C.D. Howe Institute Fiscal and Tax Working Group

Communiqué #3: Permanently Higher Federal Spending Threatens GST Hike

The C.D. Howe Institute has initiated a special project to rapidly provide expert policy advice to Canadian policymakers as they navigate fiscal policy during the COVID-19 recovery. The Institute's Fiscal and Tax Working Group is co-chaired by John Manley, former federal minister of finance, and Janice MacKinnon, former minister of finance of Saskatchewan, and comprised of a group of experts from both the private sector and academia. The group's third and fourth meetings were held on October 6, 2020, and November 11, 2020. This communiqué reflects the conversations held at these meetings.

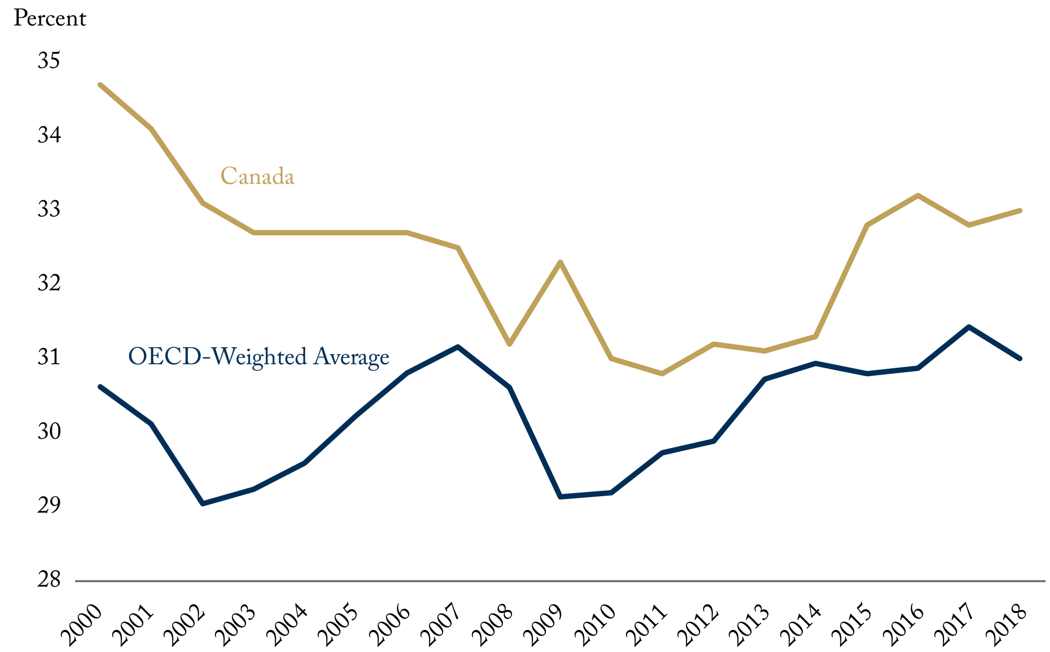
The group discussed and debated the following questions: At the first meeting, what is the right tax policy mix for Canada to remain competitive? And, at the second meeting, how to sustainably finance an ongoing expansion of federal program spending over and beyond the spending required to help Canadians cope with the economic consequences of the pandemic.

At the turn of the century, Canada's taxes as a share of GDP was approximately four percentage points higher than the OECD average. While falling in the subsequent 15 years, it has been on the rise since 2014 (see Figure 1), setting the stage for the current conversation.

Where Canada stands out is in its ambitious post-pandemic spending plans. Most other OECD countries are not planning similarly ambitious post-pandemic reforms. In the midst of the crisis, one shared world-wide, members agreed that now is not the time to raise taxes to pay for planned increases in government spending for necessary pandemic relief, nor for committing to new post-pandemic program spending. Ottawa's intentions to introduce substantial new permanent program spending in the Speech for the Throne threatens Canadians with tax hikes to pay for it. However, a thorough review of existing programs to find cost savings would be better – personnel expenses would be a good place to start.

