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The 2005 Tax Competitiveness Report:

Unleashing the Canadian Tiger

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with
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In this issue...

A new analysis shows that federal and provincial taxes have made Canada a remarkably high-tax nation when it comes to investment. The negative implications for growth and wages suggest that governments should respond soon to the growing competitive threat; a multi-year framework for tax reform is the place to start.

The Study in Brief

This inaugural *Tax Competitiveness Report* is issued on September 20, the 88th anniversary of the promulgation of the 1917 *Income Tax War Act* in Canada.

While taxes are critical to funding public services, they discourage people from working and saving and businesses from investing in capital. The most competitive tax system is efficient, fair and simple, doing the least harm to the Canadian economy. This is accomplished by keeping tax rates low and bases broad so that the tax system distorts least the decisions made by Canadians in their pursuit of opportunities to raise their standard of living.

Specific findings in this report include the following:

- Canadian governments in 2003 raised taxes and other revenues equal to 41.7 percent of GDP, in the middle range of 28 OECD countries.
- Canadian governments impose taxes on businesses' capital investments at an effective rate of 39 percent. Taking into account corporate income taxes and other capital-related taxes, in 2005 Canada had the second highest effective tax rate on capital among 36 industrial and leading developing countries.
- Saskatchewan and Ontario have the highest effective tax rates on capital. Newfoundland, Nova Scotia and New Brunswick have the lowest effective tax rates.
- Business taxes vary considerably by business activity with burdens greatest for construction, communications, trade and service industries.
- Marginal tax rates on employment income for families with children may be 60 percent or higher for parents with modest incomes, owing to payroll taxes with earnings limits and clawbacks of federal and provincial income-tested programs.
- Seniors face extraordinarily high taxes on their investment income, with rates reaching or exceeding 80 percent for those with modest incomes.

Governments should develop multi-year tax plans to address the many existing problems in the tax system to achieve better economic growth and a higher standard of living for Canadians. This Commentary offers a number of recommendations for tax reform at federal and provincial levels.

The Author of This Issue

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This inaugural *Tax Competitiveness Report* focuses on tax policies that affect Canada's competitiveness. Canada faces the dual challenge of an aging population and mobile working people and capital. The analysis and recommendations in this report would redesign Canadian taxes to encourage entrepreneurship, effort and investment and build the income and wealth needed to finance private consumption and fund public services. The most competitive tax system is fair, simple and efficient with low rates and broad bases. Lowering tax rates, broadening tax bases and decreasing reliance on the sources of government revenues that are most harmful to Canada's potential growth would unleash the Canadian tiger.

The challenge for any country today is to provide an economic environment that promotes economic growth and job creation in a dramatically changing world. With aging populations, the work force in industrial countries will grow less quickly and declining saving rates will make capital scarcer. At the same time, new growth centres, especially in Asia, create opportunities and challenges for industrial economies to attract workers and to provide an investment climate that underpins job and wage growth.

While Canada offers many attractive features to investors — a strong rule of law, a good communications and transportation infrastructure, a well-trained work force and political stability — many other developed economies have similar attractions. One of the policy challenges facing Canada if we are to attract investment concerns taxation. It is to our detriment that Canada has the second highest effective tax rate on capital (taking corporate income and other capital-related taxes into account) out of 36 developed and leading developing competitors, as highlighted later in this report. Canadian governments also tax Canadians heavily on their work effort and savings, with marginal tax rates, averaged across provinces, often reaching 80 percent on investment income and 60 percent on employment income earned by people with modest incomes.

In the upcoming budget cycle, federal and provincial governments should encourage work, investment and risk-taking by shifting taxes from investment and savings to taxes on expenditures and applying these on broad bases with low rates. What is most crucial to Canada is to develop a set of policies that will improve our competitiveness, in particular:

- Reducing marginal income tax rates to correct the severe cases where marginal tax rates exceed 50 percent and to provide more general tax relief,
- Increasing the incentives for Canadians to accumulate income for their retirement in RRSPs or pensions or by other means that would reduce taxes on investment income,
- Removing the tax discrimination against corporate equity financing by reducing dividend taxes,
- Reducing corporate income tax rates to far more competitive levels,

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- Eliminating provincial capital taxes,
- Reducing withholding taxes and other tax barriers to outbound and inbound foreign direct investment, and
- Broadening the tax bases to make them more neutral especially with respect to incentives that are ineffective in accomplishing their aims in improving the economy.

The above proposals would generally result in a net reduction of taxes that could be accommodated by governments spending less rapidly than in the past. Fiscally-prudent governments should develop five-year tax plans that would provide room for tax relief as part of an overall fiscal framework. Further, base-broadening initiatives would offset the cost of some tax rate cuts. And some taxes, such as those related to the use of public services and those applied to less sensitive tax bases could be adjusted upward as part of an overall plan to reduce the most harmful taxes in the economy.

The Tax Competitiveness Report does not deal with spending issues. It also focuses on personal and business taxes, especially the income tax, which was adopted by Canada on September 20, 1917. The report will not focus on sales and property tax reform, which is taken up in forthcoming papers from the C.D. Howe Institute.

The following section analyses the competitiveness of Canada's tax system. It is followed by a set of tax policy recommendations for federal and provincial governments' budgeting and longer term planning.

How Do Canada's Taxes Compare to Those of Other Countries?

Tax competitiveness is related to the size of the tax burden: The more resources used by governments to fund public services, the more taxes will impinge on the private sector's desire to work, save, invest and take risks. While wise public spending can improve economic growth, taxes — especially poorly structured ones — will undermine growth and job creation.

Tax competitiveness is often measured by comparing across countries the size of the tax burden, or government revenues as a percentage of Gross Domestic Product (GDP).[1] Presumably, a lower revenue/GDP ratio would imply that the economy would be more competitive although, as highlighted below, this need not be the case.

Table 1 ranks the industrialized countries by their revenue/GDP ratios, which are broken down between tax and non-tax revenues. As of 2003, the latest year for which comparable figures are available, Canada's government revenue as a share of GDP was close to 42 percent, or eleventh lowest of 28 OECD member countries.

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1 Some tax burden measures ignore non-tax revenues (such as royalty payments to governments, user fees, profits of state-owned enterprises, foreign aid receipts and land transfer taxes).The revenue/GDP measure is more suitable than the tax/GDP measure, because the former indicates the extent to which government is financed by both tax and non-tax revenues without judging which sources of revenue impose the greatest economic costs. However, to understand how public revenue requirements affect the economy, analysts focus on specific revenues rather than aggregate measures.

Table 1: *Governments Ranked According to Their Revenue Size, 2003*

	Total General Government Revenue	Tax Revenue	Non-tax Revenue
		% of GDP	
Sweden	58.6	50.8	7.8
Denmark	57.5	49.0	8.5
Norway	56.5	43.9	12.6
Finland	53.3	44.9	8.4
Belgium	51.3	45.8	5.5
Austria	49.5	43.0	6.5
France	49.4	44.2	5.2
Iceland	46.9	40.3	6.6
Italy	46.3	43.4	2.9
Greece[a]	45.9	35.9	10.0
Netherlands	45.8	38.8	7.0
Luxembourg	45.6	41.6	4.0
Slovak Republic[a]	45.2	33.1	12.1
Germany	44.2	36.2	8.0
Hungary[a]	44.1	38.3	5.8
Poland[a]	43.9	32.6	11.3
Portugal[a]	43.3	33.9	9.4
Canada	**41.7**	**33.9**	**7.8**
Czech Republic	41.6	39.9	1.7
New Zealand[a]	41.2	34.9	6.3
United Kingdom	40.0	35.3	4.7
Spain	38.2	35.8	2.4
Australia[a]	37.0	31.5	5.5
Switzerland	35.6	30.3	5.3
Ireland	34.6	30.0	4.6
United States	31.9	25.4	6.5
Korea	31.3	25.5	5.8
Japan[a]	30.3	25.8	4.5

a. 2002.

