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Commentary

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Missing the Bigger Economic Picture

Debates over income splitting, taxes and transfers, and mandatory savings ignore the need for economic growth

This article is based on testimony by Macdonald-Laurier Institute Senior Fellow Philip Cross before the House of Commons Standing Committee on Finance, hearing evidence on Bill C-59, implementing certain provisions of the April 21 federal budget and other measures. Cross's comments and committee members' questions have been edited and condensed.

Philip Cross

Introductory Remarks

Before I get started, just some background. From what I saw with the previous panellists and from this panel, I think what you're mostly going to get from them is micro-analysis of the individual proposals. I'm going to bring you some macro-analysis about the broad trends and the tax and transfer system that might help put these changes in context. The overview is based on a detailed report I wrote for the Macdonald-Laurier Institute called *"Giving and Taking Away: How Taxes and Transfers Address Inequality in Canada"*, which members can refer to for more details.

The main conclusion is that the tax and transfer system became markedly more progressive between 1976 and 2011. The progressivity of transfer payments had a much greater impact than taxes on the redistribution of income. The greater role of transfers partly reflects that cutting income taxes does little to help low-income people, as the lowest income quintile effectively pays no income tax, with an effective rate of 2.4 percent. Instead, it is transfers and government that provide over half of their tax income.

As we move up the income quintiles, taxes progressively increase and transfers steadily decrease up to the highest quintile for whom transfers are as negligible, at 3 percent, as taxes are for the lowest quintile, while the effective tax rate for the highest quintile reaches an average of 22 percent.

Looking at combining the impact of tax and transfers, it shows that only the highest two income quintiles pay more into the tax and transfer system than they take out, while the other three lowest quintiles are net beneficiaries. The highest income quintile pays 80 percent of the total net redistribution going on within the tax and transfer system. So the system is quite progressive, even if it's not completely offsetting the growing inequality of market incomes over the last 35 years.

Table 1 The impact on taxes and transfers on income by quintile, 2011

	Lowest Quintile	Second Lowest Quintile	Middle Quintile	Fourth Quintile	Highest Quintile
(1) Average Market Income	$7700	$23,200	$38,500	$57,100	$108,400
(2) Transfers from Governments	$8700	$7600	$6100	$4800	$3300
(3) Total Income (1+2)	$16,400	$30,800	$44,600	$61,900	$111,700
(4) Transfers as % of Income (2/3)	53.0%	24.7%	13.7%	7.8%	3.0%
(5) Income Taxes	$400	$2400	$5500	$9900	$24,600
(6) Effective Tax Rate (5/3)	2.4%	7.8%	12.3%	16.0%	22.0%
(7) After Tax Income (3-5)	$16,000	$28,400	$39,100	$52,000	$87,100
(8) Taxes Minus Transfers (5-2)	-$8300	-$5200	-$600	$5100	$21,300
(9) Taxes Net of Transfers as Share of Income (8/3)	**-50.6%**	**-16.9%**	**-1.3%**	**8.2%**	**19.1%**

Source: Statistics Canada Cansim Table 202-0706 and author calculations.

Despite rising incomes earned in the marketplace, net transfers to the middle class have increased. This was particularly the case for the second-lowest income quintile, where net transfers rose from 2 percent to 17 percent. Only the highest quintiles saw a net contribution increase. So overall, the tax and transfer system has become more progressive in redistributing income from the highest income earners to the lowest and middle incomes.

For 35 years Canada has moved to a system of higher transfers and lower tax rates for 80 percent of the population being paid for by the highest 20 percent of earners. We may be nearing the limits of the amount of resources that can be transferred from one quintile to the other four. As noted by Professor Kevin Milligan in a recent study for the C.D. Howe Institute, raising the marginal tax rate further on high-income earners risks reducing their labour supply and may even lead to lower tax revenues. Advocates of higher tax rates for upper-income earners should take note of the growing contribution of the tax and transfer system over the longer term. Critics of the benefit that income splitting (known as the “Family Tax Cut”) may give to some of the highest quintiles should also be aware of this trend.

Finally, the focus of all parties on aiding the middle class at some point risks becoming either a transfer from some parts of the middle class to other parts of the middle class, or worse, from the left pocket to the right pocket of the same person.

