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After 87 Years, It Is Time To Fix the Income Tax Act

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On Sept. 20, 1917, the federal government promulgated the *Income War Tax Act* to help fund Canada's strained war effort. Income taxes quickly became a central feature of Canada's tax system, with Ottawa and the provinces now using it to collect over $200 billion annually in personal and corporate taxes. In fact, income tax is the most important source of government revenue.

The *Act's* introduction provoked a substantial debate over key issues affecting the livelihood of Canadians, including the effect of an income tax on Canada's competitiveness. Its major flaw was its discrimination against productivity-enhancing investment.

The 10-page 1917 *Act*, mercifully short compared to today's volumes of tax legislation and regulations, reflected both simplicity and the economic relationships of that time. Individuals paid no taxes if income was less than $1,500 and the top rate of 25 percent applied to incomes above $100,000. Married individuals, or those with dependants, had an extra $2,000 exemption. By comparison with today, after adjusting for inflation, taxes were much less punitive in 1917. For example, using 2004 dollars, no single individual with an income less than $25,980 would have paid tax, while today the federal exemption level is $8,012. The top rate in 1917 applied to incomes above $1.73 million in 2004 dollars, while the current top federal rate kicks in at $113,805.

Corporations paid tax at 4 percent, while individuals were able to credit any corporate taxes collected on their share of profits in a company against their personal taxes. Some individuals and organizations were tax exempt, including the governor general, diplomats, municipal corporations, charities, labour organizations, farmer associations and the military.

The definition of income for tax purposes was relatively simple in 1917, with few of the special deductions or credits that are found today. Income included any net profit, including wages, salaries, fees, business income, dividends and undistributed corporate profits, as well as interest. Capital gains and life insurance proceeds were not subject to tax. The *Act* allowed some deductions, such as an

allowance for capital depreciation and contributions to some patriotic and war funds.

Although income tax revenue was critical to the war effort, the *Act* raised several contentious issues at the time. One particular concern related to Canada's competitiveness. In the early 20th Century, Canada was losing immigrants to the United States, a fact well recognized by then-finance minister Sir Thomas White, who said: "Canada has been and will continue to be a country inviting immigration. I have thought it desirable that we should not be known to the outside world as a country of heavy individual taxation."

Competitiveness remains a central issue for Canadian tax policy; in the absence of fair taxes, people, businesses and capital will leave. As well, countries with high taxes, especially on capital investments, undermine productivity by discouraging businesses from buying new equipment and structures. Chen and Mintz (2003) showed that Canada's effective tax rate on capital is higher than that in the United States, Ireland, Sweden and other developed-country competitors. Outside Alberta, Canadian investment in new machinery and non-residential structures as a share of GDP is less than in the U.S. and other expanding economies, because Canadian governments impose high taxes on capital investment. As a result, Canadian employment and wages do not grow as quickly as they might.

As in 1917, the current *Income Tax Act* is based on a concept of earnings that undermines competitiveness by unfairly taxing invested income. Individuals who have already paid tax on income from the fruits of their labour pay again on income from invested earnings. Effectively, the *Act* discriminates against investors and is biased towards consumers by taxing more highly the earnings that are invested rather than consumed. While arguments are made that exempting investment income from taxation is unfair to the poor who save little, they miss the central point: Lowering tax rates and providing income support, such as child tax benefits and old age pensions, rather than imposing a damaging tax on investment income, is a better way to provide help for low-income Canadians.

Individuals should pay tax only on their earnings, not on invested income. Ottawa can accomplish this by taxing people on their consumption — as is the case with Registered Pension and Retirement Savings Plans where savings are deducted from income and later withdrawals are fully taxed — or by explicitly exempting investment income from taxation, as would be the case with Tax Pre-Paid Savings Plans (Kesselman and Poschmann 2001). Corporate income should be treated on the same basis by enabling businesses to deduct from profits their expenditures on equipment, structures and other capital goods, while paying no tax at all on financial income. For both personal and corporate income tax purposes, interest on borrowed funds would not be deductible.

This kind of pro-growth system is based on a principle entirely different from the concept that underpinned the *Income War Tax* of 1917 and that is with us still. If Ottawa and the provinces eliminated the bias against investment, the income tax would not only improve economic growth prospects and fairness, it would also make the tax system much simpler. No longer would complicated rules be needed to determine depreciation, depletion, capital gains and interest deductibility, the source of vast reams of legislation and regulations.

In some respects, the 1917 *Act* got things right — rates were kept as low as possible by defining income broadly. Now, governments define income much

more narrowly and are compelled to maintain high tax rates to generate enough revenue to offset the drain caused by the many exemptions for venture capital, small businesses and a host of other favoured economic activities. However, rates at these levels inhibit work effort, risk-taking, and investment. The difficulty could be largely overcome by broadening tax bases to prevent federal and provincial governments from losing revenue. As the federal government reviews expenditures to reallocate spending from low to higher priorities, it should undertake an income tax review to redistribute tax burdens and improve growth and fairness.

A pro-growth tax reform would help lift Canada's standard of living, improve prospects for jobs and provide higher incomes for workers as Canada becomes more competitive. It is time for politicians to get with it and finally fix an antiquated income tax regime.

References

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