



C.D. Howe Institute

Tax Competitiveness: Why It Is Important and What We Should Do About It

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CHECK AGAINST DELIVERY

Good morning. It's always a privilege to speak at the Economic Club of Toronto and I want to especially thank Mark Adler for giving the C. D. Howe Institute the opportunity to make an important announcement here.

Today is the 87th Anniversary of the passage of the Income Tax War Act of 1917 in Canada. The government of the day designed the Act as an instrument to help fund the country's strained war effort. But, as we all know too well, its successors — way more ambitious in their reach — are with us still. We also know that none of us can escape two realities in life — death and taxes. Actually, Canadians now live an average of about 15 years longer than they did in 1917 — they have to in order to get their taxes paid!

Still, it is interesting that even in 1917, Canadian politicians were concerned with the issue of tax competitiveness. Canada was losing immigrants to the United States, a fact that then-finance minister Sir Thomas White was well aware of. He commented: "Canada has been and will continue to be a country inviting immigration. I have thought it desirable that we should not be known to the outside world as a country of heavy individual taxation."

And hadn't Sir Wilfrid Laurier said confidently on January 8, 1904: "I think we can claim that it is Canada that shall fill the 20th Century"?

I think both men might be appalled today by the level and complexity of taxes in Canada that may have been at least partly responsible for that bold forecast falling so far short of reality.

Consider:

In 1917, individuals paid no taxes if income was less than \$1,500, and the top rate of 25 percent applied to incomes above \$100,000. Married individuals, or those with dependents, had an extra \$2,000 exemption. By comparison, using 2004 dollars, no single individual with an income less than \$25,980 would have paid any tax, while today the federal exemption level is \$8,012.

The top rate in 1917 applied to incomes above \$1.73 million in 2004 dollars, while the current top federal rate kicks in at \$113,805.

Today, as Canadians look to governments to fund health care, education and infrastructure, it is too easy to lose sight of the important role that taxation can have on competitiveness and growth prospects for a country. Federal and provincial governments now collect \$475 billion annually in revenue — almost \$16,000 for each adult and child — by far the biggest hit on a typical family's budget. However, as I hope to make clear, I do not mean that only the *level* of taxes matters to competitiveness. What is also critical is the *structure* of taxation — the degree to which we rely on inefficient taxes that inhibit economic growth, create unfairness, and cost Canadians dearly by forcing them to comply with onerous rules and regulations.

We at the C. D. Howe Institute believe that taxation must be continuously examined to make sure that Canada's standard of living is not eroding as a result of uncompetitive tax policy. Politicians and the public should not lose sight of how much taxation can affect the economy. We hope to bring to light the significant problems in the tax system that need repair so that Canada's economic performance will improve.

To that end, we are launching the Tax Competitiveness Centre on the anniversary of the promulgation of the Income Tax War Act. The Centre's mission will be to conduct studies on the tax system to ensure that Canadians understand how tax policies can be changed to support better economic growth and job creation in Canada. We will periodically publish data showing how various tax rates affect people and businesses. We will also review specific aspects of the tax system and recommend important policy changes.

Some of you already know our record on tax policy. We have published papers on the impact of income-tested benefits, on savings and work, health care financing, capital gains taxation, RRSPs, Tax Pre-Paid Savings plans, payroll taxes and business tax competitiveness, as well as on Canada-U.S. withholding taxes as an obstacle to North American capital market integration. Many of our ideas have been adopted by governments or are getting serious consideration. With this Centre, we will bring together the many researchers who have worked with us to improve our tax system. The new Centre also expands our research capability by providing funding for a new Scholar's position — the George Weston Limited Tax Policy Analyst — to be held by Duanjie Chen, as well as enhancing our ability to improve and disseminate research funded by the John Dobson Foundation.

Let me expand further now on why I believe Canada's tax system needs careful attention. Specifically, taxes erode competitiveness when governments assess them at rates that are too high and when they are structured poorly, resulting in prohibitive economic, administrative and compliance costs.

Looking at the relatively high level of tax rates first:

High rates substantially erode Canada's competitiveness by discouraging people from working, investing in capital and up-to-date technologies, and taking on risk. Recent economic studies have largely come to the same conclusion — a country's tax levels strongly influence its people's economic decisions.

In Canada, the top personal income tax rate is about 46 percent. Compared to other countries, this is neither the lowest nor the highest top rate, though it is less favourable than the situation in the United States, where the top rate is about 40 percent and kicks in when incomes exceed US\$319,000, compared to about US\$88,000 in Canada.

What is less well known is that the most punitive tax rates apply to Canadians with modest incomes. For example, take a working, single-parent Mom with two children, living in Ontario and making an income of about \$30,000. After the imposition of combined federal and provincial income taxes, payroll taxes, income-tested tax credits and sales taxes on what is left to spend, the tax rate on any additional income received by that hard-working Mom is well over 75 percent. Employers know that any bonuses that they might give to such employees will be eaten up by taxes, leaving hardly anything in their pockets. And that, understandably, erodes the incentive for people to work.

At the same time, a low-income person trying to save money for retirement purposes faces an extraordinary tax on any withdrawals from RRSPs and pension plans after the age of 65. Not only will the government tax RRSP savings at a personal rate of 22 percent, but the over-65s have 50 cents of the Guaranteed Income Supplement clawed back for each dollar of RRSP withdrawn. Add on sales taxes when a person spends the money on daily living expenses, and RRSP withdrawals are taxed at rates close to 80 cents on the dollar. Why would a low-income person save for retirement purposes when governments punitively confiscate most of their savings?

I'd like to give you just a couple of more examples.

