**The Comparative Politics of Fair Taxation**

Chapter 1

Funding the State: Taxation in Canada from a Comparative Political Economy Perspective.

Olivier Jacques[[1]](#endnote-1)

Despite what many people might believe, the tax burden in Canada remains low in comparison to most other developed economies.[[2]](#endnote-2) With its heavy reliance on personal income taxes and property taxes and comparatively low levels of social security contributions and taxes on goods and services, Canada’s tax structure is more progressive than most European countries’ tax systems. Nevertheless, the tax structure in the country is far from uniform: interprovincial differences in terms of revenue levels are often more important than differences between countries. The difference between tax levels in Quebec and Saskatchewan is as large as the difference between Canada and Sweden. The first part of this chapter compares Canada’s tax structure with other developed economies to highlight our tax system’s distinctive features.[[3]](#endnote-3)

 The second part of the chapter explains the size and shape of Canada’s tax structure with theories derived from comparative politics and political economy. In political economy, taxation is conceived as a bargain between political actors regarding their expenditure and revenue-extraction objectives. There are two typical bargains in advanced democracies. The first is a low level/high progressivity tax structure, which does not generate high levels of government spending. The second bargain involves lower tax progressivity but higher tax revenues that are used to fund more generous government spending. Canada’s tax structure fits with the first type along with other Anglo-American democracies, while more generous European welfare states rely on the second.

 Theories of comparative political economy have focused on institutions to explain these diverging tax policy patterns. They highlight the impact of electoral systems and interest group representation in the policy process, relying on the Varieties of Capitalism school.[[4]](#endnote-4) Both proportional representation (PR) electoral systems and a specific system of interest group representation called a “coordinated market economy” (CME) help to foster a bargain between employers, unions, and political parties of different ideologies. Countries with a PR system and a CME are able to strike a high tax and spending bargain where capital income is proportionately less taxed than labour income. This bargain is impossible in Anglo-American democracies like Canada which rely on a majoritarian electoral system and a system of interest group mediation called a “liberal market economy” (LME). In Canada, employers, unions, and political parties are unable to commit to a compromise on tax and spending policies to satisfy their diverging preferences. As a result, taxes and spending levels are lower. The tax system is more progressive because it relies heavily on income taxes while maintaining relatively low levels of social security contributions and taxes on goods and services.

Finally, the conclusion reviews the main findings of the chapter and briefly discusses the consequences of Canada’s tax policy choices on income redistribution. It argues that because income redistribution depends on social spending levels, strategies to reduce income inequality should focus on tax revenue levels rather than tax progressivity.

**1. Canada’s Tax System in a Comparative Perspective**

*Basic concepts.*

First, it is necessary to explain the fiscal policy concepts used in this chapter. In a progressive tax system, the proportion of taxes paid increases with income (high-income citizens pay a larger proportion of their income in taxes than low-income citizens), whereas in a proportional tax system, the percentage of tax paid is equal along the income distribution. Still, even in a proportional system, high-income citizens pay a larger amount of taxes (40% of $100,000 is more than 40% of $20,000).

The most common measure of the tax burden is total tax revenues as a percentage of Gross Domestic Product (GDP). This measure gives an overview of the size of tax revenues in relation to the size of the economy and allows for meaningful comparisons between countries and within countries over time. According to the Organization of Cooperation and Economic Development (OECD)’s categorization, there are four main types of taxes: taxes on income, profits, and capital gains of individuals and corporations; social security contributions; taxes on property; and taxes on goods and services. Social security contributions are indirectly tied to social benefits. For example, Employment Insurance (EI) premiums and Canada Pension Plan (CPP) contributions are social security contributions. They can be paid by employers, by employees, or by both together, and are used to fund a specific social insurance program. Property taxes include taxes on immovable property (like real estate), as well as wealth and inheritance taxation. Taxes on goods and services are sales taxes on the final consumption of a good or a service, like the Goods and Services Tax (GST). Income taxes include taxes on individual labour income, to which dividend and capital gains taxes can be added, as well as taxes on corporate profits. It is important to note that this definition of taxes excludes user fees on public services (which can represent up to 7.5% of GDP in some countries like Finland), natural resource revenues like royalties on oil or minerals, as well as custom duties.

These different types of taxes have diverging degrees of progressivity. Income taxes tend to be the most progressive, although a tax progressivity depends on its specific design (like the top rate on high-income people and the amount of low-income exemptions). In general, sales taxes are proportional or regressive, because consumption represents a larger share of poorer households’ income than of high-income households that have more fiscal capacity to save and invest their money. Social security contributions tend to be proportional or regressive because the maximum contributions are capped at a certain income level. The progressivity of property tax is difficult to assess because the category includes very progressive taxes[[5]](#endnote-5) on wealth and inheritance, but also taxes on immovable property like housing. The progressivity of taxes on immovable property depends the relative income of homeowners and, in the case of rental property, their capacity to shift the tax burden on tenants.

*Revenue levels and progressivity of the Canadian tax system.*

Canada is at the lower end of OECD countries in levels of taxes in proportion to GDP, with total tax revenues representing around 32% of GDP in recent decades. Canada’s revenue levels are very similar to those of the United Kingdom (32.5%), higher than the United States (26.2%), but much lower than most western European countries. France for example, maintains a tax burden of 45.2% of GDP, while the OECD tax revenue average is 36% of GDP.

**Insert Figure 1.1. here**

 Figure 1.2 shows that Canada’s tax system is among the most progressive of OECD countries; few countries have more progressive tax systems. I create an index using two measures of progressivity: a concentration coefficient of taxes, which measures how much the tax burden is concentrated on high-income individuals (higher values indicate that the tax system is more progressive) and the share of taxes paid for by the richest decile of the population.[[6]](#endnote-6)

**Insert Figure 1.2. here**

Canada’s combination of low taxes and high progressivity is similar to other Anglo-American democracies like the United States, the United Kingdom, Australia, Ireland, and New Zealand. This is because their tax system relies heavily on relatively progressive income and property taxes while keeping low levels of regressive taxes like social security contributions and taxes on goods and services. According to these progressivity measures, the United States is tied with Ireland for the most progressive tax system. This can be explained in large part by the low levels of taxes on goods and services in the United States (the federal government does not impose a national sales tax). In the United States, taxes on the poor are comparatively low, but the American tax system does not generate high levels of revenues. Hence, poor people in the United States don’t receive much from the government in comparison to countries with higher tax levels. In contrast, countries with lower levels of tax progressivity tend to maintain higher levels of taxes and, in consequence, more government spending.

