THE CANADIAN CHAMBER OF COMMERCE
LA CHAMBRE DE COMMERCE DU CANADA

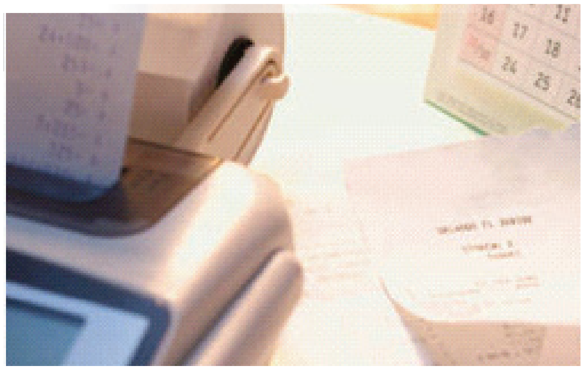
Policy Brief

Economic Policy Series – April 2010

Embracing a Growth-Oriented Tax System

Introduction

Advances in communications and information technologies and the liberalization of trade and investment policies are accelerating the pace of global economic integration. Skilled workers, businesses and capital move easily across national boundaries, seeking the best economic opportunities. In response, even as the recession ravaged public finances, many countries have continued to overhaul their tax systems to improve their global competitiveness.



According to PricewaterhouseCoopers and the World Bank Group, between June 2008 and June 2009, 45 economies reduced the tax burden, broadened the tax base and/or made it easier to pay taxes, a 25 per cent increase from the previous year.[1]

In recent years, Canada has moved to meet the challenge with a remarkable transformation in the business tax landscape. Federal and provincial business taxes have been substantially reduced, with further changes legislated. By 2012, Canada will have the lowest statutory corporate income tax rate in the G7 group of industrialized nations. It already has the lowest effective tax rate on new business investment in the G7. These measures have made Canada a more attractive location for new investment and have helped existing businesses compete.

In a recent speech about how Canada can succeed in the global marketplace, Bank of Canada Governor Mark Carney pointed to Canada's progress to date in improving its tax competitiveness and

1 PricewaterhouseCoopers and the World Bank Group. 2010. "Paying Taxes 2010: The Global Picture." February.

The Canadian Chamber is committed to fostering a strong, competitive and profitable economic environment that benefits all Canadians. This paper is one of a series of independent research reports covering key public policy issues facing Canada today. We hope this analysis will raise public understanding and help decision-makers make informed choices. The papers are not designed to recommend specific policy solutions, but to stimulate public discussion and debate about the nation's challenges.

encouraging trade openness. According to Mr. Carney, "staying the course in these regards is likely the single most important contribution of the public sector."[2]

As Canada emerges from a global recession, its political leaders are searching for strategies to balance the books. It is crucial that the government refrains from hiking taxes or reneging on promised corporate tax rate reductions. International competition is intensifying by the day. If Canada turns back now, as other countries continue to improve their tax competitiveness, it will fall behind.

Reining in spending and improving efficiencies as the recovery takes hold will enable the federal government to eliminate deficits over the medium-term and regain the fiscal flexibility to tackle areas that are crucial to Canada's long-term competitiveness, including high marginal personal income tax rates (especially as they apply to individuals with modest incomes) that reduce the incentive to work, save, invest in human capital and act entrepreneurially.

A long-term strategic and comprehensive tax reform plan is needed to achieve strong economic growth and prosperity. This paper focuses on a few key areas in need of improvement.

Principles of Sound Tax Policy

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': The 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.

