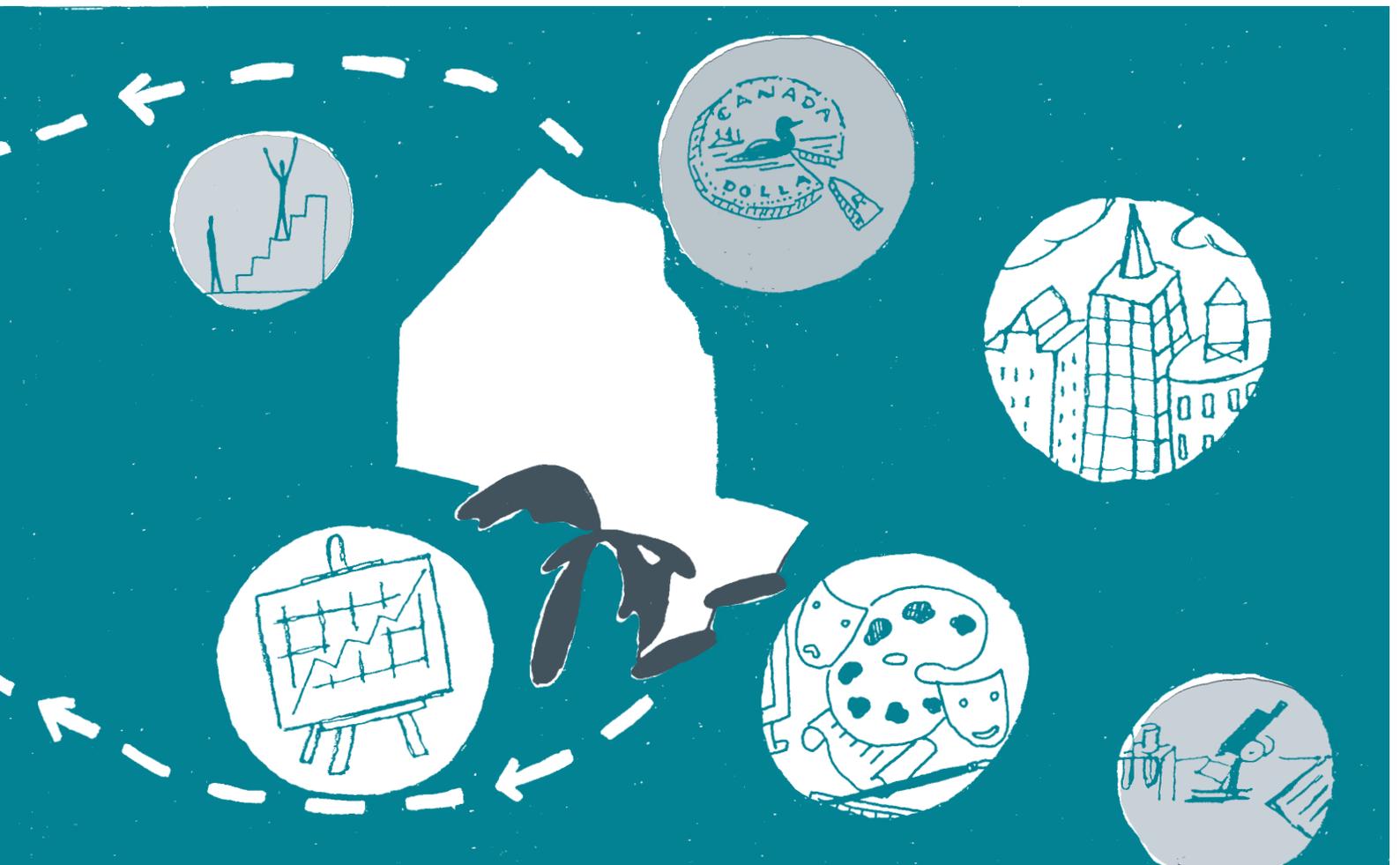


Taxing smarter for prosperity

The Institute for Competitiveness & Prosperity
Working Paper 7
March 2005



The Institute for Competitiveness & Prosperity is an independent not-for-profit organization established in 2001 to serve as the research arm of Ontario's Task Force on Competitiveness, Productivity, and Economic Progress.

Working papers published by the Institute are primarily intended to inform the work of the Task Force. In addition, they are designed to raise public awareness and stimulate debate on a range of issues related to competitiveness and prosperity.

The mandate of the Task Force, announced in the April 2001 Speech from the Throne, is to measure and monitor Ontario's competitiveness, productivity, and economic progress compared to other provinces and US states and to report to the public on a regular basis. In the 2004 Budget, the Government asked the Task Force to incorporate innovation and commercialization issues in its mandate.

It is the aspiration of the Task Force to have a significant influence in increasing Ontario's competitiveness, productivity, and capacity for innovation. The Task Force believes this will help ensure continued success in the creation of good jobs, increased prosperity, and a higher quality of life for all Ontarians. The Task Force seeks breakthrough findings from their research and proposes significant innovations in public policy to stimulate businesses, governments, and educational institutions to take action.

The Task Force published its First Annual Report to the people of Ontario, *Closing the prosperity gap*, in November 2002. The Second Annual Report, *Investing for prosperity*, was published in November 2003. The Third Annual Report, *Realizing our prosperity potential*, was published in November 2004.

Comments on this working paper are welcome and should be directed to the Institute for Competitiveness & Prosperity.

The Institute for Competitiveness & Prosperity is funded by the Government of Ontario through the Ministry of Economic Development and Trade.



Taxing smarter
for prosperity

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Foreword and acknowledgements



I am pleased to present the seventh working paper of the Institute for Competitiveness & Prosperity in support of the Task Force on Competitiveness, Productivity, and Economic Progress.

In this working paper, we turn our attention to the *motivations* factor in the AIMS framework we apply to understand our capacity for innovation and upgrading. We use this framework to assess *attitudes* towards competitiveness, growth, creativity, and global excellence; *investments* in human and physical capital; *motivations* for hiring, working, and upgrading as a result of tax and fiscal policies; and *structures* of markets and institutions that encourage and assist upgrading and innovation. While many forces beyond taxation are at play in determining Ontario's prosperity, our work shows that we can and should tax "smarter" to help close the productivity gap that is hindering our economic growth. This working paper focuses on the tax burdens and tax mix in our taxation system; it is not about levels of taxation or government expenditure.

Smart taxation equitably and efficiently raises the tax revenue necessary to fund the public services and infrastructure that Ontarians value. Smart taxation limits the disincentives that individuals face in participating in productive economic activities and that businesses face in considering investment.

Our research and modeling suggest two broad themes for taxing smarter to enhance Ontario's competitiveness and prosperity. On the business side, we should avoid taxing productivity-enhancing investment. To do this, we should consider eliminating the capital tax and sales taxation of capital investment. We should also explore breakthrough options such as a shift to cash flow taxation – or even the elimination of corporate income taxation altogether. Revenue lost through these measures could be replaced by higher consumption taxes, in particular a provincial value-added tax that is harmonized with the federal GST. On the personal side, we need to focus on removing the perversely high marginal tax burdens on those with lower incomes. To do this, we should consider several options, including the breakthrough options of focusing taxation on consumption instead of earnings and investment or of taxing personal income on the basis of lifetime earnings rather than one-year slices.

A smart tax system will promote job creation, higher investments in physical and capital resources, increased innovation, and the adoption of new technologies. This environment will enhance future economic growth, laying the foundation for a dynamic and prosperous economy and the strong government financial position necessary to fund the quality public services and infrastructure that the people of Ontario value.

We gratefully acknowledge the funding support from the Ontario Ministry of Economic Development and Trade.

We look forward to sharing and discussing our work and our findings. We welcome your comments and suggestions.

Roger L. Martin, *Chairman*
Institute for Competitiveness & Prosperity

A collage of various items including a hand holding a pen, a dollar coin, a pencil, a ruler, and a calculator.

Executive summary

Taxing smarter for prosperity

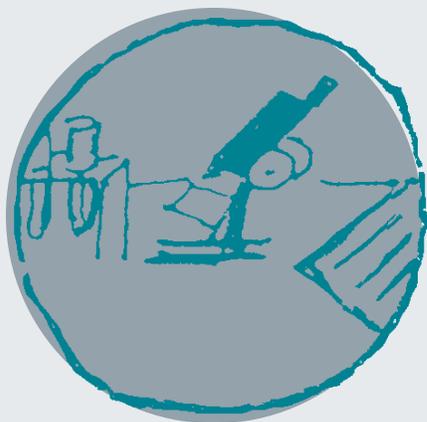
Since 2001, the Institute for Competitiveness & Prosperity has been exploring opportunities for strengthening Ontario's competitiveness and prosperity. We have identified a significant prosperity gap with a peer group of large US states and have concluded that most of this gap currently stems from our lower productivity. To help us understand the factors behind our capacity for innovation and upgrading, we developed the integrated AIMS framework:

- **Attitudes** towards competitiveness, growth, creativity, and global excellence
- **Investments** in human and physical capital
- **Motivations** for hiring, working, and upgrading as a result of tax policies and government fiscal policies and programs
- **Structures** of markets and institutions that encourage and assist upgrading and innovation.

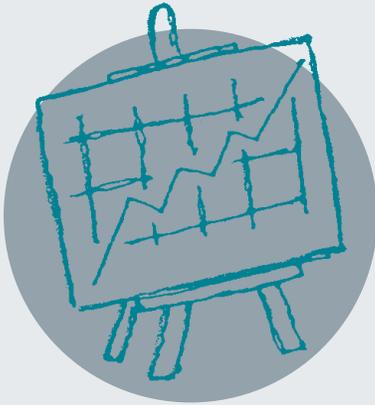
These four factors drive our prosperity in an interrelated circle that can be virtuous – or sometimes vicious.

In this working paper, we turn our attention to the *motivations* factor in the AIMS framework, which addresses the impact of taxes, regulations, and government transfer programs, such as employment insurance and social assistance, on economic activity.

By taxing smarter, we can improve the way our governments raise money without sacrificing their ability to provide the public services and infrastructure that Ontarians value. Smart taxation can enhance the standard of living of all individuals and families in Ontario.



Smart tax policy achieves equity and efficiency in raising the required government revenues and in driving economic prosperity



Governments face a balancing act. They need to make the appropriate expenditures for Ontario's quality of life and its business environment. They also need to ensure that the necessary taxes for these expenditures are not unduly hindering motivations to work, invest, and engage in entrepreneurial activity.

Achieving the right balance requires smart taxation. Ontario's taxation system is not as smart as it could and should be.

A smart tax system is *equitable*, raising revenue in a transparent manner from those most able to afford it, and *efficient*, limiting the negative impact of taxes on decisions to engage in productive economic activities.

Our review of the research and recent work done by the federal Department of Finance indicates that the smart way to stimulate prosperity through tax policy is to shift taxation away from capital investment towards consumption. Higher levels of capital investment would increase productivity and wages.

In Ontario, we have dramatically higher marginal effective tax burdens than in the peer states. This may be unavoidable given our choice for a relatively larger government role. But higher tax jurisdictions, such as Sweden, have smarter taxation with a relatively low burden on investment and a relatively high burden on consumption. Australia, which is closer to Canada in tax burden, has embarked on an impressive path to smarter taxation.

Smart taxation is not about choosing other values. It is about efficiently and equitably raising the funds for the public services and infrastructure that Ontarians value. Currently, our tax burdens are higher than those in the United States and our mix is not as smart as Sweden's.

Ontario has many options for smarter taxation of business and individuals to increase equity and efficiency – and investment in our long-term prosperity

One key taxation challenge is to motivate productivity-enhancing investments by businesses. We identify improvement opportunities within the current system before putting forward a proposal for fundamental change – the elimination of corporate income taxes altogether.

Eliminate the corporate capital tax. This tax on existing business capital is particularly damaging to investment because it is levied even if the business is not profitable. Few other advanced economies levy business capital taxes. Capital taxes are the most important reason why the marginal effective tax rate on capital in Ontario and Canada is greater than in the United States.

Reform Ontario's sales taxes on capital goods. While most people regard the provincial sales tax (PST) as a retail tax aimed at personal consumption, it also applies to items for capital investment – such as steel, machinery, and computers. These taxes raise overall prices to businesses making capital investments and can affect their decisions to invest or when to invest. The province could allow businesses to recover the sales tax paid on investments by claiming input tax credits. Converting the PST into a broad-based value-added tax covering goods and services would be even better.

Rethink the approach to capital cost allowance. While accelerated depreciation in the United States is an important factor in its tax advantage over Ontario, increasing rates is not necessarily smart taxation. Rather than copying the US approach with a temporary acceleration of the capital cost allowance, a smarter approach is to switch from accounting based corporate taxation to a cash flow based system. With a cash flow tax, a firm's taxes essentially would be based on its cash receipts less its cash expendi-

tures; in years when a large capital expenditure was made relative to sales revenue, taxes paid would be relatively low.

Reduce variability in tax approaches to different business types. Besides having relatively high rates in international comparisons, our corporate tax structure suffers from too much variability in its treatment of firms based on size and industry. This distorts investment decisions and lowers our economic performance. A smart tax system should aim to eliminate such tax rate differentials.

Consider eliminating corporate income taxes. However beneficial each of the foregoing measures would be, eliminating the corporate income tax could be a much more innovative approach to increasing productivity and prosperity. Governments in Canada should explore this fundamental shift to a potentially smarter tax system.

A corporation's taxes are actually paid by its workers whose wages are lower than they would otherwise be; by its customers who must pay higher prices; and by its stockholders, including individuals' pension funds and mutual funds in their RRSPs. Eliminating corporate income taxes has the potential to enhance prosperity by increasing wages, lowering prices, and increasing investment returns.

This is an unconventional solution and further research is required to assess the long-term impact on tax revenues, earnings repatriation by foreign companies, and other issues. But we encourage the Ontario and federal governments to examine this approach further.

Our other taxation challenge is to lower perversely high marginal tax rates for individual Canadians. A major weakness of

our personal tax and benefit system is the high marginal tax rates it imposes on individuals and families trying to scale the economic ladder or retire comfortably. In addition to statutory income tax rates, the marginal effective tax rate – the tax rate on the last dollar of income – is determined by tax credits and income-tested government transfers. Because of clawbacks of social benefits, the marginal rate can be very high at relatively low income levels.

Thus, while benefit programs provide valuable assistance to low-income families, an unintended consequence of clawbacks is that families progressing towards higher income levels can face a dramatically higher marginal tax rates. A single earner family of four faces a marginal effective tax rate of 60 percent on income increases shortly after they pass \$31,000 in taxable income. In other words, these families are keeping only 40 cents of each new dollar they earn because of clawbacks. At \$36,000 the marginal rate climbs to an absurd 90 percent.

Seniors also face high marginal rates, exceeding 70 percent at employment earnings between about \$4,800 and \$9,100 – largely because of the stiff clawback rates to the Guaranteed Income Supplement and Spouse Allowance.

Any progressive tax and benefit system will have the feature of high marginal tax burdens at certain points of the income scale. The problem in Ontario is that our system is characterized by plateaus not by spikes. Lower-income Ontarians face the highest marginal effective tax burdens. We see several smart ways to redress this inequity.

Smooth marginal effective tax rates. The province can smooth the high marginal tax rates by closer integration of the tax and transfer systems to reduce the adverse incentives to persons at work-force entry levels. Reform would require federal and provincial cooperation and possibly consideration of significant changes to tax credits and social assistance programs.

Reduce the basic personal allowance and marginal rates. Currently, any income below the Basic Personal Allowance (BPA) is exempt from federal and provincial income tax. But the BPA benefits all taxpayers, not just low-income earners. Consequently, marginal tax rates are higher than they need to be as governments must replace the tax revenue lost by the BPA. A better approach would be to lower – or scrap – the BPA, find more efficient ways to help low-income earners, and reduce marginal tax rates on all other taxpayers. Thus income earners would face lower tax rates not on the first dollar they earn, but on the last dollar where most make decisions on how much more to work or to save and invest.

Reduce taxation on savings and personal investment income. The tax and clawback system affects seniors with low levels of employment income most. Reform is needed to promote savings, investment, and provide relief to low-income seniors. One option is to expand programs such as registered retirement savings plans (RRSPs) even further – possibly eliminating contribution limits.

However, this is not the best option for all individuals because withdrawals from RRSP accounts are taxable, triggering clawbacks of income-tested transfer programs for seniors. Instead, some argue that Canada should introduce a “tax-prepaid” option for individuals. In a tax pre-paid system, savings would not be deductible for tax purposes; but returns and withdrawals later in life would not be taxed.

These options would be positive steps in making our taxation of individuals smarter. But we think Ontarians and Canadians should also consider two breakthrough proposals: switching to consumption-based taxation through a higher GST or basing personal taxation on lifetime, not annual, earnings.