Figure 1.3 shows an inverse relationship between levels of taxes and the overall progressivity of the tax system (measured by a concentration coefficient). In general, countries with higher levels of taxes have less progressive tax systems.[[7]](#endnote-7) As mentioned, this is in large part because countries with high levels of taxation need to rely on higher levels of regressive revenue sources like social security contributions or taxes on goods and services.[[8]](#endnote-8) Indeed, it is almost impossible for a government to rely only on progressive income taxes to fund high levels of tax revenues, especially in an era of tax competition. Heavy taxes on high-income individuals or corporations might provoke capital flight, while social security contributions on employees, property taxes on immovable property, and taxes on goods and services are almost immune to tax competition between countries.[[9]](#endnote-9) Still, some countries, like Switzerland, combine a regressive tax system with low levels of revenues, while Finland shows that it is possible to maintain a relatively progressive tax system with high levels of revenues.

**Insert Figure 1.3. here**

 *A Detailed Picture of Taxation in Canada.*

This section focuses on some of the key features of Canada’s tax system: low levels of social security contributions and of taxes on goods and services, a high ratio of capital taxes relative to taxes on labour, and large interprovincial differences of tax burdens. Firstly, figure 1.4 shows the proportion of each of the four major taxes as a share of the total tax burden in Canada, on average in the OECD, and in Anglo-American democracies.[[10]](#endnote-10) Figure 1.4 reveals that the proportion of each tax is very similar in Canada and in other Anglo-American democracies. Section 2 shows that the common institutions of Anglo-American democracies can explain why their tax policies are similar. The main distinguishing feature of Canada’s tax system is its heavy reliance on income taxation of individuals and corporations. Income taxes represent almost half of the tax burden in Canada, while the proportion of income taxes represents only 34% of the total in the rest of OECD countries. In consequence, Canada has a lower proportion of social security contributions (17% in Canada against 27% in the rest of the OECD) and of taxes on goods and services. Indeed, in other OECD countries, taxes on goods and services represent a similar proportion of tax revenues than income taxes (33%), while in Canada, they only represent 23% of the total tax burden, which is also much lower than in other Anglo-American democracies (28.7%). Finally, property taxes are more important in Canada (12%) than they are in other OECD countries (6%) and in Anglo-American democracies (9.9%).

**Insert Figure 1.4. here**

Social security contributions fund social insurance programs, mostly old age and disability pensions and as well as unemployment benefits. Canada’s level of social security contributions (4.8% of GDP) remains in the lower tier of OECD countries. Figure 1.5 shows a strong correlation between social security contributions and spending on unemployment benefits and pensions. Canada’s relatively cheap unemployment benefits and old age pensions mirror the low level of social security contributions. Indeed, unemployment benefits in Canada are not particularly generous and offer a relatively low replacement rate and coverage (0.6% of Canadian GDP, against an OECD average of 1.1%).

Pensions represent the main social insurance expenditure in OECD countries. The goal of many European public pension systems is to provide retirees with a similar income to their lifetime earnings.[[11]](#endnote-11) This is why they spend close to 10% of their GDP on pensions and have low levels of private spending for pension plans. Like most other Anglo-American pension system, the Canadian public pension system does not aim to provide lifetime income replacement for all retirees: upper middle class and high-income Canadians need to supplement their public pension with a private pension scheme to maintain their standard of living when they retire.[[12]](#endnote-12) The Canadian pension system relies extensively on Old Age Security, a basic universal cash benefit offered to all seniors, and the Guaranteed Income Supplement (GIS), whose objective is to lift low-income seniors out of poverty. Both programs are funded by general taxation, not by social security contributions. The Canada and Quebec pension plans are funded by social security contributions, but they remain a complement to Old Age Security and private pension schemes. In consequence, social security contributions in Canada are very low in comparative perspective and pension income replacement rates remain low. Thus, private spending on pensions is high (3.2% of GDP, against an OECD average of 1.3%). Still, poverty rates among seniors in Canada are low in comparative perspective because the GIS achieves high poverty reduction for seniors (comparable to Scandinavia), at comparatively low costs.[[13]](#endnote-13) In brief, Canada’s low social security contributions reflect a lean pension system achieving efficient poverty reduction but forcing middle and upper income citizens to buy private pension schemes.[[14]](#endnote-14)

**Insert Figure 1.5. here**

Canada’s tax system is also characterized by low levels of taxes on goods and services. Political science research has identified the late implementation of value-added taxes (VAT),[[15]](#endnote-15) which is the modern form of taxes on goods and services applied only on final consumption, as one of the causes of a smaller welfare state.[[16]](#endnote-16) Indeed, some estimates show that adopting value- added taxes raises tax revenues in the long-run by 4.5% of GDP.[[17]](#endnote-17) VATs are particularly efficient: they create few economic distortions, are applied on imports rather than on exports, and are not subject to tax competition, which explains why welfare states with high revenue needs tend to rely extensively on VAT.[[18]](#endnote-18) Canada had to wait until the second Mulroney government in the early 90s to implement a value-added tax (the GST) and the debate about value-added taxes in the country has always been contentious, as the Chrétien Liberals promised to repeal the tax, while the Harper government was elected on a promise to reduce the GST by 2 points. This reflects a lack of political consensus that will be addressed later in this chapter. This late implementation of VAT certainly helps to explain both the low levels of revenues generated by taxes on goods and services (see figure 1.6) and the low level of overall revenue.

**Insert Figure 1.6. here**

 One of Canada’s distinctive features is its heavy reliance on property taxes. As shown in figure 1.7, Canada maintains the highest level of property taxes in the OECD, after France and the UK. But Canada’s taxes on immovable property, which homeowners pay to their municipality (and local school board) every year, are the highest of the OECD. In countries like Belgium or France, inheritance taxation represents a relatively large proportion of property taxes, while property taxes in the UK are in large part composed of taxes on financial transactions. Canadian governments make little use of wealth and inheritance taxes as well as taxes on financial transactions to fund themselves. In Canada, inheritances are considered as capital gains taxable like other sources of income; they are not considered as property taxes per se.