2 Remarks by Bank of Canada Governor Mark Carney, to the Ottawa Economics Association. Ottawa: March 24, 2010.

The Tax Base

The tax base should be as broad as possible to enable lower tax rates for businesses and individuals. Targeted tax relief (including exemptions, deductions, credits or rebates) favours specific economic activities so, to compensate for lost revenue, other areas are taxed more heavily. By favouring one activity over another, governments are put in a position of picking winners and losers, a task at which they rarely succeed. "Once economic activity takes on a pattern that is based on tax rates, resources in the economy are misallocated and inefficiency results, as economic activity shifts away from its most valuable opportunities."[3]

According to the C.D. Howe Institute, there are more than 170 federal tax measures with the amount of foregone revenue exceeding more than a third of total tax revenue collected.[4]

Piecemeal changes and tinkering with the tax system, like the constant addition of special provisions and targeted tax benefits, undermine the internal consistency of the tax system, introduce unnecessary complexity, have unintended consequences, create opportunities for avoidance and may not achieve their intended purpose.

"Differential tax burdens may be justified if certain economic activities should be encouraged (such as research) or discouraged (such as pollution), but only if other alternative policies, such as regulations or grants, are less effective than tax policy. Otherwise, the best tax system is one that is neutral among taxpayers and has various activities to minimize the economic cost of taxation."[5]

3 Congressional Budget Office. 2005. "Corporate Income Tax Rates: International Comparisons." November.

4 Laurin, Alexandre, William B.P. Robson, Colin Busby, and Finn Poschmann. 2010. "Back to Balance: A Shadow Federal Budget for 2010." C.D. Howe Institute Backgrounder. No. 127. Toronto: C.D. Howe Institute. February.

5 Mintz, Jack M. 2006. "The 2006 Tax Competitiveness Report: Proposals for Pro-Growth Tax Reform." C.D. Howe Institute Commentary. No. 239. Toronto: C.D. Howe Institute. September.

Tax System Complexity Increases Compliance Costs

"The intricacy of a country's tax system and cost of tax compliance impacts its global competitiveness."[6]

In a nationwide survey of more than 8,200 Canadian businesses, the Canadian Federation of Independent Business (CFIB) estimates it costs businesses $12.6 billion annually to comply with their tax obligations, the lion's share of the burden ($11.4 billion) carried by small- and medium-sized businesses (SMEs).

The smaller the business, the higher the tax compliance cost per employee. Average tax compliance costs range from $3,928 per employee for very small firms (i.e. those with fewer than five employees) to an average of $481 per employee for firms with 50 to 499 employees.[7]

Factors contributing to tax compliance costs include the amount of paperwork, complexity of the tax system, frequent changes in tax legislation, different rules across jurisdictions and dealing with multiple audits (federal and provincial/territorial).[8] Complying with sales tax rules is a top frustration of many small business owners.

Canada ranks 28th best among 183 countries for its ease of paying taxes for small- and medium-sized businesses, 30th in the time it takes to comply with various laws (i.e. prepare and file returns and pay taxes) and 21st in the number of tax payments required annually.[9]

"Where tax compliance imposes heavy burdens of cost and time, it can create a disincentive to investment and encourage informality."[10] Reducing the compliance burden for SMEs can make a significant difference to their bottom line and productivity.

The federal government announced in its 2010 budget that it will explore the possibility of implementing a formal system of loss transfer or consolidated reporting for corporate groups. This would improve the functioning of the tax system, significantly ease compliance and strengthen international competitiveness. More than two-thirds of OECD member-countries now offer group taxation. Canada is the only country within the G7 with no tax consolidation regime.

6 PricewaterhouseCoopers. http://www.pwc.com/ca/en/tax/total-contribution.jhtml

7 Canadian Federation of Independent Business. 2008. "The Hidden Tax Burden: A Business Perspective on the Cost of Complying with Taxes." CFIB Tax Research Series. Report 1. August.

8 Ibid.

9 PricewaterhouseCoopers and the World Bank Group. 2010. "Paying Taxes 2010: The Global Picture." February.

10 Ibid.

Not All Taxes Are Created Equal

Corporate taxes are the most economically destructive for long-term economic growth, followed by personal income taxes.[11] The "distortions that the corporate income tax induces are large compared with the revenues that the tax generates."[12] Yet in Canada, 49 per cent of total tax revenue is generated from income and profit taxes compared to 36 per cent among OECD countries. Twenty-six of the 30 OECD companies rely less than Canada on high-cost income and profit taxes and more on less economically-damaging taxes like the GST.

