Income tax turns 100. What have we learned?

By Doug Saunders
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Canadians are about to mark the anniversary of an event that gave birth to their modern country and shaped its present-day livelihoods like no other. No, not that event: Confederation was a comparatively minor shift from colonial to quasi-colonial status. We are talking about the creation, in the summer of 1917, of income tax.

I suspect you're not going to be setting off any fireworks to celebrate that particular centennial. But looking back a century can show us what we ought to avoid as we talk about rejigging the tax system today.

Prime minister Robert Borden certainly hadn't wanted to be the father of Canadian income tax. Prior to 1917, almost all of Canada's public revenue came through tariffs and duties. This had the theoretical benefit of making Canada a low-tax country, but the practical result of making Canada a trade-walled country where goods were expensive and entrepreneurship difficult. This kept talented immigrants away. Borden didn't mind: he had risen to power on a potent Tory platform of anti-Americanism, white supremacy and trade protectionism.

Income tax, which the Yanks introduced permanently in 1913, represented everything Mr. Borden opposed.

It took an emergency to change his mind. The First World War had run up $600-million in public-sector debts (equivalent to $12-billion today). There was no way Canada, with a population of eight million, could pay that bill by taxing its meagre imports, so income tax was born.

Mr. Borden had no idea what he had created.

"In the blink of an eye, Canada changed in ways that took decades to fully understand," writes public-policy analyst John Stapleton in a new Mowat Centre paper. "All of a sudden, the federal government had appropriated the greatest tool available to governments to raise revenues."

As Mr. Stapleton notes, this meant Ottawa would forever be the main collector of revenues while most spending responsibilities fell to the provinces – the birth defect of 1867.

But also, because a fiscal policy based on individual earnings could pump funds in both directions, 1917 launched the development of the policies that turned Canada into a middle-class country – especially with the introduction of unemployment insurance and the federal spending power in the 1940s.

Canada's century of income tax has seen it waver between a European system that strongly redistributes earnings and a U.S. system that keeps taxes to a minimum to give people greater spending power. Taken to their extremes, both systems can choke off the economy. At the moment, Canada has lower tax rates and a less generous benefits system than in the past, but a more progressive system than before (that is, its rates rise more steeply as your income goes up).

Despite its many flaws – including slowly rising rates of inequality – Canada's tax-and-benefits system has made it a much more middle-class, upwardly mobile country than it would be if its citizens relied only on earned income. That was proven again this week as Statistics Canada released its study of income mobility. It found that, unlike the United States, Canadians born in the 1970s and 1980s continue to have higher family earnings than their parents did at the same age, and the chance of rising from poverty to middle-class earnings remains high.

This is in large part because our tax-and-benefits system has protected middle-income Canadians from devastating shocks during financial crises. During the Canadian crash of the 1990s, and again during the worldwide financial crisis after 2008, Canada's social safety-net spending shot up dramatically.

A recent study by statisticians Andrew Heisz and Brian Murphy found that the "tax-and-transfer system" completely compensated for income losses in both the 1990s and post-2008 crises. In fact, during the latter crisis, Canadian average incomes actually rose (and poverty fell), almost entirely because of temporary recourse to safety-net income. The United States, according to the OECD, suffered a lasting loss in individual income because neither its anemic benefits system nor its lower tax rates (and therefore higher after-tax incomes) were enough to compensate for the loss in earned income.

In short: Higher taxes protected a great many Canadians from ruin.

A century ago, Canadians found themselves following the U.S. lead, reluctantly, on income tax. This time around, we're better off ignoring our southern neighbours.