The high reliance on taxes on immovable property in Canada reflects a characteristic of fiscal federalism in Canada[[19]](#endnote-19): Canadian municipalities’ main (and almost only) taxation tool is property taxes. Still, municipalities have high expenditure needs and a lot of responsibilities. Because provinces are constantly struggling with the federal government about the division of revenues and expenditures, municipalities are not able to demand higher inter-governmental transfers from provinces.[[20]](#endnote-20) Already in the 1960s, Finance Minister Mitchell Sharp revealed that the Canadian property tax was the highest of all the advanced economies.[[21]](#endnote-21)

**Insert Figure 1.7 here**

Finally, it is worth looking at capital and corporate taxes. Anglo-American states have typically relied on high taxes on capital[[22]](#endnote-22) income relative to taxes on other factors of production like labour. However, corporate and capital taxes are most vulnerable to tax competition, putting a strong downward pressure on the tax base of Anglo-American democracies.[[23]](#endnote-23) Figure 1.8 shows the proportion of effective capital taxes as a share of taxes on labour income (household labour income and consumption taxes).[[24]](#endnote-24) Historically, Canada had a more capital-friendly tax structure than its southern neighbor,[[25]](#endnote-25) as reflected in the capital to labour tax ratios. With a ratio of 1, Canada taxes capital as much as labour income. This ratio is lower than the US, Japan, and Australia, but higher than the average of 0.77. Because they tend to tax labour much more and capital less, European countries have a ratio below 0.8.

**Insert Figure 1.8. here**

*Interprovincial Differences.*

To facilitate comparison, this chapter presented Canada as a unitary state, which obscures significant inter-provincial differences in terms of levels of taxes. As shown in figure 1.9, Quebec, and to a lesser extent, Nova Scotia, tax much more than the provincial average (with tax ratios on GDP of respectively 38.5% and 36.42%).[[26]](#endnote-26) Quebec’s tax level is similar to Norway’s. The difference between Quebec and the province with the lowest level of taxes, Saskatchewan (27.87% of GDP), is similar to the difference between Canada and Sweden (32% and 43.3% of GDP) and is almost twice as large as the difference between Canada and the United States’ (26.2%) tax levels. These differences are impressive because they are comparable to nation-states with full control over their taxation, even though provincial governments only control around 60% of total tax revenues, the rest being allocated by the federal government.

These large differences in tax revenues in relation to GDP are influenced by three factors: levels of spending, proportion of natural resources revenues, and gross domestic product. Levels of spending differ a lot between provinces: among OECD countries, Canada has the highest share of expenditures allocated by subnational governments (OECD 2017). Because of its larger tax burden, the level of poverty and inequality reduction of the Quebec welfare state resembles those achieved in North-Western European countries, while redistribution in other provinces is lower, and comparable to other Anglo-American democracies.[[27]](#endnote-27) Poorer provinces tend to tax more in proportion to their GDP, but the difference in tax levels between Manitoba and Quebec, two provinces with a similar GDP per capita, suggests that political choices about levels of taxes and spending matter. Finally, it is worth noting that tax levels are lower in oil-producing provinces, simply because they can afford to fund expenditures with oil royalties instead of taxes. Indeed, since 1980, natural resource revenues represent on average 25% of total revenues of government of Alberta and 19% of Saskatchewan’s government revenues. Since oil production boomed in Newfoundland in 2007, 29% of the province government’s total revenues come from natural resources.[[28]](#endnote-28) This is much higher than natural resource revenues in non-oil-producing provinces, which have to compensate with higher taxes.[[29]](#endnote-29)

**Insert Figure 1.9. here**

It is worth noting that the structure of tax systems does not vary much between provinces: provinces with higher levels of taxes maintain higher taxes on everything. The main difference comes from taxes on goods and services; Alberta has no provincial sales tax, while Saskatchewan has a 6% provincial sales tax, as opposed to a 10% provincial sales tax in Quebec and in the Atlantic Provinces. Still, Quebec’s income tax is particularly high from a comparative perspective. After Denmark and Iceland, Quebec is the jurisdiction with the highest level of income tax on individuals (13.4% of GDP).[[30]](#endnote-30)

This comparison with other OECD countries reveals the distinctive characteristics of the Canadian tax system. Overall tax revenues are low, which is largely explained by the low level of taxes on goods and services and of social security contributions. Because of this, Canada’s tax system is very progressive and relies heavily on income taxation, which provides almost 50% of Canada’s tax revenues. The tax burden in Canada falls disproportionately on homeowners, who are the most heavily taxed in the OECD. Taxes on capital in general are also relatively high. Also, interprovincial differences in revenue levels are significant, with the tax burden being higher than the OECD average in Quebec and Nova Scotia, while Alberta and Saskatchewan are among the lowest.

**2. Political and Institutional Causes of Canada’s Distinctive Tax System.**

Explaining tax policy has not traditionally been the centre of attention in social science research. In comparative politics, it was assumed that spending and taxing were two sides of the same coin: the social, political, and economic causes of spending decisions were assumed to be the same as the causes of tax policies. According to power resource theory, the power of left-wing political actors determined the level and design of spending and taxes.[[31]](#endnote-31) However, power resource theory could not explain why countries where the left was dominant (like Scandinavian countries) had less progressive tax systems than countries, like Canada, where the left never forms a government at the national level. Why did the left fund generous welfare states with regressive taxes in some countries, but not in other?

Building on Sven Steinmo’s seminal contribution *Taxation and Democracy* (1993),[[32]](#endnote-32) the comparative political economy of taxation puts institutions at the forefront to explain a government’s tax policy. Two institutions are especially relevant, because they shape the incentives of unions, employers, and political parties: the electoral system and the system of interest group representation. Understanding the role of these institutions is crucial to explaining Canadian tax policy structure and comparing it with other countries.

