Intelligence MEMOS

From: Duncan Munn and Alexandre Laurin

To: Finance Minister Chrystia Freeland

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Re: **Productivity Increases Start with Tax Reform**

Canada's labour productivity decline is making headlines across the country and raising concerns about our economic prosperity.

In real terms, per capita GDP has been stagnant since 2017. Ontario's output per capita is now on par with Alabama's, as University of Alberta economist Trevor Tombe has **pointed out**. More than ever, Canada needs tax reform to foster economic growth.

Lack of investment is not the sole explanation for disappointing productivity performance, but it is almost certainly a major contributor. The stock of business capital per worker has been **sinking** since 2015. Canada fares very poorly compared to its neighbour: each US worker, on average, benefits from almost twice as much new business investment per year than the average Canadian worker. To reverse this and speed economic growth, we need policies that tackle root causes. Tax reform is key.

All taxes distort economic activity by altering the relative prices of capital, labour and goods. But not all taxes distort equally. Some reduce productivity and economic efficiency much more than others. By shifting from more distortionary taxes, like those on income, to less distortionary ones, like those on consumption, we can enhance the incentives we provide for economic growth.

Canada is a high-tax country relative to our largest trading partner — the burden of taxes is almost 7 per cent of GDP higher here than in the US. That creates enormous competitive pressure. We also rely more heavily on taxing incomes, both personal and corporate, than do our peers, including the US. That over-reliance on income taxes is costly. Entrepreneurs and innovators take on less risk, investors pass up projects because taxes on expected returns are too high, and people work less, invest less in their future or even move to other jurisdictions. Our current tax structure offers much room for improvement in these areas.

One important aspect of tax reform is to make greater use of the federal GST and provincial HSTs, which are "value-added taxes" (VATs). Businesses collect these taxes on their sales but claim a credit for the tax they pay on their inputs, including investments in capital and equipment, with the result that they only pay on the value added at each stage of production and distribution. And exporters can recover the VAT they pay on their inputs, making them more competitive.

VATs are economically efficient taxes that don't discourage capital investments. Many other countries, especially in Europe, use them much more than we do. We should follow their lead and tax income less and value added more. Doing so would encourage businesses to invest more in equipment, infrastructure and technology, which all increase productivity.

We could also enhance economic efficiency by making greater use of user fees for government services. Toll roads and bridges are an example. User fees are fair. They shift costs from taxpayers at large to those who directly benefit from a service. They're also efficient. They create economic incentives for individuals and businesses to make informed choices regarding their use of public services.

Greater reliance on user fees would enable cuts in taxes on corporate and personal incomes. In most provinces, the top marginal rate of income tax is now above 50 percent. With tax rates that high, as economists Bev Dahlby and Ergete Ferede have **shown**, every dollar of tax revenue costs the economy more than an entire extra dollar in discouraged effort or investment.

We should also make greater use of taxes on goods, services or activities that produce "negative externalities." Imposing higher taxes on harmful substances or activities, such as carbon emissions, raises their cost, thus discouraging them. Not only is discouraging harmful activities good, but the revenues raised can be used to reduce other taxes or finance public services of one kind or another. For instance, if the GST rate on transportation fuels **were increased**, that could lead to a reduction in carbon dioxide emissions while also providing a boost to federal finances. Credits for GST paid on inputs mean that this measure raises fewer concerns about international competitiveness than a higher carbon tax.

A tax system that minimizes distortions and removes disincentives to effort and investment is essential for driving productivity improvements and economic growth. With tax reforms that prioritize value-added taxes and user fees, while easing the tax burdens on work, savings and investment, Canada could create an environment that is much more conducive to the economic activity on which continuing increases in living standards depend.

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