Tax consumption, not investment or earnings. Many tax experts point out that if the goal is to have more savings, investment, and work incentives, then governments should lower or eliminate the taxes on these activities. To replace lost revenue, they should focus taxation on consumption. Ultimately, individuals work and invest to generate income for consuming goods and services – so tax revenue opportunities will not be lost.

One approach, drawn from experience in many other countries, is to convert Ontario’s PST to a value-added tax. We could also harmonize the PST with the federal GST. Some are concerned that the GST is regressive but there are others who contend this criticism is misplaced. And there are opportunities to provide tax relief to lower income Canadians.

Base personal taxation on lifetime earnings. Our system currently taxes individuals on the basis of one-year slices of their life. Assessing income taxes on the basis of lifetime earnings, rather than annual earnings is potentially far better for Canada’s poor and enhances prosperity for all Canadians.

Our current system gives all taxpayers in Canada an annual basic personal exemption and taxes income above that at progressively higher rates. A lifetime approach would give each Canadian a lifetime exemption instead of an annual basic personal exemption. This exemption would be the equivalent of five to ten years’ of average income – say \$250,000. Any income beyond this would be taxed at a base rate until the next cumulative income level is reached when rates would rise again,

and so on. The exact rates and ranges would have to be massaged to achieve tax neutrality.

With a system based on lifetime earnings, poor Canadians would be dramatically better off and have better prospects for advancement. For years, even decades for lower wage earners, they would face a zero marginal tax on work, savings, and investment and they would have greater incentive and greater capacity to grow out of poverty. And even when their lifetime tax exemption is used up, they would face a lower marginal rate than currently because the marginal tax rate would fall for all Canadians. Taxation of lifetime earnings would also make Canada a tax-attractive place for young Canadians.

This can work because the elimination of the annual basic personal exemption would save the federal tax revenue that is currently forgone because of the BPA. These savings can be applied to lowering the marginal tax rates for all and improving the prospects of the most needy. A critical element of lifetime earnings approach is to disentangle social benefits from the tax system so that we provide assistance to those in need without complicating the income tax system and creating perversely high marginal tax rates for low-income people.

A lifetime earnings system represents a significant departure from the current taxation regime and a workable implementation plan will be complex. But we should not be deterred and simply accept the current counter-productive, complicated, and confusing system.

Governments should consider all options for smart taxation that will increase equity and efficiency. They should not shy away from exploring breakthrough approaches. These reforms may be complex to implement but merit further investigation because of their potential to contribute to higher prosperity for all.

Smarter taxes are possible and affordable and governments should begin the reform process now

We engaged the Centre for Spatial Economics (C4SE) to model the economic impact of various tax reforms that drive towards smarter taxation. The analysis confirms the benefits of specific tax reforms, especially in shifting taxation from investment to consumption.

The results point to reforming the province's approach to retail sales taxes as the best option for enhancing competitiveness and prosperity in the short and medium terms. Eliminating the provincial corporate capital tax is the next most beneficial option. Finally, some changes to the provincial corporate and personal income taxes would have some positive benefits.

Some of the reforms we are recommending are highly innovative and are difficult to model – so we are unable at this time to quantify the benefits and costs of these proposals relative to the other reforms that can be implemented more easily. Still, we believe that it would be beneficial to investigate further breakthrough changes to eliminate the corporate income tax and to take a lifetime earnings approach to personal income tax.

There will be costs to any significant tax reform undertaken in Ontario (except for the option of harmonizing the PST with the GST at a rate between 7 and 8 percent). We believe, however, that the costs of tax reform are affordable, if Ontario reduces its use of business subsidies and preferential tax treatment.

Two broad themes point the way to smarter taxation

Many forces are at play in the determination of our standard of living and quality of life: investments in public services and infrastructure, the quality of the environment, the rule of law, international trade, and the quality of the labour force. However, as this working paper makes clear, much can, and should, be done to improve our tax structure.

Our work suggests two broad themes for taxing smarter to enhance Ontario's competitiveness and prosperity:

- On the business side, we should shift away from taxing productivity-enhancing investments through measures such as elimination of the capital tax and sales taxation of capital investment and even breakthrough options such as cash flow taxation or the elimination of corporate taxation. Revenue lost through these measures could be replaced by a provincial value-added tax that is harmonized with the federal GST.
- On the personal side, our focus needs to be on removing the perversely high marginal tax burdens on those with lower incomes. To do this, we should consider several options to fix this, including the breakthrough option of taxing lifetime earnings.

A shift to a smart tax structure will promote job creation, higher investments in physical and capital, innovation, and the adoption of new technologies. This environment will enhance future economic growth, laying the foundation for a dynamic and prosperous economy and the strong government financial position necessary to fund the quality public services and infrastructure that the people of Ontario value.





Taxing smarter
for prosperity

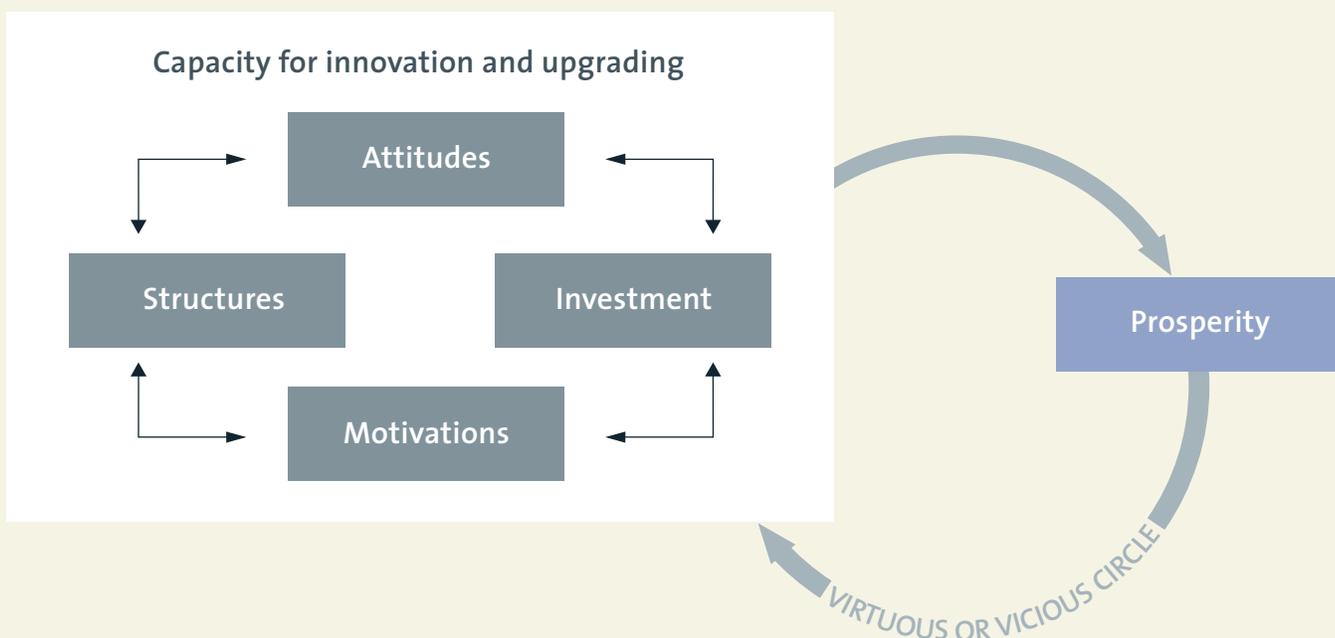
Ontarians need a “smarter” tax system that will raise the money required to pay for the public services and infrastructure they value and to enhance their prosperity

Since 2001, the Institute for Competitiveness & Prosperity has been exploring opportunities for strengthening Ontario’s competitiveness and prosperity. We have identified a significant prosperity gap with a peer group of large US states and have concluded that most of this gap currently stems from our lower productivity. Ontarians are not adding equivalent value to the human, natural, and physical resources in the province. To raise our productivity, we need to strengthen our capacity for innovation and upgrading until we catch up to our peers. That way, each Ontarian will enjoy a more prosperous life.

To help us understand the factors behind our capacity for innovation and upgrading we developed the integrated AIMS framework (Exhibit 1):

- **Attitudes** towards competitiveness, growth, creativity, and global excellence
- **Investments** in human and physical capital
- **Motivations** for hiring, working, and upgrading as a result of tax policies and government fiscal policies and programs
- **Structures** of markets and institutions that encourage and assist upgrading and innovation.

Exhibit 1 AIMS drives prosperity; Prosperity drives AIMS



These four factors drive our prosperity in an interrelated circle that can be virtuous – or sometimes vicious.

Our previous work¹ using the AIMS framework indicates that *under investment* in post-secondary education, machinery, equipment, and software and in processes for integrating immigrants into our economy is a key driver of our prosperity and productivity gaps. Our surveys and research indicate that Ontarians' *attitudes* in areas like risk taking, innovation, and the need for hard work are very similar to those held by our counterparts in the peer states.² We have explored governance and market *structures*, concluding that our most important challenge with them is to strengthen specialized support and competitive pressure in our clusters of traded industries.³

In this working paper, we turn our attention to the *motivations* factor in the AIMS framework, which addresses the impact of taxes, regulations, and government transfer programs, such as employment insurance and social assistance, on economic activity.

At the same time, as our AIMS framework indicates, we recognize that the tax system is not the only determinant of a region's prosperity. Investments in public services and infrastructure, the quality of the environment, market structures, international trade, the quality of the labour force, and a host of other variables all interact to influence the decisions by individuals and families to work, invest, and make their home in a region. Nevertheless, we think that smarter taxation can contribute to closing the productivity gap that is hindering our economic growth. It is important to note here that the peer states with the highest prosperity are not the ones with distinctly lower taxation and public expenditures.

Specifically, this working paper deals with the motivational impact of the tax system on important economic decisions. We explore opportunities to tax smarter in Ontario – and Canada – to:

- Encourage business investment by reforming our individual and corporate tax systems so that our industries and workers are more productive and Ontarians are more prosperous.
- Eliminate disincentives to work by dismantling barriers that have been erected in our personal tax system, with a special emphasis on the punishing marginal effective tax rates faced by low-income Ontarians.

We believe that taxing smarter can benefit all those who live and work in Ontario, and that there is much that can be done to change the system. For example, Ontario can improve its tax system by lowering taxes on investment, generally thought to be more damaging to economic growth than other forms of taxation. The province can reform the provincial sales tax into a broad-based consumption tax on both goods and services. In concert with the federal government, it can also reform the tax rates and the clawbacks of government income-support programs for low-income families and seniors. Additionally, reform requires that governments curb tax expenditures, such as preferential tax credits and tax rates and business subsidies.

By taxing smarter, we can improve the way our governments raise money without sacrificing their ability to provide the public services and infrastructure that Ontarians value. Smart taxation can enhance the standard of living of all individuals and families in Ontario.

¹ Task Force on Competitiveness, Productivity, and Economic Progress (2003), Second Annual Report *Investing for prosperity*.

² Institute for Competitiveness & Prosperity (2003), Working Paper 4 *Striking similarities: Attitudes and Ontario's prosperity gap*.

³ *Ibid.* (2004), Working Paper 5 *Strengthening structures: Upgrading specialized support and competitive pressure*.

Smart tax policy



Smart tax policy achieves equity and efficiency in raising the required government revenues and in driving economic prosperity

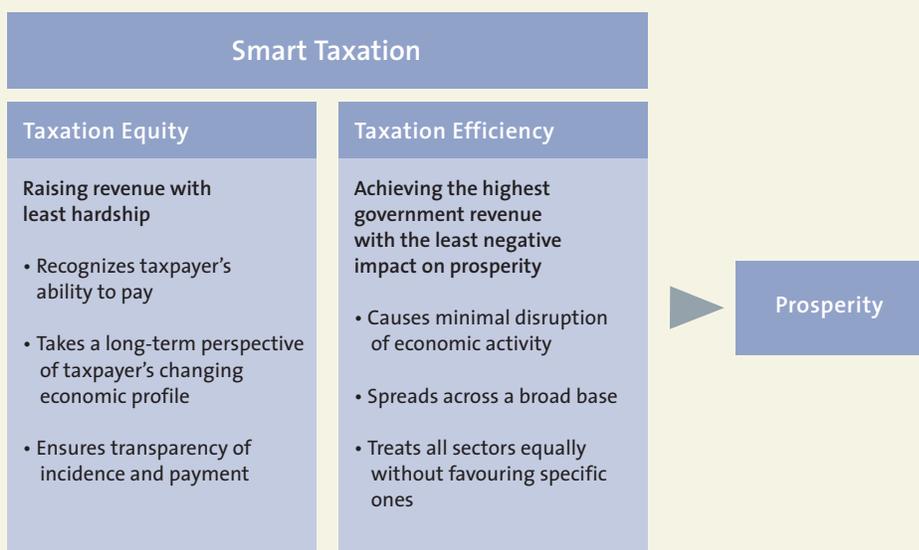
Governments face the ongoing challenge of balancing expenditures and taxes. They must ensure that Ontario is attractive to businesses and investors. They must also guarantee that individuals and families receive the appropriate level and quality of public services.

Governments need to create the fiscal environment for competitiveness and prosperity. Government expenditures in areas such as infrastructure, social programs, health care, and education are important investments in our current quality of life and our future prosperity. These expenditures also reduce the cost of doing business, since governments provide many fundamental business requirements and relieve individuals and businesses from making such expenditures.

At the same time, taxes that are necessary to fund these expenditures can hinder motivations to work, invest, and engage in entrepreneurial activity. By altering the rate of return on business, taxes affect the willingness of firms to hire additional workers, locate in Ontario, and invest in additional capital, such as machinery, equipment, and software. Additionally, by altering the rate of return on work effort, taxes affect the willingness of individuals to enter the work force, work additional hours, and invest in themselves through education and training.

Achieving the right balance requires smart taxation. Currently, Ontario has a taxation system that is not as smart as it could and should be.

Exhibit 2 Smart taxation requires equity and efficiency



Source: Institute for Competitiveness & Prosperity.

A smart tax system is equitable and efficient

Taxes are levied on many activities, including consumption, labour income, and investment income. A smart tax system – including the whole array of tax burdens, tax rates, and tax mix – creates a positive environment for individuals and businesses to work, save, and invest. A smart tax system encourages economic prosperity by not unduly preventing resources from being allocated to their most productive use.⁴ A smart tax system is equitable and efficient (Exhibit 2).

A smart tax system is **equitable** – raising revenue from those most able to afford it and where it is least likely to impose hardship. While the concept of equity or fairness can mean different things to different people, it typically implies a progressive tax system in which people with lower economic resources pay a smaller percentage of their income in taxes than do higher income people. It is also important to take a longer-term perspective. Most of us begin our working lives with much lower income and wealth than we have later in life. Consequently, bearing a lower burden of taxation in these leaner years is balanced by a higher burden in more prosperous years. Part of equity is transparency. As much as possible, people should see the taxes they are paying. Taxes that get buried in purchase prices or are passed on through lower wages undermine equity.

A smart tax system is also **efficient** – limiting the negative impact that taxes can have on decisions to engage in productive economic activities. Governments should limit the use of taxation as a vehicle for stimulating specific sectors of the economy; instead, efficient taxation should be based on as broad a set of activities as possible. In 2004, the Panel on the Role of Government in Ontario concluded that efficiency could be achieved by: setting tax rates as low and uniform as consistent with revenue requirements; implementing as broad a tax base as possible in all fields; and relying on a tax mix that depends more on taxes on consumption relative to taxes on investment.⁵

While beyond the scope of this working paper, efficiency also includes minimizing the costs and disruption of collecting taxes. The Ontario government, for example, recently indicated its intention to collaborate more closely with the federal government to design a single corporate income tax collection and processing system.

Governments must sometimes trade off equity against efficiency. Some taxes are very efficient but may not be equitable. And taxes can be both inequitable and inefficient. Different tax burdens, tax rates, and tax mixes can reduce incentives to work, save, invest in both physical and human capital, to take risks, and to engage in entrepreneurial activities. For example, high personal income tax rates can encourage emigration of some workers, especially the highly skilled, and high marginal rates on labour income may discourage work effort and savings while encouraging tax avoidance.⁶

Similarly, relatively high taxes on investment create incentives for firms to invest elsewhere by locating in low-tax jurisdictions or by shifting income to low-tax jurisdictions through transfer pricing, financial transactions, and leasing arrangements.⁷

Although all taxes can have a negative impact on prosperity, some are more damaging than others. Smart taxation involves finding the mix of taxes that is borne by those most able to afford them and that has the least negative impact on economic growth per dollar of revenue raised. By achieving this balance, smart taxation minimizes the negative impact taxes can have on economic growth and raises required government revenues with the lowest possible tax rates.