 From this political economy perspective, taxation can be conceived as a bargain between political actors concerning their expenditure and revenue extraction objectives. Left-wing parties and unions prefer more social spending for their constituencies, while right-wing parties and employers prefer lower taxes, but not necessarily lower spending. Both proportional (PR) electoral systems and a specific system of interest group representation called a “coordinated market economy” (CME) help to foster a bargain between employers, unions, and political parties of different ideologies. In countries with a PR system and a CME, notably in northern and western Europe, this bargain involves higher social spending financed by broad-based taxes whose burden falls on workers, while the tax burden on employers is kept relatively low.[[33]](#endnote-33) This bargain was impossible to achieve in countries like Canada with a majoritarian electoral system and the system of interest group mediation of a “liberal market economy” (LME) because employers, unions, and political parties are unable to commit to a compromise on tax and spending policies to satisfy their divergent preferences. As a result, tax and spending levels are lower and tax policies are more conflictual. Left-wing parties aim to increase taxes on the rich while right-wing parties aim to decrease taxes, making the overall system more progressive, and more reliant on income taxes than on social security contributions and taxes on goods and services. It is important to highlight that there are institutional complementarities between electoral systems and varieties of capitalism: CMEs have proportional electoral systems and LMEs have majoritarian electoral systems.[[34]](#endnote-34)

This chapter focuses on one perspective building on rational choice institutionalism. Epistemologically, this perspective proposes that theories should be conceived as instruments simplifying the social world: the objective is not to explain all cases but rather to have a sufficiently accurate theory to clarify most situations. The theory I present in this chapter is fairly consensual in the comparative political economy of taxation literature and is supported by case studies, quantitative research, and formal models. However, it cannot explain the idiosyncrasies of each case, which is better explained by detailed historical analysis. For example, the theory cannot explain why Canada maintains such high levels of taxes on immovable property.

Before focusing on our political economy model, there are important alternative and complementary explanations to address. The war mobilization perspective proposes that mass warfare led to calls for the “conscription of wealth” in exchange for soldiers’ conscription: countries waging World War II, like Canada, considerably increased top marginal income taxes up to confiscatory rates (close 95% in some cases) not only to fund the war effort, but also to ensure fairness between citizens sent to war and those staying at home.[[35]](#endnote-35) While pertinent to explain why some countries adopted extremely high top marginal tax rates, this perspective cannot explain the perpetuation of differences between countries long after the war, nor why some countries reduced their top income taxes more than others.

Scholars studying political behaviour could argue that tax policies reflect public opinion. However, after recognizing that public preferences do not cause differences between countries in tax policies,[[36]](#endnote-36) political science research has reversed the causal arrow and analyzed how taxation feeds back into public opinion and influences citizens’ preferences. Some scholars have shown that very progressive tax structures, like Canada’s, tend to polarize public opinion[[37]](#endnote-37) and reduce overall support for government redistribution and for sustaining current tax burdens,[[38]](#endnote-38) while social security contributions produce a pro-tax political dynamic.[[39]](#endnote-39) This literature is burgeoning, but I prefer to disregard it here because it is very difficult to distinguish the cause (tax structures) from the effect (public opinion) and because cross-country research tends to use the same international survey (the ISSP), which relies on a survey conducted only once in Canada.

 One could also argue that Canada’s tax structure mirrors policy choices made in the United States; the similarity between the two countries’ tax policy could be explained by policy diffusion and tax competition. Indeed, Shirley Tillotson suggests that Canadian tax policy has never been completely independent from that of its southern neighbour. It has been shown that Canadian taxes on high income individuals and corporations are influenced by the United States’ tax policy decisions.[[40]](#endnote-40) However, this observation cannot explain why the tax structures of all Anglo-American democracies, not just those of Canada and the US, are so similar. Also, Canada and the US maintain similar levels of taxation on immovable factors, like taxes on goods and services, taxes on immovable property, and social security contributions, a fact that cannot be explained by tax competition alone. The comparative political economy theory I present suggests that the common institutional characteristics shared by the US and Canada provide a better explanation.

*Majoritarian and Proportional Systems.*

Canada’s electoral system is single-member plurality: each riding is won by the candidate earning a plurality of votes. This system creates a disproportion between the number of votes and the number of seats, which discriminates against small parties (except those with very strong regional support). Such a system helps the formation of a two-party system and a single-party government holding the majority of seats in parliament. Hence, Canada’s electoral system can be qualified as majoritarian, in contrast to proportional electoral systems where the discrepancy between the number of votes and seats won by a party is smaller. In proportional systems, there are usually more representatives from more parties in parliament. In consequence, parties rarely get a majority and need to govern in coalition or as minority governments.[[41]](#endnote-41) All Anglo-American democracies have a majoritarian electoral system, although New Zealand switched to proportional representation in the mid-1990s.

 Electoral systems have a clear effect on taxation. Canada’s relatively low levels of tax revenues, its progressivity, its heavy reliance on income tax and low levels of value-added taxes can all be explained with reference to its electoral system. Firstly, left-wing parties have more success in proportional systems, while right-wing parties are stronger in majoritarian systems.[[42]](#endnote-42) Left-wing governments are associated with higher levels of spending and of taxes, while right-wing governments prefer lower taxes and spending. Hence, revenues and expenditures tend to be higher in PR systems than in majoritarian systems. In Canada, at the federal level, the left (the New Democratic Party) has never won a plurality of seats and the centre (the Liberal Party) has traditionally been the “natural” governing party. In recent decades, Liberal governments have not increased tax levels significantly, while Conservative governments have decreased tax levels.[[43]](#endnote-43) The absence of a left government and the rotation between a tax-cutting right-wing party and a “not-so-keen-on-increasing-taxes” centrist party at the federal level helps explain the relatively low levels of overall taxation.

