Presentation to the Standing Committee on Finance

Study: Bill C-74, An Act to implement certain provisions of the budget tabled in Parliament on February 27, 2018 and other measures

Presented by:

Randall Bartlett
Chief Economist
Institute of Fiscal Studies and Democracy (IFSD)
University of Ottawa

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Good afternoon Chair, Vice-Chair, and Committee Members.

Thank you for inviting me to speak today as part of the study of Bill C-74. As requested, I will focus my remarks on Part 1 of Bill C-74, more particularly to the section pertaining to the small business tax rate and dividend tax credit, as well as the small business deduction based on passive income and on preventing income sprinkling.

While discussing the specific tax measures included in the budget, I would like to touch on some commonly cited concepts used when evaluating tax policy. These include the priciples of fairness, efficiency, and administrability.

According to Kevin Page, former Parliamentary Budget Officer and President of the Institute of Fiscal Studies and Democracy at the University of Ottawa, in a recent article in *Policy* entitled *Tax Cuts are Easy, Tax Reform is Hard*, "Tax theorists typically talk about two fairness concepts. One is vertical equity, usually taken to mean the more you earn, the more you pay. Two is horizontal equity, meaning those in similar circumstances pay the same amount. The Liberals were effectively making the case that potential base-broadening reforms to small business taxation were 'two birds with one stone'." Indeed, the proposed small business tax changes, while unpopular among those who will see their tax bills rise, increase the fairness of the tax system from a tax theory perspective.

The efficiency of a tax system speaks to the ability to generate tax revenue in a manner which is least distortive to incentives and behaviours, thereby having the least impact on economic activity.[1] Looking to the small business tax regime

[1] A study from the federal Department of Finance that is now more than a decade old, entitled *Taxation and Efficiency: Results from a Canadian CGE Model*, found that the changes to tax rates which

specifically, a 2015 study from the CD Howe Institute by Benjamin Dachis and John Lester, entited *Small Business Preferences as a Barrier to Growth: Not so Tall After All*, looked at two major federal programs intended to provide special support for small business: the Small Business Deduction and Scientific Research and Experimental Development investment tax credit. To quote the authors, "The purpose of these programs is to improve overall economic performance by mitigating inefficiencies in the market. However, since receiving benefits is conditional on staying small, these programs could act as a barrier to growth." Further, the authors found that neither of these programs have a meaningful impact on boosting investment. Meanwhile, these "supports for small business have a social cost. The largest cost arises from the fact that the government must recoup forgone tax revenue by cutting spending or imposing higher taxes elsewhere… A more effective way of spurring economic growth is to reduce corporate income tax rates for all firms rather than providing preferential tax rates for small businesses."

But the inefficiency in the tax system created by the small business tax regime goes further. Specifically, the rules governing private corporations as they currently exist allow for income to be moved between personal and business income, thereby creating an opportunity for tax avoidance.[2] Indeed, the current rules incent taxpayers to structure their businesses to report income in a manner which is advantageous to them but isn't the intent of the tax policy per se, with lower tax revenue being collected as a result.

This brings us to the ability of the federal government to administer its tax system in the spirit in which the tax legislation is written. This is at times difficult, as the letter and spirit of tax legislation are not always one and the same. To close this gap at times requires changes to tax law.

In the context of changes to small business tax rules, these changes were first telegraphed by the federal Liberal Party in its 2015 election platform. Then, in July 2017, the Minister of Finance began his *Consultations on Tax Planning Using Private Corporations*. And while the federal government should be commended for engaging in public consultations, I'm sure no one in this room has any illusions about how this rolled out. It didn't go well.

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are most efficient, meaning that have the least impact on national well-being and long-run economic activity, in descending order are: consumption taxes; payroll taxes; personal income taxes; corporate income taxes; and taxes on capital. A subsequent survey of the literature undertaken by the federal Department of Finance further reinforced these findings.

[2] To be clear, tax avoidance, as discussed above, is both a legal and rational response by any individual or business, who will and should always strive to reduce their tax bill and maximize their household or business after-tax income. This should not be confused with tax evasion, which is the illegal misrepresentation of one's income so as to reduce one's tax bill, and has nothing to do with our discussion today.

But just because people get mad about the fact that tax preferences will no longer be available to them doesn't mean the baby should be thrown out with the bathwater. While there were definitely areas for improvement in the proposed changes to small business tax rules, there was also a great deal of misinformation. In the end, from the Fall Economic Statement 2017 through Budget 2018, the federal government rolled out the tax changes, adjustments having been made to address some of the concerns raised in the consultation process. And while some stakeholders remain unhappy, tax practitioners I've spoken with seem to be of the opinion that a lot of the most glaring concerns have been addressed.

In closing, the tax rules governing private corporations were known to have been unfair and inefficient, as defined by economists, while making administration challenging. The changes that have been implemented are intended to correct this, but only time will tell if this was actually the case and if business investment is impacted as a result. That said, a better approach would have been to include these tax changes as part of a broader tax reform package, which could have broadened the taxbase while at the same time lowering the average tax bill of Canadian households and businesses.

Thank you.