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E-BRIEF

November 19, 2015

NATIONAL PRIORITIES 2016

Tax Reform Priorities for Canada: Creating More Income to Go Around

by
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"One approach to meeting Canada's long-term fiscal challenge is to reduce future commitments and fight over the fair distribution of slow growing income. Another, and superior approach, is to look for ways to boost productivity and competitiveness. In other words, the focus should be on increasing the income pie so there would be more fiscal room to maneuver."

Canada faces a deep long-term fiscal challenge. Economies grow because they either have more workers or employ their workers more productively. Canada is aging and labour force growth is slowing. Meanwhile, Canada's productivity performance over the past decade has been poor. As a result, the benchmark for good national economic growth is likely only slightly above 1.5 percent. Add on inflation and national income growth will be modestly above 3.5 percent annually in coming decades. This income growth is more than a third less than policymakers were counting when they made fiscal promises over the 1980s and 1990s. The demographic pressures are also evident at the provincial level, with all regions poised to experience slower economic growth, in some cases precipitously. Since income in the economy is the basis for tax revenues, how will governments generate the revenues to pay for social and economic priorities?

One approach to the fiscal challenge is to reduce future commitments and fight over the fair distribution of slow growing income. Another, and superior approach, is to look for ways to boost productivity and competitiveness. In other words, the focus should be on increasing the income pie so there would be more fiscal room to maneuver.

In this E-Brief, the first of a series on National Priorities for Canada in 2016, we zero in on the tax system as a place to start the examination of boosting productivity. Oliver Wendell Homes Jr. said that "Taxes are the price we pay for a civilized society." And, this is absolutely true. The core issue is finding the most efficient mix and structure of the tax system that complements the goals of supporting economic growth and job creation, while providing the revenues governments require.

Business Taxes: Low and Competitive

Some have argued that higher corporate taxes could be a source of additional revenue to meet future fiscal commitments, but higher corporate taxes would hamper investment, job creation and growth. As it is, Canada has an internationally competitive corporate tax regime (Figure 1).[1]

Investors care about the after-tax return they can expect to earn on their investments; and the larger the tax bite, the higher the expected rate of return has to be for a given investment to be attractive. Over the long term, as businesses adjust their level of investment or location decisions, higher corporate tax rates may lead to lower-than-anticipated economic growth and, in some cases, lower tax revenues than without the tax hike.[2]

Another important question is on whom the corporate tax burden ultimately falls? Early economic literature pointed to shareholders, assuming them to be owners of capital in a closed-economy setting (Harberger 1962). Later literature, assuming an international setting where capital can flow freely from one country to another, arrived at the opposite conclusion: the corporate tax burden in a small open economy like Canada's is entirely borne by its workforce through lower wages.

Although results from recent empirical investigations, led by the development of new data sources, vary considerably, it appears that a substantial portion of the corporate tax burden is shifted to labour. A $1 rise in corporate tax revenues translates into a 45 to 92 cents decline in wages over the long run, with many studies pointing to the higher end of this range.[3]

The effective incidence of the corporate tax is crucial to the current income inequality debate. If the tax falls to a large extent on labour, then higher corporate taxes might actually harm workers, and benefit shareholders, since the latter would be over-compensated by the dividend tax credit and the partial taxation of capital gains at the personal tax level. [4]

One view is that businesses' recent record of weak job creation and investment, as well as increases in retained earnings, provide evidence they have not been pulling their weight and that there is 'dead money' on corporate balance sheets. What is missed in these discussions is the counterfactual of how much worse economic growth would have been if corporate tax rates were higher. Businesses have been creating jobs and investing at an appropriate pace when one factors in the weak and uncertain global environment. There are very sensible reasons for a rise in cash balances, such as reducing leverage to increase resiliency or holding cash to