"To the extent that our tax system over-relies on high-cost sources of tax revenue, the Canadian economy grows at a lower rate than might be possible with a more efficient tax system."[13]

As long as we have taxes, we need to ensure that their mix and structure are as efficient as possible.

Business Taxes

The combined federal-provincial corporate tax rate has been reduced from 47 per cent in 2000 to about 31 per cent. Proposed cuts in federal and provincial tax rates will further reduce the rate to 26 per cent by 2012. By 2012, Canada will have the lowest statutory corporate income tax rate in the G7 group of industrialized nations. Canada already has the lowest effective tax rate on new business investment in the G7.

Delivering on planned business tax relief is essential for Canada's prosperity. To do otherwise would seriously harm business and investor confidence just as the economic recovery takes hold. If Canada turns back now, as other countries continue to improve their tax competitiveness, it will fall behind.

Internationally competitive firms generate jobs. They attract the best and brightest people to Canada and ensure that Canada's young people can have a bright future here at home. Business tax cuts not only give employers greater flexibility, but can also benefit consumers as firms pass on the savings. Additionally, as lower corporate taxes improve the long-term earnings outlook for companies and increase stock values, they help Canadians who own equity through pension plans, RRSPs and mutual funds.

In contrast, higher business costs make Canada less attractive as a place to invest, expand and innovate. They drive companies from Canada to low tax-rate jurisdictions.

According to an Oxford University study, a $1 increase in corporate taxes tends to reduce real median wages by 92 cents.[14] The American Enterprise Institute for Public Policy Research found a one per cent increase in corporate tax rates leads to an almost equivalent decrease in wage rates. The Institute also noted that "as capital

11 See Organization for Economic Co-operation and Development. 1997. *OECD Economic Surveys: Canada*. Paris: OECD. Also, Jorgensen, Dale and Kun-Young Yun. 1991. "The Excess Burden of Taxation in the United States." *Journal of Accounting, Auditing and Finance*. Volume 6, Number 4. pp. 487-508.

12 Congressional Budget Office. 2005. "Corporate Income Tax Rates: International Comparisons." November.

13 Clemens, Jason, Niels Veldhuis, and Milagros Palacios. 2007. "Tax Efficiency: Not all Taxes are Created Equal." *Studies in Economic Prosperity*. No. 4. Vancouver: The Fraser Institute. January.

14 Arulampalam, Wiji, Michael P. Devereux, and Giorgia Maffini. 2009. "The Direct Incidence of Corporate Income Tax on Wages." Working Paper No. 0707. Oxford University Centre for Business Taxation. April 3.

flows out of high tax 'neighbour' countries to low tax countries, this increases worker productivity and hence, wages, in the low tax country. Thus countries try to compete for capital with other countries by lowering their relative tax rates."[15]

Cutting rates is important, but it is also essential that we create a more neutral business tax structure. Marginal effective tax rates on capital investment[16] vary widely by industry. For example, the retail and wholesale trade sectors face a rate of about 32 per cent. The communications and construction sectors are most heavily taxed, at 37 per cent. In contrast, marginal effective tax rates on capital are relatively low for forestry and manufacturing (11 per cent and 18 per cent respectively). While Canada's aggregate marginal effective tax rate on capital has fallen to 28 per cent, the services sector remains highly taxed.[17] This is concerning because services are a major source of job creation and are increasingly exposed to international trade and competition.

"Studies have shown that corporate taxes can hurt the economy most when they are not neutral among industries (Dahlby 2008). Economic distortions arising from non-neutral corporate tax policies in Canada can increase the cost of raising revenue by as much as 37 cents on each dollar of corporate tax collected (Baylor and Beausejour 2004)."[18]

Finally, a lower statutory corporate income tax rate would reduce the differential between large and small business tax rates. The combined federal-provincial tax rate is about 16 per cent on small business profits and 31 per cent on large business profits, a 15 percentage-point difference. The current business tax structure undermines growth by imposing higher taxes on businesses as they grow.