However, as we look ahead to the threat of tax increases, we must discuss the appropriate tax structure for Canada to remain competitive, grow, and get people back to work, all while replenishing government revenue.

Figure 1: Taxes as a Percentage of GDP, Consolidated for All Levels of Government, 2000 to 2018



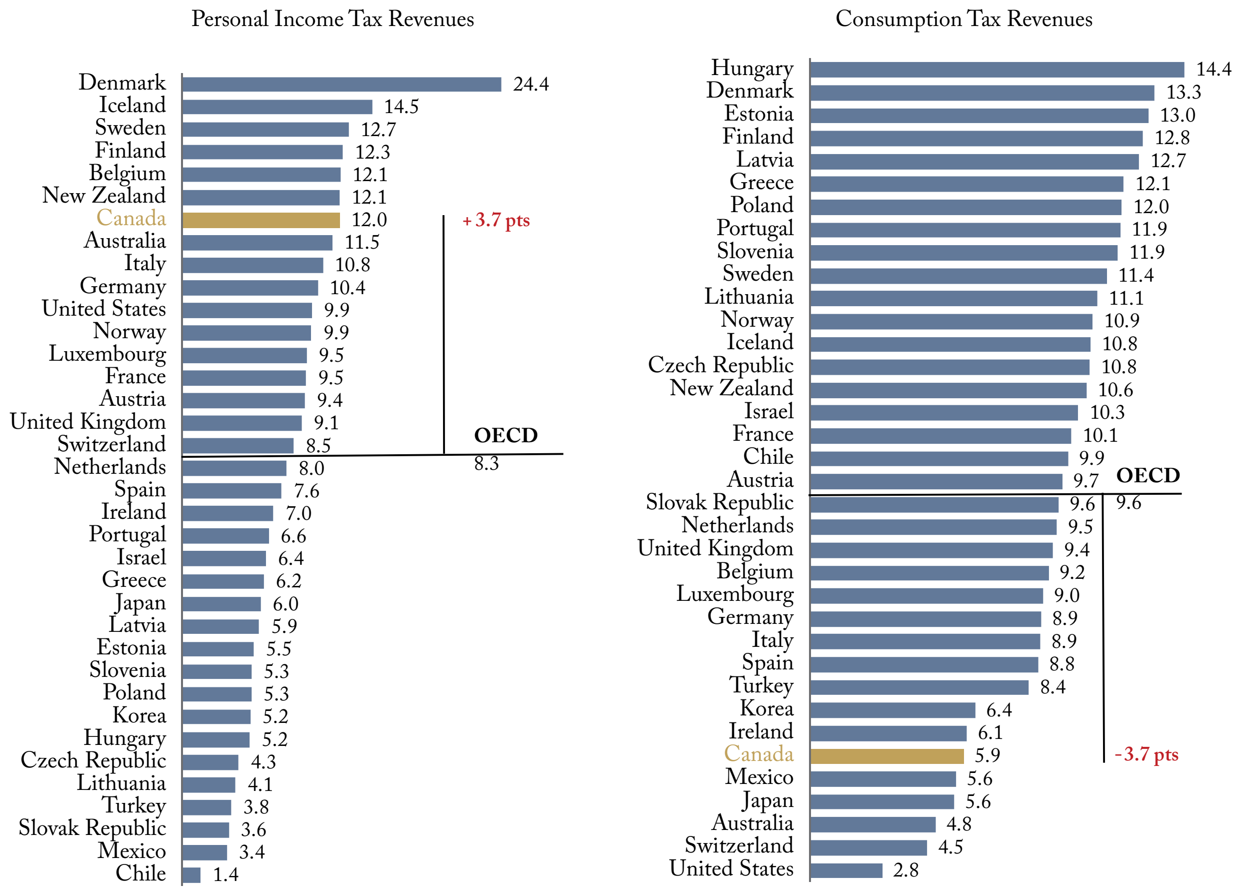
Note: OECD average is the GDP-weighted average of tax/GDP ratios of OECD countries.

