



A Competitive Tax Regime: A Building Block of a Vibrant and Productive Economy

Policy Brief

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Introduction

In a highly integrated global economy, skilled workers, businesses and capital move easily across national borders, seeking the best economic opportunities. In response, many countries have overhauled their tax systems to maximize their attractiveness as a destination for talent, capital and innovation.

Canada has witnessed a remarkable transformation in the business tax landscape. The combined federal-provincial/territorial statutory corporate income tax rate has come down from approximately 42 per cent in 2000 to 26 per cent today.¹ Once known for having one of the highest corporate income tax rates in the developed world, Canada now has one of the lowest rates of the Group of Seven (G7) leading industrial economies and is near the middle of the pack of OECD countries.



We can do even better by striving to achieve a more efficient business tax system – one that levies similar tax burdens on all business activities to ensure the optimal allocation of capital throughout the economy.

¹ Weighted average.

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.

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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 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.

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 the most efficient way to pay for cuts to personal income rates is to increase the GST, but they also have no illusions of the difficulty of the task since the GST is a widely hated tax. Personal income tax cuts can also be paid for by phasing out special tax preferences (exemptions, deductions, credits and rebates offered through the personal income tax system) that do not deliver value for money or

are not achieving their intended purpose. While introduced with good intentions, tax preferences have undermined the coherence and integrity of the tax system.

Canada's tax code has become overly complex, making it difficult for taxpayers to understand and comply with the rules. Canadian taxpayers – individuals and businesses – spend billions of dollars each year to comply with their tax obligations – money that could be put towards more productive uses. Additionally, governments spend billions of dollars to administer the tax system, including collecting taxes, maintaining records and enforcing tax regulations.

The complexity of the current tax system coupled with global competition for capital and labour and global changes in taxation structures provide a once-in-a-generation opportunity to design and start to implement a tax system that will position Canada for future growth and prosperity.

When It Comes to Business Taxes, Canada Has Come a Long Way

Back in 2000, Canada had the highest corporate income tax rate (federal-provincial/territorial combined) amongst industrialized countries. Prime Minister Jean Chrétien's government gradually reduced the federal general corporate income tax rate² from 28.0 per cent in 2000 to 21.0 per cent in 2004. Prime Minister Stephen Harper's government further reduced the rate from 21.0 per cent in 2007 to 15.0 per cent in 2012. A low corporate income tax rate has increased the incentive for businesses to locate in Canada.

To further improve the business climate in Canada, the corporate surtax was eliminated in 2008 for all corporations. The federal capital tax was eliminated in 2006 and the last of the provincial general capital taxes was eliminated in 2012.

The small business tax rate was reduced to 11 per cent in 2008 from 12 per cent, and the amount of income eligible for this lower rate was increased to \$500,000 in 2009.

In its 2007 *Economic Statement*, the federal government sought the collaboration of the provinces and territories to cut their general corporate income tax rate to 10.0 per cent to reach a 25.0 per cent combined federal-provincial/territorial statutory corporate income tax rate by 2013.

Alberta was already at 10.0 per cent. British Columbia and New Brunswick reduced their rate to 10.0 per cent in 2011. In the face of large budgetary deficits, Ontario announced in its 2012 budget that it will keep its rate at 11.5 per cent, with any further rate decreases deferred until the province's deficit has been eliminated. In this year's provincial budget, British Columbia reserved course and increased its general corporate income tax rate from 10.0 per cent to 11.0 per cent (effective April 1, 2013) and New Brunswick increased its rate from 10.0 per cent to 12.0 per cent (effective July 1, 2013). The only province at 10.0 per cent is Alberta (see Table 1). It appears we have fallen short of attaining a combined federal-provincial/territorial general corporate income tax rate of 25.0 per cent.

While rates are going up in Canada, other countries are not standing still. Despite budgetary pressures, the United Kingdom is cutting business taxes at the very same time as it has to make very painful cuts to public spending, demonstrating the priority it gives to boosting its competitiveness. It has reduced its corporation tax rate from 28 per cent in 2010 to 23 per cent in 2013. The rate will be further reduced to 21 per cent in April 2014 and to 20 per cent in April 2015. Japan – which formerly had the highest corporate tax rate in the OECD – reduced its tax rate in 2012 and has enacted further rate reduction to take effect in 2015.