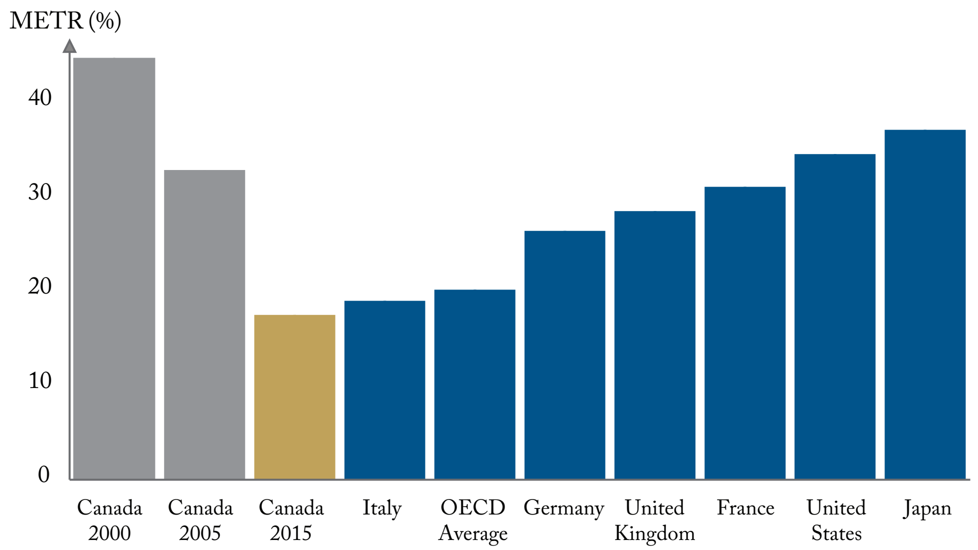
1 Canada's total tax burden on new investments for existing firms – i.e., including everything from federal and provincial corporate tax rates to the impact of various business allowances, deductions, credits, capital and input taxes – has decreased to 18 percent in 2015 from 45 percent in 2000 and 33 percent in 2005. At 18 percent, it is lower level than any other G-7 countries and the OECD average (see Figure 1).

2 Dahlby and Ferede (2011) estimate the long-term response to provincial corporate income tax changes in Canada, and find that "the cost of increasing provincial tax revenue through a corporate tax rate increase is very high, and in some provinces a corporate tax rate reduction would increase the present value of the government's total tax revenue."

3 See Aus dem Moore (2014), Arulampalam (2008), and Gentry (2007) for recent reviews of the literature.

4 These two personal tax provisions are meant to compensate shareholders for the taxes paid on profits at the corporate level.

Figure1: Marginal Effective Tax Rate (METR) on New Business Investment, Canada and Selected Countries, 2015



Source: Canada (2015, p. 7).

meet the needs of a just-in-time inventory system (Poschmann 2014). The conclusion is that Canada benefited materially from lowering taxes on new business investment and this should be maintained.

The federal and provincial tax system, however, has too many industry specific tax preferences, which should be eliminated and used to lower the general level of corporate taxes. Through business tax allowances, credits, and deductions the tax system can be used to achieve economic and social objectives the same way as spending programs. Their goal is to encourage certain industries or business activities, but often they inadvertently distort market outcomes in ways that are more harmful to society than the benefit they provide.

It should be stressed that not all tax expenditures are equal. Some can, in fact, help to boost productivity. For example, the Scientific Research and Experimental Development (SR&ED) Program is a federal tax incentive program designed to encourage Canadian businesses of all sizes and in all sectors to conduct research and development (R&D) in Canada. And, R&D can lead to innovation and boost productivity. However, the design of the SR&ED program could be improved to raise its effectiveness.

Other tax preferences, aimed at noble goals, may have unintended side consequences. For example, the federal government has implemented accelerated capital cost allowances to incent manufacturers to invest in productivity enhancing machinery and equipment. Lowering the cost of capital is a positive goal, but why only manufacturing? Many service industries would benefit from greater incentives. But, if the incentive is for everyone, it would be more effective to simply lower corporate tax rates to reduce the cost of capital generally.

Another example is the preferential lower tax rate for small businesses. This is intuitively aimed at helping young and small businesses to invest and grow, but the large gap between the corporate tax rate and the small business tax rate may induce some firms to stay small (Dachis and Lester 2015). At a minimum, the lower tax rate could be better targeted at young firms rather than at all firms that are small, thereby mitigating the growth disincentive effects (Howitt 2015).

The main message is that all business tax preferences should be regularly scrutinized on the same basis as if they were direct government spending, and reviewed through the lens of whether they are productivity enhancing and whether they are distorting efficient outcomes. Business taxes should be kept low to compete internationally while also treating businesses equally.

