POLICY REVIEW

Closing the Gap
Addressing Inequality through Tax Policy in a Globalized Economy

Daniel Ribi, Carleton University

Executive Summary
Rising income inequality is a pressing political issue in Canada and internationally. Yet, policymakers in advanced economies have thus far failed to meaningfully address the issue. Tax policy is one of the primary tools available for governments to structure local distributive realities, but there is uncertainty regarding the ability of governments to take effective action in a globalized world economy. This policy brief puts forward viable reforms. The Canadian federal government can mitigate income inequality in Canada through targeted corporate and personal income tax reforms and a new approach to compliance enforcement.

Sommaire exécutif
La croissance de l'inégalité du revenu est un problème urgent au Canada comme à l'échelle internationale. Jusqu'à présent, toutefois, les décideurs politiques des économies avancées n'ont pas répondu de manière significative à cet enjeu. La politique fiscale est l'un des principaux instruments dont peuvent se servir les gouvernements pour affecter les réalités distributives, mais une incertitude demeure quant à leur capacité de prendre des mesures efficaces dans le contexte d'une économie mondialisée. Cette note de politique propose des réformes viables. Par des réformes du régime d'impôt sur le revenu des particuliers et des sociétés, ainsi que par une nouvelle approche des mesures d'assurance de conformité aux exigences, le gouvernement fédéral du Canada peut atténuer l'inégalité du revenu au Canada.

Introduction
Income inequality has become one of the major political issues in the developed world. Since the global financial crisis, a greater awareness of the extent and structure of contemporary economic inequality has been made possible by academic advances, such as the work of French economist Thomas Piketty (2014), and global developments, such as the Panama and Paradise Papers leaks. Economic and financial globalization, long considered a linchpin of economic prosperity by policymakers has come under greater scrutiny. Social movements like Occupy Wall Street have brought inequality to the forefront of political discourse, as evidenced in Canada by the fact that all five major parties put forward policies in the name of addressing some aspect of economic inequality during the 2015 federal election (Banting & Myles, 2016, p. 509). A policy window has opened, providing policymakers an opportunity to undertake meaningful reform.

The Growth in Top-End Inequality since 1980

Since the 1980s, the developed world has seen a significant increase in income inequality. Using the Gini coefficient, income inequality across the Organisation for Economic Co-operation and Development (OECD) increased by almost 10% from the mid-1980s to the late 2000s.[1] Contemporary inequality features runaway incomes at the very top of the income spectrum. In Canada, between 1998 and 2007, a third of all income growth went to the top 1% of income earners (Conference Board of Canada, 2011). Taking a longer view, between 1982 and 2014 the income *shares* of the top 1%, 0.1%, and 0.01% increased 53%, 91%, and 133%, respectively (Statistics Canada, 2017). These figures have been calculated using official figures, which means they are underestimated.

Piketty (2014) has shown that a significant portion of historical inequality dynamics is explained by the fact that the rate of return to capital has almost always outpaced economic growth in normally functioning capitalist economies, creating high capital-income ratios in the world's advanced economies. These ratios, which Piketty predicts will continue their decades-long rise barring aggressive policies, lead to high levels of inequality due to the fact that wealth is more concentrated than income (pp. 96–102).

In addition to the historical economic dynamics identified by Piketty, the rapid increase in inequality has been a result of the acceleration in what had been, until the 1980s, a relatively slow process of economic globalization. Capital controls, which were built into the Keynesian post-war political economy to enable national governments to exert control over national demand, came to be seen by policymakers as impediments to the evolution of a global economy that featured a growing presence of large multinational corporations and were gradually removed (Ghosh & Qureshi, 2016, p. 18).[2] As a result, since the 1980s, financial markets have undergone a historically-unparalleled process of expansion and integration (Wolf, 2015, ch. 4). One of the effects of economic globalization has been the rapid growth of the offshore economy.