² According to Finance Canada, well over 100,000 businesses employing millions of Canadians pay the federal general corporate income tax rate. The general corporate income tax rate applies to all income except income that qualifies for special tax treatment such as small business income eligible for the small business deduction, investment income of Canadian-controlled private corporations and income earned by credit unions, mutual fund corporations, mortgage investment corporations, most deposit insurance corporations and investment corporations. The small business rate (11.0 per cent) applies to active business income of Canadian-controlled private corporations up to the threshold amount of active business income (\$500,000).

Table 1: General Corporate Income Tax Rates (%) by Province and Territory (year-end)

	2007	2008	2009	2010	2011	2012	2013
Federal	21.0	19.5	19.0	18.0	16.5	15.0	15.0
British Columbia	12.0	11.0	11.0	10.5	10.0	10.0	11.0
Alberta	10.0	10.0	10.0	10.0	10.0	10.0	10.0
Saskatchewan	13.0	12.0	12.0	12.0	12.0	12.0	12.0
Manitoba	14.0	13.0	12.0	12.0	12.0	12.0	12.0
Ontario	14.0	14.0	14.0	12.0	11.5	11.5	11.5
Quebec	11.9	11.9	11.9	11.9	11.9	11.9	11.9
New Brunswick	13.0	13.0	12.0	11.0	10.0	10.0	12.0
Nova Scotia	16.0	16.0	16.0	16.0	16.0	16.0	16.0
Prince Edward Island	16.0	16.0	16.0	16.0	16.0	16.0	16.0
Newfoundland and Labrador	14.0	14.0	14.0	14.0	14.0	14.0	14.0
Yukon	15.0	15.0	15.0	15.0	15.0	15.0	15.0
Northwest Territories	11.5	11.5	11.5	11.5	11.5	11.5	11.5
Nunavut	12.0	12.0	12.0	12.0	12.0	12.0	12.0

Canada Leads the G7 With the Lowest Overall Marginal Effective Tax Rate (METR) on New Business Investment

One of the most important factors influencing economic growth is business investment in capital goods (new machinery, equipment and structures). Business investment decisions are affected by the marginal effective tax rate (METR) on capital investment. The METR on a capital encompasses taxes on corporate income, retail sales taxes on business inputs as well as deductions and credits available in the corporate tax system that impinge on investment decisions. In 2006, Canada had the third highest METR on capital investment in the G7. It now has the lowest and, hence, the most tax-competitive METR on capital in the G7 and one that is below the OECD average.³

However, METRs on capital investment vary widely by industrial activity. Service providers (e.g., the retail trade, wholesale trade and communications sectors) face a rate that is substantially higher than that faced by other sectors for the economy, including forestry and manufacturing.⁴ This results in a less than optimal allocation of capital throughout the economy as capital tends to flow to those sectors with the most favourable tax treatment rather than to those where growth prospects may be higher.

To spur economic growth and employment, governments (federal and provincial/territorial) should strive to achieve a business tax system that does not favour or disadvantage particular sectors of the economy.



³ Government of Canada. "Economic Action Plan 2013." March 21, 2013. See page 149.

⁴ Chen, Duanjie and Jack Mintz. "2012 Annual Global Tax Competitiveness Ranking – A Canadian Good News Story." *SPP Research Papers*. Volume 5. Issue 28. Calgary: The School of Public Policy, University of Calgary. September 2012.

Personal Income Taxes – Much Unfinished Business

In 1987, Canada implemented a major reform of the personal income tax system. The top federal marginal personal income tax rate was cut from 34 per cent to 29 per cent; the number of federal tax brackets were reduced from 10 to three (with three federal income tax rates: 17 per cent, 26 per cent, and 29 per cent) and a number of exemptions and deductions were eliminated or converted into non-refundable tax credits, thereby broadening the personal income tax base.