 In majoritarian systems, political parties’ main objective is to attract the median voter. Hence, parties are very sensible to the will of the majority. Recent public opinion data reveal that the median voter wants to soak the rich and pay less tax: people prefer higher taxes on the rich and on corporations and a lower overall tax burden.[[44]](#endnote-44) Hence, governments in countries with majoritarian electoral systems end up with higher taxes on capital, proportionally more taxes on high-income people, and lower taxes on the median voter. In contrast, in PR systems, small parties representing capital holders are more likely to have an influence in parliament and to prevent a disproportionate taxation of capital.[[45]](#endnote-45) This is part of the explanation of the pattern of high progressivity and low taxes in Anglo-American democracies.[[46]](#endnote-46) The tax reform proposed during the 2015 election by Justin Trudeau’s Liberals fits this pattern: it raises the progressivity of the system by increasing taxes on high income earners and decreasing taxes on the middle class, without raising overall revenues.

 This low tax/high progressivity pattern can also be explained by the high electoral volatility inherent to majoritarian electoral systems. In a majoritarian system, a small change in votes can lead to a large difference in the number of seats won. Hence, it is very difficult for parties to credibly commit to a long-term strategy involving higher taxes on the middle class to fund higher spending.[[47]](#endnote-47) Parties are more likely to adopt a short-term tax strategy pleasing as many voters as possible, preferably in key ridings.[[48]](#endnote-48) In PR systems, opposition parties maintain some degree of influence on the government because they keep a sufficient number of seats in parliament and in parliamentary committees. For example, PR systems are associated with an earlier adoption of value-added taxes, which leads to higher levels of revenues collected by taxes on goods and services.[[49]](#endnote-49) This is made possible because political parties can credibly commit to tax the middle class and the poor with value-added taxes and use this revenue source to fund more generous social spending.[[50]](#endnote-50) In majoritarian systems, parties cannot credibly commit to raising regressive taxes to fund social spending. If they lose elections, they will not be able to influence the next government, which could simply decide not to raise social spending. Because of the absence of credible commitment between parties in majoritarian systems, right-wing parties cut taxes while left-wing parties increase taxes on the rich and refuse to increase taxes on their own supporters.[[51]](#endnote-51) In Canada, the left has historically campaigned for a higher personal exemption of income tax to alleviate the burden of poorer Canadians[[52]](#endnote-52) and has never campaigned to increase sales taxes, even if this would involve higher overall tax revenues. In contrast, it is not rare to hear centre-left European parties proposing to increase sales taxes to fund more generous social spending.[[53]](#endnote-53)

*Coordinated and Liberal Market Economies.*

The distinction between coordinated and liberal market economies (CME and LME), developed by the Varieties of Capitalism (VoC) school,[[54]](#endnote-54) is necessary to understand variations in tax policy choices. In a nutshell, the Varieties of Capitalism literature focuses on the preferences and organization of firms and employers and aims to understand why employers consent to large welfare states in some countries but not in others.

Firstly, this literature argues that employers’ incentives regarding the provision of social insurance vary between countries. In CMEs, employers need employees with industry-specific skills. Hence, employers want to incentivize their employees to commit to long hours of training to ensure that these skilled employees will not be poached by other firms. To do so, employers have incentives to consent to high levels of employment-based social insurance, which acts as a guarantee against job losses for employees.[[55]](#endnote-55) Also, CME firms have traditionally been funded by bank-based patient capital, allowing them to pursue long-term strategies, notably by investing in workers’ industry-specific skills. In contrast, in LMEs, industries rely on more general skills and employers have fewer motivations to provide social insurance. Firms’ funding in LME relies on financial markets whose priority is short term productivity and shareholder value maximization.[[56]](#endnote-56) Thus, in CME, there is a join support between firms and workers for higher social spending, whereas LME produce an antagonism between capital and labour, leading to lower spending.[[57]](#endnote-57)

Secondly, the VoC school stresses the role of macro-corporatist institutions, where peak associations representing unions and employers meet with government representatives to implement public policies related to wages, taxes, and spending. The literature on VoC shows that macro-corporatist institutions have been used to exchange wage moderation for higher social insurance.[[58]](#endnote-58) These macro-corporatist institutions are central to tax policy-making. Repeated contacts between unions and employers can educate employers and unions on the cost of high capital taxes on firms’ competitiveness and on the benefit of social insurance spending. Employers and unions represented by peak associations are better able to aim for a collectively beneficial position and overcome the particular interests of their individual members. The engagement of unions, employers, and the state in macro-corporatist institutions makes it possible to credibly commit to tax policies conceded by each actor. In CMEs, employers and unions can consent to a tax and spending policy bargain that involves high social spending paid for by taxes on workers. Employers consent to high social insurance since they are able to tailor tax policies to their own needs, notably by making sure the tax burden is not disproportionately theirs to shoulder. Hence, unions consent to higher taxes on their own members, knowing that they can count on higher social spending.[[59]](#endnote-59)

 In marked contrast, employers and unions are not represented by a peak association in LMEs: they represent the particular interests of their own industry and hence cannot impose bargains on their members. Unions and employers aim for short-term objectives and prefer to shift the tax burden to the other group.[[60]](#endnote-60) The conflictual relationship between employers and unions make this type of high tax/high social insurance bargain impossible to sustain in liberal market economies.[[61]](#endnote-61) For example, whereas leftist governments in coordinated market economies fund higher spending by regressive taxes on consumption,[[62]](#endnote-62) leftist governments in liberal market economies fear that an increase in regressive taxes will not be used to fund higher social spending in the future, and therefore favour higher income taxes on the rich. In brief, the political dynamic inherent to each variety of capitalism shapes the incentives of employers, unions, and their representatives within political parties regarding tax policy design. Table 1.1 synthesizes the theoretical arguments about the institutional causes of Canada’s tax policy distinctiveness.

**Insert Table 1.1. here**

**4. Conclusion: What about Redistribution?**

The main findings of this chapter can be summarized by some key findings:

* The overall tax burden in Canada is low from a comparative perspective.
* However, the tax burden on immovable property is the highest of the OECD.
* Tax progressivity is high, because Canada relies heavily on progressive income taxes and maintains low taxes on goods and services and social security contributions, which are more regressive tax components.
* Tax systems’ size and shape depends on the electoral system and on the system of interest groups representation.
* Our majoritarian electoral system and “liberal market economy” explain many features of Canada’s tax system and its similarity with the pattern of low revenues/ high progressivity seen in Anglo-American democracies.