Zucman (2015) calculates that, as of 2014, US$7.6 trillion, or 8% of global wealth, is hidden from tax authorities.[3] The fiscal impacts of such a significant portion of global wealth being hidden offshore is significant, with estimates suggesting that Canada, for example, is losing anywhere between six and eight billion dollars in tax revenue annually (Standing Committee on Finance, 2016). Worldwide, estimates have pegged the lost tax revenue to be in the range of US$200 billion (Kemme, Parikh, & Steigner, 2017, p. 520). Like runaway incomes,

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[1] Such a shift is substantial, as the Gini coefficient skews towards the middle and is less responsive to movement at the poles (Heisz, 2016, pp. 77–102; Organisation for Economic Co-operation and Development, 2011).
[2] The internationalization of corporations, and commercial activity more generally, meant that capital account restrictions began to negatively affect countries' trade positions and were seen as incompatible with free trade (Ghosh & Qureshi, 2016, p. 5).
[3] Relying on alternative methods, other estimates place the number upwards of US$21 trillion (Kemme et al., 2017; Standing Committee on Finance, 2016). However, Zucman's methods have been widely adopted since the publishing of his book in 2015, including by the Canada Revenue Agency in their tax gap studies. See Canada Revenue Agency (2018).

offshore tax evasion is a phenomenon that occurs with greater magnitude as one moves up the wealth scale. Alstadsaeter, Johannesen, & Zucman (2017) who used available data, from audits, leaks, and amnesties, estimate that the top 0.1% wealthiest households in the European countries included in their study own 80% of offshore wealth and the top 0.01% own half. While these same statistics are not available for Canada, the problem is likely of a similar magnitude, as the share of Canadian wealth held offshore, at 9%, is only one point below the European share, at 10% (Zucman, 2015, p. 53).

Another ramification of the offshore economy, corporate tax avoidance, also has significant implications for inequality. In the United States (US) in 2013, 55% of corporate profits earned abroad (which account for almost one third of total corporate profits) were earned in six zero- or low-tax jurisdictions that did not figure in any substantial way into US corporate sales, production, or employment (Zucman, 2015, p. 105). The percentage of US corporate profits earned in these jurisdictions has nearly quadrupled since the 1980s and by 2013 represented $130 billion in lost tax revenues (Zucman, 2014, p. 128).[4] Similar evidence of avoidance activity is observed in Canada. Statistics on investment flows for 2018 indicate that after the US and the UK, the biggest recipients of Canadian foreign direct investment (in stocks) were Luxembourg, Barbados, the Cayman Islands, and Bermuda (Global Affairs Canada, 2018). Each of these countries is a well-known tax haven, facilitating corporate tax avoidance either through very low corporate tax rates or specialized corporate tax exemptions.

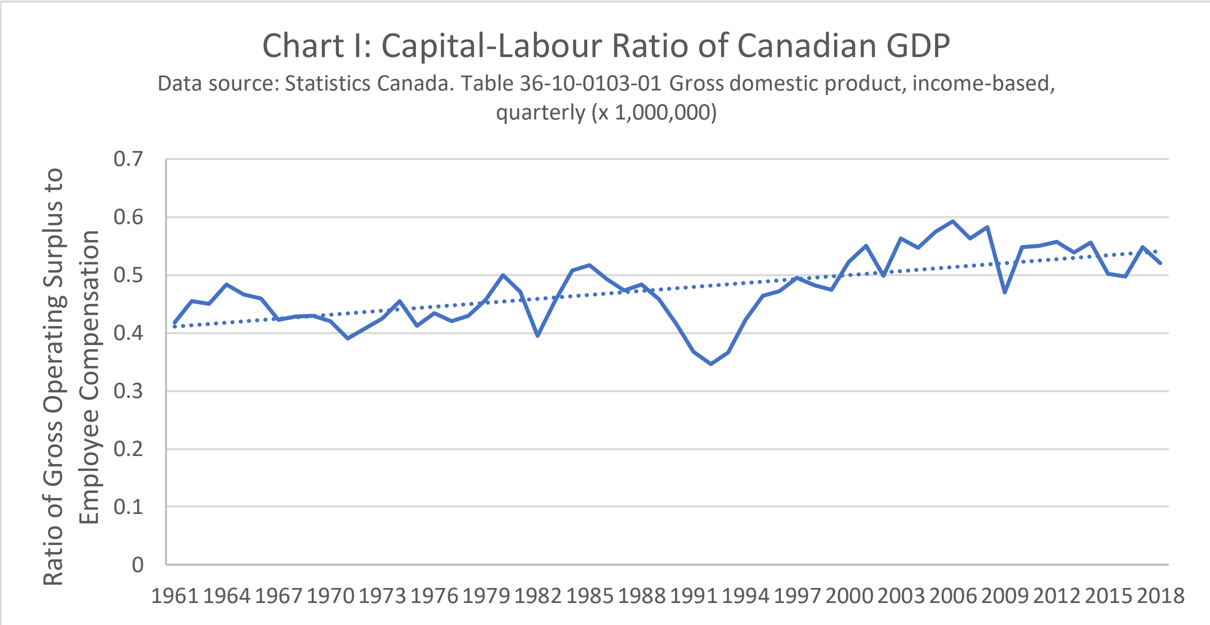
Another development driving the increase in top-end inequality since the 1980s is the growing presence of economic rent in advanced economies. Piketty (2014) identifies a correlation between returns on investment and portfolio size. In a competitive market, investment capacity should not, in theory, affect returns in a consistent manner. But in a market featuring significant economic rent, it is not surprising to see those controlling large amounts of capital to be able to utilize their market power in order to generate consistent supernormal returns. The share of global GDP held by profits, an indication of market power held by corporations, has been calculated to have increased from 7.6% to 9.8% 1980 and 2013 (Tomkiewicz, 2017, p. 207).