The 2000 federal budget brought the most significant changes in tax policy since the tax reform of 1987. The federal government presented a five-year tax reduction plan, with close to \$40 billion in personal income tax relief. The most significant measure was the restoration of full indexation to tax brackets and basic exemptions in January 2000. The middle tax rate was lowered from 26 per cent to 24 per cent in July 2000. The deficit reduction surtax was eliminated in January 2001. Also in January 2001, the first bracket rate was reduced from 17 per cent to 16 per cent (and subsequently to 15 per cent in 2005), and the middle tax rate was further reduced to 22 per cent. A fourth tax bracket was introduced in 2001.

Despite the reforms, Canada's tax system has some very high personal marginal tax rates that are especially affecting Canadians with modest incomes.

Today, the top marginal personal income tax rate in Canada (federal-provincial/territorial combined) averages 45.5 per cent and applies to anyone earning more than \$135,054. In the United Kingdom, the top 45.0 per cent rate kicks in at £150,000 (approximately C\$232,000). The top marginal personal income tax rate in the United States (federal/state combined) of 43.4 per cent applies to income in excess of US\$400,000 for single individuals, US\$450,000 for married individuals filing joint returns, US\$425,000 for heads of households and \$225,000 for married individuals filing separate returns.

In the face of daunting fiscal challenges, a number of provinces have increased personal income tax rates. Both Ontario and Quebec have increased the tax rates of their top earners. In Ontario, the combined federal-provincial top marginal rate for taxable income in excess of \$500,000 increased from 46.41 per cent in 2011 to 47.97 per cent in 2012 and to 49.53 per cent in 2013. In Quebec, the combined federal-provincial top marginal tax rate for taxable earnings in excess of \$100,000 increased from 48.22 per cent in 2012 to 49.97 per cent in 2013. Effective July 1, 2013, all New Brunswickers will see their personal income tax rates go up. Those in the lower income tax bracket (with incomes up to \$38,954) will see the combined federal-provincial rate increase from 24.1 per cent to 24.39 per cent, while those in the top tax bracket (earning over \$126,662) will see the rate jump from 43.3

per cent to 45.07 per cent. Lastly, British Columbia's top marginal personal income tax rate (federal-provincial combined) will go up from 43.7 per cent in 2013 to 45.8 per cent effective January 1, 2014 for those making over \$150,000.

"High-income taxpayers respond strongly to high tax rates by increasing unproductive activities such as tax avoidance, and reducing their productive labor and entrepreneurial efforts. And many in the top tax brackets are entrepreneurs."⁵

Canada needs a competitive strategy to entice and retain skilled workers, upper management, entrepreneurs and professionals. To do so, the federal government should consider raising the threshold at which the top federal marginal personal income tax rate kicks in to \$225,000 from \$135,054 when fiscal conditions permit. As a result, income in the \$135,054 and \$225,000 range would be taxed at a rate of 26 per cent, down from 29 per cent.

Many low- and middle-income Canadian families with children and with income in the \$25,000 to \$45,000 range face marginal effective tax rates in excess of 50 per cent because many of the income-tested benefits and tax credits 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.⁶ Additionally, many low-income retirees

encounter effective marginal tax rates as high as 80 per cent as their Guaranteed Income Supplement or their Old Age Security pension gets clawed back as taxable pension savings – RRSPs/RPPs – are withdrawn.⁷

The Canadian Chamber recognizes personal income tax rate reductions carry a high fiscal cost, particularly as they apply at the lower end of the income spectrum. Hence, it recommends the federal government put in place a multi-year plan to reduce rates, especially for low- and middle-income Canadians. Other reforms should include lowering clawback rates for income-tested benefits to achieve lower marginal rates for low-income earners and seniors.

Rate reductions can be financed by eliminating the various tax credits and other exemptions offered through the personal income tax system that are not cost effective or are not achieving their intended purpose. Alternatively, the C.D. Howe Institute proposes 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.⁸

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.

5 Edwards, Chris. "Cut Tax Rates, Cut Government Waste." Washington: The Cato Institute. May 24, 2001.

6 Laurin, Alexandre and Finn Poschmann. "What's My METR? Marginal Effective Tax Rates Are Down – But Not for Everyone: The Ontario Case." *e-brief*. Toronto: C.D. Howe Institute. April 27, 2011.

7 Ibid.

8 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).

Tax Simplification: In the Best Interest of Taxpayers, Businesses and Governments

Piecemeal changes to tax legislation by successive governments and the enactment of temporary provisions have increasingly complicated the tax system. Taxpayers spend far too much of their hard-earned money and time navigating our convoluted tax system.

