Intelligence MEMOS

From: Jeremy M. Kronick and William B.P. Robson

To: Minister of Finance Chrystia Freeland

Date: October 4, 2022

Re: **The Economic Perils of Federal Tax Hikes on Banks and Insurers**

Taxes are a necessary evil. Necessary, because we must fund government services. Evil, because they do damage beyond the cost to those who pay them – discouraging work and saving, misallocating where our scarce resources go, and encouraging underground activity.

The federal government's upcoming levies on banks and insurers – a corporate income surtax and the "Canada Recovery Dividend" – don't come close to necessary.

These taxes were part of the Liberal campaign platform last year. It committed to raising the corporate income tax rate on bank and insurer profits above $1 billion from the 15 percent other businesses pay to 18 percent.

It also proposed the recovery "dividend": A one-time 15-percent tax on 2021 profits above $1 billion. The argument for both taxes was that government support during COVID-19 had boosted the profits of banks and insurers, so it was time for them to repay.

The sight of some businesses prospering during the pandemic made many people angry, but anger rarely inspires wise actions. These targeted taxes will do a lot of damage.

To start with, corporations are legal persons, not real ones. Governments can make them collect taxes, but the taxes they collect come from people: the owners, employees and customers of the business. How much each pays depends on how readily each can change what they own, where they work, or what they buy. Capital flows freely enough among sectors and across borders that owners likely take the smallest hit. Employees change jobs less readily, but especially in a tight labour market, they are also relatively well protected from a tax hike. That leaves the customers, for whom switching among financial institutions, or buying something else entirely, is much harder, as the group the higher tax will hit hardest.

Next problem: The discriminatory nature of these taxes. Some harmful activities might warrant special taxes or tax rates to discourage them or help pay for the harm. That is why we tax smoking, drugs and pollution. But where is the harm from chequing accounts, GICs and life insurance? COVID is increasing demand for health and disability insurance. Higher taxes will make these services less available in Canada, with investors and entrepreneurs looking for activities and jurisdictions where tax rates are lower.

The intent is not the only problem. The original proposals, drafted in haste, did not survive further thought. The 2022 federal budget featured changes to the surtax: an income threshold of $100 million, and a rate of 16.5 percent. Draft legislation released in August made average taxable income in 2020 and 2021 the base for the "dividend." Further revisions may follow.

This chopping and changing is bad for everyone. Critically, it creates uncertainty – not just for the owners, employees and customers of the banks and insurers, who do not know how the taxes will actually work, but also for owners, employees and customers of other businesses, who wonder if they might be the next targets.

Does necessity – the need for new revenue to fund our now much larger federal government – outweigh these costs? Budget 2022 prefigured an increase in the federal debt of $140 billion over four years. The Parliamentary Budget Office's recent estimates put the yield from the surtax and "dividend" over that period at $4 billion. If fiscal necessity was the motive, these taxes would not be the response.

The least damaging way to fund government services is through taxes that are neutral, levied on broad bases at low rates. The federal government's reforms of the 2000s moved us in that direction. Canada became more competitive. Our reputation for smart tax and budgetary policies grew.

We need a similar reorientation of federal fiscal policy now. Canada's economy has not only returned to its productive capacity, it has exceeded it. The federal government should be bringing its spending into line with what it can support with taxes that are neutral, broad, and levied at reasonable rates. The surtax and the "dividend" are arbitrary in their targets, obscure in their incidence, uncertain in their application, and ineffective in their function as revenue raisers.

Taxes should be heavy on the necessary and light on the evil. The proposed taxes on banks and insurers strike the wrong balance.

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A version of this Memo first appeared in The Globe and Mail.