In addition, the increasing market power associated with the financialization of the US economy has been well documented.[5] While Canada's financial sector did not undergo such an extreme deregulation and transformation as that south of the border, our economy has also felt the effects of financialization, notably reduced productive investment on the part of businesses and an increase in the share of top 1% income earners held by the finance and insurance sector

4 The OECD has conducted significant research into the scale of global tax avoidance and has similarly concluded that it is a big, and growing, problem. For example, their 2015 report on the state of base erosion and profit shifting found that (1) foreign direct investment is increasingly concentrated in a small number of jursidictions, (2) the location of profits derived from intangible assets in increasingly separated from the location of the value-creating activity, and (3) the effective tax rate of multinational corporations is significantly lower than similar corporations with only domestic economic activities. (OECD, 2015, pp. 15–16).

5 For instance, see Tomaskovic-Devey & Lin (2011).

(Rochon, 2015).[6] By one estimate, economic rent now accounts for at least 40% of corporate income in Canada (Boadway, 2015). An implication of rising market power is a rise in the share of Canadian national income going to capital, particularly since the early 1990s, as seen in the chart below.



The Role of the State and Tax Policy in Shaping Inequality

When market income inequality began first increasing in the late 1970s and early 1980s, and up until the early 1990s, Canada's tax-and-transfer system largely absorbed these jumps and reduced after-tax changes in income distribution to such a large degree that they were barely perceptible in Gini coefficient measurements (Heisz, 2016, p. 88).[7] Around 1994, this ceased to be the case, as after-tax inequality began to rise (Banting & Myles, 2016, p. 509; Conference Board of Canada, 2011). A primary cause of this was tax policy reform, which saw government revenue fall from 45% to 38% of GDP (Banting & Myles, 2016, p. 526).

At a time when the share of market income earned by the top 1% was increasing dramatically, tax rates were falling. Across the OECD, top statutory personal income rates fell from an average of 66% in 1981 to 42% in 2010, a fall that was compounded by a decrease in tax rates on dividend income from domestic sources from 75% to 42% (Förster, Llena-Nozal, & Nafilyan, 2014, p. 10). Canada fit into the trend, with the top combined marginal rate on personal income falling from over 60% in 1975 to below 50% in 2010 (Förster et al., 2014, p. 41).

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[6] The finance and insurance sector saw its share of Canada's top 1% income earners rise from 5.4% to 11% between 1981 and 2011 (Lemieux & Riddell, 2016, p. 120).

[7] After-tax income refers to total income (i.e. after the effect of both taxation and government transfers are accounted for).

Across the OECD, between 1993 and 2006, corporate tax rates fell from an average of 37% to an average of 28.5% (Norregaard & Khan, 2007, p. 8). In Canada, taking a slightly longer view, the statutory federal corporate tax rate fell from 38% in 1986 to 15% in 2012 (Bird & Wilson, 2016, p. 5).