Some taxes are more equitable and efficient than others

Different tax mixes lead to different benefits and costs to Canadians.⁸ Recent research by the federal Department of Finance assessed many of the leading sources of tax revenue, estimating the benefit or cost to Canadians if the tax were reduced or increased. The Department produced a ranking of tax types based on the benefits for each tax reduction. In this analysis, the revenue lost from a specific tax reduction is replaced by a general tax spread evenly across all Canadians.⁹

⁴ See Harvey S. Rosen *et al.* (1999) "Public Finance in Canada" (McGraw-Hill Ryerson); Jack M. Mintz and Finn Poschmann (1999) "Tax Reform, Tax Reduction: The Missing Framework," C.D. Howe Institute Commentary No. 121.

⁵ Richard Bird and Thomas A. Wilson (2003) "A Tax Strategy for Ontario" Research Paper No. 32, Panel on the Role of Government in Ontario; Jack Mintz and William Robson (2003) "Ontario's Future Prosperity: Issues, Challenges and Recommendations" Research Paper No. 7, Panel on the Role of Government in Ontario; Jack Mintz and Thomas A. Wilson (2004) "Assessing Expenditure and Tax Reform Measures: A Review" Research Paper No. 50, Panel on the Role of Government in Ontario.

⁶ Bird and Wilson (2003); Richard Bird and Michael Smart (2001) "Tax policy and Tax Research in Canada" in *The State of Economics in Canada: Festschrift in Honour of David Slater*, (John Deutsch Institute and the Centre for the Study of Living Standards).

⁷ Duanjie Chen and Jack Mintz (2003) "Assessing Ontario's Fiscal Competitiveness" Report prepared for the Institute for Competitiveness & Prosperity.

⁸ Canada, Department of Finance (2004) "Taxation and Economic Efficiency: Results from a General Equilibrium Analysis" in *Tax Expenditures and Evaluations*. For further detail, see Maximilian Baylor and Louis Beauséjour (2004) "Taxation and Economic Efficiency: Results from a Canadian CGE Model" Canada, Department of Finance Working Paper.

⁹ A neutral tax is a tax that does not alter incentives to save, work, or invest. An example of a neutral tax is a 'lump-sum' tax, a specific amount that is paid per person. This lump-sum approach is used in the modeling exercise for analytical purposes only to compare the welfare effects of specific taxes. It is not proposing the adoption of a lump-sum tax.

To measure the benefit of each tax, the Department used a measure referred to as “economic well-being.” This measure captures the increased potential for consumption or leisure from replacing a specific tax with other taxes. As the tax system becomes more efficient, Canadians have more disposable income so they can consume more goods and services or increase their leisure time – by working fewer hours – while maintaining their consumption levels.

The Department’s ranking shows the benefit for each dollar of tax reduction. For example, a one dollar reduction in personal income taxes paid would result in a 30 cent increase in economic well-being for the average Canadian (Exhibit 3). This is a net benefit, since the analysis accounts for raising the lost revenue in other ways.

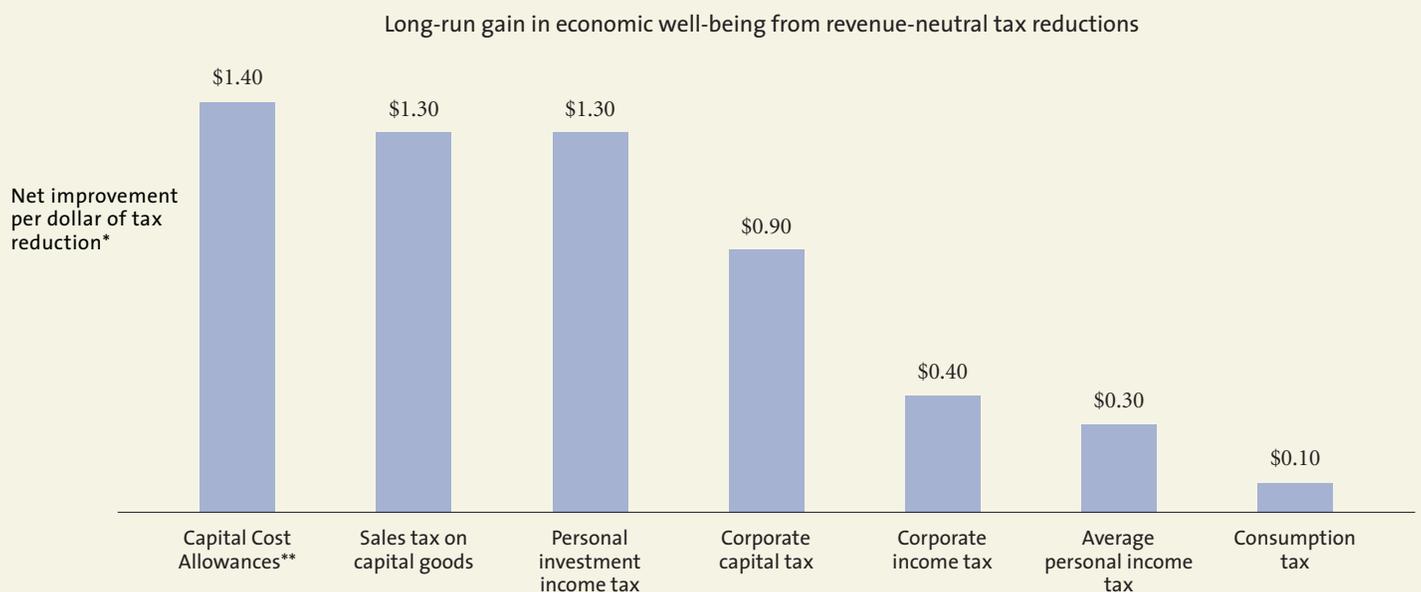
The rankings show that the greatest impact on the economic lives of ordinary Canadians comes from reductions in taxes paid by corporations on their investments – the sales taxes on capital goods and the capital cost allowances. In fact, the most positive impact would come from **increasing the speed at which corporations can write off their investments in new capital** through the capital cost allowance. This would increase capital investment which in turn would improve prosperity.

When businesses invest in an asset that lasts longer than a year, they account for the cost of the asset over its useful life. Instead of counting the cost of the investment in the year it is made, they spread the accounting of the cost over this useful life. Each year as they measure their profits, they include this “depreciation” in their costs. So, for example, if a business invests

in a machine that will last ten years, it does not include the full cost of the machine that year when it calculates its net profit; it takes one-tenth of the investment cost and does that for ten years.

For a variety of reasons, the rules for depreciating capital investments are different for taxation than for normal business accounting. Both federal and provincial governments prescribe the depreciation rates businesses can use on specific types of assets. The Department’s analysis finds that, if business were allowed to depreciate faster¹⁰ – spreading the asset costs over a shorter period and getting the tax benefits of the investment sooner – the average Canadian would be better off by \$1.40 for every dollar of tax revenue lost (and replaced with a general tax) because of faster depreciation.

Exhibit 3 Taxes on consumption are more efficient than taxes on investment



*The revenue losses from reductions in specific taxes are matched through an increase in lump-sum taxation.

**The economic well-being gain for Capital Cost Allowances represents the gain from increasing the Capital Cost Allowance.

Source: Canada, Department of Finance (2004), “Taxation and Economic Efficiency: Results from a General Equilibrium Analysis” in *Tax Expenditures and Evaluations*.

¹⁰ The Department’s analysis focuses on new capital; it does not measure the impact of faster depreciation on existing capital.

Why is this? Businesses would have greater incentives to invest in machinery and equipment, since the cost of investment would be reduced. This cost reduction comes about from the time value of money. Businesses would, in turn, improve the productivity of their workers, since more modern capital equipment and software make workers more productive. This higher productivity would translate into higher wages, which in turn would increase the amount of goods and services Canadians could consume or enable Canadians to work less and have more leisure. One feature of this tax change is that its cost to government treasuries is minimal. Faster depreciation does not reduce the amount of taxes ultimately paid by corporations; it simply reduces taxes in the early years of an asset's life and increases them by the same amount in the later years.

The next most beneficial tax reduction is to lower the **sales tax on capital goods**. Provincial sales taxes are imposed on nearly all purchases made by individuals and by businesses. All of us in Ontario are familiar with the 8 percent provincial tax added to our purchases. But what most fail to realize is that this tax is charged to businesses when they purchase machinery, equipment, and software and also when they build new structures. This raises the cost of new investment and reduces the incentive for businesses to make productivity-enhancing investments. The Department's analysis indicates that for every dollar governments reduced sales taxes on capital goods (and replaced this dollar with a general tax), the economic well-being of ordinary Canadians would improve by \$1.30. The logic is similar to the discussion on capital cost allowances. More investment in machinery, equipment, and software means higher worker productivity and higher wages. Higher wages improve Canadians' welfare through greater consumption or more leisure.

The next most beneficial tax reduction is in the area of **personal taxes on interest, dividends, and capital gains**. By reducing the taxes on the returns that individuals earn from stocks, bonds, and other investments, these returns increase. Consequently, more Canadians will save, and this added pool of funds will be available to businesses for increasing investments to grow their businesses and improve the average Canadian's economic well-being. A key assumption is that these higher savings will be invested in Canada, since Canadians invest 80 percent of their wealth in Canada.

Reductions in the **corporate capital tax** provide the next level of benefit. Canadian businesses pay taxes on the assets that are in the business. It is difficult to find proponents of this form of taxation. For one thing, it is yet another tax that reduces incentives for capital investment; more important, it is a tax that must be paid whether or not a business is profitable or whether or not the asset is even in use. Both the federal and provincial governments are phasing out their capital taxes by 2008 and 2012 respectively. The Department's analysis indicates that for every dollar cut (and replaced with a general tax), the positive benefit to economic well-being would be 90 cents.¹¹

The next most beneficial change would be to reduce the statutory rate of **corporate income tax**. This increases economic well-being by promoting business investment resulting from increased after tax returns to capital. Greater business investment increases worker productivity – which increases wages – and expands the number of jobs. According to the Department of Finance, the benefits from a cut in corporate income taxes may be under stated as their analysis does not capture the effects of multinational firms rearranging their tax reporting so that more profits would be “booked” in Canada. While economic activity

would not increase as a result of shifting reported earnings, tax revenues would increase. Consequently, the impact on lost tax revenue may be over stated – and the benefit therefore under stated.

A reduction in average **personal income tax**¹² would generate 30 cents of welfare gain for every dollar of tax replaced. In this case, some Canadians would find it advantageous to work more hours, as the tax on their income drops. This extra work effort would increase overall GDP and improve average economic well-being. Other Canadians would continue to work the same hours they are now and have more take-home pay at their disposal. Still others would find they could reduce their work effort.¹³ The net effect of these factors, according to the Department, would be 30 cents per dollar of reduced personal income taxes (replaced by other taxation).

Finally a reduction in **consumption taxes** – the federal GST and provincial retail sales taxes (that is, the portion paid by individuals, not businesses) – would have the lowest impact on economic well-being; the net benefit is 10 cents per dollar of tax revenue replaced. The main reason for the relatively low impact on economic well-being is that Canadians would save and invest more as the relative price of consumption increased. This higher savings and investment would stimulate economic activity, offsetting the reduced immediate consumption by individuals. But the net effect is only 10 cents per dollar of revenue replaced. The logic also works in reverse. Increasing consumption taxes would have the least harmful effect on the average Canadian's economic well-being.

¹¹ Note that this 40 cents is a true net benefit; the analysis replaces the dollar of revenue lost by another tax and takes into account the negative impact of the other tax.

¹² The Department's analysis included both investment and wage income; in a separate calculation it estimated the benefit from reducing “taxes on wages” to be 20 cents.

¹³ Through fewer hours for part-time or full-time workers or simply through exiting the labour force because the spouse's take-home pay has increased.

The Department’s analysis can also be used to show how shifting taxes from one type to another would benefit Canadians. It shows, for example, that implementing faster depreciation through changes to capital cost allowance and replacing the lost tax revenue by an increase in consumption tax would improve Canadians’ economic well-being by \$1.30 (the faster depreciation improves welfare by \$1.40 and the higher GST reduces welfare by 10 cents).

The estimates indicate that the smart way to stimulate prosperity through tax policy is to shift the tax mix away from taxing capital investment and towards consumption. Reducing taxes on capital investment increases

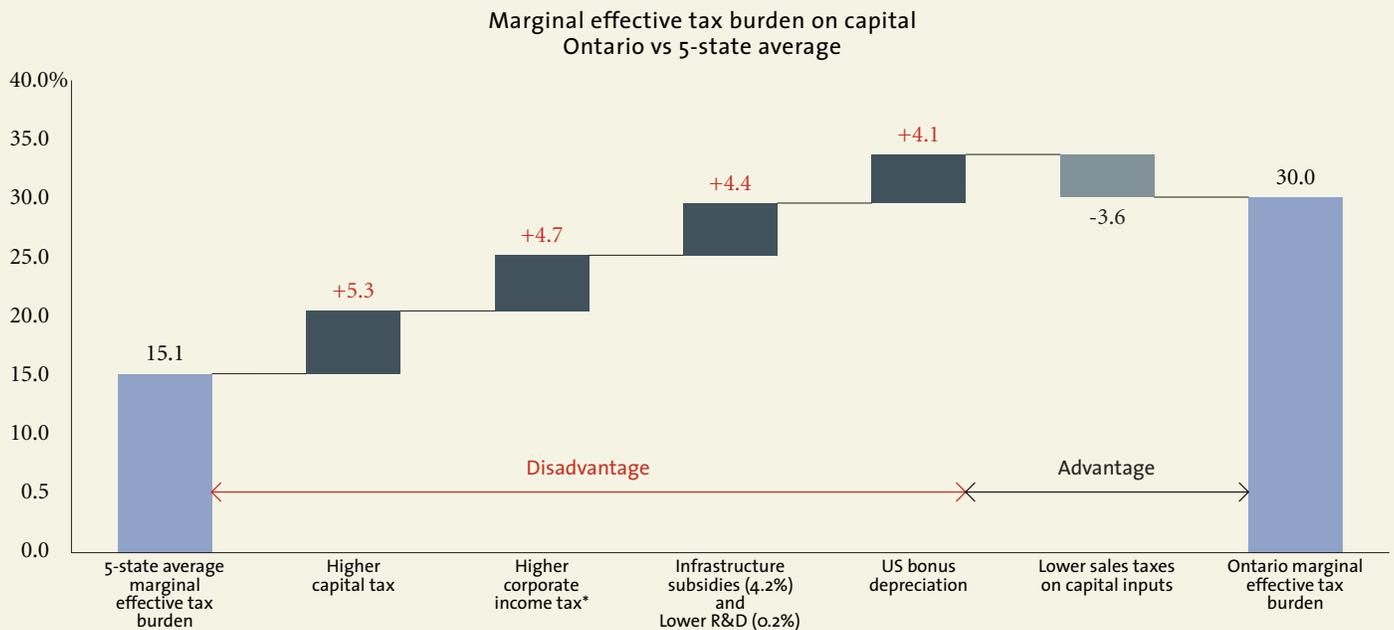
the rate-of-return on capital, encouraging investment in capital goods, such as machinery, equipment and software. Reducing or eliminating sales taxes on capital inputs is helpful, because they apply to new capital investment. Higher levels of capital investment result in higher levels of productivity and wages.

This shift would lead to higher taxes on consumption and employment income. Consumption taxes include value-added taxes (the federal GST) and provincial sales taxes that apply to consumer spending only. While taxes on consumption and employment income also lower real wages, they are *relatively* more efficient than taxes on investment

because labour supply is less sensitive to changes in wages than investment is to the cost of capital.¹⁴ That is, labour is less mobile than financial capital. As a result, decisions by most individuals to work are less responsive to personal tax rates than decisions by investors to invest are to tax rates on capital investment.

In sum, the analysis by the federal Department of Finance indicates that Canadians’ economic well-being would be enhanced most by reducing taxes on investment. This conclusion is consistent with work done by other economists and tax experts.¹⁵

Exhibit 4 Ontario’s marginal effective tax burden on capital is double the peer states’ burden



*Ontario has lower statutory rates than the US states. However, differences in areas such as depreciation and inventory result in a higher effective corporate income tax rate in Ontario. Source: Data provided by Duanjie Chen and Jack Mintz (unpublished).

¹⁴ Canada, Department of Finance (2004).

¹⁵ For further detail regarding taxation and economic growth see R. Kneller, M.F. Bleaney, and N. Gemmill (1999) "Fiscal Policy and Growth: Evidence from OECD Countries" *Journal of Public Economics*, 74, pp. 171–90; OECD (1997), OECD (2004a) *OECD Economic Surveys: Canada*, (Paris: OECD); Dale W. Jorgensen and Kun-Young Yun (1991) "The Excess Burden of Taxation in the United States" *Journal of Accounting, Auditing & Finance*, 6 (Fall), pp. 487–508.