Sources: OECD (2004, 2005).

Canadian governments collect considerable amounts of non-tax revenues (7.8 percent of GDP), with a substantial portion thereof from resource royalties. While Canadian governments collect less revenue than the governments of many continental European countries — where public pension plans funded by payroll taxes are far more significant — in Canada governments raise more revenues than in its most important trading partners — the U.S., the U.K. and Asia. Further, government revenues are not the only measure of government size. With deficits, government expenditures are larger than revenues. Deficits will require governments to cut future spending or increase taxes, while surpluses will provide opportunities to increase future spending or cut taxes.

Rich countries are those with the greatest capacity to provide both private and public goods and services to their citizens. To what extent do these revenue/GDP ratios matter for economic growth? Most experts would agree that neither the absence of government nor the absorption by government of 100 percent of the economy's resources would maximize economic growth. Governments provide important services, such as law and order, infrastructure and education, that support economic growth. On the other hand, large centralized government — as in the former Soviet Union — undermines innovation and incentives to work and invest because the failure to use pricing mechanisms in markets makes it difficult to achieve an allocation of resources according to their best economic use.

Several studies have examined what size of government, as measured by the revenue/GDP ratio, maximizes economic growth (Branson and Lovell 2001 and Tanzi and Schuknecht 2000). The overall conclusion is that the size of government that maximizes growth is no more than 30 percent of GDP. In some calculations, we examined whether the growth in real per capita GDP has any relation to the revenue/GDP ratio. For example, during the period 1986-2003, Irish per capita GDP grew an astonishing 160 percent while its revenue/GDP ratio fell almost 10 percentage points to 34.6 percent. On the other hand, Korea grew by over 150 percent in the same period and its revenue/GDP ratio rose by a little over 13 percentage points to 31.3 percent.

Those figures suggest that countries with small governments might find that they need to have larger public spending to provide services for development whereas countries with large governments might achieve higher economic growth rates with lower spending and revenues. Our analysis, which accounted for the size of government in 1986, found that an increase of one percentage point in the revenue/GDP ratio lowered growth in real GDP per capita over the period 1986–2003 by 1.7 percentage points, although the relationship is weak.[2]

The weakness of that finding is due to the aggregation of different revenue sources. The aggregate measure treats all sources the same — income, commodity, payroll, property taxes and non-tax revenues. It therefore tells us little about how the structure of taxes can affect competitiveness. Kneller, Bleaney and Gemmell (1999) find that an increase of one percentage point in what they classify as distortionary taxes as a share of GDP (income, payroll and business taxes) causes the annual GDP per capita growth rate to fall 0.4 percentage points while non-

2 Further details of this research are available upon request.

distortionary taxes (consumption and property taxes) have no effect on growth rates.

The total amount of taxes raised in relation to GDP says little about how taxes affect specific decisions, such as how much money businesses should invest in capital and how much people are willing to work and to save. Several studies estimate that income and capital taxes impose greater economic costs than taxes on consumption (see, for example, Dahlby 1994 and Canada 2004). Thus, it is useful to analyze the effect of different taxes on economic decisions.

Below, we look at finer measures of tax rates to calculate their impact on Canada's competitiveness.

Taxing Investment: How Does Canada Rank?

One of the most important factors influencing economic growth is investment by businesses in capital goods (Jorgenson and Yun 2001). Through more capital investment, businesses increase their productivity by being able to produce more goods with the number of employees they have. Further, the adoption of new technologies strongly depends on the willingness of businesses to purchase new kinds of equipment and structures. Goldfarb and Robson (2005) show that Canada's annual private investment expenditure per worker lags behind that of OECD countries and the U.S. by $1,000 and $2,000 respectively. Harris (2005) argues that Canada's mediocre record in innovation is partly a result of a lack of investment in the new plant and equipment so necessary for technological improvement.

Among the many factors which influence investment decisions by businesses, economic studies have shown that taxes have a significant impact in reducing investment. A conservative estimate would suggest that a percentage-point increase in the effective tax rate on capital would cause capital investment to decline by at least half a percentage point and, for some industries, by as much as 1.7 percentage points (Chirinko and Meyer 1997). Recently, an analysis based on many empirical studies has shown that cross-border investment is highly sensitive to tax rates — an increase of one percentage point in the corporate income-tax rate causes the stock of foreign direct investment to decline by more than 3 percent (de Mooij and Ederveen 2003).

Business investment decisions are affected by taxes on corporate income, capital taxes, sales taxes on business inputs and other capital-related taxes. Table 2 shows a 2005 ranking of all OECD countries and leading developing countries measured according to the *marginal effective tax rate* on capital for large and medium-size corporations. The marginal effective tax rate is a summary measure of the extent to which taxes impinge on investment decisions.[3] It is the share of the pre-tax return on capital that would be required to cover the taxes, leaving a

3 The marginal effective tax rate calculations use the capital stock weights for Canadian manufacturing and services. Rates are adjusted to reflect the importance of services relative to manufacturing in each country. Country-specific inflation rates are also used under the assumption that a multinational company finances its capital investment with the same worldwide after-tax real rate of return on capital, net of risk and depreciation. Property taxes are not included in the analysis because insufficient data are available for determining the effective tax rate on non-residential property by industry.

Table 2: *Marginal Effective Tax Rates on Capital for Large and Medium-Sized Corporations, 2005 (percentages)*

	Corporate Income Tax rate	Effective Tax Rate		
		Manufacturing	Services	Average
China	24.0	45.5	46.5	45.8
Canada	34.3	35.5	41.3	39.0
Brazil	34.0	40.1	37.2	38.5
U.S.	39.2	34.6	40.0	37.7
Germany	38.4	37.7	36.3	36.9
Italy	39.4	33.3	38.1	36.2
Russia	22.0	35.0	34.1	34.5
Japan	41.9	34.4	33.1	33.6
France	35.4	33.3	33.4	33.3
Korea	27.5	31.9	29.6	30.8
New Zealand	33.0	30.1	28.8	29.3
Greece	32.0	33.0	27.8	29.3
Spain	35.0	29.9	25.8	27.3
Norway	28.0	26.1	24.7	25.1
Netherlands	31.5	25.3	24.9	25.0
India	33.0	23.2	24.9	24.3
Australia	30.0	29.4	22.1	24.1
Finland	26.0	23.5	22.4	22.9
Luxembourg	30.4	21.4	22.1	21.9
U.K.	30.0	22.7	21.2	21.7
Belgium	34.0	21.4	21.3	21.4
Poland	19.0	20.6	20.0	20.2
Denmark	30.0	20.6	19.4	19.8
Austria	25.0	20.3	18.8	19.4
Hungary	16.0	18.8	17.7	18.2
Czech Republic	26.0	21.3	14.0	17.7
Switzerland	22.0	16.9	17.1	17.0
Mexico	30.0	17.2	16.4	16.7
Ireland	12.5	14.1	13.2	13.7
Portugal	27.5	11.7	14.6	13.5
Sweden	28.0	12.8	11.6	12.1
Iceland	18.0	13.1	11.6	12.1
Slovak Republic	19.0	9.6	8.7	9.1
Hong Kong S.A.R.	17.5	6.1	8.3	8.1
Turkey	30.0	7.3	5.7	6.4
Singapore	20.0	5.8	6.6	6.2

Note: The marginal effective tax rate is the tax paid as a percentage of the pre-tax rate of return to capital, based on the assumption that the after-tax rate of return is sufficient to cover the cost of equity and debt finance provided by international lenders.