Tax expenditures, which are the various credits and exemptions that lower effective tax rates, have also played a significant role in the decline of the tax-and-transfer system in Canada. While the total size of these expenditures relative to the amount of tax revenue collected is currently at a similar level as the early 90s, the top 10% of Canadian income earners saw the share they capture increase from 36% to 42% (Macdonald, 2017, p. 21). Policies meant to integrate the personal and corporate tax systems, such as the partial inclusion of capital gains and the dividend gross up and credit, work to reduce the tax burden on capital income and concentrate their benefits among top income earners.[8]

The Canadian federal government's response to tax evasion has also been problematic. Cockfield (2017) has documented the underwhelming and ineffective responses by Canadian authorities to offshore financial leaks dating back to 2008. Beyond the surprisingly low number of prosecutions related to leaks of offshore financial information, the Canada Revenue Agency (CRA) has also worked to prevent investigative results from reaching the public.[9] In addition, interviews with twenty current and former CRA auditors uncovered suspicions that political interference had affected the auditing process in several of the cases (Standing Committee on Finance, 2016, pp. 20–22).

Tax Policy in a Globalized Economy

Corporate Taxation

The ability of corporate taxation to mitigate inequality has been reduced by increased capital mobility. Multinational corporations have increasingly been able to separate profits from their underlying business activity and shift them between jurisdictions in search of the lowest tax rates (Zucman, 2015, pp. 103–104). Beyond corporate tax avoidance, global economic integration leads to tax competition, which prevents governments from seeking overall progressivity through corporate taxation.

As in most countries, Canadian corporations face prices for their products and rates of return to capital set on global markets, limiting their ability to raise prices or reduce investor returns in response to increased tax rates (Boadway & Tremblay, 2014, p. 23). Unlike the postwar norm of discrete capital markets, the global integration of financial systems has caused the burden of corporate taxation to be shifted to inputs, notably labour, which works to exacerbate contemporary income inequality (Boadway & Tremblay, 2014, p. 23).

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8 The first sees 87.4% of its benefits accrue to the top 1% of income earners, and the latter 47.8% (Murphy, Veall, & Wolfson, 2015, pp. 671–672).

9 A CBC investigation into a tax evasion scheme run by accounting firm KPMG found that the CRA took steps to ensure the penalties applied in the case did not become known to the public (Canadian Broadcasting Corporation, 2017).

Many reforms have been proposed to transform the current model of corporate taxation from one that taxes all profits, to one that targets rents. One of these, the Allowance for Corporate Equity (ACE) approach, which is widely used in Europe, removes the normal return to capital from the tax base.[10] This makes the corporate tax rate more immune to competitive pressures and could allow for increased tax rates, particularly on rents generated domestically. Adopting an ACE-type corporate tax system will not prevent profits accruing to highly mobile capital, like intellectual property, from continuing to avoid taxation, but it would discourage rent-seeking and has the potential to facilitate increased tax revenues.

Personal Taxation

Capital income is earned by two separate economic entities, corporations and individuals, that do not share the same mobility. As in most countries, Canada's personal income tax is based on residence. However, double-tax treaties mean that, in most cases, Canadians earning income overseas (whether from labour or capital) will pay income tax in that jurisdiction. A crucial difference between corporate taxation and personal taxation is that individuals must still declare their foreign income in Canada (along with foreign taxes paid) and pay additional income tax if the rate was lower in the jurisdiction where the income was earned.

Increasing the tax burden on capital income is much more feasible by targeting capital income when it is earned at the personal as opposed to corporate level. This is due to the fact that individuals, even high-income individuals, are far less mobile than corporations.[11] And, by removing the tax on the normal return to capital through an ACE-type reform, tax policies meant to integrate the personal and corporate tax systems could be removed across the board without producing the consequences associated with disintegrating the tax system.[12]

To the extent that higher taxes on capital income create a disincentive to save, decreasing the savings rate is very much desirable in the context of contemporary inequality, as a lower savings rate and increased consumption directly reduces top-end inequality by lowering an economy's capital-income ratio. Less saving gradually reduces the capital stock, while more consumption increases economic growth, and thus, wages. Despite an increased share of the national income generated by economic growth going to capital, most still goes to labour, therefore wage growth has the effect of reducing inequality in most circumstances.