To conclude, it is pertinent to discuss the impact of Canada’s tax system on income redistribution, since one of the explicit objectives of taxes is to affect the distribution of income. On the one hand, the progressivity of Canada’s tax system reduces income differences between the rich and the poor, but on the other hand, the relatively low level of revenue generated limits the government’s capacity to reduce poverty and inequality with social spending. Indeed, the size of the Canadian welfare state is small in comparative perspective: public social spending in Canada is among the lowest of the OECD (OECD 2018a). As a result, income redistribution after taxes and transfers is also very small, and income inequality and poverty remain relatively high in Canada (OECD 2018b). The case of Quebec in comparison to other provinces is revealing: Quebec taxes much more, spends even more and, in consequence, redistributes income more than any other province.[[63]](#endnote-63) If taxes in Canada were higher, income inequality and poverty would quite possibly be lower.

As pointed out by figure 1.3, there is an inverse relationship between tax progressivity and tax revenues: countries with very high levels of tax revenues use more regressive revenue sources. This trade-off suggests that focusing on tax progressivity might not be the best strategy to achieve income redistribution. It is widely known in international research that the bulk of income redistribution is achieved by the spending side, especially with social cash benefits to households, rather than by the revenue side, through taxation.[[64]](#endnote-64) An additional dollar spent by the government is likely to end up in health care, education, cash transfers to individuals, or public infrastructure, which are redistributive expenditures. To achieve higher levels of redistributive expenditures, governments must maintain high levels of revenues. To do so, they cannot rely only on progressive sources and must also use more regressive revenue sources, both because of tax competition and because of necessity; at a certain level of expenditures, a government cannot be funded only by progressive income taxes. Considering that Canada already has a very progressive tax system, equality-seekers should not focus their efforts on taxing the rich by increasing top income tax rates or property taxes. Instead, they should seek to increase overall levels of revenues. The use of efficient taxes with high revenue-generating capacity, like taxes on goods and services, should be considered by progressive reformers. If this additional revenue is spent on redistributive social spending that lifts people out of poverty, the overall result will be highly egalitarian, even if increasing a particular tax might reduce the overall progressivity of the tax system. The outcomes of a broad-based tax increase would actually be more egalitarian than limiting tax increases to few high-income citizens, which will not raise much revenue.

