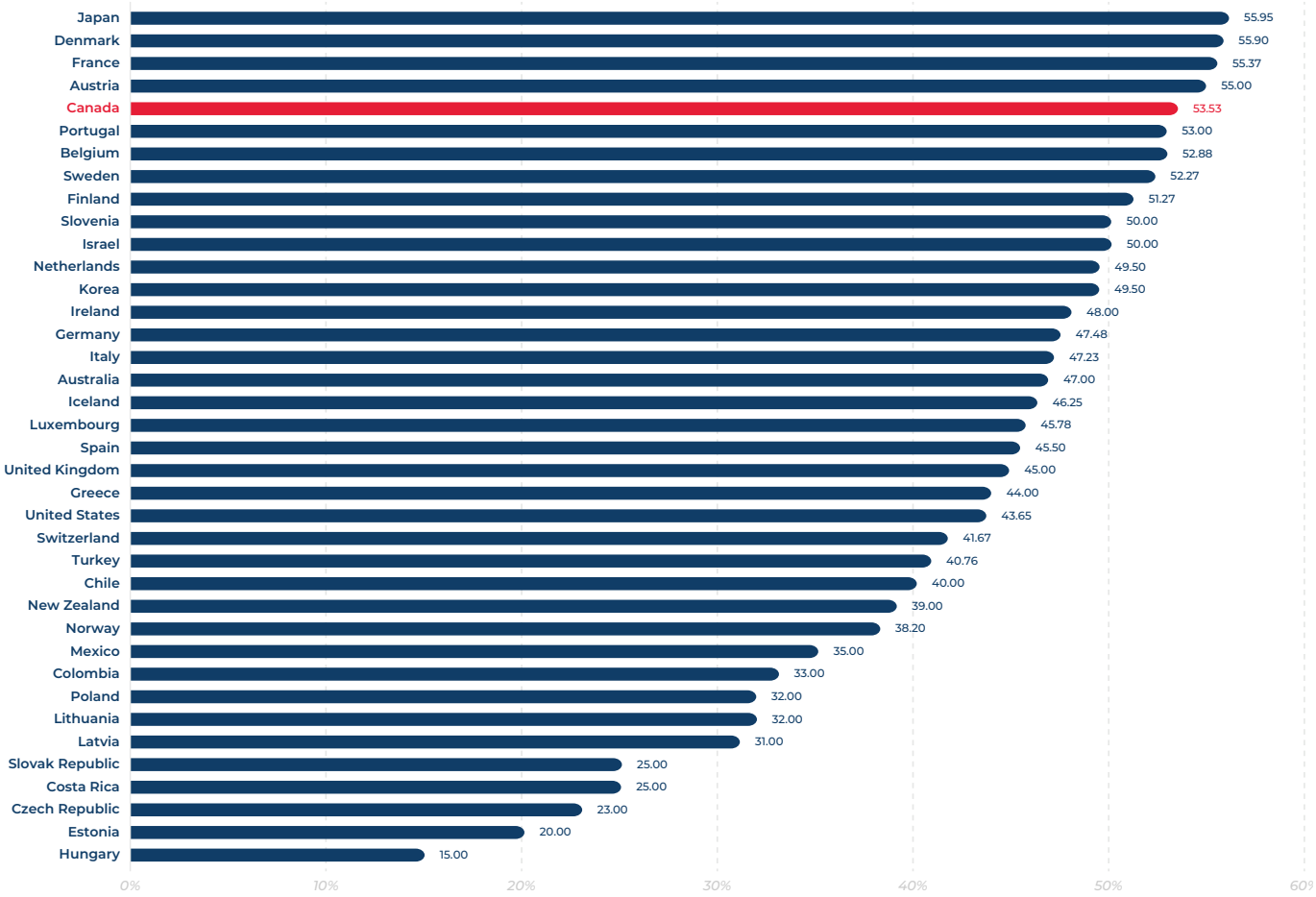
Combined top income tax rates, with a federal rate of 35%, Canadian provinces vs. America states, 2022



Notes: Combined federal-provincial or federal-state rates, 2022; United States: local taxes excluded; Quebec: federal abatement included; New Hampshire: 5% tax on interest and dividends only, excluded; Washington: 7% tax on capital gains only, excluded.
Sources: Authors’ calculations. Tax Foundation.