Source: OECD Taxation Statistics as compiled by Philip Bazel.

Along those lines, members discussed the characteristics of different taxes with respect to four areas: their economic cost, their distributive properties, their impact on Canada's competitiveness, and their domestic regional effects. A consensus[1] emerged that there are many impediments in the tax system that are hindering productivity improvements and economic growth, such as a comparatively higher personal income tax burden in Canada than in many OECD countries (Figure 2). In addition, the small business tax preference is impeding small businesses from growing as well as diverting resources to tax planning opportunities. Consumption taxes are the least distortive to economic growth, and, considering Canada's relatively low reliance on them among OECD countries, are an ideal way to raise needed revenues.

1 Consensus denotes agreement amongst a large share of members, not unanimity.

Figure 2: Personal Income and Consumption Taxes, Consolidated for All Levels of Government, 2018, as a percentage of GDP



Source: OECD Taxation Statistics and Statistics Canada, as compiled by the Chaire en fiscalité et en finances publiques.

Similar to measures in other countries, Ottawa's September Speech from the Throne signaled the government's intention to continue to provide extraordinary, targeted income support to business and population groups most affected by the pandemic. But this support is temporary and will be wound down once the crisis recedes. The Throne Speech also introduced the government's intentions with respect to a host of potential expenditure initiatives that would result in ongoing increases in federal spending. Excluding crisis-related, time-limited spending such as income support programs, we calculate that these initiatives in the Speech from the Throne may add between roughly $19 billion and $44 billion in permanent annual federal program spending.[2]

A consensus emerged that a permanent increase in non-growth-enhancing federal spending – like some of the announcements from the Speech from the Throne – will, if implemented, impose a cost on most Canadians. Significantly higher debt will have a cost eventually felt by all through lower future investment, which will be crowded out by higher taxes and/or interest rates. Likewise, an attempt to finance spending through efforts only targeted at business will be felt by their customers and employees. Added costs to business would eventually be passed along in the form of higher prices or lower wages. Only broadly based tax increases that affect most taxpayers would come close to covering the cost of the new spending. Proposed spending should be assessed alongside proposed tax financing in a transparent manner. Only then would Canadians be able to assess how much they value the proposed initiatives.

Members agreed on four principles for the financing of new permanent spending: (i) the majority of this spending should be met with increased tax revenue; (ii) these new sources of revenue should do as little harm to investment and growth as possible; (iii) these new sources of revenue must be reliable; and, (iv) to be able to raise enough revenue, these new sources should be as broad as possible. Members thought all four principles could be satisfied by a potential increase in consumption taxes (GST/HST) of at least 2 percentage points, raising the GST rate from 5 percent to its original 7 percent, combined with selected base broadening measures, with an offsetting low-income GST tax credit to neutralize its regressive impact.

Making Canada's Tax Mix More Competitive

Canada relies heavily on personal income taxes, with a progressive system, and one where the top tax rate begins at a comparatively low threshold level. Some members discussed concern over this low threshold as discouraging talent retention in a globalized world. The current low level at which top rates

2 The wide range to these estimates reflects the lack of details in the Speech from the Throne over the precise intentions with respect to implementation.

apply should be a lens for the federal government as it seeks ways to tax extreme wealth inequality as promised in the recent Speech from the Throne. There is scope to raise the threshold, and this could be offset with, for example, raising the capital gains inclusion rate.[3]

Regarding corporate income taxes, members pointed to research showing that this form of taxation has the highest economic cost per dollar of revenue raised. It scares capital away, which harms workers. It also penalizes domestic firms relative to multinationals given the latter have more scope to minimize their Canadian tax obligations. Accordingly, this would be a particularly harmful tax at this time of economic recovery. Others pointed out that businesses do not worry as much about the headline corporate tax rate, and, instead, concern themselves more with the talent the country produces and the effective tax rate on new investment.