15 Hassett, Kevin A., and Mathur Aparna. 2006. "Taxes and Wages." *AEI Working Paper*. No. 128. Washington: American Enterprise Institute for Public Policy Research. June.

16 Domestic investment depends on after-tax returns. If a business earns a higher return on capital in a particular jurisdiction, it will expand its investment in that jurisdiction. Corporate income tax, sales tax on capital inputs, and other capital-related taxes reduce the after-tax return on investment. This diminishes demand for capital by businesses. According to Jack Mintz, a one percentage-point increase in the effective tax rate on capital investment reduces investment in plant, equipment and non-residential structures by 0.5 to 1.0 percentage points. See Chen, Duanjie and Jack M. Mintz. 2008. "Still a Wallflower: The 2008 Report on Canada's International Tax Competitiveness." *C.D. Howe Institute e-brief*. Toronto: C.D. Howe Institute. September.

17 Chen, Duanjie, and Jack M. Mintz. 2009. "The Path to Prosperity: International Competitive Rates and a Level Playing Field." *C.D. Howe Institute Commentary*. No. 295. Toronto: C.D. Howe Institute. September.

18 Ibid.

Labour Taxation

Canada's personal income tax system has undergone sporadic change, but there is still much unfinished business.

Canada relies heavily on personal income taxes which account for 37 per cent of tax revenue in Canada compared to an average of 25 per cent in the OECD.

High and uncompetitive marginal personal tax rates on labour income and savings (the average top combined federal-provincial rate is 46 per cent) erode Canada's productivity and competitiveness by discouraging people from working, saving, investing and upgrading their skills and entrepreneurs from taking on risk and funding capital investments. They promote unproductive tax avoidance and evasion activities that result in higher compliance and administration costs for audits, information gathering and enforcement activities.

Many low- and middle-income Canadian families with children face punishing marginal tax rates on their labour earnings, and substantially higher tax rates than individuals at the top of the income spectrum 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) are clawed back as income rises. Punitive marginal tax rates send a strong negative message about the merits of working, upgrading one's skills and pursuing higher education.

Additionally, many low-income retirees encounter extraordinary high 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.

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.

Going forward, growth in the Canadian labour force will slow considerably. Additionally, technological change and globalization will accelerate the shift towards more skilled and educated workers. Economic growth and business success will depend very much on the availability of talent and the productivity of the workforce. We need to ensure our personal income tax is competitive to entice high-tech skilled workers, upper management, entrepreneurs and professionals to Canada in the light of the projected slowdown in the labour force.

Employment Insurance Premiums

The projections in the 2010 federal budget suggest employment insurance (EI) premiums will rise significantly (the maximum of 15 cents per $100 of insurable earnings for employees and 21 cents for employers) over the 2011-2014 period to recover the deficits incurred by the EI program during the recession. Thereafter, premiums will be set at the break-even level.

Rising payroll taxes will discourage employers from hiring just as the economic recovery matures. Over the long-term, these costs are ultimately passed on to employees in the form of lower wages, taking a bite out of personal income. The large "wedge" created between the cost of hiring employees and workers' take-home pay stifles productivity and damages the economy's long-term performance.

EI premium rate increases can be kept at manageable levels by balancing the EI account over the business cycle of up to 10 years.

Both the Technical Committee on Business Taxation (1997) and the OECD (2004) recommended that Canada design and introduce an employer-based experience rating system. Businesses that lay off fewer workers would pay lower premiums. Thus, businesses would have a greater incentive to create jobs. Without employer-based experience rating, the EI system levies taxes on firms that minimize layoffs (for example, through smoothing of production and the use of work-sharing arrangements) and subsidizes businesses that readily resort to layoffs.

Conclusion

Smart tax policies create the conditions for stronger economic growth, higher incomes for Canadians and higher returns for businesses. Canada has much to gain by using the tax system optimally to promote employment, productivity and living standards. Reducing its 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.

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