Figure 3-3

Top personal income tax rates among OECD countries (2020) – Canada with a 35% federal rate



Source: OECD.Stat, Table I.7, Top statutory personal income tax rates, consulted June 3, 2022.

In conclusion, as a result of wanting to increase the tax burden for the rich, it is the economy as a whole and the entire Canadian population, richer and poorer alike, who risk suffering the consequences, in the short term and in the longer term as well.

As a result of wanting to increase the tax burden for the rich, it is the entire Canadian population, richer and poorer alike, who risk suffering the consequences.

CHAPTER 4

Federal Corporate Income Tax Hike: Canadian Society Will Pay a Steep Price

The three fiscal measures discussed in the previous chapters directly target wealthy individuals. The public debate, though, often refers to "corporate citizens" or corporate taxpayers. The rationale for wanting to "punish" the rich through the tax system has also been extended to companies by targeting the profits they earn.

During the 2021 federal election campaign, it was thus proposed to increase the tax rate for banks and insurance companies from 15% to 18% (for revenues above $1 billion).[67] A modified version of this measure was introduced in the 2022 federal budget, the rate going from 15% to 16.5% (for revenues above $100 million).[68]

The federal corporate income tax rate was gradually lowered from 28% in 2000 to 15% in 2012.

However, the perception that the profits of companies should be taxed more is very present. An increase in the federal corporate income tax rate from 15% to 18%, for all companies, is a proposal that is already resonating in the public debate.[69]

Of course, such a measure in theory seeks to hike taxes for business owners (presumed to be among the "rich"), who are meant to bear the burden of the corporate income tax increase.

However, several aspects of the matter are generally ignored:

- *Historical evolution* – Put in perspective, current proposals undeniably fall within a context of radical change that goes against the political consensus of the early 2000s which had formed around the lowering of corporate income tax rates since the start of the millennium.[70]
- *Negative impact on investment, economic growth, and wages* – While concretely, it is companies that pay this tax to the taxman, the sums involved do not necessarily come out of their pockets, but rather out of the pockets of all economic actors. In other words, companies can transfer their tax burden by passing on the weight of the tax to other economic agents. Thus, among the actors who will have to pay the price for the tax, there are certainly the shareholders or the owners of companies. However, what is often left out is that other economic actors, notably employees, also bear the burden of this tax, and sometimes even a greater share of it. And if companies are able to raise the prices of their products and services, it is consumers who will ultimately pay for the tax hike. This is especially true in markets in which the demand the company's goods or services is relatively inelastic.
- *Loss of competitiveness* – As we shall see below, following the reductions of the early 2000s, Canada enjoyed a corporate income tax that was competitive with the United States and with certain other OECD countries. In recent years, though, this advantage has melted away, notably because other countries have also lowered their tax rates. With Canada experiencing anemic growth, it would be especially ill-advised to increase the corporate income tax and weaken the country's international fiscal ranking.

4.1 A Radical Change Running Counter to the Historical Consensus

The consensus from the early 2000s up until recently was to not fiscally penalize companies. As they favour economic growth and job and wealth creation, the need to maintain Canada's international attractiveness was acknowledged.

67. Bruce Ball, "Re-elected government's agenda for tax," Chartered Professional Accountants of Canada, October 19, 2021.