Tax burdens are higher in Ontario than in the peer states

Ontario’s marginal effective tax burden is higher than in the peer states (see *Marginal efficient tax burdens on labour and capital influence motivations*). We tax marginal investments by business at twice the rate in the five peer states we have analyzed – 30.0 percent versus 15.1 percent.¹⁶ Our disadvantage is the result of several factors. The largest of these is the higher capital tax which accounts for 5.3 percentage points of the difference (*Exhibit 4*). Next is the higher corporate tax rates which account for 4.7 percentage points. The lower subsidies we provide for infrastructure and R&D accounts for 4.4 percentage points. The lack of bonus depreciation in Ontario accounts

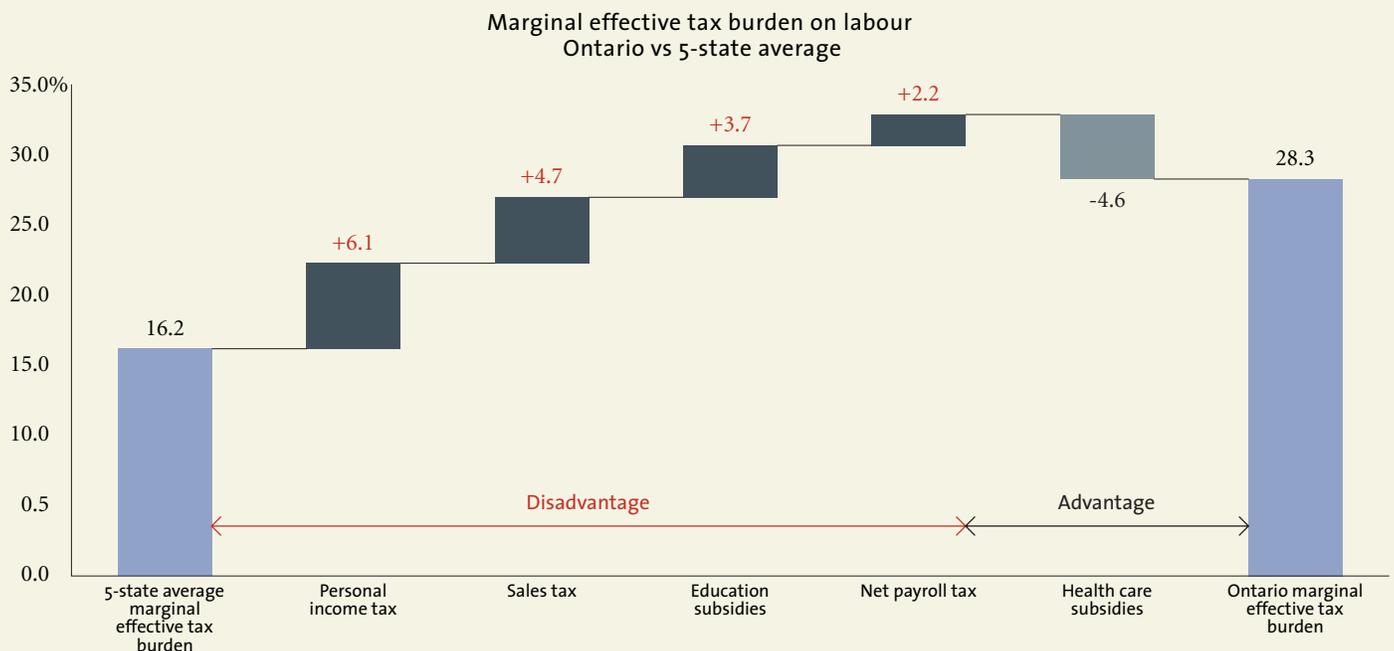
for 4.1 percentage points, though this US tax measure expired at the end of 2004. Ontario does have an advantage over the peer states in taxing business investment. This is in the area of sales tax on capital investment goods where the peer states out-tax Ontario by 3.6 percentage points.

In Ontario, we also have a significant disadvantage in the marginal effective tax burden on labour versus the peer states – 28.3 percent versus 16.2 percent. The largest factor in this disadvantage is in personal income taxes – a 6.1 percentage point disadvantage for Ontario (*Exhibit 5*). Our higher sales taxes (PST and GST) account for 4.7 percentage points of the disadvantage; our lower subsidy for education accounts for 3.7 percentage points; and payroll

taxes account for 2.2 percentage points. Our marginal effective tax burden is offset somewhat by our higher health care subsidies (a 4.6 percentage point advantage for Ontario). But overall we face a disadvantage versus the peer states in the taxes we impose on labour, despite this important subsidy.

Against our peer group of US states, we have significantly higher marginal effective tax burdens on both capital investment and labour. This may be unavoidable given the choices we have made for relatively larger government in Canada and Ontario. But, as we shall see with Sweden, high-tax jurisdictions can have smarter tax systems than we do.

Exhibit 5 Ontario’s marginal effective tax burden on labour is almost twice the peer states’ burden



Source: Data provided by Duanjie Chen and Jack Mintz (unpublished).

¹⁶ In previous work, we use the median of the five peer states (California, Georgia, Illinois, Massachusetts, Michigan) analyzed to indicate their aggregate marginal effective tax burden. This is 15.0 percent. However, since median statistics are unsuitable for disaggregating the components, we use average measures in this working paper.

Marginal effective tax burdens on labour and capital influence motivations

PREVIOUS STUDIES commissioned by the Institute have assessed the *marginal effective tax burden* on labour and capital.^a They calculate the impact of taxation on the cost of doing business by taking into account all the taxes paid,^b net of relevant government subsidies, on all factors used in producing goods and services. The purpose of this approach is to recognize that investment and work effort decisions are influenced by more than statutory income tax rates. In addition, the income tax is not the only tax that is levied on capital investment or on labour. Further, there are government expenditures that lower the cost of doing business and influence investment and work effort decisions. That is, businesses will consider government spending on infrastructure and subsidies for research and development in making decisions on how much and where to invest. Businesses and workers will also consider government subsidies for education and health care in making decisions about hiring and hours worked.

The **marginal effective tax burden on capital** influences the willingness of firms to go the extra step and invest the incremental dollar in capital, such as machinery, equipment and software. In addition, it influences the decision by investors – from entrepreneurs to angel investors to venture capitalists to financial institutions – to invest in Ontario or elsewhere. For example, if investors pay high tax rates on capital investment they will supply less capital or demand a higher rate of return, raising the cost of doing business. Chen and Mintz’s analysis incorporates corporate income taxes, capital taxes, and sales taxes paid on business purchases. Depreciation allowances and government infrastructure expenditures, research and development, and other business subsidies are subtracted from taxes on capital to arrive at the marginal burden.

To avoid confusion it is helpful to distinguish between some of the different tax rate measures reported by tax analysts. *Statutory rates* are the tax rates set out in federal and provincial tax legislation. The *marginal effective tax rate* (METR) on capital “is the amount of corporate income and other capital-related taxes as a percentage of pre-tax profits for marginal investments,”^c and includes tax reduction measures, such as depreciation allowances and tax credits. The *marginal effective tax burden on capital* is the *marginal effective tax rate* net of public subsidies (i.e., government provided subsidies for infrastructure and R&D).

The most recent analysis finds that in 2004, marginal tax burdens on capital remained significantly higher in Ontario at 30 percent

than the median of 15 percent in the five peer states examined: California, Georgia, Illinois, Massachusetts, and Michigan.^d

We illustrate the difference between the METR and marginal effective tax burden on capital in Ontario and the average of the five peer states examined by Chen and Mintz (Exhibit A). The analysis shows that on top of corporate income taxes, business investment attracts the capital tax (the annual tax on capital stock that is paid over the life of the investment) and sales tax on purchased capital items. These add 6.0 percent and 4.1 percent respectively to the cost of investments and with the income tax drive the effective tax rate on the marginal business investment to 32.8 percent. In the peer states, the cost of business investments is increased by 18.0 percent through the corporate income tax (Exhibit B). In addition the cost is increased by 0.7 percent through capital taxes and 7.7 percent through sales taxes on the purchase of capital goods. Sales taxation on capital goods is one of the few areas where Ontario has a tax advantage over the peer states. Nevertheless, we argue in this working paper that Ontario and Canada should eliminate this taxation on capital goods as this sales tax reduces investment and prosperity.

Mintz and Chen calculate the benefits from subsidies in infrastructure and research and development to arrive at a net burden tax burden on business investment. In Ontario businesses benefit from subsidies in these areas to reduce the marginal cost of investments by 2.0 percent and 0.8 percent respectively (Exhibit A). This takes the marginal tax burden down to 30.0

^a See Duanjie Chen and Jack M. Mintz (2004) “Ontario’s Fiscal Competitiveness in 2004” Report prepared for the Institute for Competitiveness & Prosperity. They refer to the *marginal effective tax burden* as the *marginal fiscal burden*.

^b Some of the limitations of this model should be noted. First, property taxes are not included in this analysis largely due to the lack of comprehensive data. As discussed in the Institute’s Working Paper 3, *Missing opportunities: Ontario’s urban prosperity gap*, business property taxes tend to be greater than services received by business while the opposite is true for taxes on individual residences. The model also does not assess the costs and benefits of regulations on the cost of doing business. And the model is based on assumptions in areas like appropriate discount rate for future cash flows. For further discussion on methodology see Chen and Mintz (2003); Jack M. Mintz (2001) *Most Favored Nation: Building a Framework for Smart Economic Policy* Policy Paper 36, C.D. Howe Institute, pp. 71-2.

^c Chen and Mintz (2005)

^d For calculating marginal effective tax rates or marginal effective tax burdens, as with all economic models, the impact of different assumptions on calculations can change results significantly. For example, important assumptions include the tax status of the marginal investor, whether firms are financing through debt or equity, and how infrastructure benefits are allocated across industries. For an examination of different assumptions on marginal tax rate calculations see Robert Carroll, Kevin A. Hassett, and James B. Mackie III (2003), “The Effect of Dividend Tax Relief on Investment Incentives,” *National Tax Journal*, 56(3), September, pp. 629-51.

percent from the marginal effective tax rate of 32.8 percent. In the peer states, business subsidies for infrastructure and for R&D are higher at 6.2 percent and 1.0 percent respectively (Exhibit B). In addition, business investment in the peer states benefits from accelerated depreciation, a temporary measure put in place through recent tax cuts, which expired at the end of 2004. These reduce the cost of business investment by 4.1 percent. So the marginal effective tax burden in the peer states is reduced from 26.4 percent to 15.1 percent by these subsidies.

In summary, the analysis reveals a 6.4 percentage point difference between METRs on capital between Ontario (32.8 percent) and the average (26.4 percent). However, this difference between the two jurisdictions increases significantly to 14.9 percentage points when infrastructure subsidies and bonus depreciation are incorporated.

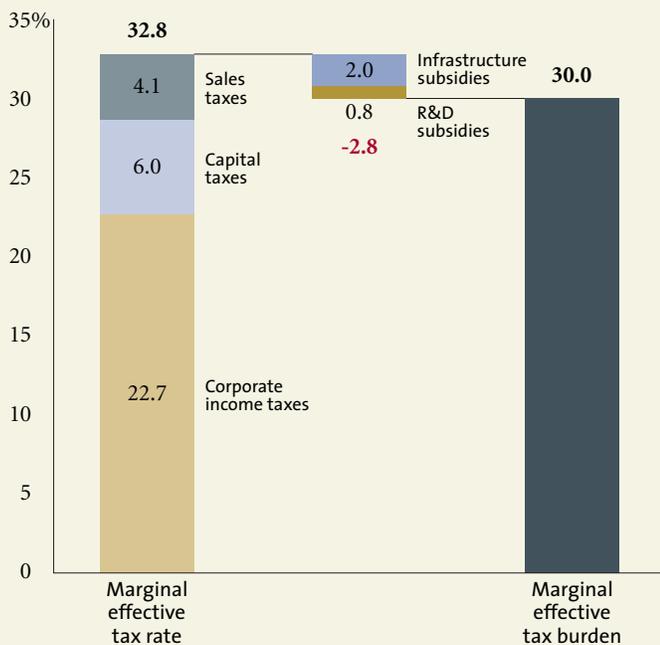
The marginal effective tax rates on labour influence the willingness of firms to hire more workers and for people to decide to work versus not to work, to work the extra hour, or to invest in upgrading their own productivity and earn more in the future. In the extreme, the higher

the marginal effective tax rate on labour, the greater the incentive for workers to opt out entirely, either into the underground economy or to a lower tax jurisdiction. Mintz and Chen's analysis of taxes on labour focuses on personal income taxes, payroll taxes, and sales taxes. Their analysis captures labour taxes borne by employers and employees. Government expenditures in areas such as education and health care are deducted from these taxes.

In Ontario, personal income taxes add 28.3 percent to the cost of labour (Exhibit C). The effective tax rate is increased by sales taxes (both PST and GST) which add 9.3 percent to the

Exhibit A Ontario's marginal effective tax burden on capital is slightly lower than the marginal effective tax rate

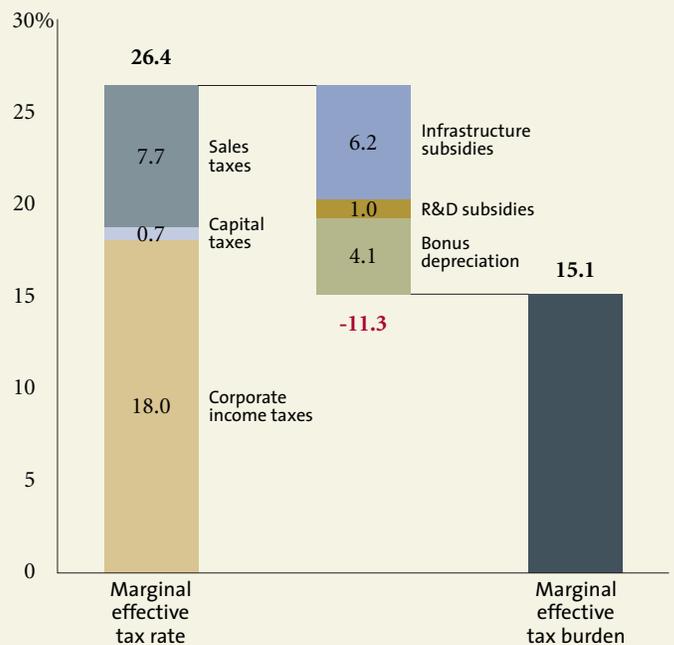
Components of marginal effective tax burden on capital, 2004 Ontario



Source: Data provided by Duanjie Chen and Jack Mintz (unpublished).

Exhibit B Peer states' marginal effective tax burden is lowered by subsidies

Components of marginal effective tax burden on capital, 2004 5- state average



Source: Data provided by Duanjie Chen and Jack Mintz (unpublished).

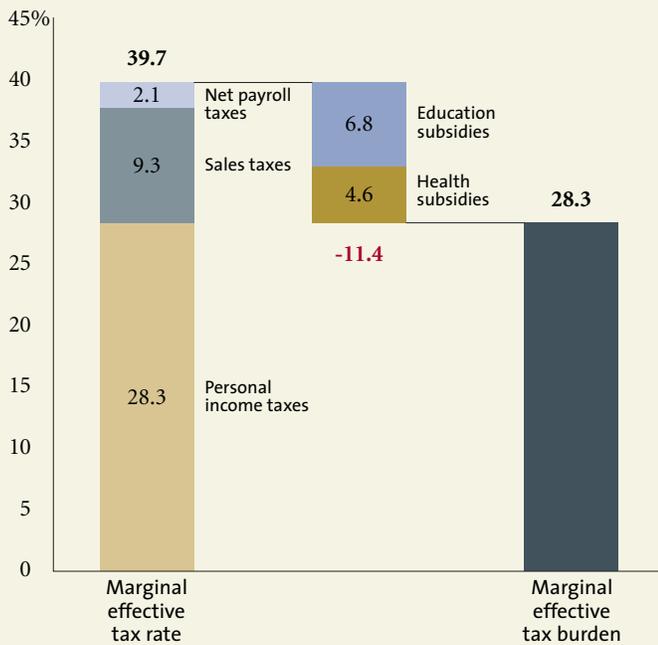
cost of labour. The logic here is that ultimately all labour income is earned to consume goods and services so that taxes on consumption should be included. In addition, the marginal effective tax rate on labour is increased by 2.1 percent to reflect payroll taxes which are not paid out in benefits directly to workers. This includes Ontario's health and education payroll taxes, which go into general revenues, not specific programs (the subsidies for health care and education are applied in this analysis separately however) and the excess of contributions over payouts in the employment insurance system.

In the peer states, the marginal personal income tax rate on labour is 22.2 percent (Exhibit D). Sales taxes add 4.6 percent to this and payroll taxes have almost no net effect as contributions and payouts in their employment insurance systems tend to be in balance. Consequently, the marginal effective tax rate on labour is 26.8 percent versus Ontario's 39.7 percent. These rates are reduced by subsidies for education and health care. In the peer states, the subsidy for primary, secondary, and post-secondary education is 10.6 percent of labour income and this reduces their effective rate to a 16.2 percent marginal effective tax burden.