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.⁹

Canadians deserve a simpler, less costly and less burdensome tax system.

In 2010, the United Kingdom created the Office of Tax Simplification to give independent advice to the government on simplifying the U.K. tax system. It has completed its review of small business taxation, which identifies areas of the tax system that cause the most day-to-day complexity and uncertainty for small businesses and recommends priority areas for simplification; it carried out a review into all tax reliefs, allowances and exemptions for businesses and individuals; and it studied how the length of legislation is a factor that contributes to complexity.

Similar tax matters need to be examined in Canada. The government should consider establishing an independent tax simplification office similar to that in the U.K. Alternatively, it should convene an expert panel with the broad mandate to (among others):

- Review and clarify the language used in tax law.
- Recommend specific changes to existing legislation that is not achieving its purpose or is unclear, or it 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.
- Undertake a comprehensive review of the myriad tax-preference measures (exemptions, deductions, credits and rebates) that are part of the federal tax code to determine if they are cost effective and are achieving their intended purpose. 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

⁹ 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.

preferences to achieve social objectives rather than funding the initiative through direct program spending. Savings realized from eliminating or reducing such expenditures could support lower income tax rates. The broad-base low-rate approach to taxation has other benefits, including administrative simplicity and reduced opportunity for tax avoidance and arbitrage.

- Recommend broad tax policy changes in areas like the taxation of corporate groups. Many developed countries have a formal system to consolidate the tax reporting of corporate groups or to otherwise transfer corporate profits and losses among related companies. Canada does not. As a result, businesses use various tax-planning strategies to transfer tax attributes between related entities that are time consuming and entail significant internal reorganization which is costly. Businesses competitiveness would be significantly enhanced if Canada created a formal loss-transfer system to address corporate group taxation. While we appreciate the federal and provincial governments likely have concerns about the short-term fiscal costs, re-engaging stakeholders in a more open dialogue can help the government resolve these and other concerns.

- Provide advice on whether improvements can be made to Canada's withholding tax system (under Regulation 102), including the withholding tax requirements themselves and the process for obtaining waivers from the obligation to withhold. In many cases, the service providers Canadian businesses are seeking for short-term assignments reside in the United States or abroad. These non-resident employees and their employers often face significant and burdensome tax compliance requirements.
- Make recommendations on the use of, and possible improvements to, general and specific anti-avoidance provisions with a view to simplify as well as improve the operation of these provisions.

Simplification of the tax code would bring enormous benefits to taxpayers and the economy. It would reduce compliance costs for individuals and businesses, reduce administration costs for governments, allow tax administration to focus on tax oversight, increase efficiency of tax collection and provide incentives for all transactions to be officially reported.



In Summary

Taxation raises revenue for governments to deliver various programs and services. Canadians benefit and are prepared to contribute to their costs. But there are also economic costs associated with taxation. The most obvious and visible is the tax bite on personal and business income. Less visible are the effects of taxes on behaviour. High taxes can discourage people from working more or saving more if a large portion of their earnings and savings are taxed away. They can discourage businesses from investing or expanding if the after-tax rewards are insufficient, and they can discourage businesses from hiring. Even less visible are the costs of complying with the tax code and the costs of administering the tax system.

The stakes are certainly high when it comes to our nation's tax policies. Canada can significantly enhance its international appeal as a destination for talent and investment by keeping tax bases

as broad and rates as low as possible; by seeking to improve the efficiency and fairness of the business tax system; by making tax laws easy to understand and comply with; by identifying areas of the tax system that cause the most day-to-day complexity and uncertainty for taxpayers and simplifying those areas; and by ensuring the administration of the tax system is efficient.

Smart tax policies can invigorate economic growth and bring far more tax revenue as employment grows, consumer demand rises and investment increases.

“Competitiveness is a journey, not a destination. Periodic reforms will not get us to where we need to be. Unless we keep moving forward as soon as we catch up, we will begin to fall behind. Canada's policy improvement process must be ongoing and continuous.”¹⁰

10 Competition Policy Review Panel. “Compete to Win: Final Report.” Ottawa: Government of Canada. June 2008.

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