Intelligence MEMOS

From: William B.P. Robson and Alexandre Laurin

To: The Honourable Bill Morneau, Minister of Finance

Date: February 11, 2019

Re: **TAX RELIEF FOR THE 2019 FEDERAL BUDGET**

The C.D. Howe Institute's Shadow Federal Budget for 2019 last week aims to enhance Canada's competitiveness and dynamism, while setting the stage for a return to surpluses during the next Parliament. Today we examine the tax competitiveness challenge.

Canadians pay relatively high personal taxes due to a combination of relatively high rates and relatively low thresholds at which taxes become payable.

Meanwhile, lower corporate income tax rates in other developed countries, and big changes in the United States, have eroded a long-standing Canadian advantage in business taxation. This Shadow Budget address both challenges.

Personal Taxation

Since 2010, provincial governments have raised their tax rates on higher-income earners, and the federal government did the same after 2015. The combined federal/provincial top tax rate is currently close to 50 percent – a threshold typically seen as psychologically, and perhaps economically, important – in the three western provinces and more than 50 percent in the other seven.

High-income taxpayers can respond to tax-rate increases by converting their income to different, lower-taxed forms and by realizing that income at different times and in different jurisdictions. These responses shrink the tax base and reduce tax receipts.

Longer term, heavy taxes on high earners depress entrepreneurial activity and private investment. Excessively taxing the talent that fuels a more innovative, creative and successful economy is counterproductive. This Shadow Budget would reduce the number of people subject to the highest tax rate by doubling the threshold at which it applies from the current $205,842 to $411,684.

The net cost to the federal budget would be relatively small in the short term, since taxpayers will respond by earning, and reporting, more taxable income. The positive responses to the lower rates would expand the tax base not just for the federal government, but also for provincial governments – who need the revenue more than Ottawa does, and who will otherwise come begging for more federal transfers.

Corporate Income Tax

Taxes influence the location of economic activity and profits of multinational corporations. The large tax-rate differential that existed between the United States and Canada prior to the recent 14 percentage-point US rate reduction likely induced multinational firms to realize more of their profits in Canada than they would have otherwise. Differences in average effective tax rates also drive location decisions with respect to new corporate investment. And the marginal effective tax rate on new investments affects capital spending – which lately in Canada has been disturbingly weak.

This Shadow Budget would initiate a comprehensive review of the tax system to identify the best way to remove human and capital investment disincentives while respecting the tax principles of equity, efficiency and adequate revenue yield. While the review is underway, this Shadow Budget would reduce the corporate income tax rate by two percentage points, from 15 percent to 13 percent, effective immediately. This change would provide immediate additional locational incentives for investments and profits in Canada, while we wait for the review to bear fruit.

In the long run, more growth-friendly personal and business taxes will expand the tax base – Canadians and their fiscally challenged governments will both be better off.

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