In Ontario, the subsidy on education equates to 6.8 percent of labour income (Exhibit C). Workers also benefit from the health care system and this subsidy equates to 4.6 percent of labour income. In the United States, government subsidized health care is provided for seniors and low income people – there are no subsidies for workers as in Ontario and Canada. Despite the benefits of our health care system, the marginal effective tax burden is 12.1 percentage points higher in Ontario than in the peer states (28.3 percent in Ontario and 16.2 percent in the peer states).

Exhibit C Ontario's marginal effective tax burden raises labour costs by 28%

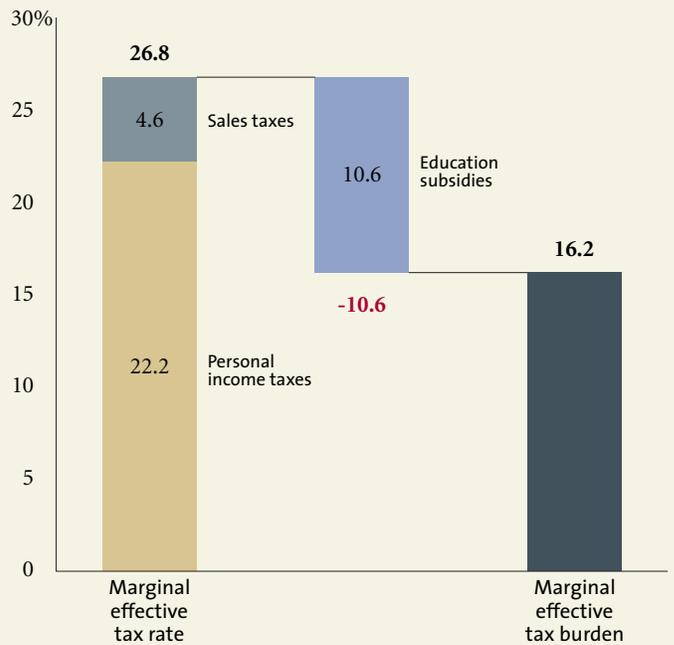
Components of marginal effective tax burden on labour, 2004 Ontario



Source: Data provided by Duanjie Chen and Jack Mintz (unpublished).

Exhibit D Peer states' marginal effective tax burden raises labour costs by 16%

Components of marginal effective tax burden on labour, 2004 5- state average



Source: Data provided by Duanjie Chen and Jack Mintz (unpublished).

Sweden has higher tax burdens but a smarter tax system

Sweden has created a smarter tax system: it has a relatively low tax burden on investment and a relatively high tax burden on consumption. Sweden is almost as prosperous as Canada, but has a much higher tax burden (Exhibit 6).

Some may balk at the high tax burden in Sweden, but it is hard to argue against the proposition that Sweden has a smart tax system. While it has a high tax burden, Sweden does not simply tax all economic activities at higher rates. Instead, it has a relatively efficient tax structure that taxes investment at a lower rate than Canada and the United States and consumption at a higher rate. Their tax system raises the revenues necessary to pay for the social programs the citizens of Sweden value.

Sweden generates a smaller portion of its government revenue than others through taxation of capital investment (corporate and property taxes), the most harmful form of taxation, with a relatively low rate. It generates more of its tax revenue from consumption (by using a VAT) and wage income, the least harmful forms of taxation (Exhibit 7).

The United States generates none of its tax revenue from a VAT and compared to Sweden more of its revenue from corporate taxes but still less than Canada. In a sense the United States does not have a particularly “smart” tax system; this disadvantage is less important because its taxes are among the lowest in the industrialized world.

The positive features of Sweden’s tax mix become clear when comparing tax rates across the members of the Organization for

Economic Cooperation and Development (OECD). Sweden has VAT rates above the OECD average (Exhibit 8), but its corporate income tax rates are below the OECD average (Exhibit 9). It also taxes dividends at lower rates than Canada (Exhibit 10). But Sweden has higher personal income tax rates (including social security contributions) than the OECD average (Exhibit 11).

Ontario’s and Canada’s tax rates are much different from Sweden’s. We tax capital investment at a relatively high rate. Our consumption tax rate is below the OECD average; our statutory corporate income tax rate, while below the United States, is above the OECD average. Our tax rate on dividends is higher than the OECD average, while our personal income tax rates (including social security contributions) are below the OECD average.

Exhibit 6 Prosperity is not necessarily linked to tax burdens

Total tax revenue and GDP per capita for OECD countries, 2002



Note: Excluding Iceland and Luxembourg because they have small populations.
 Source: OECD (2004b), *Revenue Statistics: 1965-2003*; OECD (2004c), *National Accounts of OECD Countries*, Volume 1.

Exhibit 7 Sweden has a smarter tax mix than Canada and the United States

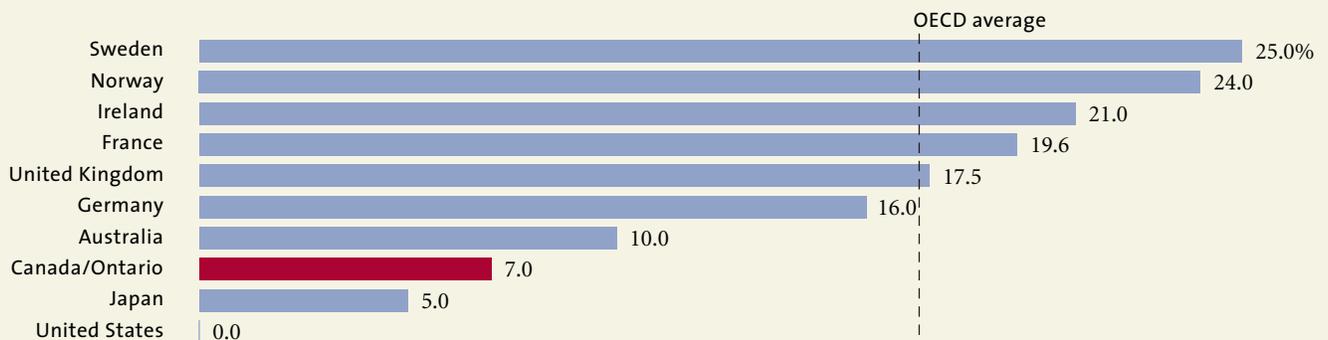
Tax mix (% of total tax revenue), 2002



Source: OECD (2004b) Revenue Statistics: 1965-2003, Tables 45 (Canada), 67 (Sweden), 71 (United States).

Exhibit 8 Sweden has the highest VAT rate among OECD countries

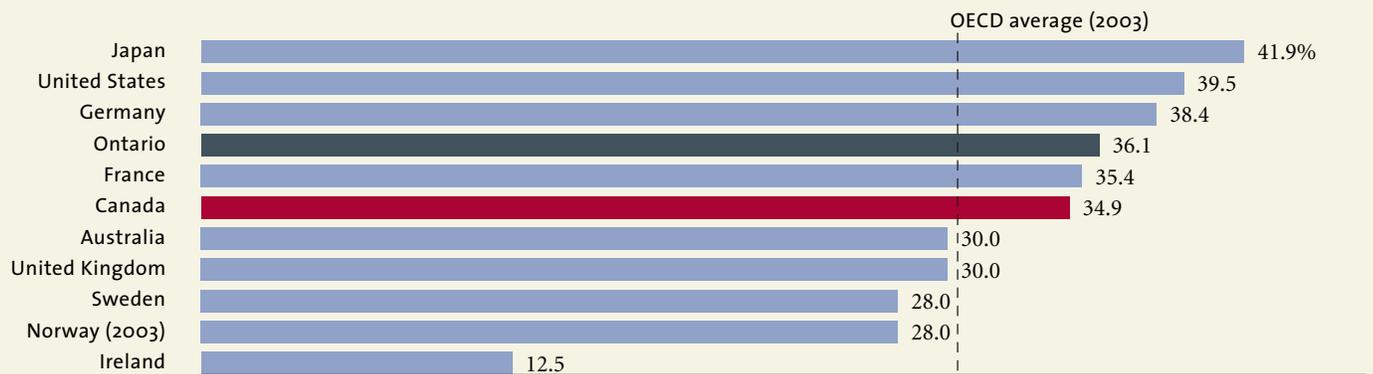
Standard VAT/GST rate, 2003



Source: OECD Tax Database, Table 1.7, www.oecd.org.

Exhibit 9 Sweden's corporate income tax rate is among the lowest of OECD countries

Statutory general corporate income tax rates,* 2004

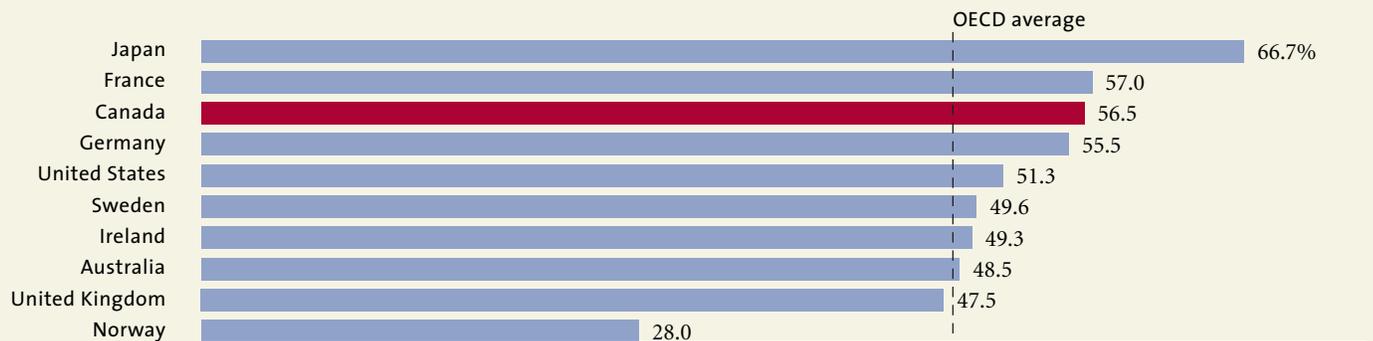


* All levels of government

Source: OECD Tax Database, Table I.5, www.oecd.org; Duanjie Chen and Jack Mintz (2005), "How to Become More Seductive: Make Canada More Investment Friendly," C.D. Howe Institute e-brief.

Exhibit 10 Sweden's dividend tax rate is lower than Canada's

Overall* tax rate on dividends, 2003

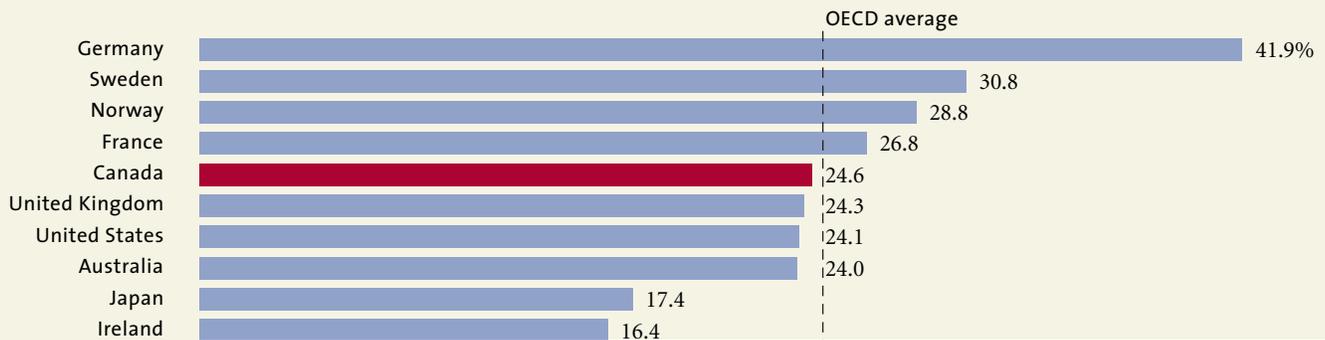


* Corporate plus personal taxes

Source: OECD Tax Database, Table 11.4, www.oecd.org.

Exhibit 11 Sweden’s personal income tax rate is higher than Canada’s

All-in* average personal income tax rates, 2003



* The tax rate reported is the “combined central and sub-central government income tax plus employee social security contribution, as a percentage of gross wage earnings” for a single person with no children. The wage used is the “average production wage (in national currency), meaning the average annual gross wage earnings of adult, full-time workers in the manufacturing sector.”
 Source: OECD Tax Database, Table I.3, www.oecd.org.

Exhibit 12 Sweden’s marginal effective tax rate on investment is much lower than Canada’s

Marginal effective tax rates on capital investment, 2004



Note: Norway was not included in the analysis.
 Source: Chen and Mintz (2005) “How to Become More Seductive: Make Canada More Investment Friendly,” C.D. Howe Institute e-brief.

The result of low corporate taxes, no sales taxes on capital goods, and lower taxation of investment in general is that Sweden has a much lower *marginal effective tax rate* (METR) on investment (Exhibit 12). The METR “is the amount of corporate income and other capital-related taxes as a percentage of pre-tax profits for marginal investments,”¹⁷ and includes tax reduction measures, such as depreciation allowances and tax credits. Canada, with our relatively high corporate tax rates, provincial sales taxes applying to capital goods, capital taxes, and a less favourable tax treatment of investment in general, has a METR that is 20.1 percentage points higher than Sweden and 8.3 percentage points higher than the United States.

Australia has embarked on a path to smarter taxation

A shift from taxing investment to taxing consumption is possible. Australia undertook significant tax reform through *The New Tax System*, which was implemented on July 1, 2000.¹⁸ The reform measures were designed to create a more efficient tax system by moving to a consumption base, recognizing that the taxation of consumption is the least damaging form of taxation.

The federal government levied a 10 percent GST on most goods and services consumed in Australia. As in Canada, some goods and services were exempted. The GST replaced the federal government’s wholesale sales tax and a number of state sales taxes. Further, the introduction of the GST was balanced with a reduction in marginal personal income tax rates, an increase in the tax-free threshold, and increases in assistance for families, low-income individuals, and the elderly.

The result is that at least 75 percent of taxpayers now face a marginal tax rate of 30 percent or less. Prior to reform only 30 percent of taxpayers faced a marginal tax rate of 30 percent or less. The numerous reforms at the personal level were made to “ensure that most low- and middle-income individuals [would] benefit from an increase in real disposable income after adjusting for changes in the indirect taxation [the introduction of the GST].”¹⁹

Additionally, recognizing the damage of taxing investment, the reform package reduced corporate taxes and broadened the corporate tax base. Corporate tax rates were reduced from 36 percent to 30 percent between 2000 and 2002.

It is too early for definitive results on Australia’s tax reform. However, its GDP per capita growth outpaced the OECD average between 2000 and 2003.

Sweden and Australia are not alone in having a smarter tax system. The United Kingdom and Ireland also have higher VAT and lower taxes on investment, producing a dramatically lower effective tax rate on investment.

The lesson to be drawn is that smart taxation is not about choosing other values; it is about efficiently and equitably raising the funds for the public services and infrastructure that Ontarians value. By doing so, governments can increase economic growth and welfare without reducing expenditures in critical public services and infrastructure in order to finance reform. Currently, our tax burdens are higher than those in the United States and our mix is not as smart as that in Sweden, Australia, the United Kingdom, and Ireland.

¹⁷ Chen and Mintz (2005).

¹⁸ This section based on OECD (2003b) *OECD Economic Surveys: Australia*, (Paris: OECD), p. 220-23.

¹⁹ *Ibid.*, p. 221.

How we can tax smarter



Ontario has many options for smarter taxation of business and individuals to increase equity and efficiency – and investment in our long-term prosperity

Having set out the criteria of equity and efficiency for smart taxation, assessed some of the broad lessons learned from the work done by the Department of Finance and others, and drawn on lessons from other countries, we now turn to opportunities for smarter taxation here in Ontario. We review opportunities for smarter taxation relating to business investment and to individuals' work efforts.

Motivate productivity-enhancing investments by businesses

In this section, we identify improvement opportunities within the current system before putting forward a proposal for fundamental change – the elimination of corporate income taxes altogether. The general goal of these opportunities is to strengthen motivations for increased capital investment that will raise productivity and increase Ontarians' prosperity.

We recognize that the motivational aspects of taxation are not the only factors driving investment decisions. As our AIMS model indicates, attitudes are important, as are market and governance structures. But smarter taxation matters.