Andrew Saxton: Mr. Cross, can you please explain your organization’s opinion on the difference between voluntary and mandatory savings vehicles? In particular, you have the tax-free savings account, which is a voluntary vehicle. Do you agree this is a good vehicle to help Canadians save for the future?

Cross: I think when it comes to pension savings, we’re very much of the view that voluntary is better than mandatory.

One of the problems with pensions in this country – and Malcolm Hamilton now researching at the C.D. Howe Institute, has done a lot of work on this over the years – is that people are scared a lot by financial institutions into saving too much. I did a study last year and I looked at what chartered banks recommend and when they had something on their websites, they universally said you should replace 75 percent to 80 percent of your working income in retirement. Most people outside of banks say 50 percent to 60 percent is more than enough.

The result is we end up with a lot of people saving too much. Malcolm has openly said that the number one problem with savings among older people in our society is that people die with too much money.

Scott Brison: Mr. Cross, your statement that the number one issue is people dying with too much money doesn’t necessarily reflect the reality in Cheverie, Hants County, where I live. You say the issue is that people are being scared by the banks into saving too much. Are you suggesting that Canadians ought to perhaps save less than what the banks are recommending?

Cross: I think it’s obviously in the self-interest of banks to scare people into saving more. Who benefits from that? Banks do. They want people to park large quantities of money with them at low interest so they can lend it out.

I should make it clear that, when I say “too much money”, it’s not as if these people are living in palaces or anything; the point is that people are dying with positive savings. People in this country are not running out of money, for the most part, before they die. The idea that we’re not saving enough and we have to increase savings because people are going to run out of money in their retirement, is behind a lot of these plans to expand savings.

If people on their own want to be scared by financial institutions into saving more, fine. People are always responsible for their own actions.

Scott Brison: Well, why would government facilitate them doing what you say would be the wrong thing, by expanding the TFSAs (tax free savings accounts)?

Cross: Some people are always going to do the wrong thing. I don’t think it’s government’s role to prevent people from doing anything in our society.

Joyce Bateman: I have to say I enjoyed your op-ed in the National Post on April 22 about compressing the size of government. I particularly appreciate your comments in your presentation today about the tax and transfer system and how progressive Canada’s tax and transfer system truly is. … I’m very

interested in hearing, within the context of our progressive tax and transfer system, the importance of voluntary saving mechanisms, whether a tax-free savings account, or [choosing] to voluntarily augment my CPP.

Cross: The distinction between voluntary and mandatory sometimes is overdrawn. We've seen in the past, for example, in the late 1990s, a lot of Canadians didn't believe the Canada Pension Plan was on a sound footing. As a result, you could see one reason the savings rate was high in the 1990s was people didn't think CPP would be there. When CPP was put on a sound footing with the reforms in 1998, you could see almost immediately voluntary savings came down. People had confidence, all of a sudden, that those mandatory savings would be there for their pension. … Sometimes one is done in anticipation of what the other is going to do.

In the case of CPP, I've written extensively that I've been against the idea of mandatory contributions because I'm not convinced – certainly it is not a problem now – there's going to be a problem in 20 or 30 years. If people on their own want to take out an insurance policy against what's going to happen in 20 or 30 years, God bless them. Am I so confident there's going to be a problem in 20 or 30 years from now that I want to impose and make that mandatory today? No.

Ms. Joyce Bateman: Obviously that's the conclusion of our caucus. If somebody feels so passionately about it, they would choose to do that with their own resources, great, but not to make it mandatory given the lack of need, as you have indicated. What are your thoughts on the balanced budget legislation? I'd be very interested if you could expand on that.

Cross: I'm rather cynical about it. With all these pieces of legislation, the holes that are available in them are large enough to drive huge convoys through. I wonder, what's the point?

Ms. Joyce Bateman: You wrote: The best policies are those that would encourage our ability to fully benefit from more vigorous economic growth in the U.S., notably through fostering a better climate for business investment. Could you expand on that, sir?

Cross: In the debate about the economy, everything seems to be fixated on redistributing income, and I think we've become so wrapped up in that analysis and a lot about who's going to benefit from income splitting and so on, we forget the number one solution to all these problems is good economic growth.

