Federal Fiscal Policy

Issue

Stubbornly low commodity prices and a tenuous recovery in Canadian manufacturing output and exports combined with our rapidly aging population and slower growth in the labour force will continue to 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 be reminded of how they raise tax revenue and finance government programs and services and they need to drastically simplify the tax system to achieve tax fairness and reduce high compliance costs.

Vigilance on reining in spending and improving efficiencies should enable the government to stay on target with balanced and even surplus budgets in the near term. This could enable them to regain the fiscal flexibility to respond to changing circumstances and tackle areas that are crucial to Canada's long-term competitiveness. To do this during the election year the government must also avoid introducing additional "popular" spending programs or initiatives that will strain fiscal capacity or threaten full economic recovery.

Background

The April 2015 Federal Budget was undoubtedly an election budget with a strong emphasis on tax cuts for (hardworking) Canadian families and a number of business-friendly tax adjustments and spending commitments. These initiatives will however also help stimulate an economic rebound especially the plan to reduce the small business tax rate from the current 11 percent to 9 per cent by 2019.

In contrast, a lot of things still need to go right in fiscal 2015–16 to go beyond a balanced budget and show a $1.4 billion surplus – a sustained focus on federal spending efficiencies and a global rebound in growth and commodity prices in particular.

Returning to balanced budgets during 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 and potentially below its pre-recession level.

Canada's relatively favourable fiscal position sets it aside from most other major industrialized economies and provides a strategic advantage for long-term growth. In spite of the reinvigorated focus on trade and international affairs in Budget 2015, Canada is in no position to be complacent. What was missing from the 2015 Federal Budget was as important as the many small perks doled out to geographically select interest groups and industry sectors throughout the country. Absences include: tax simplification; equitable tax treatment for generational wealth transfers in all business sectors; Accelerated Capital Cost Allowances for ALL industries; a temporary foreign worker program; concrete investment in tourism promotion; and strategic investments in market access infrastructure.

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 the individual should pay (vertical equity).

- Efficiency: The tax system should minimize adverse effects on taxpayer behavior 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 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.

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

- 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 Organization of Economic and Development (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]

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 gross domestic product (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 and 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.

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

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[3] OECD Tax Revenue Statistics 2013 edition.

[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.

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. 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 the best ranking among G7 countries. Although the plan to reduce the small business tax rate to 9 percent will help to maintain our good ranking, 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:

1. Re: Debt Management
    a. Annually target for balanced (or conditions permitting, surplus) budgets subject to recessionary conditions indicating a requirement for deficit spending to stimulate economic activity;
    b. Achieve and maintain a debt-to-GDP ratio below 30 per cent with financial contributions to debt reduction as necessary to sustain that position;
2. Re: Program Spending
    a. Confine program spending to core areas of federal responsibility and limit growth in program spending to a maximum of national population growth plus inflation;
    b. 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;
3. Re: Tax Policy

[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).

[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.

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

b. Avoid unnecessary complications to tax legislation by rigorously reviewing any addition of special provisions and targeted tax benefits;

c. Undertake a comprehensive review of taxing statutes with the objective of identifying and ensuring the implementation of new ways and means to simplify tax legislation, reduce the complexity of Canada's tax system and decrease compliance costs. The review should include an examination of the hundreds of exemptions, deductions, rebates, deferrals and/or credits that are part of the federal tax system to determine which ones are inefficient or wasteful and can be eliminated; and

d. 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 in combination with a multiyear plan to reduce personal income tax rates with an immediate focus on reducing marginal tax rates.