Tax Compliance

Evidence from international cases suggests small, open economies can work to mitigate offshore tax evasion. Beginning in 2008, Norwegian authorities began an aggressive campaign to crack down on tax evasion (Alstadsæter, Johannesen, & Zucman, 2018, pp. 2–6). The Norwegian campaign relied on policies that also form the core of Canada's compliance regime: a lenient amnesty program and information exchange agreements. Alstadsæter et al. (2018) find

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10 It estimates the normal return to capital by taking the product of the long-term government bond rate (equivalent to the risk-free market rate of return) and the amount of equity finance (Boadway, 2015, p. 259).

11 For evidence of the relative immobility of high income earners in the US and Canada, see (Helliwell, 1999; Statistics Canada, 2000; Young, Cristobal; Varner, Charles; Lurie, Ithai Z.; Prisinzano, 2016).

12 These include incentives for companies to remain unincorporated, to pay capital income as salaries, to favour debt over equity financing, among others (Boadway, 2015, pp. 259–260).

that, between 2008 and 2016, 11% of the top 0.01% wealthiest Norwegians used the amnesty program (p. 6). Among all participants, there was a 60% increase in net wealth, a 25% increase in income, and a 30% increase in taxes paid over the years that each individual evaded tax (p. 2–6). In 2013, only part way through the government's campaign, the share of Norwegian wealth held offshore was nearly two percentage points lower than Canada's.[13] This is despite being in an economic union with countries that have a far higher percentage of their private wealth offshore than Canada's southern neighbour.[14]

While Chile and Argentina had similar tax rates, tax structures, and systems of tax administration in the 1990s, and had undergone similar reforms in the years prior, Bergman (2003) notes that levels of tax evasion in Argentina over the course of the decade were almost double those of Chile (p. 594). Surveys conducted in the late 90s offer an explanation: 82% of Argentine taxpayers felt the risk of evasion being detected was "very low", while 75% of Chilean taxpayers thought the risk was "extremely high" (pp. 600–601). Bergman attributes this to the success on the part of the Chilean government and authorities in achieving a tax environment in which compliance was "internalized" (p. 594). In Argentina, a disorganized registration system, lack of trained auditors, and the government's vulnerability to corporate lobbying only resulted in brief, unsustained jumps in what was otherwise a low-compliance environment (pp. 602–603). Bergman concludes that developing effective tax agencies is as much a political endeavor as an organizational one.

Policy Recommendations

1. *Introduce a rent-targeting corporate income tax reform, such as the ACE model.* Such a reform would work to discourage rent-seeking while minimizing capital flight. A corporate income tax rate increase is then necessary to maintain the current revenue levels due to the narrowing of the tax base that ACE produces.
2. *Remove the two principal policies that serve to integrate the corporate and personal tax schedules by incorporating the full value of capital gains and dividend income into the progressive personal income tax schedule.* This will ensure the tax system better targets top incomes by shifting the personal tax burden towards capital from labour income. Taxing all capital income at the same rate as labour income will have minimal distortionary effects if combined with the corporate tax reform recommended above.
3. *Ensure public disclosure of the results of investigative efforts related to offshore tax evasion.* Provide greater resources to the CRA to pursue offshore tax evaders and increase the transparency of the investigative process and results in order to improve

13 By using the total stock of private financial wealth in Canada and Norway in 2013, provided by the World Inequality Database, and Zucman's estimates of the share of the world's offshore wealth in 2013 attributed to both Canada and Norway, we attain the estimate that 1.7% less of Norway's private financial wealth is hidden offshore than Canada's (World Inequality Database, n.d.; Zucman, 2013).

14 The share of the United States' private wealth held offshore was calculated to be 4%, versus 10% in Europe (Zucman, 2015, p. 53).

investigative capacity and grow public awareness of compliance enforcement. The recently published CRA tax gap studies are a positive step in this regard.[15]

[15] One part of the four-part series recently published by the CRA on Canada's tax gap focused on the international tax gap and compliance efforts. See Canada Revenue Agency (2018).

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