Members did agree that the inconsistency in corporate taxation between large and small businesses is distortive, and discourages business growth – indeed, encourages breaking up companies for tax purposes – thus harming economic growth. To help small businesses, other measures should be considered, including a lifetime limit on the small business deduction, and/or expensing the first $200,000 of capital regardless of size. Small businesses have been disproportionately hurt by this pandemic, and members agreed now was not the time to remove or change this preference, though it is something the government should consider over the medium term.

Consumption taxes, such as the GST/HST are the most efficient tax, with little impact on competitiveness, and Canada relies on these taxes less than the OECD average. Governments could also look to broaden the base, for example, by taxing imported digital services and content. Many members agreed on the need to tax the domestic consumption of digital services, something Canada can move on unilaterally. This will create a more level playing field between digital and bricks-and-mortar businesses. Ottawa could also do more to clear the way for provinces in Western Canada to harmonize their retail sales taxes with the GST.

How to Pay for Post-Pandemic Spending

A cursory review of potential permanent expenditure initiatives from the last Throne Speech revealed that they might add between roughly $19 billion and $44 billion in new ongoing annual federal program unfunded spending. This amount of unfunded spending would leave the country vulnerable to adverse shocks and is likely not sustainable.

3 The capital gains inclusion rate determines the percentage of a capital gain that is included in a taxpayer's taxable income each year.

There was some debate as to what portion of this potential increase in permanent spending would pay for itself, e.g., childcare, and what percentage could be paid for through borrowing, given low interest rates. However, members agreed that a significant portion of, although not necessarily all, new permanent spending would have to be paid for by increases in tax revenue. And, to get to the level of potential new spending, a notable revenue increase would be needed relative to the status quo. Options should be put on the table immediately so that Canadians can evaluate the potential benefits of new ongoing spending initiatives against their cost.

Numerous tax options were discussed, including consumption taxes, i.e., increases to GST/HST, increasing the capital gains inclusion rate, a carbon tax, removing the small business tax preference, taxing capital gains on primary residences on the same basis as secondary residences or income-producing real estate, and a wealth or financial transactions tax.