Source: C.D. Howe Institute.

residual to cover the costs of debt and equity used to finance capital investments. Say the rate of return on capital that attracts financing from investors is equal to 6 percent (net of risk) as a hurdle rate for an acceptable investment. If an investment yields a pre-tax rate of return on capital equal to 10 percent with taxes reducing the rate of return on capital to 6 percent (equal to the hurdle rate) then the marginal effective tax rate is 40 percent (10% minus 6% divided by 10%). For further explanation on the methodology used to estimate the marginal effective tax rates, see Chen (2000).[4]

As shown in the table, Canada has the second highest marginal effective tax rate on capital among 36 countries in 2005. Thus, compared to other countries, Canada tends to tax capital investments highly even though its overall revenue/GDP ratio would rank it lower. Even though Canada's statutory tax rate is lower than five other countries, deductions for depreciation and inventories at less than economic cost, capital taxes and sales taxes on capital inputs cause the effective tax rate on capital to be high.

China has the highest effective tax rate, primarily as a result of a VAT on machinery investments that raises its effective tax rate by 28 percentage points. The Chinese reduce taxes on a concessionary basis, which is not reflected in these estimates. Brazil's effective tax rate on capital is the third highest, partly because of high sales taxes on capital goods and a high inflation rate. The U.S. effective tax rate on capital at 37.7 percent is fourth highest due to the high statutory federal-state corporate income tax rate, state sales taxes on capital inputs and the cancellation of bonus depreciation for tax purposes. Germany's effective tax rate is fifth highest owing to a high corporate income tax rate and municipal profit taxes that allow a half deduction for interest expenses on long-term debt.

Many countries, including Iceland, Ireland, Hong Kong, Portugal, Singapore, Slovakia and Turkey, have marginal effective tax rates below 15 percent, which is far less than that paid by businesses in Canada. Ireland has a low corporate income tax rate of 12.5 percent. Sweden provides liberal deductions for depreciation, inventory and reserve costs and taxes corporate income at 28 percent, lower than the statutory rate in Canada.

Since 2000, federal and provincial governments have been cutting business taxes to improve competitiveness. However, most other OECD countries have also been cutting their business taxes, and some much faster than Canada (Yoo 2003). Further cuts are on the way — by 2008 the federal government will eliminate entirely the large corporations tax on non-financial businesses. In its 2005 budget, the federal government promised to reduce corporate tax rates a further 2 percentage points and to eliminate the corporate surtax. However, this proposal was dropped under the deal brokered with the New Democratic Party. Provincial governments are planning further cuts to business taxes and B.C., for example, has just announced a cut in its corporate income tax rate from 13.5 to 12.0 percent,

4 As a result of data revisions, the marginal effective tax rates in this report are substantially different from those presented in previous publications. The most important source of the difference is the use of higher economic depreciation rates. Preliminary analysis at Statistics Canada indicates that economic depreciation rates now used by the agency to estimate net capital stock are too low (see, for example, Gellatly, Tanguay and Beiling 2002, Tanguay 2005, and Patry 2005). We plan to provide an historical series of effective tax rates in the future.

Table 3: *Marginal Effective Tax Rates on Capital for Large and Medium-Sized Corporations, Canada and the Provinces, 2005, in Percent*

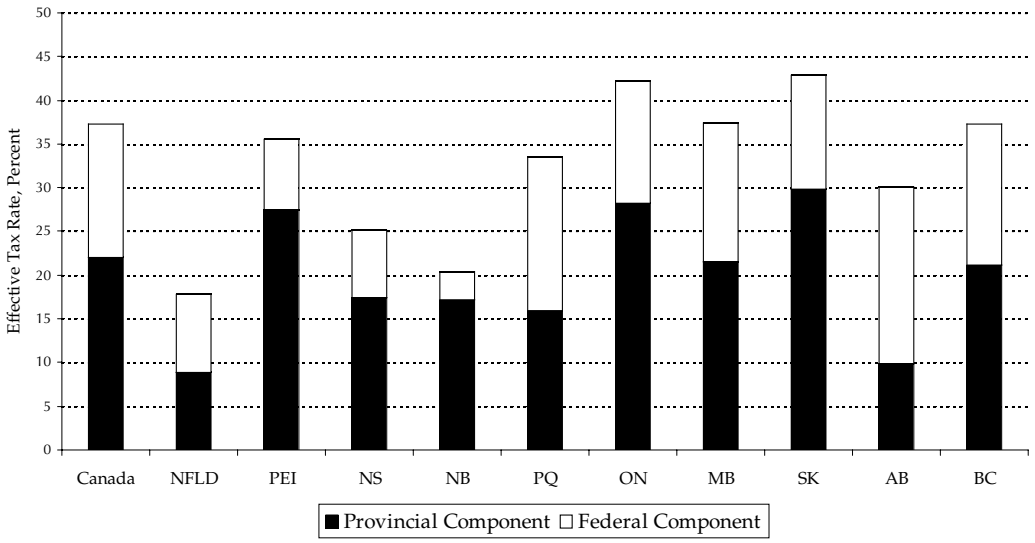
By Industry	Forestry	Manuf.	Constr.	Transport	Comm.	Public Utilities	Wholesale Trade	Retail Trade	Services Total	Aggregate
Canada	21.4	35.5	42.3	33.4	46.1	36.0	40.9	40.1	42.3	38.9
Newfoundland	NA	-5.6	21.9	26.3	33.6	14.8	32.4	30.1	33.6	20.1
Prince Edward Island	NA	-7.9	42.4	35.7	53.7	30.3	45.4	44.3	54.1	37.1
Nova Scotia	14.8	13.0	28.7	33.7	39.5	23.2	38.5	39.2	38.7	28.1
New Brunswick	12.9	10.0	25.9	31.9	37.3	19.9	36.2	36.9	36.4	22.5
Quebec	25.4	36.0	37.5	31.4	37.2	36.2	36.8	36.8	37.0	36.3
Ontario	28.1	38.8	47.2	38.1	51.6	42.9	44.1	43.0	47.8	43.5
Manitoba	30.7	20.4	48.2	39.8	51.2	45.0	46.3	45.5	48.6	39.7
Saskatchewan	31.6	39.2	49.8	41.7	54.1	46.4	48.3	45.4	51.7	44.1
Alberta	18.7	33.7	30.3	26.6	32.7	32.2	31.4	32.3	32.8	31.8
British Columbia	23.1	34.4	42.4	33.0	47.0	38.7	39.2	38.8	42.1	38.8

By Asset Type

	Buildings	M&E	Land	Inventory	Aggregate
Canada	42.0	38.6	19.0	36.9	38.9
Newfoundland	24.0	14.6	16.2	30.8	20.1
Prince Edward Island	35.9	39.3	18.2	37.0	37.1
Nova Scotia	32.1	18.8	21.0	40.0	28.1
New Brunswick	32.2	6.9	19.8	37.7	22.5
Quebec	42.1	33.3	21.1	37.8	36.3
Ontario	46.2	44.8	20.0	37.8	43.5
Manitoba	43.5	38.3	22.7	41.4	39.7
Saskatchewan	45.2	45.0	23.5	41.7	44.1
Alberta	36.4	28.8	15.7	32.8	31.8
British Columbia	41.2	39.7	16.0	33.2	38.8

Sources: C.D. Howe Institute.