Eliminate the corporate capital tax

In Ontario, the general provincial corporate capital tax of 0.3 percent is levied on shareholders' equity and most debt held by a corporation in Ontario.²⁰ The federal government also levies a capital tax on corporations. This tax is particularly damaging to investment

because it is levied even if the business is not profitable. Few other advanced economies levy corporate capital taxes at the federal level. For example, the US federal government does not levy a national corporate capital tax, although many states levy a minor capital tax.²¹ As a result, capital taxes are the most important reason why the marginal effective tax burden on capital in Ontario is greater than that in the five peer states (see *Marginal effective tax burdens on labour and capital influence motivations*).

Canadian governments have recognized the high economic costs of the capital tax and are working to eliminate them. In 2004, the federal government reduced its capital tax on large corporations and is scheduled to eliminate it by 2008. The Ontario government's plan is to eliminate all provincial capital taxes by 2012.

Another tax on business capital investment is the property tax. In 1998, Ontario reformed its property tax by designing a market-based, current-value assessment system. But that system still imposes distortions on capital investment that hinder economic growth. One problem that has been identified is that non-residential property, such as commercial and industrial property, is taxed at a higher rate than residential property and this may hinder business investment and hence Ontario's prosperity.²² Overall, however, little research has been conducted on the extent and impact of property taxes on capital investment in Ontario and elsewhere.

²⁰ Ontario has a higher rate for financial institutions.

²¹ Jason Clemens, Joel Emes and Rodger Scott (2002) "The Corporate Capital Tax: Canada's Most Damaging Tax" Fraser Institute Occasional Paper, p. 5.

²² See Bird and Wilson (2003), p.3 and p.20 for their research into business property taxes.

Reform Ontario sales taxes on capital goods

Current provincial sales taxes (PST) apply to nearly all purchases, whether by individuals or businesses. They raise overall prices to purchasers and can affect their decisions to invest or when to invest.

Sales taxes on capital investment – such as steel, machinery, and computers – generate a significant proportion of PST revenue. Statistics Canada data indicate that in 2000, \$2.9 billion of the \$13.2 billion collected by the PST were levied on investments in capital goods. Another \$3.2 billion were levied on non-capital business expenditures, such as office supplies. So while most people regard the provincial sales tax as a retail tax aimed at personal consumption, we need to recognize that just under half of the PST revenue comes from business activity – 22 percent of the tax is generated from capital investments and a further 24 percent from business expenditures.

Sales taxes on capital goods affect investment in shorter-lived assets, such as computers, more than longer-lived assets, such as buildings. This occurs because the PST is paid each time an asset is purchased, so the disincentive to invest is compounded the more often a company needs to purchase or replace assets. Consider, for example, a computer, with an expected life of five years, being used in a building, with an expected life of 30 years. To maintain operations, a business would need to purchase computers six times over the life of the building with the PST being paid each time.

Further, levying the sales taxes on intermediate business inputs and capital goods results in tax “cascading”; that is, sales taxes are levied on goods used to produce other goods that are taxed again by the provincial sales tax, in some instances. This cascading further raises not only domestic prices, but also export prices, hurting the ability of our businesses to compete internationally.

There are different reform options. The province could simply allow businesses to recover the sales tax paid on purchases by claiming input tax credits. Another option is to convert the PST into a broad-based value-added tax covering goods and services. Taxing both goods and services would recover some of the revenue lost if business inputs are no longer taxed. In fact, a broad-based tax could generate more revenue than the current PST, depending on the tax rate set. A further option is to harmonize the PST fully with the GST, so that the reformed PST would cover the same base as the GST, as is done in Newfoundland, New Brunswick, and Nova Scotia. A graduated option, as in Quebec, is to undertake partial GST harmonization – where the reformed PST would cover a different base, for example, by applying differential tax rates to services and goods – and then move in steps to full harmonization.

Value-added taxation can be fair

Some argue that broad-based value-added taxes like the GST are not “fair” because the rate does not vary with an individual’s ability to pay, hurting low-income individuals and those living on a fixed income because they will pay a higher proportion of their income in value-added taxes than the wealthy. However, Sweden and Norway, the world leaders in equitable income distribution,^a have VAT rates in excess of 20 percent, suggesting that an increased reliance on VATs need not economically harm low-income individuals and families.

Distributional issues can be addressed within the personal income tax framework and through the base of the consumption tax. The federal government introduced the GST tax credit for those with lower incomes to offset the GST. Ontario already has a tax credit for its provincial sales tax, so a new tax credit would not be necessary if Ontario harmonized. Furthermore, depending on the rate of the reformed PST, the provincial government could use the revenue increases from the consumption tax to reduce personal income taxes for those in low-income brackets.

In addition, the federal government mandated that the GST not be applied to some goods and services such as basic groceries, prescription drugs, and most health and medical services. Some countries have reduced rates for specific goods and services. For example, Sweden applies a reduced rate of 6 percent (the general rate is 25 percent) on certain goods, such as books and magazines.

Furthermore, some conclude that taxing consumption is not as regressive as may appear at first glance. For example, Dahlby argues that “[i]ncome is not a proper base for measuring the progressivity of a tax system [...] the proper base is individuals’ consumption of goods and services over a number of years since it reflects their real standard of living. It follows that the progressivity of the tax system should be measured by individuals’ tax burdens as a percentage of consumption over a long period of time. Measuring tax progressivity in this way means that consumption taxes are proportional or slightly progressive, not regressive.”^b

^a Based on GINI measure of household personal income; see Institute for Competitiveness & Prosperity, *Realizing Canada’s prosperity potential*, January 2005, p. 10 for a discussion of GINI as a measure of equity in income distribution.

^b Dahlby (2003), p. 102.

Rethink the approach to the capital cost allowance

While accelerated depreciation in the United States lowered the marginal effective tax burden on capital for the average peer state by 4.1 percent, increasing rates is not necessarily smart taxation. Rather than copying the US approach with a temporary acceleration in the capital cost allowance, a smarter approach is to switch from accounting based corporate taxation to a cash flow based system. Under the current system of corporate income taxation, firms are allowed to depreciate the costs of capital acquisitions over time, as well as deduct the interest cost of financing capital acquisitions. With a cash flow tax, a firm's taxes essentially would be based on its cash receipts less its cash expenditures; in years when a large capital expenditure was made relative to sales revenue, taxes paid would be relatively low.

The current corporate tax system favours debt-financed investment over equity-financed investment, because interest payments are tax deductible, but dividends are not, distorting investment decisions.²³ Under a cash flow system, the tax benefits of debt financing versus equity financing would be even more pronounced. Conversion to a cash flow system would present an opportunity to eliminate the interest deductibility of debt financing, thus putting debt and equity financing on an equal footing. The positive effects of "lessening the tax discrimination against financing through new equity would benefit business start-ups and innovative and fast-growing companies which may face difficulties in borrowing from banks."²⁴

Chen and Mintz argue that "[n]ot only would this reform result in a neutral treatment of different activities but it would also eliminate

taxes paid on marginal investments since expensing of capital is equivalent to providing a deduction for the economic costs of capital depreciation and financing over time."²⁵ The elimination of depreciation and interest deductions would also simplify tax accounting.

Chen and Mintz also note that a cash flow tax system requires reform of the personal income tax system: "[g]iven that capital gains are only taxed when assets are disposed, a cash flow tax in the presence of a personal income tax would encourage businesses to shift interest expense to investors who could borrow funds to invest in business equity (without any income inclusion for capital gains) and deduct interest from taxable personal income."²⁶ Therefore, movement to a cash flow tax would require that personal taxation shift to a consumption based tax regime (exempting investment income from personal income taxation). Federal and provincial co-operation to reform corporate and personal income taxation would be necessary to reap the full economic gains of a cash flow tax.²⁷

Reduce variability in tax approaches for different business types

In 2004, Ontario benefited from reductions in federal corporate and capital taxes; however, for the most part, this benefit was offset by actions at the provincial level. The combined federal-provincial general corporate tax rate for a large corporation in Ontario is 36.12 percent. The federal tax rate is 21 percent plus a 1.12 percent surtax; the provincial rate is 14 percent. In the recent federal budget (February 2005), Ottawa announced the elimination of the 1.12 percent surtax by 2008. As we have shown, our statutory rates are below the US average, but above the OECD average. Further, while our statutory rates are below those in the

United States, our marginal burdens in Ontario are well above those of the five peer states analyzed.

The Ontario government increased the general corporate income tax rate from 12.5 percent to 14 percent and the manufacturing/resource tax rate from 11 percent to 12 percent. The small business rate remains at 5.5 percent. In contrast, in 2004, the federal government cut its general corporate income tax rate from 23 percent to 21 percent, eliminating differences in corporate tax rates for manufacturing and non-manufacturing income.²⁸ In its recent budget, the federal government announced a reduction in the corporate income tax rate from 21 percent to 19 percent, although this will be phased in over the next five years.

Besides having relatively high rates in international comparisons, Ontario's (and Canada's) corporate tax structure suffers from several problems that hinder our economic success. First, our practice of taxing small corporations at a lower rate than large corporations might be discouraging firms from growing. An OECD study noted that "a progressive corporate income tax system may create threshold effects and/or induce the splitting of companies in order to qualify for the reduced taxation scheme."²⁹ Second, governments offer numerous subsidies, tax exemptions, and incentives to specific industries, clusters, firms, and regions. Further, as noted above, different tax rates are applied to different types of corporations (manufacturing and non-manufacturing; large and small corporations).

One result of these problems is that effective tax rates vary widely across different industries within Ontario and Canada,³⁰ adversely distorting investment decisions and lowering our

²³ Joel Emes *et al.* (2001) "Flat Tax: Principles and Issues" *Critical Issues Bulletin* The Fraser Institute, p. 17.

²⁴ Isabelle Joumard (2002), "Tax Systems In European Union Countries" *OECD Economic Studies*, No. 34, (Paris: OECD), p. 132.

²⁵ Chen and Mintz (2003), p. 16.

²⁶ *Ibid.*, p. 17.

²⁷ Additional concerns with cash-flow taxation are addressed by Kesselman (2004), pp. 14-5.

²⁸ Chen and Mintz (2004b).

²⁹ Joumard (2002), p. 124.

³⁰ Chen and Mintz (2004a,b).

economic performance. A smart tax system should aim to eliminate the tax rate differentials between industries and between large and small firms.

Consider eliminating corporate income taxes

However beneficial the foregoing measures would be, eliminating the corporate income tax could be a much more innovative approach to increasing productivity and prosperity. Governments in Canada should explore this fundamental shift to a potentially smarter tax system.

Corporations do not pay taxes, people do. A corporation's taxes are, in fact, paid by its workers whose wages are lower than they would otherwise be if the company did not have to pay corporate taxes; by its customers who must pay higher prices; and by its stockholders, including individuals' pension funds and mutual funds in their RRSPs, through lower returns on their investments. Thus, eliminating corporate taxes has the potential to enhance prosperity by increasing wages, lowering prices, and increasing investment returns.

We recommend that further research be undertaken to determine the feasibility of this option. An important area that requires analysis is to what extent the increased economic activity resulting from eliminating corporate income taxes will offset the loss in government revenues. The analysis would also have to take account of the impact of earnings repatriated by foreign firms – again the increased investment activity could potentially offset the lost tax revenue.

Some would argue that eliminating corporate taxes would increase inequality. However, as we stated earlier, the result would likely be higher wages and lower prices, which would benefit all Ontarians. And if the goal is to ensure that higher income individuals pay a higher share of taxes, the elimination of the corporate income tax would increase personal income and the taxation it draws – potentially offsetting the lost revenue.

We acknowledge that this is an unconventional solution, but we think the analysis points to its potential benefits. And with the United States embarking on a major tax reform process, Ontario and Canada need to be setting their own tax and innovation agenda rather than reacting to developments elsewhere. Eliminating the corporate income tax represents real innovation in a global setting. We encourage the Ontario and federal governments to examine this approach further with a view to realizing a breakthrough in our competitiveness and prosperity.

We now turn from business investment to the taxation of individuals.

Lower perversely high marginal tax rates for individual Canadians

As we examine the taxation of individuals, we find a significant opportunity for improving equity and efficiency. More specifically, we find that we need to ensure that tax burdens on individuals are not acting as a disincentive to work, upgrade skills, and save for the future.

Research done for the Institute by Finn Poschmann³¹ shows that a major weakness of our personal tax and benefit system is the high marginal tax burdens it imposes on individuals and families trying to scale the economic ladder or retire comfortably. In fact, the current system of personal taxation and social benefits

acts as a de-motivator for lower income Ontarians, particularly families. As with taxes on capital, individuals face more than statutory personal income tax rates. Surtaxes, tax credits, and various income-tested government transfers determine the marginal effective tax rate (METR) – the tax rate on additional income – for individuals and families. For example, the METR takes into account refundable credits, benefits, high-income surtaxes, transfer programs, tax reduction mechanisms, and the cost of payroll taxes, such as employment insurance and Canadian Pension Plan contributions. For families, the highest marginal burdens on taxable income are reached between approximately \$22,000 and \$54,000 (Exhibit 13).

These high marginal rates are largely the product of clawbacks of tax credits, benefits, and transfer programs rather than statutory personal income tax rates. Clawbacks refer to the reduction of these assistance programs that occurs as an individual's income increases. For example, in 2004, clawbacks of the National Child Benefit Supplement began when net family income reached about \$22,000. Poschmann observes that the high marginal burden problem has worsened since 1988 for those earning less than \$40,000, largely as the result of redesigns and expansions of child tax credits and child care supplements (Exhibit 14).

Thus, while benefit programs provide valuable assistance to low-income families, an unintended consequence of benefit clawbacks is that families progressing towards higher income levels can face a dramatically higher marginal tax rate on their additional income. Further, the rates are high because “provincial and federal taxes and benefits and their clawbacks and reductions stack on top of one other.”³² For example, a single earner couple with two children faces a marginal effective

³¹ Finn Poschmann (2004) “Marginal and average effective tax burdens in Ontario” available online at: www.competeprosper.ca

³² *Ibid.*, p. 2.

tax rate of 60 percent on their higher income shortly after they pass \$31,000 in taxable income. In other words, these families are keeping only 40 cents of each new dollar they earn, the result of clawbacks of the GST tax credit and federal and provincial child benefits. As taxable income reaches \$36,000 the marginal rate climbs to an absurd 90 percent.

To be sure, average tax rates³³ (net of benefits) are progressive and are still below zero for families with a taxable income below \$40,000. Nevertheless, the persistently high marginal effective rates on taxable income do not encourage greater work force participation and work effort. As Poschmann notes: “It is

inescapable ... that high [marginal effective tax rates] will cause some share of the population to forgo incremental work opportunities. The higher the rate, the more people within a given income range will respond to the marginal incentive.”³⁴ In fact, recent research suggests that the potential negative impact of high marginal effective tax rates caused by clawbacks is greatest for single-parent families, which are usually headed by women.³⁵

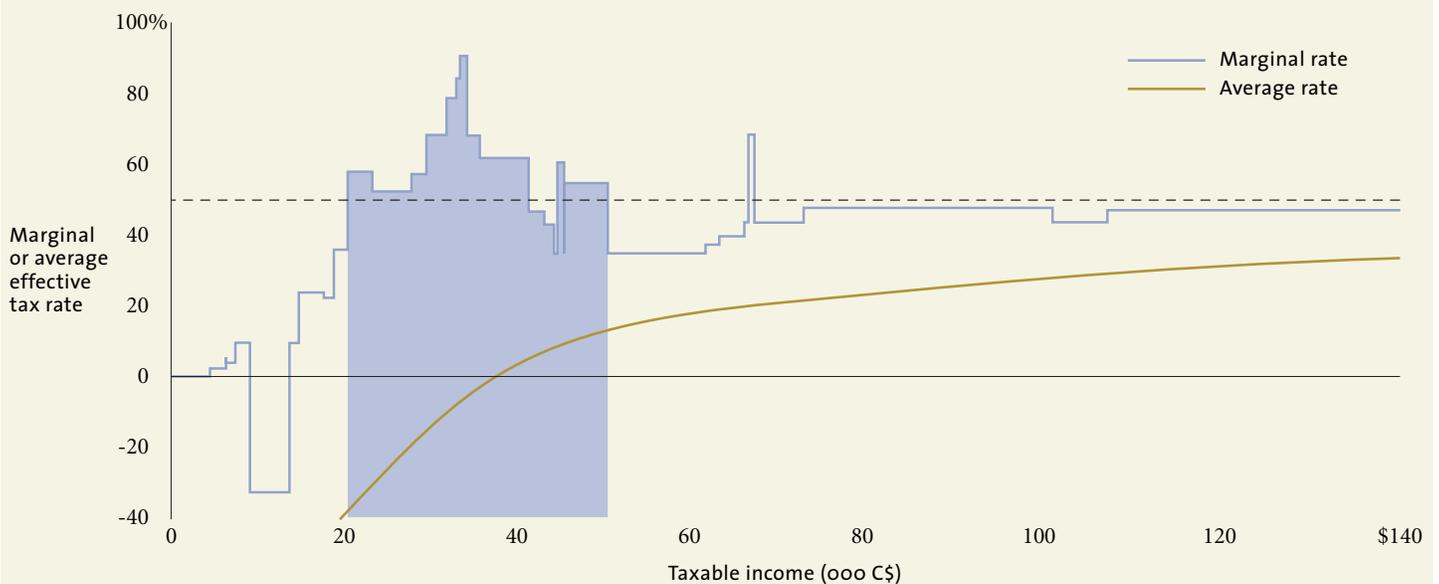
Any progressive tax and benefit system will have the feature of high marginal tax burdens at certain points of the income scale. The problem in Ontario is that our system is characterized by plateaus, not by spikes.