Taxes on interest income enable governments to usurp the most important source of investment income for many low- and middle-class Canadians, who have to save money to retire, finance their children's education or cover emergency needs. Typically, a one-year bond offers little more than a 3-percent rate of return on savings. A person with moderate income would pay tax on interest at a rate close to 33 percent, leaving 2 percent as the after-tax yield. However, with inflation rates of roughly 2 percent, a moderate-income saver earns next to nothing after taxes. In other words, the tax rate on interest, adjusted for inflation, is close to 100 percent. Would we call this smart tax policy?

At the same time, tax rates on investments can be extraordinarily high, especially on risky assets. Suppose an entrepreneur is investing \$1.5 million in a new medical technology. There is a half chance that the project will earn a healthy profit of \$2 million over and above the initial investment. There is also a half chance that the project will fail miserably, causing a \$1.5 million dollar loss.

If the project is successful, the government will tax the earnings of \$2 million at 45 percent, leaving \$1.1 million in profit. However, if the project fails, the government walks away, leaving the \$1.5 million loss solely to the entrepreneur. It does not take a genius to figure out that, after tax, the entrepreneur should not bother with the investment — she has a half chance of gaining \$1.1 million and a half chance of losing \$1.5 million because the government taxes away profits and does not share losses. In other words, taxes take any attractiveness out of this innovative activity.

I won't shower you with any more examples. My point is that our current tax structure has many excessively high rates and needs repair. In part, this is because governments simply spend too much money — over 40 percent of Canada's GDP — and should make further tax reduction a priority. However, it is also the case that taxes could be levied more intelligently by improving the tax structure.

Now, let me turn to the tax *structure* before I conclude:

The heart of the problem is to be found back in 1917 when government incorrectly defined income as the earnings a person receives *plus* investment income. This 87-year-old concept unfairly discriminates against people who try to save for their future needs. For example, if a person earns a salary and spends it immediately, income taxes are paid *once* — on the earnings. However, if that same person saves part of the salary for retirement purposes, income is double taxed — once when earned, and again when income is derived from investments. A person who wants to consume more in the future must pay more tax than a person who consumes all income as it's earned.

Many of the problems in the tax system could be avoided by eliminating taxes on investment income. This can be easily achieved by removing restrictions on RRSP deductions, exempting investment — as would be the case with Tax Pre-Paid Savings Plans — and eliminating the need to deduct interest expenses from income. Corporations should be taxed on the same basis — investment would be expensed and interest expenses would not be deductible for tax purposes. This pro-growth tax reform — sometimes known as the expenditure approach to taxation — has many virtues:

- It allows people to accumulate more resources for their retirement, education, medical needs and other contingencies because the tax on invested income is removed. With our aging population, this is an important consideration. Further, both risky and non-risky investments will be treated the same.
- It achieves greater fairness in the tax system by treating consumers and savers on the same basis. Some might argue that higher-income people tend to save more, and that removing taxes on investment income favours the rich. However, many low- and middle-income Canadians have to save, and the best way to help the poor is to exclude income from taxation, provide refundable grants and keep tax rates low.
- It is a very simple system. There is no need to adjust investment income for inflation, restrict the use of investment losses or needlessly administer rules related to interest deductibility, financial derivatives and other complicated aspects of the tax system. With an expenditure tax, many Canadians could file their income taxes on a postcard.

Time does not allow me to delve more deeply into some of the complexities involved in excluding income from investments for tax purposes. However, these technical issues are not beyond our grasp — we already know from the Goods and Services Tax that the principle of

taxing consumption, not investment, is a more pro-growth, fairer and simpler approach than our current income tax.

While removing discriminatory taxes on invested earnings would do much to improve our *Income Tax Act*, other tax reforms are needed, as well. Our current income tax system is riddled with complexity because of often politically motivated policy decisions to favour some forms of economic activity over others. The list of special preferences that distort economic decisions is a long one. Numerous economic studies have shown the ineffectiveness of many targeted tax cuts; they produce little new productive activity, while adding to the incomes of those who are already well off.

A partial list of special preferences that could be abandoned if we eliminated taxes on investments include:

- Federal and provincial investment tax credits, such as labour-sponsored venture capital credits and film-tax credits.
- Provincial stock-savings plans.
- Federal grants for registered retirement education plans.
- Federal and provincial flow-through shares for mining and oil and gas investments.
- Lifetime capital gains exemption for shares in private corporations and farm property.
- The federal pension income deduction.
- Federal and provincial differential, sector-specific, corporate tax rates on business income.
- Federal and provincial dividend tax credits.
- Provincial tax holidays.

With lower tax rates, many of these targeted tax preferences that needlessly distort economic choices, create unfairness and complicate the tax system could be eliminated, minimizing the impact of tax reform on government revenues.

As well, governments could rely more on user fees and consumption-based levies, rather than income taxes that undermine productivity and job creation. A shift towards user fees, including health, garbage collection, water usage and transportation would also improve fairness because Canadian taxpayers would have to contribute some of the cost of public services that benefit them directly.

Federal and provincial governments *both* have to review taxes, with the aim of improving Canada's tax competitiveness. High tax rates have to be cut and tax bases broadened to get governments out of corporate boardrooms and family homes.

National Revenue Minister John McCallum is studying ways to reallocate funds from low- to high-priority expenditure programs. This is a very good idea, indeed. But why only expenditures? Shouldn't we be doing the same with our tax system by reviewing our tax structure to reduce high rates and remove inappropriate tax preferences? Of course we should.

So, my own personal call to each government in Canada is to review their tax systems with the aim of promoting growth, fairness and simplicity.

Canada's tax system needs reform. It must foster competitiveness, fairness and lower rates. It has to eliminate special preferences, redefine income and create jobs. If the C. D. Howe Institute's Tax Competitiveness Centre is able to provide new research that helps accelerate that process and liberate the nation's creativity, then it will serve the public well.