Figure 1: *Effective Tax Rates on Capital by Province for Large and Medium-Sized Non-Resource Companies: Federal and Provincial Components, 2010*



Source: C.D. Howe Institute.

Note: The federal tax rate component illustrated is the residual of the combined rate and the provincial component.

effective July 1, 2005. After 2005, Quebec is reducing its capital tax from 0.6 percent to 0.29 of assets by 2009 although it will be increasing the corporate income tax rate on large businesses from 8.9 to 11.9 percent. Alberta has pledged to cut the corporate income tax rate from 11.5 to 8 percent, but no action was taken in the 2005 budget. Ontario has legislated the elimination of the capital tax between 2009 and 2012, although, given that previously legislated corporate income tax rate cuts were rescinded in 2004, time will tell if the government will make these planned cuts to capital taxes after the next provincial election. Manitoba and Nova Scotia have planned some further corporate tax cuts as well.

Taking into account the elimination of the federal capital tax on large non-financial corporations and some of the provincial tax changes that have been legislated (except for Ontario's), by 2010 Canada's marginal effective tax rate will decline almost 2 percentage points to 37.3 percent. Even so, if all other effective tax rates remained unchanged over the next four years, Canada would have the fifth highest marginal effective tax rate on capital among the 36 countries, just below the U.S. rate.

However, other countries are not standing still. The German government has proposed a cut in the federal corporate income tax rate from 25 to 19 percent. The U.S. will be cutting corporate income tax rates by 3 percentage points by 2010, and an expert panel will soon be reporting on recommendations for fundamental changes to the U.S. tax system that could bring lower U.S. taxes on investment. As several other countries have reform proposals in mind that will lead to substantial changes to their corporate tax systems, effective tax rates around the world could be sharply lower by 2010.

The provincial and industry breakdown of marginal effective tax rates for non-resource companies in 2005 is shown in Table 3. Figure 1 shows the federal and

provincial components of the marginal effective tax rate, aggregated across all industries for each province, as expected by 2010. Provincial taxes now dominate federal business taxes in most of the provinces except Alberta, which has no provincial sales tax and no capital taxes. By 2010 the federal effective tax rate on capital will be small in the Atlantic provinces because the federal Atlantic investment tax credit offsets much of the federal corporate income tax paid on marginal investment projects. Figure 1 illustrates that provincial governments especially need to pay attention to their business tax policies if they wish to spur on investment and economic growth.

The provinces with the highest effective tax on capital in 2005 are Saskatchewan and Ontario at 44.9 and 43.5 percent respectively. If Ontario were an independent country, its effective tax rate would be close to China's 45.8 percent effective tax rate on capital, hence almost highest of all jurisdictions surveyed.

The lowest effective tax rates on capital are found in Newfoundland, followed by New Brunswick and Nova Scotia. That is a result of the aforementioned federal Atlantic investment tax credit primarily for qualifying investments in resource and manufacturing industries and, in the case of Newfoundland, a low corporate income tax rate. Alberta's effective tax rate on capital is surprisingly high at 31.8 percent, placing it below France and tenth highest in the world. By and large, the largest four provinces in Canada — Alberta, British Columbia, Ontario and Quebec — fail to have internationally competitive tax regimes for investments.

By 2010, despite planned declines to 42.9 and 42.3 percent respectively, Ontario and Saskatchewan will continue to have the highest effective tax rates on capital. Quebec's effective tax rate on capital will fall from 36.3 to 33.7 percent and Alberta's from 31.8 to 30.1 percent.[5] Except for Quebec, the primary source of the business tax cuts is the federal elimination of the large corporations tax.

The business tax system also discriminates among activities. The most highly taxed sectors are construction, communications, wholesale and retail trade, and household and business services, with large corporations paying rates above 40 percent. The least taxed are primary forestry and manufacturing businesses and public utilities. Across Canada, taxes are especially high on investments in structures at 42.0 percent, followed by machinery at 38.6 percent, inventories at 36.9 percent and land at 19.0 percent. Thus, businesses that rely more on structures pay the highest effective tax rates. This unevenness of the tax burden on different business activities lowers productivity because the tax system invariably distorts the allocation of investment that would occur if economic profitability were the sole criterion for investment decisions.

All in all, Canada has a significant problem with international competitiveness for mobile capital investments, with unneeded differences in tax burdens on business investments. Despite the past and planned cuts in corporate rates,

5 A significant part of the reduction in Quebec's effective tax rate on capital is the federal elimination of the capital tax. The net effect of the Quebec capital tax reduction and corporate income tax rate increase reduces the effective tax rate by less than one percentage point. Further, as a result of the increase in Quebec's corporate income tax rate, the average statutory corporate income tax rate applied to corporate taxable income will rise by 2009 to over 35 percent unless other provinces reduce their corporate rates and the federal government proceeds with the rate cut initially included in the 2005 budget.

Canada will retain a burdensome tax climate for investment, undermining its prospects for robust economic growth — unless governments act.

Tax Barriers to Work

Canada's standard of living depends on capital investment and on the willingness of people to work. Earnings from employment provide the resources for current consumption and, through saving, for consumption upon retirement (this is discussed further below). As the population ages, workers will be increasingly difficult to obtain and Canada's current advantage will be lost. Thus, policies that reduce barriers to work will be important in the coming years.

Taxes influence working decisions in two ways.

First, individuals may be willing to work more hours or to work harder if they are offered higher after-tax earnings. Thus, a high marginal tax rate — the tax paid on additional earnings received (such as overtime work and bonuses) — will discourage extra effort and employees may decide to substitute leisure for work. On the other hand, additional taxes reduce people's income, thereby encouraging them to work more if they want to recover the tax to maintain their standard of living.

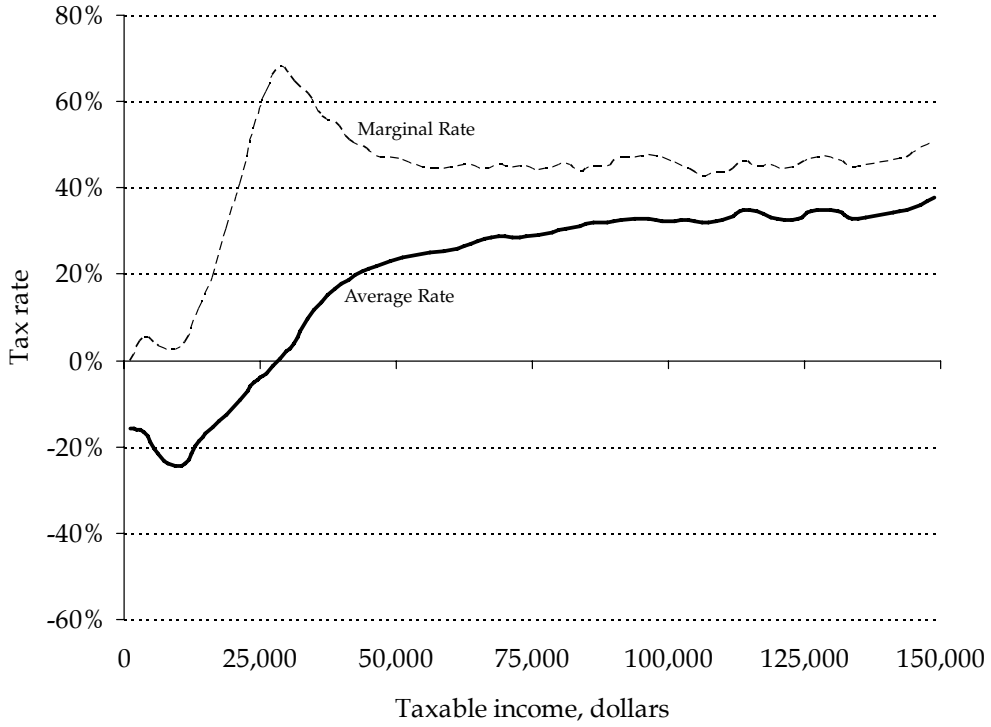
Second, taxes discourage work effort if people decide to not to be part of in the workforce but instead to work in the non-market economy, stay at home or retire early. The average tax rate — taxes as a proportion of income — affects the decision to participate in the labour force.

