

## A More Efficient Tax System

Canada needs a strategic vision for future tax policy. We must review Canada's tax competitiveness, debate how best to use our tax system to stimulate economic growth and prosperity, and implement the needed reforms urgently.

The following criteria should guide what changes should be made to our tax system.

- **Tax Neutrality.** Economic activities should bear similar tax treatment to encourage the best allocation and profitable use of resources in the economy.
- **Tax Fairness.** A tax system should distribute its burdens fairly. There are two aspects of fairness – horizontal equity means that individuals in similar economic circumstances should pay similar amounts of tax; vertical equity is sometimes referred to as the ‘ability to pay’ principle – the amount of taxes someone pays should increase as their income increases.
- **Efficiency.** Taxes impose efficiency costs on society because they change how individuals and businesses behave – they affect the incentive to work, save and invest, for example. An efficient tax system minimizes the distortions and disincentives that taxes invariably create.
- **Simplicity.** The tax system should be simple, transparent and easy to understand and comply with.

Ad hoc changes to tax legislation – like the constant addition of special provisions and targeted tax benefits – may introduce unnecessary complexity, have unintended consequences and create opportunities for tax avoidance, while not achieving their intended purpose.

Targeted tax relief (including the numerous tax credits that are part of Canada's tax system) favours one activity over another, and puts government in the position of picking winners and losers, a task at which they rarely succeed. “Differential tax burdens may be justified if certain economic activities should be encouraged (such as research) or discouraged (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 various activities to minimize the economic cost of taxation.” (Source: Mintz, Jack. “The 2006 Tax Competitiveness Report: Proposals for Pro-Growth Tax Reform.” *C. D. Howe Institute Commentary* 239. C.D. Howe Institute. September 2006).

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.

All taxes are not created equal. According to a Department of Finance study, corporate income taxes impose a marginal efficiency cost of \$1.55 for each additional dollar of revenue raised, compared to fifty-six cents per additional dollar from personal income taxes, twenty-seven cents per dollar from payroll taxes, and seventeen cents per dollar raised through a consumption tax. In plain language, it costs the economy much more to raise a dollar through corporate and personal income taxes than by a consumption tax, which is why twenty-three of the thirty OECD countries rely less than Canada does on

high-cost income and corporate taxes, (including the United States) and more on less-damaging taxes like the GST and payroll taxes. While the United States relies less on consumption taxes than Canada, it depends more on payroll taxes than Canada. As long as we have taxes, we need to ensure that their mix and structure are as efficient as possible.

Corporate income tax rates should be reduced to internationally acceptable levels to make Canada the location of choice for business, and the tax base broadened to improve efficiency and fairness. Personal income tax rates should also be reduced to internationally acceptable levels and the base broadened to increase labour participation, particularly in light of coming demographic changes. Reducing personal income tax rates would also reduce taxes on interest, dividends and capital gains income helping to stimulate investment, productivity and economic growth.

The Government should rely more on consumption-based taxes, such as the GST, which are more likely to encourage saving and capital formation and, therefore, promote productivity and economic growth. Taxes on consumption provide fewer opportunities for tax evasion and rely on a broader base, thus, they can be more equitable and economically efficient than income taxes.

There are also administration costs incurred by governments to manage and maintain the tax system (that taxpayers ultimately pay for through higher taxes) and costs of complying with tax laws and regulations. The Fraser Institute estimates that administration costs in Canada are in the range of \$2.7 to \$5.8 billion annually. Estimates of total compliance costs range from \$2.9 to \$5.5 billion for personal income taxes and \$13.0 to \$19.3 billion for business taxes.

### **Recommendations**

That the federal government:

1. Ensure that Canada's tax system is as neutral, simple, efficient and fair as possible so that it facilitates job creation, productivity, long-term economic growth and a higher standard of living.
2. Avoid ad hoc changes to tax legislation - like the constant addition of special provisions and targeted tax benefits.
3. Reduce Canada's reliance on more damaging, high-cost sources of taxes, namely income and profit taxes, and broaden the tax base. Rely more on consumption-based taxes, such as the GST.
4. Continue to look at ways to reduce the cost of administration and compliance for all taxpayers.