The one key to that, and I think the Bank of Canada has emphasized that in its research, the thing that's been missing from the recovery so far has been business investment. I think we should be doing more to stimulate business investment in this country.

Ms. Joyce Bateman: We were just talking briefly about people getting buried in the numbers. … Could you expand on the econometric piece we were talking about earlier?

Cross: People talk about our knowing the marginal impact that the changes in income splitting are going to have to the labour supply of women as if we know it to the decimal point. One of the problems with that type of analysis, one reason I was never a fan of this when I was at Statistics Canada and am still not a fan, is that it assumes other things are equal. Well, other things aren't equal.

We know, for example, that the lowest women's labour force participation in the country is in Alberta. Why? It's because with husbands who earn more than $100,000, women tend to stay home more often.

That's changing rapidly in Alberta. If Alberta raises the minimum wage from $10 to $15, that's going to have big impacts on labour supply.

There are many other things moving.

Mr. Raymond Côté: I was sitting on the Standing Committee on Finance in 2013 when we passed Bill C-48, which expanded the Income Tax Act by 1,000 pages. Canada's tax system is quite staggering in its complexity. This is nothing more than fiscal clientelism, the effect of which is a huge fragmentation of the real clients. Tax breaks for families is one example of that. Unfortunately, they make things more complicated.

One phenomenon that I find disturbing is that fewer and fewer individuals are doing their tax returns themselves. I do not know which organizations measure that, but the fact remains that only a third, a little less than 40 percent, of individuals prepare their tax returns themselves. The rest go to professionals or to family members to do those returns.

Could you talk to us about that complexity and what families lose as a result? Canadian households actually often have to pay for their taxes to be done.

Cross: I completely agree with you. The tax system is too complex. I do my personal tax return myself. It is quite simple. However, my business is set up as a company. As a result, I have to pay an accountant $3,500 a year for him to be aware of all the details. It kind of brings us back to what we were saying about the tax rate of small businesses in comparison to large businesses. As we were saying earlier about family income, there is no real justification for the fact that the tax rate is different depending on whether one person or two people are involved. I agree with that.

Following the same logic, the gap between the tax rate for small businesses and large businesses should be smaller. At the moment, the gap is a major one. It is difficult to see the economic logic in the fact that the tax rate is so different for one as opposed to the other. That is sometimes an incentive for businesses to remain small.

Mr. Dave Van Kesteren: Mr. Côté was talking about the complexities of filing returns. Mr. Cross, I think you were not disagreeing, but I think the premise of the question was that the people who are not filing their returns are not filing because of the complexity. Would you agree with that? I think you said, if I heard you right, that there is a fair amount of complexity for corporations and businesses; however, they're not stopping the return of their taxes.

Cross: You're right. I've never seen polls on why people for their personal income taxes are referring to H&R Block. It might be the increased complexity. It may be the growing lack of numeracy in our population. I don't know.

Cross: If I can indulge the chair, I would like to say something about sick leave (in the federal public service). There have been two questions asked about it, and if I don't say something I'm going to damage some internal organs here.

Chair: Sure. I have 30 seconds left.

Cross: Let's put the context of public service sick leave benefits in the context of overall benefits. When I retired, I had six weeks of vacation, three weeks sick leave, a professional development day, a family support day. I got Monday and Friday at Easter. I got Remembrance Day. So it's put in the context of overall benefits. It's not just sick leave that's out of line. It's the whole wave of benefits in the public service.

There's also the way that sick leave is used. I was quoted in the *Citizen*. There's a very famous case in StatsCan of somebody putting up a sign saying "I'll be sick every Friday the rest of the year". That culture has to change, that this is a joke, that it's a free day off.

About the Author

Philip Cross is a Senior Fellow at the Macdonald-Laurier Institute, a non-partisan Ottawa think tank that promotes better public policy. He is also a member of the Business Cycle Dating Committee at the CD Howe Institute. Before that, he spent 36 years at Statistics Canada, the last few as its Chief Economic Analyst. He wrote Statistics Canada's monthly assessment of the economy for years, as well as many feature articles for the *Canadian Economic Observer*.

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