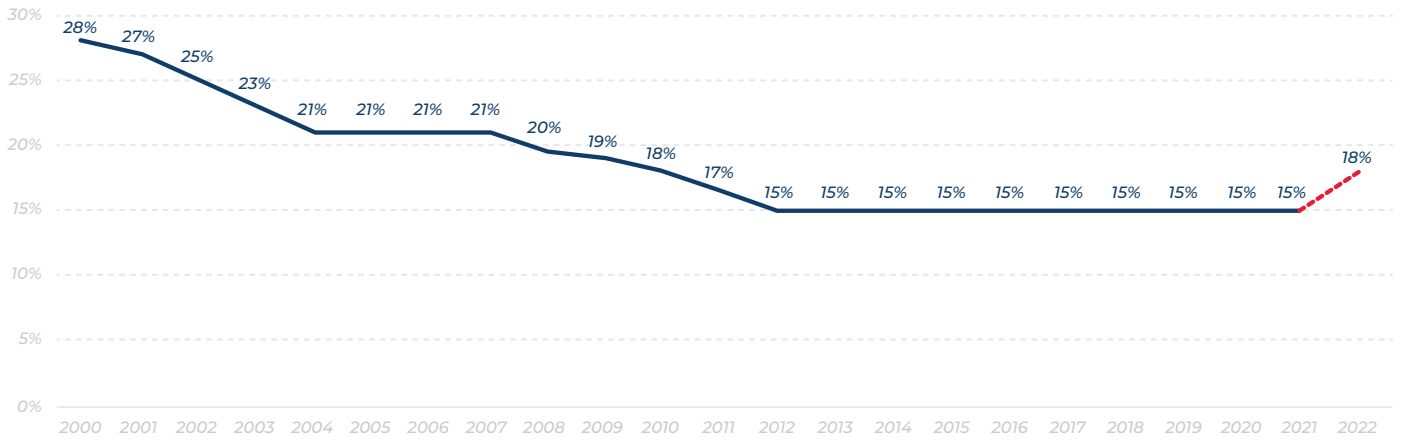
68. Government of Canada, *2022 Budget: A Plan to Grow Our Economy and Make Life More Affordable*, 2022, p. 205.

69. Erika Beauchesne, "C4TF has a plan to make taxes more progressive," Canadians for Tax Fairness, October 3, 2019.

70. Library of Parliament, Economics and Finance, "Corporate Income Taxes in Canada: Revenue, Rates and Rationale," Hill Notes, November 2, 2021.

Figure 4-1

Evolution of the federal corporate income tax rate, 2000-2022 (with proposed hike to 18%)



Source: Library of Parliament, Economics and Finance, "Corporate Income Taxes in Canada: Revenue, Rates and Rationale," Hill Notes, November 2, 2021.

The federal corporate income tax rate was thus gradually lowered from 28% in 2000 to 15% in 2012 (see Figure 4-1).

A corporate income tax hike would clearly reverse a historic trend, which would entail adverse economic consequences and undermine the international competitiveness and attractiveness of Canada.

4.2 Negative Impact on Investment, Economic Growth, and Wages

Raising the corporate income tax in order to increase the tax burden for the rich actually comes down to penalizing the profitability of companies. Lower profitability discourages managers from investing in certain projects, as the company would then incur a loss.

However, less investment eventually leads to slower economic growth, which in turn hurts all economic actors:

- *Business owners*: Among business owners are included, to be sure, rich individuals or families. But it must not be forgotten that unions and pension funds, upon which tomorrow's retirees depend, are also among the shareholders (owners) of large companies and will be affected by a heavier corporate income tax.

Pension funds, upon which tomorrow's retirees depend, are also among the shareholders of large companies and will be affected by a heavier corporate income tax.

- *Consumers, namely all Canadians*: Prices can be higher than they otherwise would have been if initially anticipated investment levels had been maintained. Indeed, less investment leads to reduced productivity gains, which means that companies have more trouble keeping prices low.
- *Employees*: An increase in the corporate income tax limits wealth creation, economic growth,[71] and productivity increases. Yet wage raises are dependent on productivity gains. This is an impact that is rarely emphasized,

71. Simeon Djankov *et al.*, "The Effect of Corporate Taxes on Investment and Entrepreneurship," *American Economic Journal: Macroeconomics*, Vol. 2, No. 3, July 2010, pp. 47-48.

namely that corporate income tax hikes reduce wage increases.

In the economic jargon, it is "corporate taxpayers" that constitute the *impact point* of the tax, because as far as the law is concerned, they are the ones who are responsible to pay the amounts that are due. However, what is really important is not so much the impact point, but rather the point of *incidence of the tax*. This concept identifies the economic actor upon whom the tax burden effectively rests. In other words, the incidence refers to the pocket from which the amounts due to the taxman will really be taken, because even if companies are designated by law, they can pass on this tax to other economic actors. Indeed, the economic literature is unequivocal: The burden of the tax is always borne by individuals. "[P]eople ultimately pay corporate taxes. They do so either as shareholders through lower returns on investment, as employees through lower wages, or as consumers through higher prices."[72]

Less investment leads to reduced productivity gains, which means that companies have more trouble keeping prices low.