Personal Taxes: Taxing Consumption Instead of Earnings

With regard to personal taxes, Canadians carry a higher burden than their US counterparts, but a lesser tax burden than many Europeans (Figure 2). This reflects Canada's typical middle-of-the-road economic and social model. Canadians ultimately have to pay for the government programs they want to draw on. But, there is an issue about the mix of personal income taxes versus consumption and sale taxes. Many OECD countries, other than the US and Canada, tend to rely more on consumption taxes than on other types of personal taxes. In achieving the right balance, the tax system should be structured such that it finances the desired level of public spending at the lowest cost to the economy and society.

Taxpayers respond to taxes and tax changes. The higher the tax rates, the higher the incentive to avoid them. A common reaction is to reduce work efforts.[5] Taxpayers, especially high-income earners, will also plan their affairs in a way to minimize their tax burden. Tax planning can involve, for example, postponing the sale of capital assets, switching sources of income, moving to or avoiding another jurisdiction, or legally using foreign trusts. In short, taxpayers will react to high taxes by attempting to reduce their taxable income as much as possible (Dahlby 2008, Canada 2010).

On the consumer side, high consumption taxes will tend to increase underground transactions. They may also induce consumers to substitute the purchase of taxable goods and services for those that are non-taxable, taxed at a preferable rate, or bought in another jurisdiction. Empirical studies of the behavioral response to taxes have generally concluded that income taxes create a larger economic burden than broad-based consumption taxes (Dahlby and Ferede 2011, Baylor and Beauséjour 2004). Economic efficiency would be enhanced by shifting the taxation base from personal income to consumption, thus putting a greater weight on consumption taxes – ideally harmonized between the federal and provincial governments (Laurin and Robson 2013). Alberta, for instance, would benefit from introducing an HST and lowering its personal income tax burden by an equivalent amount (Busby and Laurin 2013). However, it is clear that Canadians dislike consumption taxes, making it politically difficult to shift the tax system. A common criticism is that consumption taxes are not progressive, but

5 Impacts on work efforts through employment income for high-income earners have been documented in Canada (2010) and Milligan and Smart (2014). Also, the labour force participation of mothers and secondary earners in response to taxes has also been the focus of many empirical studies. Reviews of the literature on the relationship between wage earnings, taxation, and employment can be found in Bargain et al. (2013), Meghir and Phillips (2010), Fortin and Lacroix (2002), and Blundell (1995).

Figure2: Tax Revenues from Consumption, Employment Earnings, and other Personal Income Sources as Percentage of GDP, Selected OECD Countries, 2012

Source: Organisation for Economic Cooperation and Development (OECD). Data extracted on 31 October 2015 from OECD.Stat.

there are ways to minimize the adverse distributional effects.[6] There is an important role for policymakers in educating voters and showing leadership in putting more emphasis on consumption taxes.

Targeting Higher-Income Earners: An Inefficient Way to Raise Revenues and Deal with Income Inequality

There is a federal and provincial shift towards making the personal income tax system more progressive. One key plank of the 2015 federal Liberal election platform is the promise to cut the middle-income tax bracket by 1.5 percentage points and introduce a new federal tax rate of 33 percent for incomes above $200,000. Several

6 Busby and Laurin (2013) proposes a revenue-neutral HST in Alberta accompanied by the introduction of generous fiscal benefits geared to lower- and mid-income families, which would overcome the adverse distribution effects on tax burdens.

provinces have also introduced higher taxes on high-income earners, with the result that the marginal income tax rate will be above 50 percent in many jurisdictions (Table 1).

The reduction in tax rates for middle-income households is desirable, as it will boost disposable income for a group that has experienced only modest income growth in recent years. However, heavy taxation of high-income Canadians is at odds with the desire for more entrepreneurial activity. Canada is in a competition for talent. Canada needs competitive tax rates for high-income earners, or we run the risk of a brain drain and the risk of being less able to attract foreign talent. Excessively taxing the talent that fuels a more innovative, creative and successful economy is ultimately self-defeating.

As mentioned, it may be that high-income taxpayers will respond to tax-rate changes in ways that reduce tax receipts (Laurin 2013, 2012a, 2012b). The C.D. Howe Institute estimates that the proposed 4 percentage points tax increase on incomes above $200,000 could result in those affected taxpayers reporting approximately 4.5 percent less taxable income, costing the personal income tax base $7.3 billion in 2016.[7] This erosion of the tax base could reduce projected tax receipts from the hike by about 70 percent; delivering to the government only about $1.0 billion of a potential $3.3 billion. The erosion of the tax base also means that provincial governments could also suffer from lower-than-otherwise personal income tax revenues – a non-negligible shortfall of $1.4 billion in 2016 (Laurin, forthcoming).