Among the taxes that affect labour supply are not only federal and provincial income taxes but also payroll taxes that fund Employment Insurance and the Canada/Quebec Pension Plans, clawbacks of various federal and provincial income-tested programs (for example, welfare benefits, property tax credits, child tax benefits and the Goods and Services Tax (GST) and provincial sales tax credits), and sales taxes on the current and future consumption people pay for with their earnings.

As an example, the average federal-provincial marginal tax rate for families with two children is about 60 percent in the $25,000 to $35,000 income range (Figure 2).[6] Once $20,000 in income is reached, marginal tax rates are never below 40 percent and tend to be close to 50 percent. Further, for a family with two children that earns little income, the average tax rate — if one takes refundable tax credits and benefits into account — is highly negative (in other words, a subsidy) at minus 20 percent. However, once a family's income rises over $20,000, the subsidy is halved. By $50,000, the average tax rate rises above 20 percent, implying that a family with two children will pay about $15,000 in net taxes. The steep increase in average tax rates for incomes above $20,000 is not surprising given the

6 Similar patterns of effective tax rates apply to families with one or three children. These figures are averages across provinces, meaning that the valleys and peaks in provincial tax rate profiles are smoothed out. Because the peaks in different provinces occur at slightly different places on the income scale, some taxpayers may pay a marginal effective rate much higher than the illustrations suggest. The estimates of personal tax rates were prepared by Finn Poschmann, using Statistics Canada's Social Policy Simulation Database and Model, Release 10.2; the responsibility for the results and their interpretation lies with the authors.

Figure 2: *Average and marginal effective tax rates for a family with two children; all province average, 2005*



Source: Finn Poschmann via Statistics Canada's Social Policy Simulation Database and Model, Release 10.2.

sharp rise in marginal tax rates. The result is that if a mother with two children enters the workforce, earning a modest income of about $30,000, she will pay income, sales and payroll taxes as well as lose significant child tax benefits and other income-tested credits.

Studies of the impact of marginal tax rates on work effort have found that they reduce especially the supply of labour provided by secondary workers in families. On the basis of the averages of three studies, Blundell (1996) suggests that, for each percentage increase in the after-tax wage, labour provided by primary workers will increase by about a quarter of a percentage point while secondary workers will increase their labour supply by almost one percentage point.[7]

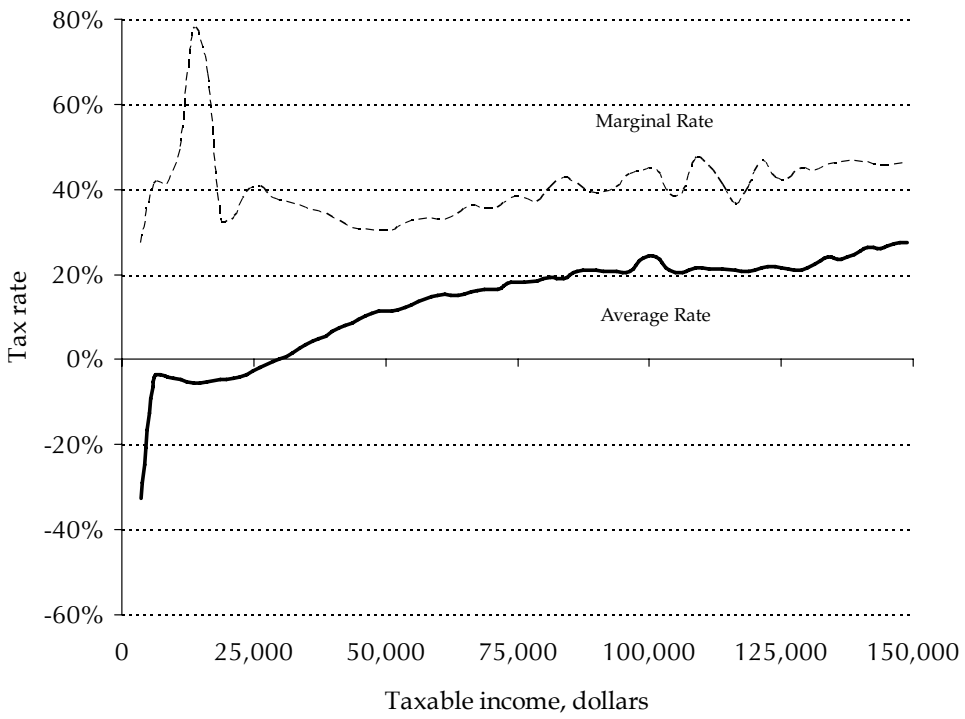
Overall, reductions in marginal tax rates would increase work effort and avoid the cycle of dependency on government benefits and welfare that occasionally traps Canadians.

Taxation and Savings

Not only does the Canadian tax system impose quite high tax rates on investment and work effort, but it also taxes saving very heavily. The ability to accumulate wealth for retirement and contingencies will be affected by taxes that reduce the

7 See also Fuchs, Krueger and Poterba (1998) who survey experts to provide their best estimates — the mean estimate is similar to Blundell (1996).

Figure 3: *Average and marginal effective tax rates for a senior with interest income; all province average, 2005*



Source: Finn Poschmann via Statistics Canada's Social Policy Simulation Database and Model, Release 10.2.

yield earned by investors. With Canadians' saving rates recently plummeting to historical lows, the lack of resources available for future needs will create greater pressure on governments to provide retirement and other benefits to the broad population. Even if saving rates are unaffected by tax reductions on investment income, Canadians are able to accumulate greater wealth for private needs when they are able to earn a much higher return on their personal investments. The high taxes on investment income makes it more difficult for Canadians to accumulate wealth for their retirement — for example, a 40 percent tax rate on interest for a bond yielding a 6 percent rate of return reduces the wealth available after 20 years by 37 percent.

With inflation, taxes on investment income expropriate a large share of wealth from Canadians saving for future needs. For example, a bond with a 6 percent yield will only provide a 3.6 after-tax yield, assuming the taxpayer's marginal tax rate on interest income is 40 percent (since the tax will reduce the yield by 2.4 percentage points). With inflation at an annual rate of 2 percent, the inflation-adjusted pre-tax and after-tax rates of return are 4 percent and 1.6 percent respectively. On an inflation-adjusted basis, the effective tax rate on savings in taxable bonds is 60 percent (2.4 divided by 4 percent) instead of 40 percent that is usually calculated when there is no adjustment for inflation.