The economic arguments and empirical proofs on the harmful effects of the corporate income tax on investment, economic growth, and wages are numerous.[73] An oft-cited study of 85 countries, including developing countries, thus analyzed the effects of corporate income tax rates (effective rates, which is to say after taking into account depreciation and other deductions) on investment and entrepreneurship. Its authors conclude that there is a "consistent and large adverse effect of corporate taxes on both investment and entrepreneurship."[74]

In the United States, the Biden administration has proposed raising the corporate income tax from 21% to 28%. An analysis of this measure estimated that the loss in terms of economic growth would be 0.96% of GDP, while the loss in terms of wages would be 1.27% for an annual salary, or $840 a year for the median American salary of $52,000.[75]

In the Canadian context, a 2019 study analyzed the effects of a corporate income tax hike at the provincial level. The same link was observed between an increased tax and decreased growth. The estimates showed that "a higher provincial corporate income tax rate reduces economic growth by reducing productivity and by lowering investment and that a one-percentage-point increase in the corporate tax rate is associated with a 0.1- to 0.2-percentage-point reduction in a province's annual growth rate."[76]

Any proposal to increase the corporate income tax rate should thus be accompanied by an estimate of the potential impact on entrepreneurship, investment, economic growth, and wages in Canada.

4.3 Loss of Competitiveness of Canada

With a federal corporate income tax rate of 15% and a combined federal-provincial rate that has fallen since the 2000s from 42.4% to around 26% (depending on the province),[77] Canada has been fiscally competitive internationally in terms of attracting investment. However, this advantage has shrunk considerably, notably among the G7 (see Figure 4-2). Canada is thus experiencing, before the potential hike proposed by the Biden administration, competition from the United States, whose rate was reduced considerably in 2018 from 38.9% to 25.8%, which is lower than Canada's combined federal-provincial rate.

Canada was ranked 28th among OECD countries in 2022 with a corporate income tax rate already among the highest. An increase in the federal rate from 15% to 18% would see Canada fall to 31st place, behind New Zealand (see Figure 4-3).

As economists Philip Bazel et Jack Mintz point out, in terms of the corporate income tax, Canada "is within spitting distance of the highest rates in

72. Charles Lammam and Hugh MacIntyre, "Corporate tax cuts benefit all Canadians," Fraser Institute, February 9, 2017.

73. Simeon Djankov *et al.*, *op. cit.*, footnote 71, pp. 31-32.

74. *Idem.*, p. 33.

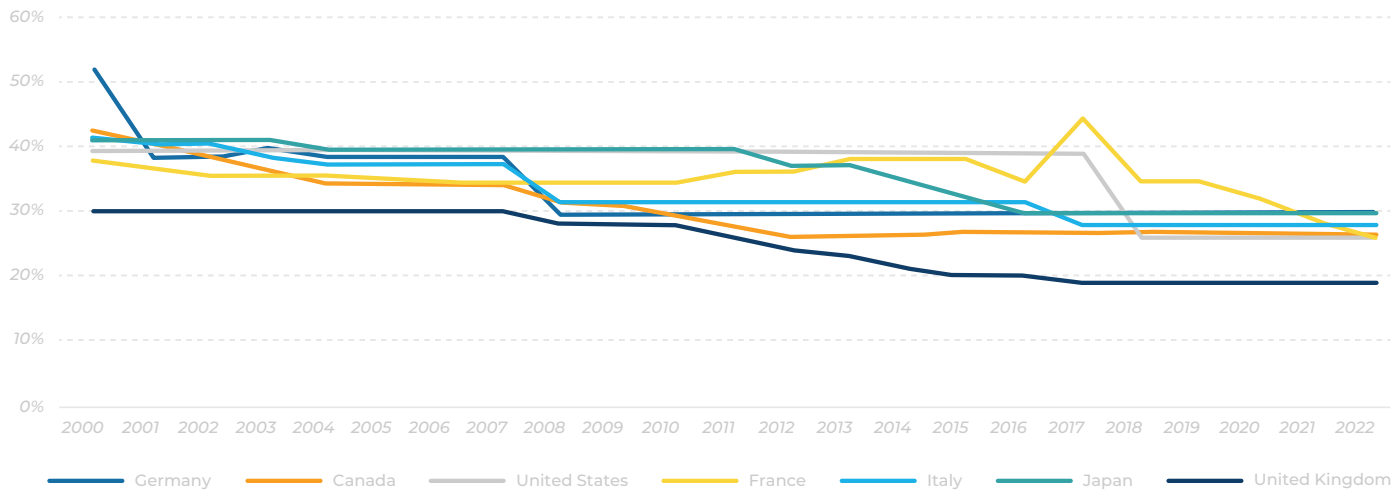
75. Parker Sheppard, *The Long-Run Economic Effects of Raising the Corporate Tax Rate to 28 Percent*, The Heritage Foundation, April 15, 2021, p. 3.