Some may feel that the increased progressivity of the tax system can reduce income inequality. However, the math doesn't work. The effect of cutting the middle-income tax rate and putting in a new tax rate on income over $200,000 will barely change the Gini coefficient – the benchmark for income inequality. The most effective way to address inequality is to remove barriers to opportunity. If Aboriginals and First Nations people, immigrants, youths and individuals from disadvantaged backgrounds had better labour market outcomes, income inequality would be reduced. This calls for upskilling workers to compete in today's global and technological economy. The result would be a larger income pie to be divvied up. And, by removing the barriers to opportunity, the increasing income could help to reduce income inequality in a constructive way.

Rebalancing Federal and Provincial Taxation

No discussion of tax reform would be complete without mentioning the current practice of raising federal taxes in order to pay for transfers to the provinces. This is highly inefficient tax policy. Governments should be held accountable for the money they raise and how it is spent. It would be more efficient and productive if federal business and personal taxes were cut, providing room for provinces to pick up the fiscal room to pay for the economic and social priorities they are responsible for (Robson and Laurin 2015).

Indeed, the greatest fiscal challenge is at the provincial level, where an aging population is driving up healthcare expenditures, precisely when the trend growth rate of tax revenue is slowing. Moreover, healthcare spending will increasingly crowd out spending on other priorities, including education and infrastructure.

7 Rate hikes may lead taxpayers to reduce their paid work, take compensation in less heavily taxed forms, adjust the timing of transactions, relocate, or use other tax planning techniques. All such changes will tend to reduce tax receipts. A common measure of the size of these responses is the "elasticity of taxable income" (ETI). Sillamaa and Veall (2001) studied the response of Canadian taxpayers and found an ETI of 1.30 for high-income earners. Milligan and Smart (2014) find that the ETI at the provincial level is large for the top one percenters (their preferred estimate is 0.69); Canada (2010) finds an ETI ranging from 0.62 to 0.72 for the highest income group. We estimated the impact of the proposed rate hike assuming a conservative ETI value at the low-end of this range (0.62) using Statistics Canada's SPSD/M (2015).

Table 1: Top Combined Federal/Provincial Personal Income Tax Rate after the Proposed Introduction of a New Federal Top Tax Bracket, 2016

	Proposed Top Combined Federal/ Provincial Rate (percent)	Top Income Threshold ($)
New Brunswick	58.75	250,000
Nova Scotia	54.00	200,000
Ontario	53.53	220,000
Quebec	53.31	200,000
Prince Edward Island	51.37	200,000
Manitoba	50.40	200,000
Newfoundland and Labrador	48.30	200,000
Saskatchewan	48.00	200,000
Alberta	48.00	303,900
British Columbia	47.70	200,000

Source: Various.

Municipalities also face fiscal challenges, in particular the tasks of funding needed infrastructure and maintaining existing structures. Residential property taxes are a stable source of revenues for local governments, and they are generally efficient at financing municipal goods and services when benefits are collectively enjoyed by local residents. When they are not, user fees are a better option if they finance services with benefits that are easily measurable and conditioned on individual usage. Neither of these two sources of revenue is popular with voters.

Business property taxes (BPTs), on the other hand, are largely hidden from the consumers – on whom the tax burden eventually falls. Municipal and provincial governments tend to over-rely on revenues collected from BPTs to subsidize services consumed by the residential sector (Kitchen 2005). This raises concerns. BPTs raise the tax burden on new investments, lowering potential returns, driving away investment and harming local economies. The tax bite on new investments in major Canadian municipalities is on average three times greater with BPTs included (Found at al. 2014). Municipalities and provincial governments should be cautious about the detrimental impact of BPTs – which act like capital taxes – on investment and productivity. Better monitoring is needed, as well as a lower reliance on BPTs to finance public goods and services.

The Bottom Line

The bottom line is that the size and source of tax revenues has a significant impact on the economy. If Canada is to deliver on its future spending commitments, the current federal, provincial and municipal tax system should be reviewed for opportunities to simplify it and rebalance it to incent stronger productivity growth.

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This E-Brief is a publication of the C.D. Howe Institute.

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