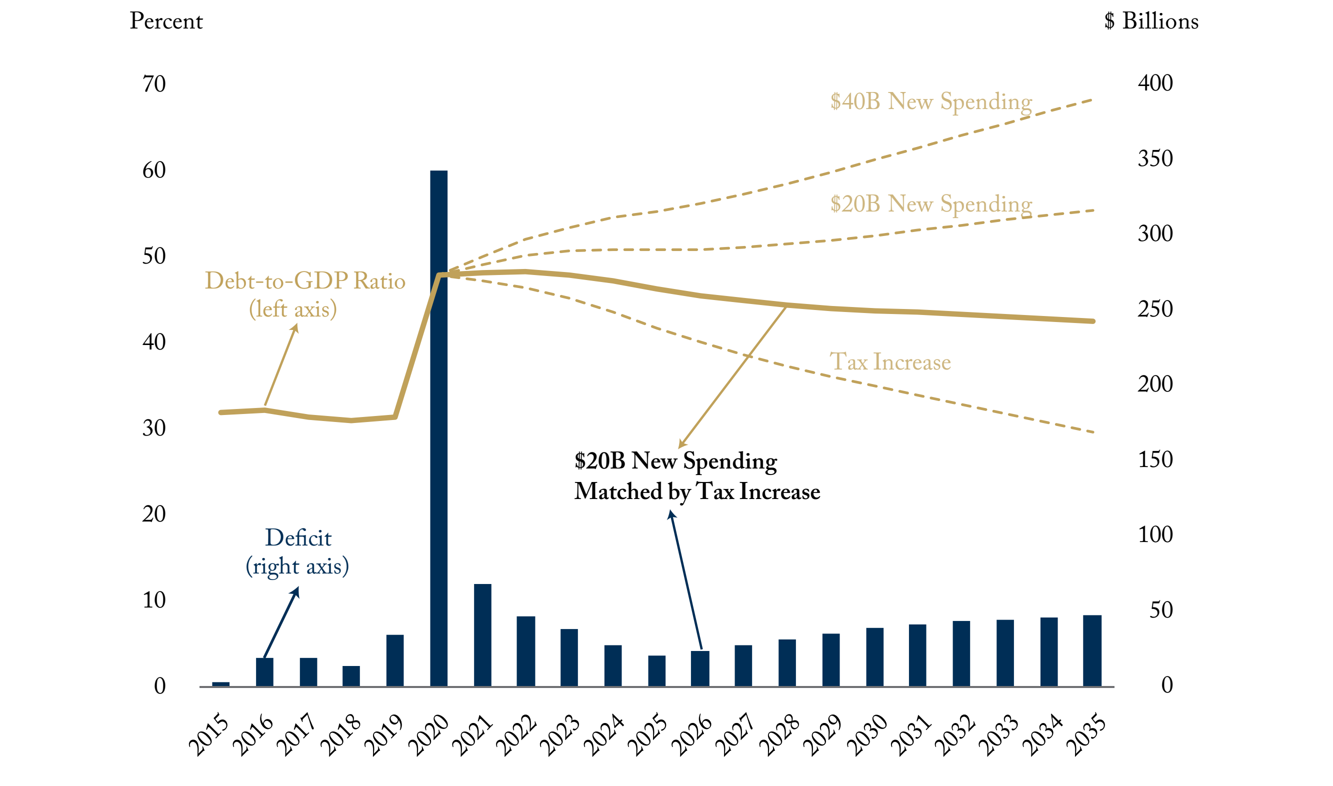
These options were examined through the following lens: new sources of revenue should do as little harm to investment and growth as possible, new sources of revenue must be reliable, and, to be able to raise enough revenues, these new sources of revenues should be as broad as possible.

There was consensus that an increase in consumption taxes meets all criteria, when coupled with an offsetting increase in the refundable GST tax credit for lower-income households. Members also argued that there were opportunities to broaden the consumption tax base. One example is looking at the digital economy, where there are missed opportunities to apply GST/HST on digital services provided by non-residents. The GST/HST is also more difficult to avoid, especially for people earning income abroad but living and spending in Canada. Increasing the GST by two percentage points, along with a 40 percent increase in the GST tax credit, would raise nearly $15 billion.

Members recognized that consumption tax increases are broad-based and unpopular, and that political acceptance may be enhanced by accompanying the GST increase with raising the capital gains inclusion rate from 50 to 75 percent. A few members mentioned the economic costs of the capital gains tax in terms of impinging on capital turnover, financial market efficiency, risk taking, savings and capital formation. However, it was also mentioned that the effective burdens of corporate and personal income taxes on capital gains and dividends have grown apart in recent years. Realignment of the capital gains inclusion rate to match the impact of the dividend tax credit would reduce the scope for tax planning. Members also recognized that a higher effective tax rate on capital gains would negatively impact capital-gains realization, thus limiting the revenue-raising potential of raising the rate.

Overall, increasing the GST rate by 2 percentage points, with a broadening of the base and an offsetting low-income tax credit, accompanied by increasing the capital gains inclusion rate from 50 to 75 percent, would raise nearly $20 billion, or about 0.9 percent of GDP. Such a move would set the

Figure 3: Various Projected Debt-to-GDP Trajectories



Note: "Tax Increase" illustrates a permanent revenue increase of 0.86% of GDP, corresponding to a 2 percentage points GST rate hike, accompanied by a broadening of the base and an offsetting low-income tax credit, along with increasing the capital gains inclusion rate from 50 to 75 percent. "$20B" and "$40B" of new spending illustrates a permanent increase of 0.86% and 1.71% of GDP, and are designed to roughly correspond to the low end and high end of the range for the cost of initiatives envisioned in Speech from the Throne. "Deficit" is shown for the $20B spending/tax increase scenario.