76. Ergete Ferede and Bev Dahlby, *The Effect of Corporate Income Tax on the Economic Growth Rates of the Canadian Provinces*, The School of Public Policy, University of Calgary, September 2019, p. 4.

77. Charles Lammam and Feixue Ren, "Raising corporate taxes is bad economic policy," Fraser Institute, September 18, 2015.

Figure 4-2

Evolution of statutory corporate income tax rates in G7 countries (2000-2022)



Source: OECD.Stat, Table II.1. Statutory corporate income tax rate, consulted August 12, 2022.

the OECD. While some industries may benefit from special preferences, the corporate tax has become increasingly inefficient and complex with targeted measures, and in some cases impeding the allocation of capital to growth industries like communications and services."[78]

This is an impact that is rarely emphasized, namely that corporate income tax hikes reduce wage increases.

Another measure that illustrates Canada's competitiveness in terms of corporate income tax is the marginal effective rate (which is to say, after deductions and other tax provisions are taken into account). This indicator shows that Canada still enjoyed an advantage in 2020, notably thanks to a favourable tax regime for certain industries, including the forestry sector (see Figure 4-4).

However, this advantage compared to other countries has since very likely been eroded.

The Bazel and Mintz study emphasizes that:

> Canada is already at a disadvantage with lagging growth and productivity even before the massive economic destruction caused by the COVID-19 pandemic. Before the pandemic hit, Canada's corporate tax system was already becoming uncompetitive in attracting highly profitable investments relative to other developed countries. [...] This was having a serious effect on Canada's economic health before COVID-19. Business investment in Canada has lagged that of many countries since 2015, well before the pandemic. Productivity has been weak and wages for workers have been depressed, particularly for unskilled labour.[79]