Taking into account income taxes and clawbacks of elderly benefits, seniors with interest income pay tax at rates close to 40 percent. However, those with modest incomes may pay tax close to 80 percent on the margin (see Figure 3),

owing to the clawback of the Guaranteed Income Supplement and its companion benefits (which may be reduced by 50 or 75 cents per dollar of private income, depending on age and marital status). On an inflation-adjusted basis, the 80 percent tax rate on a bond yielding a nominal pre-tax return at 6 percent would imply a negative inflation-adjusted yield of -0.8 percent. Given this onerous tax rate — equal to 120 percent — investors would do far better to store their wealth in consumer durables like their principal residence, since there is no income tax on home ownership, rather than in taxable securities issued by businesses and governments.

Canada has a private retirement system in which people can deduct contributions to pension and Registered Retirement Savings Plans (RRSPs) from their taxable income. The investment income earned in such plans is untaxed, but upon withdrawal the initial investment and accumulated income are fully subject to tax. If Canada were to eliminate contribution limits to these plans, it would effectively shift the personal tax away from earnings, investment income and capital gains and toward expenditure, which is the difference between income and saving.

Assuming that the tax rates are constant over time and the pension plan or RRSP earns a risk-adjusted rate of return on investments equal to the cost of borrowing money, the net tax on investment income earned in pension plans and RRSPs is equal to zero — in other words, investment income is sheltered from taxation.

The assumption that tax rates are constant over time is a strong one. When people retire, their income is often less than it was during their working life so that the tax they pay on withdrawals is less than the tax they saved by contributing to a tax-sheltered saving plan. In some situations, however, taxpayers may pay a higher rate after their retirement than before because of the GIS clawback, the Old Age Security clawback (for mid-range incomes) and income-testing of certain provincial benefits. If tax rates rise, the investment income is implicitly taxed because the tax paid on withdrawals is more than the tax saved by contributing to the plans (Shillington 1999). This is particularly important to seniors with incomes less than $15,000: A person who puts money into an RRSP when paying income tax at 22 percent faces an 80 percent tax rate when withdrawing principal and accumulated interest from the RRSP after retirement. Taking into account the time value of money, the taxpayer may pay higher taxes on interest income than if he or she had invested in a taxable bond. Canada's effective tax rate on retirement saving is higher than that of other G-7 nations (Yoo and de Serres 2004).

Income derived from equity investments is less highly taxed at the personal level because investors can claim federal and provincial dividend tax credits and exclude one-half of capital gains for determining personal income taxes. Both the dividend tax credit and the capital gains exclusion, however, provide tax relief in recognition of the taxes already paid at the corporate level. At present, dividends are taxed more highly than capital gains for upper-income Canadians — the top personal tax rate on dividends is about 32 percent and on capital gains 23 percent. Combined with the general corporate income tax rate of 35 percent, the effective tax rate is 56 percent on dividends and 50 percent on capital gains derived from

undistributed profits.[8] Other income, such as interest and employment income, is taxed at close to 46 percent on average across Canadian provinces.

The effect of these differential tax rates is to distort business financing:

- The high tax rate on dividends will induce businesses to pay income to investors in the form of interest or other forms of regular income that are deductible from corporate income.
- When dividends are more highly taxed than capital gains, businesses will prefer to buy shares back rather than distribute profits as dividends.

The most important example of financial distortions in recent years is the growth of the income trust market. Income trusts, now totalling over $140 billion of market capitalization, have accounted for more than a half of all capital financing in the past several years (Aggarwal and Mintz 2004). Income trusts are flow-through entities that are not subject to tax.[9] The income distributed to unitholders is subject to personal tax according to the type of income received (dividends, interest or capital gains). Usually the business operations are highly debt financed so that most income distributed to unitholders is interest or leasing income and the company pays little or no corporate tax. Income trusts are a response by markets to a tax system that discriminates against dividends compared to other sources of income. Many income trusts distribute a large share of their cash flows from companies that tend to have stable earnings and do not have plans for major capital spending (Aggarwal and Mintz 2004), hence tax policy creates a bias to finance some types of investments and not others.

Other distorting incentives for investors exist at the federal and provincial level. Owners of farm property and shares in Canadian-Controlled Private Corporations can claim a lifetime capital gains exemption of $500,000. Although touted to be a measure to help farmers and small business owners, the current lifetime capital gains exemption is regularly used by owners of large private companies to reduce their personal income taxes. Special tax credits are also provided for some investments, including the labour-sponsored venture capital funds, provincial stock savings plans and flow-through tax credits for junior resource investments.

Aside from these special incentives, taxes on saving are relatively high. Given that after 2010 many baby-boomers will have retired, a considerable proportion of Canadians will need to have enough money to live on or depend on their families or governments to help maintain their standard of living. Although the Canada/Quebec Pension Plans, senior's transfers, medical and other support provides a very basic income, many people will find that their incomes will drop by one-third to one-half when they retire.

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8 The corporate income tax rate on income earned by small businesses is about 20 percent, implying an effective tax rate of 46 percent on dividends and 38 percent on capital gains for high income earners. On regular income, the top rate averages about 46 percent.

9 Undistributed income held by the trust is subject to a withholding tax assessed at the the top personal rate.

Moreover, the retiring population will have less money available for investing in capital markets. Canadian businesses may therefore have difficulty raising capital from Canadians, and will have to rely more on foreign saving to fund their investments. However, given the aging of the populations in other industrialized countries as well as the growth in investment demands in developing countries like China and India, Canadian business will be faced with significant international competition for investment funds. Thus it is more and more crucial to consider tax policies that will encourage the accumulation of wealth for retirement.

What Governments Must Do

In the coming years, Canada should not simply react to changes in tax policy abroad, but should take the initiative and adopt polices that would unleash the Canadian tiger by making this the best country in which to work and invest.

Given the competitive and demographic challenges facing Canada, tax reform is increasingly urgent. Other countries are not standing still — the U.S. particularly will be debating dramatic reform measures after the release of the report by President Bush's tax panel this fall. In Canada both the federal and provincial governments have their work cut out for them in the coming years. They should start developing a five-year tax plan to address the issues set out above with the twin objectives of making Canada more friendly to investment and of removing tax barriers to investment, work and saving so that Canadians can keep more of the fruits of their labour to support their standard of living.

In general, the aim of any tax reform should be to improve the efficiency and fairness of the tax system while reducing the burdens of administration and compliance. Canada needs low rates, broad tax bases and a shift in the tax mix to lower the barriers to economic growth: we need to move toward greater reliance on taxes on consumption rather on savings and investments.[10]

In that spirit, this Commentary makes the following recommendations that would improve the tax system to make it more fair, efficient and internationally competitive. Existing taxes on saving should in principle be eliminated so that taxpayers pay the same tax regardless of whether they consume their earnings today or in the future. Therefore, taxes should be shifted from investments to consumption by, for example, increasing allowable deductions for pension and registered retirement contributions or by relying more on sales, excise and user-pay-related taxes.

We focus on the personal and corporate tax regimes. We do not look at sales tax reform, which could also improve the tax competitiveness of provinces whose retail sales taxes on intermediate and capital inputs hamper business' ability to invest and to compete in export markets. We also do not examine municipal taxation, the theme of a forthcoming C.D. Howe Institute Commentary.