Poschmann states that “Brief [marginal rate] spikes over a very narrow income range are less likely to be a major economic problem than are high, persistent plateaus. A spike may be jumped-over with a small raise, and therefore be mostly irrelevant, while a high plateau bears on a wide range of incremental work decisions,” and a large proportion of Ontario families.³⁶

The challenge in designing tax and benefit systems is to balance the need to support lower income individuals and families and the need to ensure that incentives to work and upgrade skills are preserved. In many instances, it might be that higher earnings that move individuals

Exhibit 13 Ontario’s low- and moderate-income families face high marginal effective tax rates

Average and marginal effective tax rates, single-earner couple with two children, Ontario 2005



Source: Poschmann (2004), *Background Issues: Marginal and average effective tax rates in Ontario*.

³³ The “average” rate refers to the total taxes including tax credits from social benefits as a percentage of total taxable income. It is typically negative at low levels of income because income taxes are zero and benefits through tax credits provide cash to recipients. The “marginal” rate refers to the tax increase and the loss in social benefits that results from an increase in taxable income.

³⁴ *Ibid.*, p. 4.

³⁵ Julie Cain (2004) “The Long Climb Beyond the Welfare Wall” Canada, Department of Finance, Social Policy Research Paper. Unpublished.

³⁶ Poschmann (2004), p. 4.

into higher brackets, or cause low-income assistance to disappear at a higher rate, eliminate or significantly reduce the incentive for an individual to make an effort to increase his or her economic well-being through additional work effort or skill upgrades.

It should also be recognized that seniors face marginal rates exceeding 70 percent at employment earnings between about \$4,800 and \$9,100 (Exhibit 15). This occurs largely because of the stiff clawback rates to the Guaranteed Income Supplement and Spouse Allowance.

Equity demands that taxes are borne by those most able to pay them. Clearly, the current system is placing the highest marginal rates on

lower income Ontarians. We see several smart ways to redress this imbalance.

Smooth marginal effective tax rates

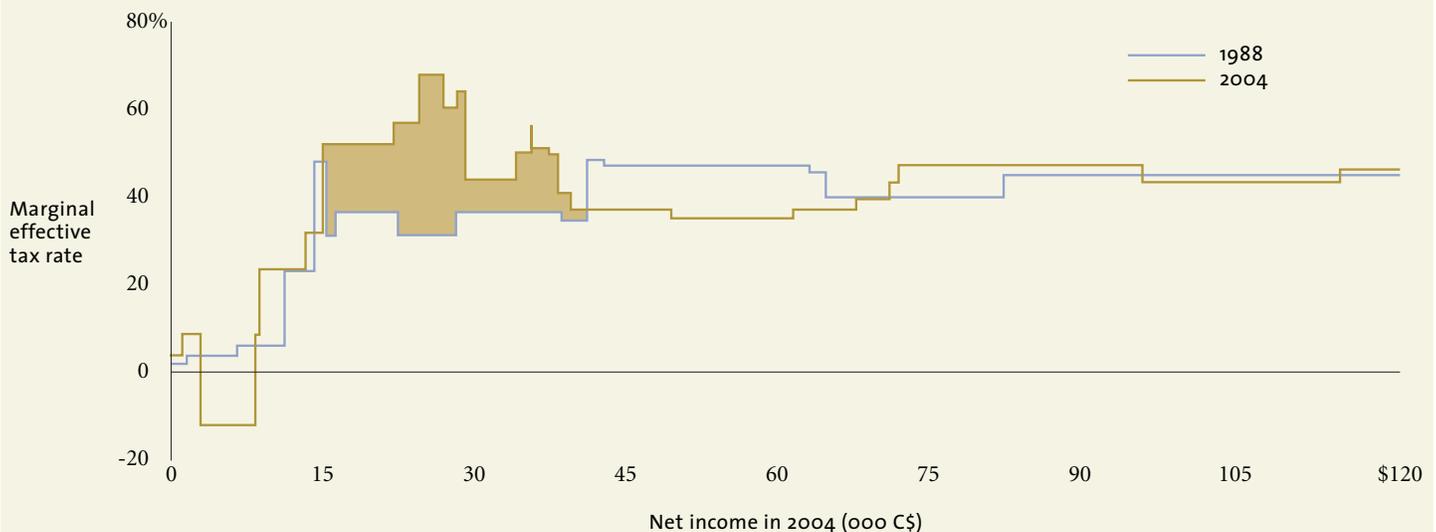
The province can improve incentives to work by smoothing the high marginal tax rates created by the current clawback system. Bird and Wilson argue that, “[c]loser integration of the tax and transfer systems is obviously needed in order to smooth out [effective marginal rates] and reduce the adverse incentives to persons at these work-force entry levels.” As this involves large portions of our social programs and tax policy at the federal and provincial levels, reform would be complicated and time consuming. But we think it is a journey worth embarking on.

Reform requires co-operation between the federal and provincial governments to redesign tax credits, such as the Child Tax Credit. One potential change would be “to replace part of the income-tested child benefit with a personal amount for dependent children,”³⁷ lowering taxes for all families with children. Other options include reducing the threshold at which benefit reductions begin, or reducing the dollar value of benefits as real incomes grow over time.³⁸

Alternatively, in some circumstances, traditional income support measures such as tax credits and other government transfers may not be effective in assisting low-income individuals and families. In certain cases, expanding fundamental assistance programs,³⁹

Exhibit 14 Increases in marginal effective tax rates for low- and moderate-income Ontario families were substantial

Marginal effective tax rates, single earner couple with two children, Ontario



Source: Poschmann (2004), *Background Issues: Marginal and average effective tax rates in Ontario*.

³⁷ Poschmann (2004), p. 5.

³⁸ *Ibid.*

³⁹ See Ross Finnie (2000) “The Dynamics of Poverty in Canada,” C.D. Howe Institute Commentary, No. 145; Morley Gunderson and Michael Trebilcock (2003) “Managing Labour Market Risk in the New World of Work” Research Paper No. 10, Panel on the Role of Government in Ontario; Morley Gunderson (2003) “Active Labour Market Adjustment Policies: What We Know and Don’t Know” Research Paper No. 33, Panel on the Role of Government in Ontario; Michael J. Trebilcock, Ronald Daniels, Andrew J. Green and Roy Hrab (2004), “Creating a Human Capital Society for Ontario” Staff Report, Panel on the Role of Government in Ontario, pp. 73-78.

such as labour market skills development, skills upgrading programs, and job search assistance, might be a better way to help individuals to adjust to economic change and increase the economic opportunities available. This would reduce reliance on income from support programs that are clawed back.

Possible reform options for seniors include allowing a private income exemption before the income testing of benefits begins. This would allow seniors' employment income to accrue toward a partial exemption from income testing or a reduction in clawback rates.⁴⁰

Reduce the basic personal allowance and marginal rates

Canada and Ontario could consider sharply reducing the Basic Personal Allowance (BPA) and supporting low-income earners more directly with enhanced income support or other initiatives. Any income below the BPA, currently \$8,012,⁴¹ is exempt from federal income tax; the Ontario BPA is currently \$8,044. The problem with the BPA is that most of this benefit goes to people who are not low-income earners. Consequently, marginal tax rates are higher than they need to be as governments must replace the tax revenue lost by the BPA. A better approach would be to lower – or scrap – the BPA, find more efficient ways to

help low-income earners, and reduce marginal tax rates on all other taxpayers. The benefit of lowering the BPA and marginal tax rates is that income earners would face lower tax rates on the last dollar they earned rather than the first. Most people make decisions on how much more to work or to save and invest based on this marginal rate.

The need for progressivity of marginal tax brackets is generally accepted in developed economies. But some research indicates that achieving equitable distribution of the tax burden is best left to national, not provincial or state governments. In the United States, Feldstein and Wrobel conclude that progressive

Exhibit 15 Ontario seniors face high marginal effective tax rates at low levels of employment income

Average and marginal effective tax rates, senior with no children, Ontario 2005



Source: Poschmann (2004), *Background Issues: Marginal and average effective tax rates in Ontario*.

⁴⁰ Poschmann (2004), p. 5.

⁴¹ Increased to \$10,000 by 2009 in the 2005 federal budget.

rates at the state and local level do not redistribute local income, but drive labour migration.⁴² This will occur as highly skilled labour migrates to lower tax jurisdictions and as lower skilled labour migrates to jurisdictions with a more progressive tax system. They find that a more progressive tax system at the state level, coupled with labour migration, “raises the cost to firms of hiring more highly skilled employees and reduces the cost of lower skilled labor. A more progressive tax thus induces firms to hire fewer high skilled employees and to hire more low skilled employees.”⁴³ A single rate schedule at the provincial level might be desirable for Ontario and all the provinces with progressivity built in to the federal income tax.

Reduce taxation on savings and personal investment income

As we have shown earlier, the Department of Finance’s analysis of taxes found that taxes on personal investment income (i.e., taxes on interest, dividends and capital gains) are one of the most damaging taxes to economic well-being. Further, we have also shown that the current tax and clawback system affects seniors with low levels of employment income most – with marginal tax rates at nearly 80 percent as income reaches \$10,000. Reform is needed to promote savings and investment and to provide relief to low-income seniors.

One option to promote savings and investment is not to tax savings. This is referred to as tax deferral where savings are permitted to be deducted from income for tax purposes. Tax deferral is offered in Canada through programs such as registered retirement savings plans (RRSPs). Individuals may contribute 18 percent of earned income to a maximum of \$15,500 for the 2004 tax year. In its 2005 budget, the federal government announced

plans to increase the maximum RRSP contribution to \$22,000 by 2009. To promote savings further, the federal government could eliminate RRSP contribution limits.

However, the RRSP option is not the best system for all individuals because withdrawals from RRSP accounts are taxable, triggering clawbacks of income-tested transfer programs. As a result, some argue that Canada should introduce a “tax-prepaid” option because many low- and moderate- income workers do not benefit from the current system. They note that “Because of the income testing of public retirement benefits, many of today’s workers will face [METRs]...that are higher in retirement than when they were working.”⁴⁴

A tax pre-paid system would not allow savings to be deducted from income for tax purposes; instead, it would exempt returns and withdrawals from tax pre-paid savings accounts from taxation. A tax pre-paid system, without contribution limits, is equivalent to eliminating personal taxes on interest, dividends and capital gains income. The benefit of tax-prepaid savings plans, or completely eliminating personal taxes on investment income, is that they would allow seniors to receive investment income without experiencing reductions in clawed back social benefits, as currently occurs with the RRSP system.

Explore two breakthrough proposals

We think Ontarians and Canadians should consider two breakthrough proposals for the taxation of individuals: shifting taxation to consumption from investment and earnings; or basing personal taxation on lifetime, not annual, earnings.

Tax consumption, not investment or earnings

Many tax experts point out that taxes work like prices in a traditional demand and supply process. If the goal is to have more savings, investment, and work incentives, then governments should lower or eliminate the taxes on these activities. To replace the lost revenue, they should then focus taxation on consumption. Ultimately, individuals work and invest to generate income for consuming goods and services – so there will be opportunities to generate tax revenue.

One approach is to raise the federal GST rates and convert Ontario’s PST to a value-added tax. As we have seen, many other countries have much higher VAT rates than Canada, and shifting to consumption based taxes provides the greatest stimulus to individuals’ economic well-being.

Some are concerned that the GST is regressive but there are others who contend this criticism is misplaced (See *Value-added taxation can be fair*). And there are opportunities to provide tax relief to lower income Canadians. But for lower income Canadians the main benefit of replacing the taxation of work, savings, and investments with taxation of consumption is that they will not face punishing marginal tax burdens from working more or gaining wage and salary increases. Critics argue that if consumption were more highly taxed, the incentive to earn more money to buy things would be lessened. This is correct, but the incentives and rewards for work would still be much higher than with the current 80 percent effective marginal tax rates faced by some lower income workers.

⁴² Martin Feldstein and Marian Vaillant Wrobel (1998), “Can state taxes redistribute income?” *Journal of Public Economics*, 68 (2), pp. 369-96.

⁴³ *Ibid.*, p. 392.

⁴⁴ Kesselman and Poschmann (2001), p. 1.

Another concern with a higher value-added tax is the possible expansion of underground economic activity that avoids tax payments. However, all taxes create incentives for evasion. Clearly, as with all the options we discuss, further analysis would be required.

Base personal taxation on lifetime earnings

As we have seen, the current personal income tax system coupled with the clawback of social benefits results in very high effective marginal tax rates on low-income individuals. There is an alternative that is potentially far better for Canada's poor and enhances prosperity for all Canadians. It requires assessing income taxes on the basis of lifetime earnings, rather than annual earnings.

As we have seen, the current income tax system gives all taxpayers in Canada an annual basic personal exemption of just over \$8,000 on their income taxes. Federal income taxes are 16 percent of the next \$27,000 of income, 22 percent on the next \$35,000, 26 percent on the next \$44,000, and 29 percent on any remaining income above \$113,000. A lifetime approach would give each Canadian a lifetime exemption of \$250,000, instead of an annual basic personal exemption of \$8,000. Rather than taxing the next \$27,000 annually at 16 percent, we would tax the next \$250,000 of lifetime income at 10 percent, the next \$250,000 at 13 percent, the next \$250,000 at 16 percent, and everything after \$1 million of lifetime earnings at 20 percent. The exact rates and ranges would have to be massaged to achieve tax neutrality.

This system would have to be established at the federal level, but the provinces could also convert to a lifetime earnings approach.

With a system based on lifetime earnings, poor Canadians would be dramatically better off and have better prospects for advancement. For years, even decades for lower wage earners, they would face a zero marginal tax on work, savings, and investment rather than a combined federal-provincial rate above 22 percent. Facing zero tax, they would have greater incentive and greater capacity to grow out of poverty. And even when their lifetime tax exemption is used up, they would face a lower marginal rate than currently because under this structure the marginal tax rate falls for all Canadians. Taxation of lifetime earnings would also make Canada a tax-attractive place for young Canadians graduating from university and entering their first job – a tax-free job for their first \$250,000 of earnings.

How can this work? How can everyone face lower tax rates and still produce the same revenues? It is because the elimination of the annual basic personal exemption saves \$23 billion (that is, the federal tax revenue that is currently forgone because of the BPA) and these savings can be applied to lowering the marginal tax rates for all and improving the prospects of the most needy. A critical element of the lifetime earnings approach is to disentangle social benefits from the tax system. We need to find ways that provide assistance to those in need without complicating the income tax system and creating perversely high marginal effective tax rates for low-income people.

A lifetime earnings system represents a significant departure from the current taxation regime and a workable implementation plan will be complex. It would take careful, deep thinking and rigorous logic. But we ought not to be deterred and thereby accept the current counter-productive, complicated, and confusing system that has high switching costs.

Governments should consider all options for smart taxation that will increase equity and efficiency. They should not shy away from exploring breakthrough approaches – such as eliminating the corporate income tax, shifting the tax mix away from savings and investments towards consumption through greater reliance on value-added taxation, or changing the basis of income taxes to a lifetime earnings. These reforms may be complex to implement but merit further investigation because of their potential to contribute to higher prosperity for all.



Realizing reform now

Smarter taxes are possible and affordable and governments should begin the reform process now

Based on our review of the literature and our own assessment of Canada's and Ontario's tax structure, the Institute engaged the Centre for Spatial Economics (C4SE) to model the economic impact of various tax reforms that drive towards smarter taxation.⁴⁵ The analysis confirms the benefits of specific tax reforms, especially in shifting taxation from investment activity to consumption activity. Since each of the reforms has a cost to the provincial treasury, at least in the short term, we also discuss possible savings to afford these reforms.

Some of the reforms we recommend are highly innovative – converting to a cash flow tax or eliminating the corporate income tax completely – and are difficult to model with existing approaches. At this time, therefore, we are unable to show the detailed impact of these proposals relative to the benefits and costs of other reforms that can be implemented more easily.

Some tax reforms are more beneficial than others

C4SE modeled the impact of eight tax scenarios. Three applied to *sales tax* reform:

- removing the PST from capital goods;
- harmonizing the PST with the GST at a rate of 7 percent; and
- harmonizing the PST with the GST at a rate of 8 percent.