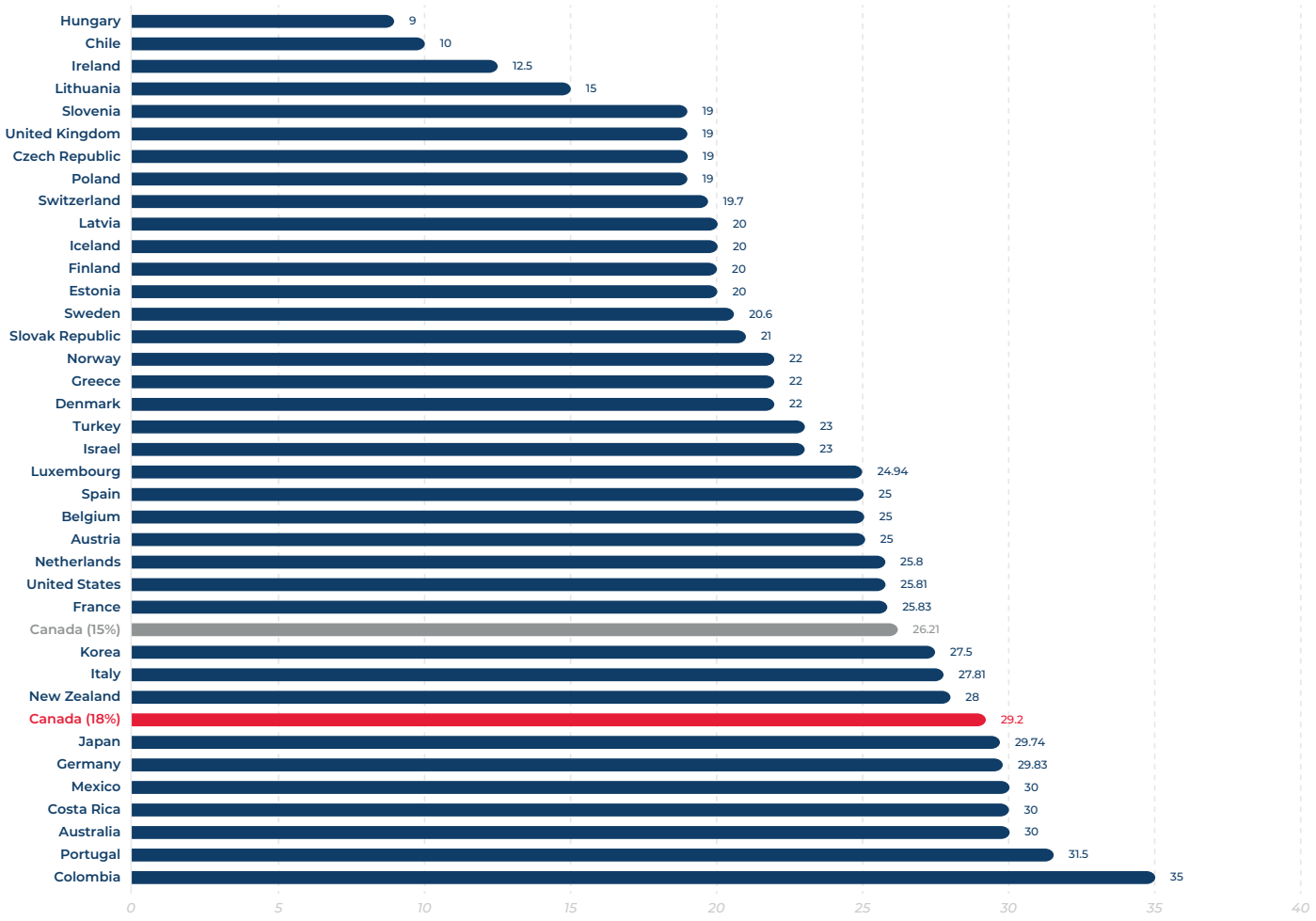
Increasing the federal tax rate from 15% to 18% for companies that succeed in growing and whose revenues increase above a certain threshold

78. Philip Bazel and Jack Mintz, *2020 Tax Competitiveness Report: Canada's Investment Challenge*, The School of Public Policy, University of Calgary, September 2021, summary.

79. *Idem.*

Figure 4-3

Statutory corporate income tax rates in OECD countries in 2022 (with and without the hike to Canada's rate)