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10 An emphasis on consumption tax as the route to growth enhancing reform is a core theme in Kesselman (2004).

Personal Tax Measures

The high marginal tax rates on employment earnings and investment income are especially damaging to people with modest incomes. Reductions in tax rates would be advisable, especially the clawback rates for income-tested programs and taxes on investments earnings.

To this end, federal and provincial governments should undertake several measures in the coming five years.

Lower Personal Tax Rates: Personal income tax rates should be lowered, especially at the federal level, where current revenues exceed the government's needs. The provinces should look toward tax reforms that would reduce personal income taxes on employment and investment income in favour of a greater use of expenditure or consumption taxes and user fees.

Reduce Clawback Rates under the Personal Income Tax: Clawback rates for income-tested federal and provincial benefits should be reduced. Federal and provincial governments should also co-ordinate their income-testing policies to avoid the stacking up of clawback rates. A pool of benefits could be subject to a single clawback rate rather than each type of benefit being subject to separate clawback rates.

Introduce Tax-Prepaid Savings Plans: Federal and provincial governments should introduce Tax-Prepaid Savings Plans (TPSPs), which would allow individuals to contribute about $5,000 a year into accounts of which the investment income would not be subject to taxation (Kesselman and Poschmann 2001). Contributions would not be deductible from income, and withdrawals from TPSPs would not be included as part of the tax base. TPSPs would let Canadians avoid high taxes and clawbacks on withdrawals when they retire. They would also allow Canadians to even out their tax base over time, since RRSP and TPSP investments have different effects on the time profile of taxable income.

Liberalize Further Pension and RRSP Rules: After years in which inflation eroded the amount of savings a person can shelter from taxation, the federal government has wisely raised the limits for contributions to pension and RRSP plans from $16,500 for 2005 to $22,000 for 2010. However, more could be done to eliminate taxes on retirement saving (see Mintz and Wilson 2003). Limits should be increased to $30,000 per year to allow upper middle-income taxpayers to accumulate more wealth to replace 70 percent of their income earned while working. Further, the limitation that a person can contribute to pensions and RRSPs at rates no more than 18 percent of earned income should be expanded to 30 percent to allow middle-income taxpayers a greater opportunity to save and invest for retirement. The maximum age at which one can contribute to saving plans, which was lowered from 71 years to 69 over 10 years ago, should be raised to 73 years in recognition of the fact that Canadians will be working and living longer. And if taxpayers withdraw their RRSP savings for contingencies, they should be able to increase their lifetime contribution room by the same amount so that they will be able to maintain their retirement income by reinvesting in their RRSPs at a later time. As a base-broadening measure, the current $500,000 lifetime capital gains exemption for owners of farm property and shares of Canadian-controlled private corporations should be replaced by a rollover provision that

allows the proceeds of sales to be folded into an enhanced farmers' and small business owners' RRSP based on the maximum limit multiplied by the number of years earning income.[11]

Increase the Dividend Tax Credit: As noted above, dividends are more highly taxed than capital gains and other forms of income, and the dividend tax credit is less than the amount of the corporate tax levied on medium-sized and large companies. That situation has given rise to the growth of alternative forms of business organizations, such as income trusts and, to a lesser extent, limited partnerships. To improve tax neutrality among different forms of business financing and organization, the dividend tax credit for publicly-traded shares and high-tax income earned by Canadian-controlled private corporations should be increased to offset the high corporate income tax rate. Suppose, for example, the corporate income tax rate were 30 percent — roughly the rate that would apply in 2010 if the 2005 federal budget corporate tax rate cuts had not been rescinded. Then, a gross-up of 150 percent (instead of 125 percent), a federal tax credit equal to 20 percent, and a provincial tax credit equal to about 10 percent would lower the top dividend tax rate to 24 percent, roughly equal to the capital gains tax rate. (A lower gross-up and credit would be reasonable if the corporate tax rate were reduced below 33 percent, as discussed in the next section.) Some complexity would prevail with added calculations of income pools at the small business level, but the proposal would benefit small business as well. Some other adjustments could be considered to ensure that dividends were taxed at same rate as other income received by investors. For example, the dividend tax credit could also be made refundable to pension plans and RRSPs and a minimum corporate tax on dividend distributions could ensure that dividends were subject to the corporate tax rate to fund the refundable credit (Canada 1998).

Employment Insurance Reforms: Employment insurance payroll taxes are too high because the program operates with a significant surplus even though, by legislation, it should be balanced with benefits equaling premiums over a business cycle. Given that payroll taxes apply up to a certain level of earnings, payroll taxes in excess of benefits fall most heavily on lower-income workers. Also, employment insurance premiums are unfairly and inefficiently levied because they are unrelated to the layoff experience of a business. Employers who take advantage of the employment insurance program by routinely laying off workers are permitted to do so without facing higher premiums. As part of a tax reform package, the federal government should further reduce employment insurance rates to match contributions with benefit payments. As also recommended by the Technical Committee on Business Taxation (Canada 1998), the federal government should adopt partial experience-rating at the business level so that employers who tend to lay off workers pay a higher premium. Partial experience-rating would especially benefit employers with good employment records, as they would pay lower Employment Insurance premiums.

Broader Bases and Fewer Gimmicks: Other personal tax measures would increase revenues and lead to greater efficiency, fairness and simplicity in the tax system. With lower taxes on saving, other incentives to save would be less necessary. The

11 As recommended by the Technical Committee on Business Taxation (Canada 1998).

federal and provincial labour-sponsored venture capital credits have not been successful in stimulating new investment, and the economic returns to investors have been low or negative: the median five-year return for labour funds in existence as of August 2005 was –9.8 percent annually; Ottawa and other provinces should follow Ontario's lead in eliminating them. Provincial tax stock savings plans have not achieved their aim of funding new investments in medium-sized and small businesses (Suret and Cormier 1997). The pension-income tax credit should be eliminated because it provides tax support for pensioners that could be more equitably provided through a larger basic personal amount available to all individuals.

Corporate Tax Measures

The competitiveness of the Canadian economy has been harmed the most by the high taxes on business investment. An increase in business investment would have substantial benefits for labour productivity, offsetting some of the adverse effects of workforce aging. Business investment is also crucial for the commercialization of technology since new vintages of capital embody the knowledge gained through research and development.

Canada's second highest effective tax rate among industrialized and leading developing countries discourages businesses from setting up shop here and creates disadvantages for those that do. Governments not only need to eliminate the disadvantage; they should create a "Canadian advantage" for businesses to locate here to serve the North American market. Investment is attracted to large markets and low costs — the United States has the former, and Mexico has the latter. Policy initiatives are the only way that Canada can create a distinct advantage for itself.