1. **Notes to Chapter 1**

 The author wishes to thank Elsbeth Heaman, Antoine Genest-Grégoire, Maxime Pelletier, and David Tough for comments on earlier versions of this chapter. [↑](#endnote-ref-1)
2. The OECD data for Canada is based on Statistics Canada data and uses an average of subnational government revenues (provincial and municipal governments). [↑](#endnote-ref-2)
3. The major primary sources for this research are: OECD, *Growing Unequal?* (OECD Publishing 2008); OECD, *Regions at a Glance* (OECD Publishing 2017); OECD 2018a, *Social Expenditure Database* (OECD Publishing 2018a); OECD, *Income Distribution* (OECD Publishing 2018b); OECD, *OECD Tax Database* (OECD Publishing 2018c); Statistics Canada, *Revenue, Expenditures and Budgetary Balance*, CANSIM 384-0047 (Statistics Canada 2018a); and *Gross Domestic Product, Income-Based, Provincial and Territorial*, CANSIM 384-0037 (Statistics Canada 2018b). [↑](#endnote-ref-3)
4. P.A. Hall and D. Soskice, “Introduction” to Hall and Soskice, eds., *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Oxford: Oxford University Press, 2001). [↑](#endnote-ref-4)
5. The OECD defines taxes as “the revenues collected from taxes on income and profits, social security contributions, taxes levied on goods and services, payroll taxes, taxes on the ownership and transfer of property, and other taxes. Total tax revenue as a percentage of GDP indicates the share of a country's output that is collected by the government through taxes. It can be regarded as one measure of the degree to which the government controls the economy's resources. This indicator relates to government as a whole (all government levels) and is measured in million USD and percentage of GDP” (OECD 2018c). [↑](#endnote-ref-5)
6. Because these measures are influenced by the level of inequality of a country or the share of income held by the richest decile, I follow the common practice (OECD 2008) of dividing the concentration coefficient by the level of inequality (measured by a Gini coefficient) and the second measure by the share of national income allocated to the richest decile. Both measures are combined to create an index of progressivity based on their average value. [↑](#endnote-ref-6)
7. A similar relationship appears using alternatives measures of progressivity. M. Prasad and Y. Deng, “Taxation and World of Welfare,” *Socio-Economic Review* 7 (2009): 431–57. [↑](#endnote-ref-7)
8. S. Ganghof, “Tax Mixes and the Size of the Welfare State: Causal Mechanisms and Policy Implications,” *Journal of European Social Policy* 16 (2006): 360–73; J. Kato, *Regressive Taxation and the Welfare State: Path Dependence and Policy Diffusion* (New York: Cambridge University Press, 2003). [↑](#endnote-ref-8)
9. P. Genschel and P. Schwarz, “Tax Competition: A Literature Review,” *Socio-Economic Review* 9, 2 (2011): 339–70. [↑](#endnote-ref-9)
10. I include the average of Australia, Canada, Ireland, N-Z, the UK, and the US. [↑](#endnote-ref-10)
11. I. Joumard, M. Pisu, and D. Bloch, “Less Income Inequality and More Growth - Are they Compatible? Part 3. Income Redistribution via Taxes and Transfers across OECD Countries,” *OECD Economics Department Working Papers* no 926 (2012). [↑](#endnote-ref-11)
12. A. D’Amours et al., *Innover pour péréniser le système de retraite* (Québec: gouvernement du Québec, 2013). [↑](#endnote-ref-12)
13. K. Milligan, “The Evolution of Elderly Poverty in Canada,” *Canadian Public Policy* 34, 4 (2008): S79–S94; J. Myles, “Income Security for Seniors: System Maintenance and Policy Drift,” in K. Banting and J. Myles, eds., *Inequality and the Fading of Redistributive Politics in Canada* (Vancouver: UBC Press, 2013): 312–34. [↑](#endnote-ref-13)
14. J. Curtis and J. McMullin, “Dynamics of Retirement Income Inequality in Canada, 1991-2011,” *Journal of Population Ageing* 12, 1 (March 2019): 51–68. [↑](#endnote-ref-14)
15. France was the first country to implement a VAT in the 1950s, while most European countries implemented a VAT in the late 60s and early 70s. [↑](#endnote-ref-15)
16. Kato, *Regressive Taxation*; P.H. Lindert, *Growing Public: Volume 1, Social Spending and Economic Growth since the Eighteenth Century* (Cambridge: Cambridge University Press, 2004); F.R. Helgason, “Unleashing the Money Machine, the Domestic Political Foundations of VAT Adoption,” *Socio-Economic Review* 15, 4 (October 2017): 797–813. [↑](#endnote-ref-16)
17. M. Keen and B. Lockwood, “The Value-Added Tax: Its Causes and Consequences,” *Journal of Development Economics* 92 (2010): 138–51. [↑](#endnote-ref-17)
18. Ganghof, “Tax Mixes.” [↑](#endnote-ref-18)
19. Property taxes are not correlated to house prices presented by the OECD (the price to income ratio and the real house price indices). Hence, property tax levels on GDP reflect tax rates, not average house prices. [↑](#endnote-ref-19)
20. S. Tillotson, *Give and Take: The Citizen-Taxpayer and the Rise of Canadian Democracy* (Vancouver: UBC Press, 2017), 217. [↑](#endnote-ref-20)
21. Ibid*.*  [↑](#endnote-ref-21)
22. “Capital income is equivalent to the sum of operating surplus earned by corporations, the capital share of operating surplus earned by private unincorporated enterprises, and operating surplus earned by the government. Capital tax revenues come from the following sources: taxes levied on corporate income, property taxes paid by entities other than households, and the household income tax on capital” (McDaniel 2007, 13). [↑](#endnote-ref-22)
23. Genschel and Schwartz, *Tax Competition*; J.C. Hays, *Globalization and the New Politics of Embedded Liberalism* (Oxford: Oxford University Press, 2009). [↑](#endnote-ref-23)
24. These are effective tax rates calculated by Cara McDaniel in “Average Taxes on Consumption, Investment, Labour and Capital in OECD Countries, 1950-2013” (2016). Online: http://www.caramcdaniel.com/researchpapers [↑](#endnote-ref-24)
25. Tillotson, *Give and Take*. [↑](#endnote-ref-25)
26. The data used in the section and in figure 9 presents provinces as if they were independent countries to facilitate international comparison; data on each province includes taxes collected by the provincial government and by the federal government. [↑](#endnote-ref-26)
27. R. Haddow, “Power Resources and the Canadian Welfare State: Unions, Partisanship and Interprovincial Differences in Inequality and Poverty Reduction,” *Canadian Journal of Political Science* (2014); R. Haddow, “The Politics of the Tax State in Canadian Provinces after the Golden Age,” *Canadian Journal of Political Science* 49, 1 (2016): 63–88. [↑](#endnote-ref-27)
28. R. Kneebone and M. Wilkins, “Canadian Provincial Government Budget Data, 1980/81 to 2013/14,” *Canadian Public Policy* 42, 1 (2016): 1–19. [↑](#endnote-ref-28)
29. For example, mining royalties and Hydro Quebec net annual benefit represent around 3% of Quebec government total revenue but most of it is not used in the general budget. Instead, a large proportion of natural resource revenue is invested in the Fonds des Générations for debt repayment. [↑](#endnote-ref-29)
30. Chaire fiscalité et Finances Publiques. 2018. *Bilan de la fiscalité au Québec.* Online : <https://cffp.recherche.usherbrooke.ca/outils-ressources/bilan-de-la-fiscalite-au-quebec-edition-2018/> (Accessed 30 May 2019). [↑](#endnote-ref-30)
31. G. Esping-Andersen, *Politics Against Markets* (Oxford: Oxford University Press, 1985). [↑](#endnote-ref-31)
32. S. Steinmo, *Taxation and Democracy: Swedish, British, and American Approaches to Financing the Modern State* (New Haven: Yale University Press, 1993). [↑](#endnote-ref-32)