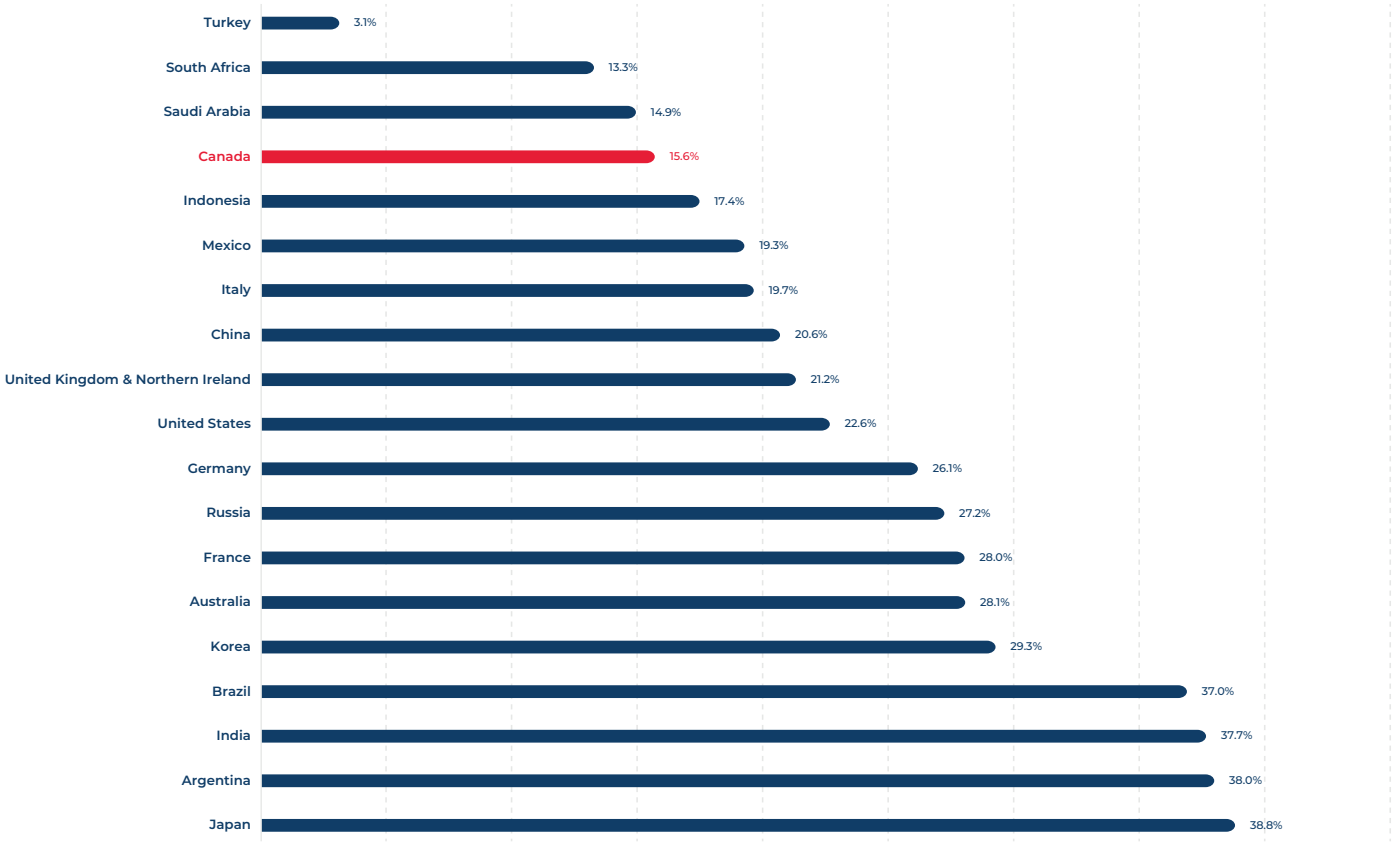
Source: Authors' calculations. OECD.Stat, Table II.1. Statutory corporate income tax rate, consulted August 12, 2022.

would dissolve Canada's historical competitive advantage. This hike would come at the expense of all economic actors, and would hit employees especially hard, negatively impacting their future wage gains.

Increasing the federal tax rate from 15% to 18% for companies that succeed in growing would dissolve Canada's historical competitive advantage.

Figure 4-4

Marginal effective corporate income tax rates in G20 countries, 2020



Source: Philip Bazel and Jack Mintz, *2020 Tax Competitiveness Report: Canada’s Investment Challenge*, The School of Public Policy, University of Calgary, September 2021, summary.

CONCLUSION

As the government's multiple interventions in the economy are very costly, they need to be financed. Developing a tax system and regularly revising its parameters is therefore inevitable.

Yet while there is admittedly a need to tax, the government should nonetheless exhibit judgment and prudence in the way it collects taxes. Even though all fiscal measures fall under the immense umbrella that we call taxation, they are not all equivalent, and they are not interchangeable, even if the tax revenues they generate can sometimes be comparable.

Indeed, from its infancy, economics has recognized a fundamental principle, largely confirmed, regarding the behaviour of individuals. This principle states that whatever role individuals play in society, they are sensitive to incentives.

Generally speaking, this means that if an activity becomes more advantageous, it will be chosen more often and by more people. In turn, other activities will be abandoned. On the other hand, if an activity loses its attraction, the opposite effect will be produced.

