Fiscal Policy

Issue

A rapidly aging population and slower growth in the labour force will exert significant pressure on the public purse in the years ahead. Demand for publicly funded programs, like health care and elderly benefits, will rise significantly and a smaller number of workers will shoulder a larger share of the tax burden. Governments need to re-think how they raise tax revenue and finance government programs and services.

Reining in spending and improving efficiencies will enable the government to eliminate deficits in the near term and regain the fiscal flexibility to respond to changing circumstances and tackle areas that are crucial to Canada's long-term competitiveness, including reducing high marginal personal income tax rates.

Background

The February 2014 federal budget stayed the course towards eliminating the deficit— Ottawa looks for the budget to get back in the black in 2015-16—thereby protecting Canadian taxpayers from higher interest charges, while boosting confidence.

A lot of things still need to go right to balance the books by fiscal 2015-16, including sustained spending restraint and a rebound in growth. The 2014 Budget projected annual program spending growth of 1.9% in 2013-14, -0.4% in 2014-15 and 3.7% in 2015-16. Most of the savings realized over the forecast horizon are a result of managing compensation costs of federal employees and by moving National Defence funding for major capital procurements to future years.

Returning to balanced budgets by 2015–16 will ensure that the federal debt, measured in relation to the size of the economy, falls to below 30 per cent by 2016-17, in line with its pre-recession level.

The government continues to incorporate additional prudence into the projections (i.e. a $3 billion annual cushion) to allow for a small underperformance in the economy, a position the Canadian Chamber supports.

Canada's relatively favourable fiscal position sets it aside from most other major industrialized economies and provides a strategic advantage for long term growth, but it is in no position to be complacent.

Delivering a Better Tax System

Canada has much to gain by using the tax system optimally to promote employment, productivity and higher living standards. Reducing our heavy reliance on economically-damaging income and profit taxes, broadening the tax base, creating a more neutral business tax system, and reducing compliance costs for taxpayers can significantly boost Canada's international competitiveness.

The following are long-standing principles of good tax policy:

- Tax Neutrality: Economic activities should bear similar tax treatment to encourage the best allocation and profitable use of resources in the economy
- Tax Equity or Fairness: A tax system should distribute its burdens fairly There are two dimensions to equity. The first facet is that people in similar economic circumstances should receive the same tax treatment (horizontal equity). The second aspect is based on the notion that the more an individual earns, the more income tax s/he should pay (vertical equity)
- Efficiency: The tax system should minimize adverse affects on taxpayer behaviour that undermine the efficiency of the economy
- Simplicity: The tax system should be simple, transparent and easy to understand and comply with.

The tax base

Ad hoc changes to tax legislation by successive governments and the enactment of temporary provisions have complicated the tax system and increased compliance costs. The C.D. Howe Institute notes there are some 260 tax-preference measures (exemptions, deductions, credits or rebates) listed in the federal government's assessment of tax expenditures.[1] Some credits simply subsidize activities many recipients would have done anyway. Others may

[1] Laurin, Alexandre and William B.P. Robson "A Faster Track to Fiscal Balance: The 2011 Shadow Budget."

stimulate spending in certain areas, prompting suppliers to raise prices, thereby negating the benefit of the tax credit. In many cases, the government is using tax preferences to achieve social objectives rather than funding the initiative through spending programs. The myriad tax preferences enormously complicate the tax structure and increase compliance costs.

The tax base should be as broad as possible, allowing tax rates to be as low as possible at all points so that everyone benefits. This practice leads to fewer economic distortions, improved fairness and efficiency, and lower administration and compliance costs.

Tax compliance and administration

The tax code is overly complex as a result of piecemeal changes to tax legislation by successive governments and the enactment of temporary provisions and hundreds of tax preferences. The Fraser Institute estimates it costs Canadians up to $6.7 billion annually to comply with their personal income tax obligations and businesses as much as $17.8 billion to comply with theirs. Additionally, governments spend an estimated $6.6 billion each year to administer the tax system.[2]

A comprehensive review of Canada's tax system is in order with the central objective of reducing its complexity and improving the way Canada raises tax revenue. The Canadian Chamber calls on the federal government to appoint an expert panel that would (among others) review and clarify the language used in tax law; recommend changes to existing legislation that is not achieving its purpose or entails costs that outweigh the revenue being raised or protected; examine the processes used to formulate tax policy and to draft the legislation to give effect to that policy; and evaluate all tax preferences (credits, deductions, exemptions, rebates) with a view of eliminating those that are not cost effective or are not achieving their intended purpose. A broader tax base would make the tax system simpler, fairer and more efficient and would allow general tax rate reductions without loss of revenue.