33. C.G. Martin, “Labour Market Coordination and the Evolution of Tax Regimes,” *Socio-Economic Review* 13, 1 (2015): 33–54. [↑](#endnote-ref-33)
34. T.R. Cusack, T. Iversen, and D. Soskice, “Economic Interests and the Origins of Electoral Systems,” *American Political Science Review* 101 .3 (2007) 373–91; C.J. Martin and D. Swank, *The Political Construction of Business Interests: Coordination, Growth, and Equality* (Cambridge: Cambridge University Press, 2012). [↑](#endnote-ref-34)
35. K. Scheve and D. Stasavage, *Taxing the Rich: A History of Fiscal Fairness in the United States and Europe* (Princeton: Princeton University Press, 2016). [↑](#endnote-ref-35)
36. For example, public opinion in Northern Europe, where value-added taxes are high, does not systematically favour VAT more than in countries like Canada with lower VAT. [↑](#endnote-ref-36)
37. P. Beramendi and P. Rehm, “Who Gives, Who Gains? Progressivity and Preferences,” in *Comparative Political Studies* 49, 4 (2016): 529–63; M. Prasad, *The Politics of Free Markets: The Rise of Neoliberal Economic Policies in Britain, France, Germany, and the United States* (Chicago: University of Chicago Press, 2006). [↑](#endnote-ref-37)
38. L. Barnes, “The Size and Shape of Government: Preferences over Redistributive Tax Policy,” *Socio-Economic Review* 13, 1 (2014): 55–78; F. Roosma, *A Multidimensional Perspective on the Social Legitimacy of Welfare States in Europe* (Ridderkerk: Ridderprint, 2017). [↑](#endnote-ref-38)
39. Z. Truchlewski, “‘Oh, What a Tangled Web We Weave’: How Tax Linkages Shape Responsiveness in the United Kingdom and France,” *Party Politics* (2018). 1-11 [↑](#endnote-ref-39)
40. S. Gordon, this book; E. Saez and M. Veall, “The Evolution of High Incomes in Northern America: Lessons from Canadian Evidence,” *American Economic Review* 95, 3 (2005): 831–49; D. Swank, “Tax Policy in an Era of Internationalization: Explaining the Spread of Neoliberalism,” *International Organization* 60, 4 (2006): 847–82. [↑](#endnote-ref-40)
41. A. Lijphart, *Patterns of Democracy* (New Haven: Yale University Press, 2012). [↑](#endnote-ref-41)
42. T. Iversen and D. Soskice, “Electoral Institutions and the Politics of Coalitions: Why
Some Democracies Redistribute More than Others,” *American Political Science Review* 100, 2 (2006): 165–81; J. Rodden, “The Geographic Distribution of Political Preferences,” *Annual Review of Political Science* 13 (2010): 321-40; H. Döring and P. Manow, “Is Proportional Representation More Favourable to the Left? Electoral Rules and Their Impact on Elections, Parliaments and the Formation of Cabinets,” *British Journal of Political Science* 47, 1 (2016): 149–64. There are many explanations put forward to explain this phenomenon. The middle class has more incentives to vote for the right in majoritarian system and more incentives to vote with the left in PR systems because it anticipates that a left-wing government in a majoritarian system could soak the rich and the middle class to give to the poor (Iversen and Soskice). Also, left wing voters are traditionally concentrated in urban areas. The left tends to win these seats by large margins in majoritarian systems, while it loses more conservative rural districts by smaller margins. This involves that in a majoritarian system, the left has fewer seats than its number of votes would give them in a PR system (Rodden 2010). Thirdly, the choice of electoral in the early 20th century reflects the strength of the left and the right at the time: when the left was very strong and the right was divided, conservative elites decided to shift toward a PR system to prevent the left from governing alone. This was perpetuated over time (Boix 2003). [↑](#endnote-ref-42)
43. O. Jacques, “L’écueil du budget libéral : le cadre fiscal conservateur,”  *Policy Options/Options Politiques*. IPRR. Online : <https://policyoptions.irpp.org/fr/magazines/march-2019/lecueil-du-budget-liberal-le-cadre-fiscal-conservateur/> (Accessed 10 June 2019). [↑](#endnote-ref-43)
44. Barnes, “The Size and Shape of Government”; F. Graves, “Canadian Public Opinion on Taxes,” in A. and J. Himmelfarb, eds., *Tax Is Not a Four-Letter Word* (Waterloo: Wilfrid Laurier University Press, 2013); M. Arsenau, J-H. Guay, and L. Godbout, “Analyse de la perception des Québécois par rapport à l’impôt: une relation paradoxale,” CIRANO (2005). 66 pages. [↑](#endnote-ref-44)
45. Martin and Swank, *The Political Construction of Business Interests.*  [↑](#endnote-ref-45)
46. J.C. Hays, “Globalization and Capital Taxation in Consensus and Majoritarian Democracies,” *World Politics* 56, 1 (2003): 79–113. [↑](#endnote-ref-46)
47. J.F. Timmons, “Taxation and Representation in Recent History,” *The Journal of Politics* 72, 1 (2010): 191–208. [↑](#endnote-ref-47)
48. In majoritarian systems, parties have incentives to use specific tax expenditures that are disproportionately beneficial to constituents concentrated in certain key ridings where the governing party must win to form a government. [↑](#endnote-ref-48)
49. Helgason, “Unleashing the Money Machine.” [↑](#endnote-ref-49)
50. Timmons, “Taxation and Representation in Recent History.” [↑](#endnote-ref-50)
51. A. Kemmerling, “Left without Choice? Economic Ideas, Frames and the Party Politics of Value-Added Taxation,” *Socio-Economic Review* 15, 4 (2016): 777–96; Steinmo, *Taxation and Democracy*. [↑](#endnote-ref-51)
52. Tillotson, *Give and Take*. [↑](#endnote-ref-52)
53. Kemmerling, “Left without Choice?” and A. Kemmerling, “How Labour Ended Up Taxing Itself and Why It Matters: The Long-Term Evolution of Politics in German Labour Taxation,” *Journal of European Social Policy* 24, 2 (2014): 150–63. [↑](#endnote-ref-53)
54. Hall and Soskice, *Varieties of Capitalism*. [↑](#endnote-ref-54)
55. M. Estevez-Abe, T. Iversen, and D. Soskice, “Social Protection and the Formation of Skills,” in Hall and Soskice, eds., *Varieties of Capitalism*; I. Mares, *Taxation, Wage Bargaining, and Unemployment* (Cambridge: Cambridge University Press, 2006). [↑](#endnote-ref-55)
56. P. Culpepper, “Institutional Change in Contemporary Capitalism: Coordinated Financial Systems since 1990,” *World Politics* 57 (2005): 173–99. [↑](#endnote-ref-56)
57. Mares, *Taxation, Wage Bargaining, and Unemployment*. [↑](#endnote-ref-57)
58. J. Pontusson, *Inequality and Prosperity: Liberal Europe vs. Social America* (Ithaca: Cornell University Press, 2005). [↑](#endnote-ref-58)
59. Timmons, “Taxation and Representation in Recent History.” [↑](#endnote-ref-59)
60. Martin, “Labour Market Coordination and the Evolution of Tax Regimes.” [↑](#endnote-ref-60)
61. Martin and Swank, *The Political Construction of Business Interests;* Martin, “Labour Market Coordination and the Evolution of Tax Regimes.” [↑](#endnote-ref-61)
62. P. Beramendi and D. Rueda, “Social Democracy Constrained: Indirect Taxation in Industrialized Democracies,” *British Journal of Political Science* 37, 4 (2007) 619–41. [↑](#endnote-ref-62)
63. Haddow, “Power Resources and the Canadian Welfare State”; Haddow “The Politics of the Tax State in Canadian Provinces after the Golden Age.” [↑](#endnote-ref-63)
64. O. Causa and M. Hermansen, “Income Redistribution through Taxes and Transfers across OECD Countries,” *OECD Economics Department Working Papers* No 1453 (2017); V.A. Mahler and D.K. Jesuit, “Fiscal Redistribution in the Developed Countries: New Insights from the Luxembourg Income Study,” *Socio-Economic Review* 4, 3 (2006): 483–511. [↑](#endnote-ref-64)