Our specific recommendations include the following:

Lowering the Corporate Income Tax Rate to 25 percent: Even though the average federal-provincial corporate income tax rate has fallen from 43 percent in 2000, which was the highest amongst industrialized countries at that time, it remains the sixth highest, at 34.3 percent, and it will rise to 35 percent by 2009 after Quebec's tax changes come into effect. Reductions in corporate income tax have three distinct advantages over other policy actions. First, lowering the corporate income tax rate will spur investment by reducing the cost of capital for businesses. Second, the reduction in rates will benefit investments in all business activities and is therefore more neutral in application than selective measures. Third, since the current high corporate income tax encourage businesses to move their income from Canada to other jurisdictions, reductions in rates do not cost governments much revenue.[12] Given that the average corporate income tax rate is roughly 30

12 Studies of income shifting suggest that a one-point reduction in the corporate income tax rate enlarges the tax base by four to eight percent as businesses shift income into a jurisdiction by changing their financial and transfer pricing strategies. See Jog and Tang (2001) and Mintz and Smart (2004) for estimated effects for Canada. For example, a reduction in the corporate tax rate from 35 to 30 percent (a 14 percent cut) would increase the tax base by 18 percent using the Mintz-Smart result. This calculation suggests that corporate tax revenues paid by large companies would actually rise.

percent in industrialized economies (KPMG 2004), Canada could create a distinct advantage by reducing its rates to 25 percent (15 percent at the federal level and 10 percent on average at the provincial level). Provinces with different corporate tax rates for different business activities (resource or manufacturing income) should move to a uniform corporate income tax rate, as at the federal level. Furthermore, a general corporate income tax rate closer to the small-business rate of 20 percent would reduce the tax penalty on the growth of small businesses beyond the asset-size threshold of $10 million.[13]

Eliminating Provincial Capital Taxes: Whereas the federal government, Alberta and British Columbia have taken steps to eliminate capital taxes on corporations, there are still substantial capital taxes at the provincial level. Ontario, Quebec and Nova Scotia plan to reduce their capital taxes in the coming years, and all provinces should phase out their capital taxes by 2010.

Moving Capital Cost Allowances Closer to Economic Depreciation Rates: Evidence suggests that many assets are now depreciating in economic value more quickly than estimated in past studies, as discussed above. Asset values decline because of wear and tear, inflation and obsolescence as technology advances. Although in some cases, such as cars, economic deprecation rates have declined, in most categories they have risen. On average, economic depreciation rates have more than doubled for structures, increased by a half for machinery and tripled for engineering capital. In response to the need to encourage businesses to replace old technologies with new ones, the federal government has recently raised the capital cost allowances for computers, pipelines and electrical transmission lines. But further work is needed. Capital cost allowance rates should reflect the estimated useful life of an asset, but the rates should also reflect price increases in the replacement cost of assets (although these can be sheltered by interest expense deductions), and recognize the uncertainties inherent in the quality of assets and replacement costs.

Reducing or Eliminating Withholding Tax Rates: Since the mid-1990s, in a reversal of hundreds of years of history, Canada has become a capital-exporting nation. Many Canadian multinationals, finding the Canadian market too small, invest in other countries to grow their business. However, several tax policies, appropriate for a capital-importing country, are no longer in Canada's best interest. A good example of this is the withholding tax on dividends, interest and other income. Such taxes are barriers to cross-border investment. Canada is less attractive to foreign investors as a result, and, moreover, bilateral negotiations with other nations result in uncompetitive withholding taxes for Canadian businesses investing abroad.

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13 Although a strong justification can be given for reductions in corporate tax rates, a recurring concern is that foreign-owned business (e.g., U.S.-owned) would have fewer Canadian tax credits to claim against tax payments to their home country. Thus, reductions in Canadian corporate income tax payments could result in a transfer of revenue to a foreign country due to tax crediting arrangements. This concern is over-blown. First, foreign companies that reinvest profits in Canada will not be crediting their taxes against home liabilities. Second, foreign regimes usually provide opportunities for multinationals to average tax paid abroad so that they can adjust their credits to be equal to their home tax liability. Third, some countries, like Germany and Netherlands, do not tax qualifying foreign dividends received by multinationals.

Unlike Canada, other countries have negotiated more favourable withholding tax regimes for the benefit of their resident multinationals. In 1998 the Technical Committee on Business Taxation recommended the elimination of withholding taxes on all arm's-length interest to reduce borrowing costs in Canada; at present, only arm's length interest on indebtedness of more than five years is exempt from withholding tax. Recent negotiations with the United States could eliminate withholding taxes on non-arm's length interest. That would make Canada more attractive for investment, and improve the competitiveness of Canadian businesses, which are increasingly losing U.S. treaty benefits for investments in the U.S., such as lower U.S. withholding taxes on income paid to Canadian subsidiaries operating in third countries.

Eventually, Canada should follow the lead of Australia, which is making itself more attractive to capital by eliminating withholding taxes on dividends paid to foreign parents with at least 80 percent ownership in an Australian subsidiary. Other tax policies interfere with Canada as a capital exporting country. Unlike some other countries, Canada provides no basic exemption for personal taxes on business income — this especially deters limited-partnership investments in Canada from Europe. As another example, Ontario denies the full deductibility of certain payments to non-residents under its corporate income tax, which has led to some companies shifting their operations to other provinces or the U.S. Further, Canadian businesses that record their income in U.S. dollars or another currency (since most of their business is outside Canada) must calculate taxes in Canadian dollars. This leads to anomalous results where their profits may not shift due to currency changes but their taxes will rise or fall depending on appreciation or depreciation of the Canadian dollar. Australia, Netherlands and Ireland allow their multinationals to calculate tax in their currency used to calculate accounting profits — Canada should do the same.

Base-broadening Measures: Amid the general disadvantage that Canada creates for investment by taxing capital so heavily, measures that encourage capital investment of specific types or in specific sectors stand out all the more starkly. An economic case can be made for some deliberate preferences, such as for research and development and exploration (since businesses cannot fully capture the returns from investments that, in part, benefit their competitors), but many preferences do not pass this test. Instead, the federal and provincial governments should review their tax credits and other special provisions with a view to reducing tax rates broadly rather than offering selective relief. For example, we could consider eliminating provincial manufacturing investment tax credits and provincial tax holidays for small business, eliminating film tax credits and replacing flow-through shares with partial refundability of exploration and development deductions to the corporation. In some provinces, scaling down the over-generous research and development tax credits might be desirable, as would the removal of the distinction between large and small businesses, because the high research and development credit for small business encourages companies' breakup.

A neutral business tax structure with low, internationally competitive tax rates could do much to unleash the Canadian tiger.

Conclusions

Productivity and demographic change are two serious issues that will be facing the Canadian economy in the coming years. Canadians need to invest in capital in order to adopt new technologies and raise their standard of living. They also need to work and save as well as acquire greater lifetime resources by saving more and obtaining a higher yield on their investments.

This 2005 report on Canada's tax competitiveness highlights three conclusions. First, Canadian governments require over two-fifths of the economy's resources to fund their activities. Second, Canada taxes business capital investments more heavily than almost every country we compete with. This type of taxation is particularly harmful to economic growth. Third, with the clawback of income-tested benefits and earnings limitations for payroll taxes, the marginal effective tax rates on employment and investment income is well above 50 percent, and people with modest incomes are affected particularly harshly.

Next year, federal and provincial governments should introduce multi-year plans and budgets that will enhance Canada's competitiveness. We offer a list of recommendations that would improve our tax structure. Some recommendations such as the elimination of withholding taxes on interest and allowing Canadian companies to do their tax calculations in their reporting currency have significant benefits relative to foregone revenues. Others, such as reducing corporate income tax and dividend tax rates and matching capital cost allowances to economic depreciation, have some fiscal cost but would be quite beneficial to economic growth. On the personal side, focusing on the highest marginal tax rates on employment and investment income should be a high priority. We encourage governments to incorporate competitive, multi-year tax plans in their fiscal frameworks.

We hope that next year our report will show that governments are grappling with these urgent issues and that the leashes holding back the Canadian tiger are indeed loosening.

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