Source: C.D. Howe Institute's calculations based on data from the November 2020 Fiscal Sustainability Report of the Parliamentary Budget Officer.

debt-to-GDP ratio on a downward trend if the new spending from the Throne Speech sits at the lower end of the range described above (see Figure 3). This downward trend is important. As the Working Group has argued before, such a clear fiscal anchor is necessary to exert fiscal discipline and improve government credibility with credit rating agencies and the public. Members argued that because most other OECD countries are not planning similarly ambitious post-pandemic reforms, any new major ongoing spending programs should not send Canada's debt ratio on an ever-increasing path.

Members differed on the revenue-raising potential of increases in the carbon tax since it is essentially rebated, and is the subject of intense regional opposition.

With respect to the primary residence capital gains tax, while members agreed there was potentially significant revenue here over the longer run, there were significant concerns over fairness, given how many people are relying on these gains to pay for retirement, the size of the real estate sector in terms of its importance to economic growth in this country, and the complexity of establishing the appropriate cost base from historical values. In addition, there is already a wealth tax on housing values through provincial and municipal property taxes.

Lastly, members debated wealth taxes. They identified many drawbacks and no advantages. A wealth tax is essentially a double tax on savings since multiple taxes are already paid on capital returns, at least in principle. It can be difficult to assess for non-marketed assets with less certain valuation, although some countries have used a wealth or capital tax as a minimum tax on income. But most of all, the tax would collect little revenue, in part due to exemptions and in part due to behavioural responses. Of 12 countries that had wealth taxes in 1990, only four have wealth taxes today.

Many on the Working Group believe there is public confusion between wealth taxes and succession or inheritance taxes. Members stressed that many Canadian governments stopped applying many of the complex and burdensome estate taxes when the capital gains tax was introduced. Deemed dispositions at fair market value at death or departure from Canada is an elegant feature of Canadian tax law, unlike the US tax treatment of inheritance, which garnered little member support.

Conclusion

If Canadians contemplate a significant increase in the level of ongoing program spending, they must do so fully aware that it will require an increase in taxes across the income spectrum for the new federal spending to be fiscally sustainable. Working Group members agreed that any permanent changes, whether ongoing post-pandemic spending increases or matching tax increases, are premature at this point. Should Ottawa go down this route, it should be clear as to how it proposes to finance it. A program review exercise could save money. On the tax side, the biggest bang for the buck and the least economically harmful, according to this group, would be to return the GST rate to its original 7 percent, with a broadening of the base, and an offsetting low-income tax credit. Taxpayers and policymakers should not underestimate the scale of tax increases needed if Ottawa increases spending as much as envisioned in the Speech from the Throne.

Fiscal and Tax Working Group members present at the meetings October 6th and/or November 11th included:

Janice MacKinnon, Co-Chair, former Minister of Finance, Province of Saskatchewan.

John Manley, Co-Chair, former Government of Canada Minister of Finance.

Paul Boothe, Faculty Director at the Ivey Academy.

Bev Dahlby, Research Fellow, C.D. Howe Institute.

Heather Evans, Executive Director and CEO of the Canadian Tax Foundation.

Luc Godbout, Titulaire Chaire en fiscalité et en finances publiques, École de gestion, Université de Sherbrooke.

Michael Horgan, Senior Advisor, Bennett Jones.

Glen Hodgson, Senior Fellow, C.D. Howe Institute.

Kay Leung, Tax Partner, Torkin Manes LLP.

Stéfane Marion, Chief Economist, National Bank.

Jack Mintz, Senior Fellow, C.D. Howe Institute.

Bill Scarth, Research Fellow, C.D. Howe Institute.

Peter van Dijk, Senior Fellow, C.D. Howe Institute.

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