Not all taxes are created equal

The federal government needs to rethink how it raises revenue and the types of taxes that are more efficient.

According to the Department of Finance, for each additional dollar of revenue raised, corporate income taxes impose a cost on society of $1.55. This compares with a cost of $0.56 for an additional dollar of revenue raised through personal income taxes. Payroll taxes impose relatively low costs on society ($0.27 per each additional dollar of revenue) and consumption taxes even less ($0.17).

- Business taxes deter productivity-enhancing capital investment and job creation. They fall directly on Canadian families—workers through lower wages, consumers in the form of higher prices for goods and services, and shareholders (including pensioners who own equity through RPPs, RRSPs and mutual funds) through lower returns
- Personal income taxes reduce the net return that workers get from working, saving or pursuing advanced training and education. They also reduce investors' rate of return and, thereby, the incentive to save and invest
- Payroll taxes (like EI and CPP) result in higher costs for businesses dampening hiring decisions. Over the long run, these costs are passed on to employees in the form of lower wages, taking a bite out of personal income
- Consumption taxes (i.e. taxes on the sale of goods and services) provide fewer opportunities for tax evasion and rely on a broader base. Additionally, consumption taxes do not threaten incentives to save and invest. Finally, they are relatively easy to collect

Yet, in Canada, approximately 47 per cent of total tax revenue comes from income and profit taxes compared to 34 per cent in OECD member countries.[3] Thirty-one of the 34 OECD countries rely on consumption taxes to greater extent than Canada does because they are the least economically damaging form of taxation.[4]

Toronto: C.D. Howe Institute. February 2011.

[2] Vaillancourt, François, Édison Roy-César, and Maria Silvia Barros. "The Compliance and Administrative Costs of Taxation in Canada." Studies in Tax Policy. Vancouver: The Fraser Institute. April 2013.

[3] OECD Tax Revenue Statistics 2013 edition.

Most governments around the world have come to the conclusion that consumption taxes are more stable and reliable and, therefore, value-added tax rates are going up and income tax rates are going down. Canada has much to gain by using its tax system optimally. Reducing our heavy reliance on economically-damaging income and profit taxes and relying more on less damaging forms of taxation, i.e. consumption taxes, can significantly boost Canada's international competitiveness.

Personal income taxes

When it comes to Canada's personal income tax system, change has been sporadic and there is much unfinished business. In international comparisons, Canada stands out as having a relatively high burden of personal income tax as a percentage of GDP. Punishingly high marginal personal income tax rates, that are especially affecting Canadians with modest incomes, reduce incentives to work, save, invest in education and skills and undertake entrepreneurial activities, all of which form the basis of a productive and growing economy.

Many low- and middle-income Canadian families with children with income in the $25,000 to $45,000 range face marginal effective tax rates on incremental income in excess of 50 per cent in most provinces because many of the public transfers they receive (including child tax benefits, the GST and provincial sales tax credits, provincial property tax credits, student financial assistance and social welfare) end up being clawed back as income rises.[5] These rates are generally higher than those for high-income families.

The impacts are similar for seniors in that marginal effective tax rates are high at the low end of the income scale. Many low-income retirees encounter effective marginal tax rates as high as 80 per cent as their guaranteed income supplement or the old age security gets clawed back as taxable pension savings—RRSPs/RPPs—are withdrawn.[6]

The Canadian Chamber of Commerce recommends that the federal government implement a multi-year plan to reduce personal income tax rates once the books are balanced. It should focus first on reducing marginal tax rates for low- and modest-income families because they face the highest marginal rates of all Canadians. Specifically, the Canadian Chamber recommends, when fiscal conditions permit, that the federal government reduce the 15 per cent personal income tax rate that applies on the first $43,953 of taxable income to 14 per cent. It also recommends that the 22 per cent rate that applies to taxable income of between $43,954 and $87,907 be reduced to 21 per cent. The

Reducing personal income tax rates can cost the treasury billions of dollars in forgone revenue, which is a major roadblock for cash strapped governments. Most economists believe that the most efficient way to pay for cuts to personal income tax rates is to increase consumption taxes, like the GST/HST—in other words, shift the tax mix away from income-based taxes to more efficient taxes based on consumption. The C.D. Howe Institute has proposed a one percentage point increase in the GST that would pay for a one percentage point reduction in rates in each of the four federal personal income tax brackets.[7]

Going forward, Canada will face the increasing challenge of attracting and retaining skilled workers that are essential to our international competitiveness. To entice high-technology skilled workers, upper management, entrepreneurs and professionals to Canada, the Canadian Chamber recommends that the federal government raise the threshold at which the top federal marginal personal income tax rate kicks in to $200,000 from $136,270. As a result, income in the $136,270 and $200,000 range would be taxed at a rate of 26 per cent, down from 29 per cent.