Unsurprisingly, profits and remuneration constitute incentives to which entrepreneurs, workers, and savers react.

Taxation, however, modifies the net gains generated by entrepreneurial activities, investment, saving, and the intensity of labour market participation. It is thus utopic to imagine that taxpayers whose fiscal burden is increased will not be incentivized to review their choices, and eventually to modify the way they allocate their time and resources.

Before implementing a fiscal measure, it is therefore essential to evaluate the way in which it modifies incentives and to delineate the direct effects that these changes will have on the behaviour of affected taxpayers, as well as the indirect effects on economic activity as a whole.

In other words, it is not sufficient to consider the expected, hoped-for effects of a tax measure. In particular, an effort must be made to identify the unintended and often adverse effects that a given measure will provoke on a societal level, both in the short term and in the longer term. As Frédéric Bastiat rightly pointed out in his celebrated 1850 publication, for any public policy, there is "what is seen and what is unseen."

It is precisely to this kind of exercise that this Paper is dedicated, particularly in the case of four tax measures targeting the segment of the population considered "rich." These four measures are:

1. A 1% wealth tax, levied on fortunes over $10 million
2. An increase in the capital gains inclusion rate from 50% to 75%
3. An increase in the federal income tax rate from 33% to 35% for incomes over $216,000
4. An increase in the federal corporate income tax rate from 15% to 18%

Each of these measures increases the tax burden on "the rich." That is "what is seen." But what about "what is unseen," yet remains very real, and frequently has negative consequences?

By increasing the tax burden, the government would push economic actors to invest less, to work less, to move, and to export their capital and wealth.

Besides the practical difficulties of imposing a 1% tax on wealth, studies have shown that it discourages saving and investment as it reduces rates of return. Since investment is one of the main engines of growth, a wealth tax is in reality a drag on economic growth.

Moreover, there is no observed impact on total tax revenues, since wealth taxes simply divert sums from other activities that themselves bring in equivalent revenues for the government.

As for raising the capital gains inclusion rate, this measure is no better. For one thing, it misses the mark since it affects all taxpayers, including those of relatively modest means. For another, it undermines Canada's international competitiveness, which reduces the influx of foreign investment and the potential for economic growth.

Increasing the top federal personal income tax rate from 33% to 35% does not stand up to analysis either. As income from labour represents 75% of the total taxable income of high earners, this measure penalizes in particular those taxpayers who contribute to economic growth and prosperity. Moreover, any increase in its rate makes Canada relatively less competitive from a fiscal perspective, which interferes with the efforts that companies deploy to attract international talent. As for the impact on provincial and total tax revenues, experience shows that it is negative as the taxation of high incomes encourages taxpayers to modify their behaviour.

Finally, like the preceding measures, raising the federal corporate income tax rate proves to be disappointing due to its undesirable consequences. Specifically, it undermines the international competitiveness and attractiveness of Canada. It also reduces the profitability of companies, which discourages investment, slows productivity increases, limits potential economic growth, and penalizes consumers and the Canadian population as a whole.

Rather than seeking to increase the tax burden on the rich, the government should favour initiatives that make Canada more attractive for foreign investment and wealth creation.

For political actors, it is tempting to target "the rich," since the harm of fiscal measures seems concentrated on a miniscule fraction of taxpayers. And as these taxpayers enjoy little sympathy from the rest of the population, the political and electoral repercussions are negligible.

However, as this Paper shows, this kind of reasoning is economically risky, for among the rich are entrepreneurs who invest and who innovate to ensure Canada's future growth and prosperity.

By increasing the tax burden, whatever the chosen measure among those studied in this Paper, the government of Canada would set off a multitude of adverse unintended consequences that would push economic actors and companies to invest less, to work less, to move, and to export their capital and wealth.

Rather than seeking to increase the tax burden on the rich simply because they are rich, the Canadian government should consider all the ins and outs of the potential measures. It would then realize that punishing the rich often means penalizing the wealth creators, and as a result, hurting all Canadians. It should instead favour initiatives that improve Canada's competitive positioning in the world, notably relative to the United States, and that make it more attractive for foreign investment and wealth creation. Most of all, it should keep in mind that when it comes to taxation, as with many areas, appearances can be deceiving.

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