[4] The Department of Finance has concluded that for each additional dollar of revenue raised, corporate income taxes impose a cost on society of $1.55. This compares with a cost of $0.56 for an additional dollar of revenue raised through personal income taxes. Payroll taxes impose relatively low costs on society ($0.27 per each additional dollar of revenue) and consumption taxes even less ($0.17).

[5] Laurin, Alexandre and Finn Poschmann. "Treading Water: The Impact of High METRS on Working Families in Canada." *e-Brief*. Toronto: C.D. Howe Institute. July 17, 2013.

[6] Ibid.

[7] Laurin, Alexandre and William B.P. Robson. "Prudence and Opportunity: A Shadow Federal Budget for 2013." Commentary No. 375. Toronto: C.D. Howe Institute. March 2013. The C.D. Howe Institute says it will cost $6.8 billion to reduce by one percentage point each of the four federal personal income tax rates (i.e. cut the 15 per cent rate to 14 per cent, the 22 per cent rate to 21 per cent, the 26 per cent rate to 25 per cent, and the 29 per cent rate to 28 per cent, with non-refundable tax credit and charitable donations tax credit rates adjusted accordingly). The federal government can fully pay for this by increasing the GST rate by one percentage point (from 5 per cent to 6 per cent).

For Canadian families, reducing personal income tax rates would result in higher disposable income. The benefits to Canada from increasing the incentive to work, save, stay in Canada and undertake further education and training come in the form of higher productivity and economic growth.

Business taxation

Once known for having one of the highest corporate income tax rates in the developed world, Canada now has best ranking among G7 countries. Nonetheless, marginal effective tax rates (METRs) on capital investment—which include the statutory corporate income tax rate, sales taxes on capital inputs as well as deductions or credits associated with purchasing capital goods—vary widely by industry. Service providers (e.g., the retail trade, wholesale trade and communications sectors) face a rate of around 23 per cent. In contrast, METRs on capital are relatively low for forestry and manufacturing (well under 10 per cent).[8] This dichotomy is concerning because services are a major source of job creation and are increasingly exposed to international trade and competition.

Corporate taxes can hurt the economy most when they are not neutral among industries because capital tends to gravitate towards industries with the most preferred tax treatment rather than to where growth prospects may be higher. Governments (federal and provincial/territorial) should strive to achieve a neutral business tax system—one that does not distort business decisions by favouring particular industries, investments or activities.

Recommendations

That the federal government:

Re: Debt Management

1. Balance the federal books by 2015-2016.

2. Ensure that the debt-to-GDP ratio falls below 30 per cent by 2016-17.

Re: Program Spending

3. Sustain program spending restraint to balance the books.

4. Continue to examine new ways to reduce costs, modernize how government works and ensure value for taxpayers' money, including in the areas of service delivery, corporate asset management, travel and administrative systems.

Re: Tax Policy

5. Ensure that Canada's tax system is as neutral, simple, efficient and fair as possible.

6. Avoid ad hoc changes to tax legislation, like the constant addition of special provisions and targeted tax benefits.

7. Appoint an advisory panel (similar to the Advisory Panel on Canada's System of International Taxation) to identify ways to reduce the complexity of Canada's tax system. This should include a comprehensive review of the hundreds of exemptions, deductions, rebates, deferrals or credits that are part of the federal tax system to determine which ones are inefficient and wasteful. The panel should be supported by a secretariat and rely on the Department of Finance, the Canada Revenue Agency and the Auditor General of Canada for information and data regarding the current system.

8. Reduce Canada's heavy reliance on more damaging, high-cost sources of taxes, namely income and profit taxes, and rely more on consumption-based taxes, like the GST/HST.

9. Once the books are balanced, reduce the 15 per cent rate that applies to the first $43,953 of taxable income (2014) to 14 per cent, and the 22 per cent rate that applies to taxable income between $43,954 and $87,907 to 21 per cent. Raise the threshold at which the top federal marginal personal income tax rate kicks in to $200,000 from $136,270. As a result, income in the $136,270 and $200,000 range would be taxed at a rate of 26 per cent, down from 29 per cent.

[8] Chen, Duanjie and Jack Mintz. "2013 Annual Global Tax Competitiveness Ranking: Corporate Tax Policy at a Crossroads." *SPP Research Papers*. Volume 6. Issue 35. Calgary: The School of Public Policy, University of Calgary. November 2013.