Four applied to *corporate tax reforms*:

- eliminating Ontario's corporate capital tax;
- instituting a uniform provincial corporate income tax of 7 percent for all corporations (large and small);
- instituting a uniform corporate income tax of 8 percent for large corporations only; and

- increasing Ontario's capital consumption allowances for new machinery and equipment (M&E) by 25 percent. This was done to provide some estimates of the benefit of faster depreciation since much of the current advantage of US marginal effective tax burdens on business investment is because of accelerated depreciation.

Finally, C4SE also modeled for comparison:

- reducing personal income taxes by 10 percent across the board.

One key difference between the C4SE and Finance models is that the C4SE analysis is conducted at the *provincial level* and assumes logically that prices and interest and exchange rates remain unaffected by changes in provincial government policy. These are affected by national and international conditions. The Department of Finance's *national* analysis allows these prices and rates to change over time in order to clear markets. The Department of Finance assumes that the nation's population is unaffected by changes in policy, whereas the C4SE's analysis allows for changes in international and interprovincial migration in response to changing economic conditions. Finally, the C4SE used estimates provided by international tax expert, Jack Mintz, to account for changes in the corporate tax base that may arise as corporate income tax rates in Ontario change relative to those in other jurisdictions; the Department of Finance model did not include these effects.

For each tax reform, C4SE estimated the impact on GDP per capita, personal disposable income, and employment and the costs to the provincial treasury. C4SE also created a measure to assess the trade-off in prosperity

⁴⁵ The report prepared for the Institute by the Centre for Spatial Economics is available on our web site, www.comepteprosper.ca

increase versus lost tax revenue. This measure, the “fiscal multiplier,” calculates the increased GDP benefit per dollar lost in tax revenue.

The results point to reforming the province’s approach to retail sales taxes as the best option for enhancing competitiveness and prosperity in the short and medium terms. Eliminating the corporate capital tax is the next most beneficial option. Finally, some changes to the corporate and personal income taxes would have some positive benefits.

Our modeling focused on changes to provincial taxes only. Hence the impact from lowering income taxes on individuals and corporations is reduced compared to the federal modeling. Still, we continue to believe that it would be beneficial to investigate further breakthrough changes to eliminate the corporate income tax and to take a lifetime earnings approach to personal income tax. These could yield more positive and long-lasting benefits for competitiveness and prosperity.

Reforming provincial sales taxes has the highest benefits

Of the eight options we modeled, *eliminating the provincial sales tax on capital investments* has the most positive impact on competitiveness at a relatively low cost to the provincial treasury. It has the highest impact on GDP per capita in the province, increasing it by 0.4 percent over the status quo (Exhibit 16). The provincial treasury would forgo 1.8 percent of the tax revenue in its first year of implementation. On this measure, the elimination of the provincial sales tax on capital goods ranks fourth best of the eight options studied (Exhibit 17). The fiscal multiplier for eliminating sales tax on capital goods is \$3.50. That is, for every dollar of tax revenue lost by eliminating the provincial sales tax on capital goods, GDP increases by \$3.50. This multiplier is the third highest of the eight options studied (Exhibit 18).

While the elimination of the provincial sales tax on capital goods does not directly affect the average Ontario family in their day-to-day life, it does have a relatively high positive impact on personal disposable income, ranking third of the eight options (Exhibit 19). And it has the second highest impact on employment growth (Exhibit 20). In summary, removing the provincial sales tax on capital investment has the highest impact on GDP per capita with a relatively modest impact on provincial tax revenues. It is also one of the best options for increasing jobs and disposable income.

The analysis points to the benefits of reform that are broader than simple elimination of one element of the provincial sales tax sales. Harmonizing the provincial sales tax with the federal GST would improve Ontario’s competitiveness and prosperity. Harmonization, which is in place in Quebec and the Atlantic provinces, would change the provincial sales tax to a value added tax and apply to the same goods and services as the GST.

For most Ontarians, the direct effect would be to begin paying a provincial tax on services such as haircuts, legal advice, and lessons. For businesses, because this would be a value-added tax, taxes on business activities would be lower and we would expect a boost in economic activity. In addition, it would eliminate the cascading effect we discussed earlier. Currently, the provincial sales tax is paid each time a transaction occurs. So when manufacturers buy raw materials or intermediate goods that they work on, they pay the 8 percent PST to their suppliers; this 8 percent is factored into the price they charge to their customers, and so on to the end consumer. In effect, all Ontarians are paying taxes on taxes with the PST. Because the GST is a value-added tax, the cascading effect is removed.

We modeled harmonization in two ways. First, we converted the PST to a value-added tax of 7 percent and made it applicable to the same base of goods and services as the federal GST. According to C4SE analysis, this would have almost the highest positive impact on GDP per capita, as business investment increased and strengthened Ontario’s productivity and competitiveness (Exhibit 16). It would, however, have the highest cost to the provincial treasury as cascading is eliminated and the rate drops from 8 percent to 7 percent (Exhibit 17). The net effect as represented by the fiscal multiplier would make this option the fourth most attractive. That is, relative to the other options, harmonizing the provincial sales tax with the federal GST at 7 percent is one of the more efficient ways to enhance prosperity. Sales tax harmonization at 7 percent also has the second highest impact on personal disposable income (Exhibit 19). And it is the most effective in creating jobs (Exhibit 20).

Since harmonizing the provincial sales tax at 7 percent has the highest cost to provincial tax revenues, we modeled harmonization at 8 percent, the current PST rate. This has nearly the same impact on GDP per capita, but costs the provincial treasury much less. Consequently, its fiscal multiplier is by far the best. Harmonizing the provincial sales tax with the GST at 8 percent stands fourth of eight in its impact on personal disposable income and third in job creation.

This analysis – consistent with the research done by the federal Department of Finance – makes it clear that shifting taxation towards consumption based taxes by harmonizing the PST with the federal GST provides the best near-term impact on Ontario’s competitiveness and prosperity. By eliminating harmful taxation of business investment, it stimulates investment and GDP per capita. By setting the rate between 7 and 8 percent, it can have the least impact on lost tax revenue.

Eliminating the corporate tax on capital is beneficial sooner rather than later

This measure would be almost as beneficial as sales tax harmonization. In general, it ranks below the options related to reforming the provincial sales tax, but higher than options related to lowering personal and corporate income tax rates. It provides the fifth most positive impact on GDP per capita, but it has the third lowest cost in terms of provincial tax revenue forgone. Consequently, it has the fifth highest fiscal multiplier. It has a relatively low impact on per capita disposable income and the fourth highest impact on job creation. The government is already set to phase out the capital tax by 2012. It should be eliminated sooner.

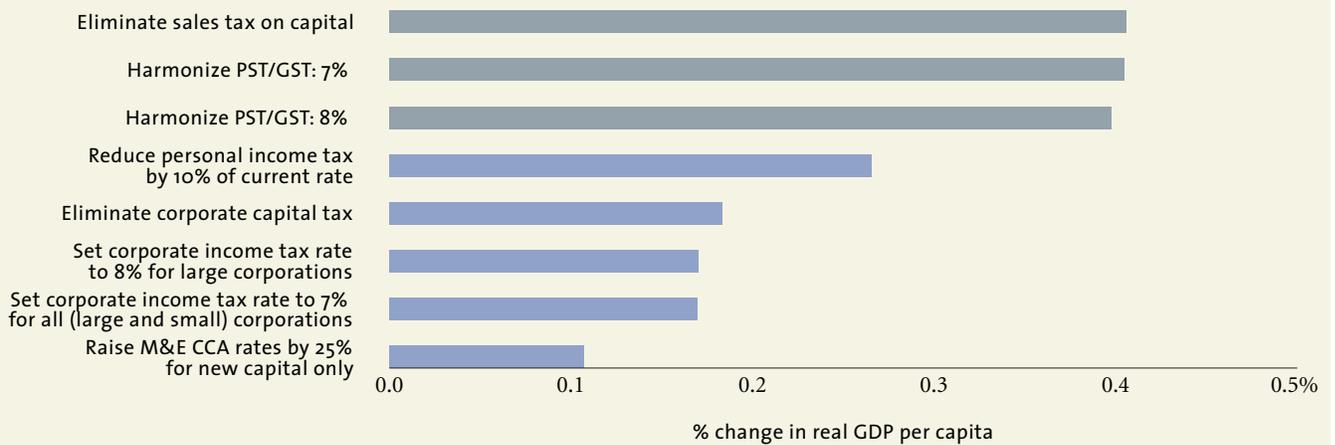
Tinkering with corporate income tax rates has limited impact

We studied two options here. One option would be to reduce the provincial corporate income tax rate to 8 percent for all large corporations – from 14 percent for non-manufacturing companies and 12 percent for manufacturing and resource companies. Another option would be to set the provincial corporate income tax rate at 7 percent for large and small companies alike (small corporations currently pay 5.5 percent). As we discussed earlier, setting income tax rates lower for small corporations discourages firms from growing and penalizes larger firms that tend to be more productive. These two options are less effective in raising GDP per capita

(Exhibit 16) and have a relatively high cost to the provincial treasury (Exhibit 17). So they have among the lowest fiscal multipliers of the eight options studied (Exhibit 18). They have limited impact on personal disposable income (Exhibit 19) and job creation (Exhibit 20).

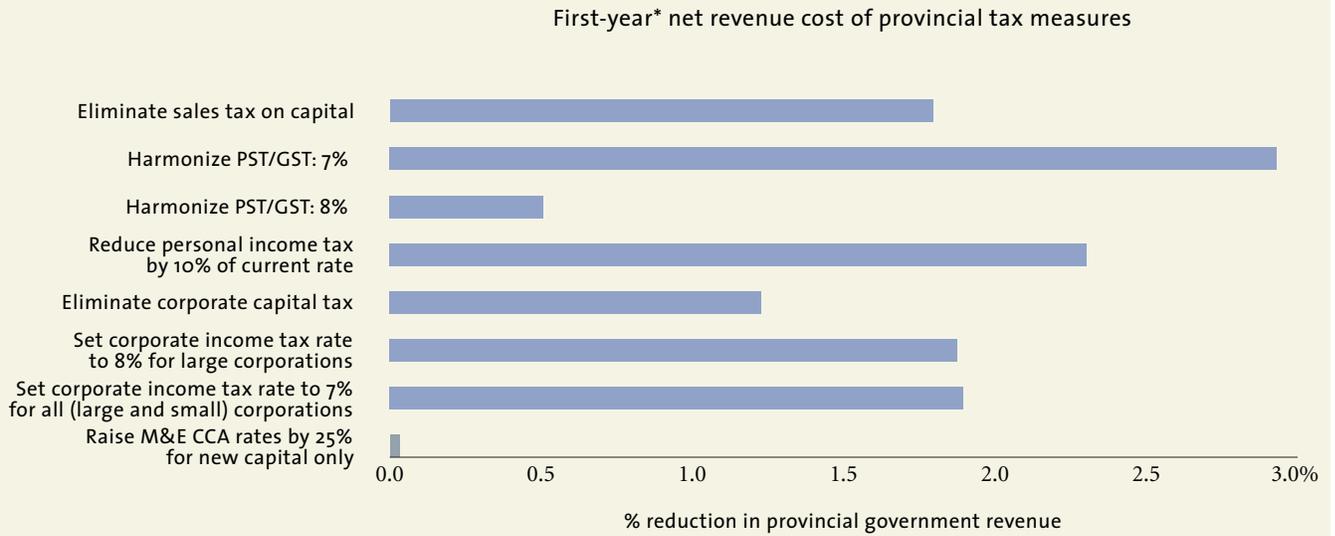
Exhibit 16 Provincial sales tax reforms deliver the largest prosperity gains

Impact of provincial tax measures on per capita GDP (after 10 years)



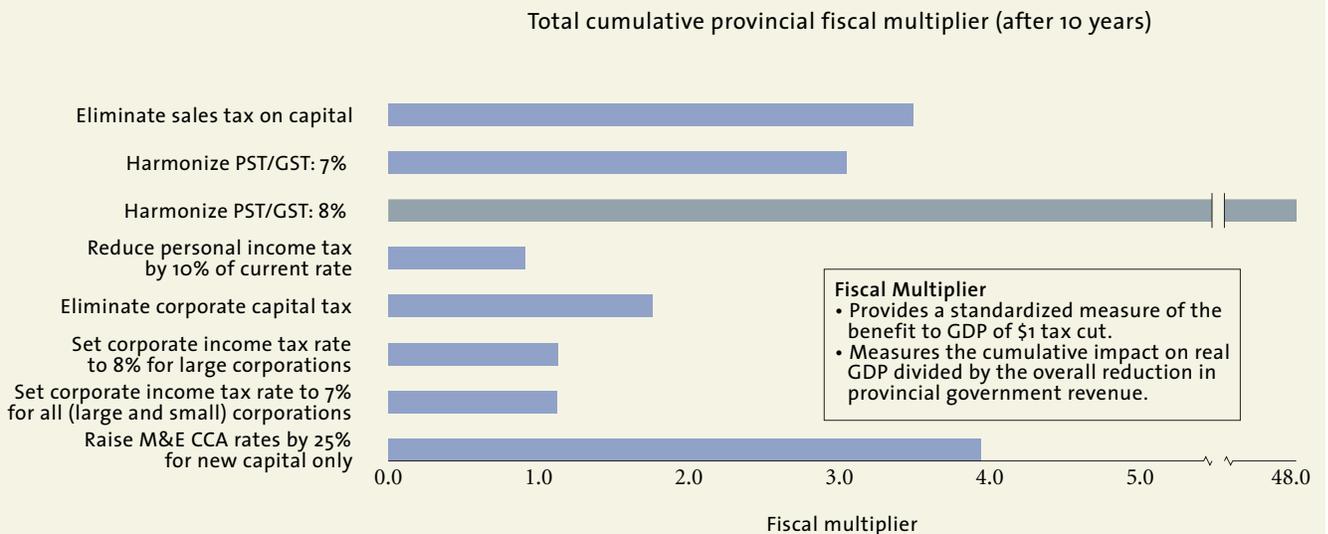
Source: Centre for Spatial Economics (2004), "Tax Policy, Competitiveness and Prosperity in Ontario" Report prepared for the Institute for Competitiveness & Prosperity.

Exhibit 17 Faster depreciation on new investment has the lowest cost



*Provincial government revenue greater than status quo after ten years for 8% sales tax harmonization.
 Source: Centre for Spatial Economics (2004), "Tax Policy, Competitiveness and Prosperity in Ontario" Report prepared for the Institute for Competitiveness & Prosperity.

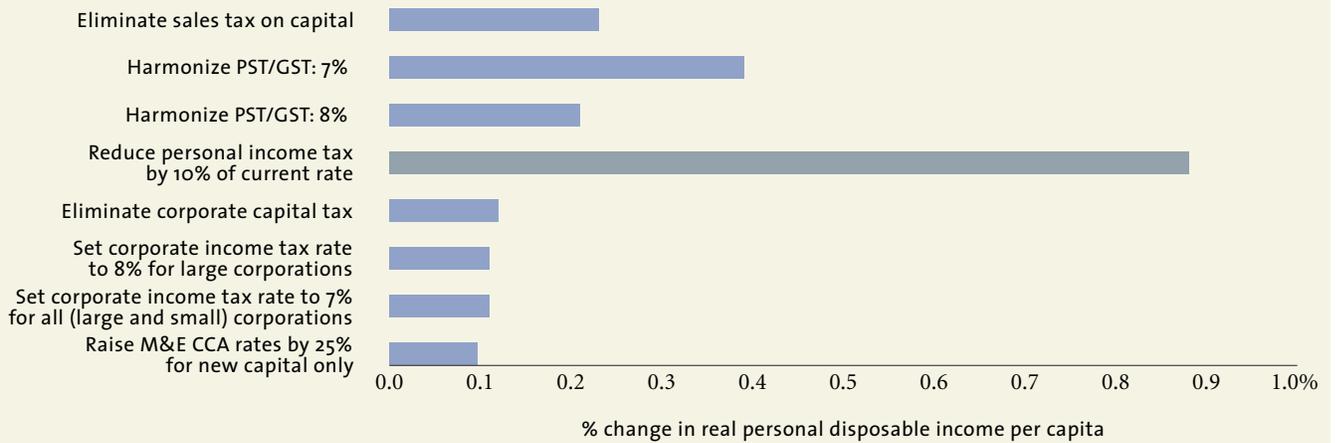
Exhibit 18 Harmonizing sales taxes between 7% and 8% is the most efficient way to raise prosperity



Note: The total revenue multiplier for the corporate income tax simulations is boosted by the shifting of taxable income from other jurisdictions in response to lower tax rates.
 Source: Centre for Spatial Economics (2004), "Tax Policy, Competitiveness and Prosperity in Ontario" Report prepared for the Institute for Competitiveness & Prosperity.

Exhibit 19 Lowering personal income taxes delivers the largest gain to Ontarians' incomes

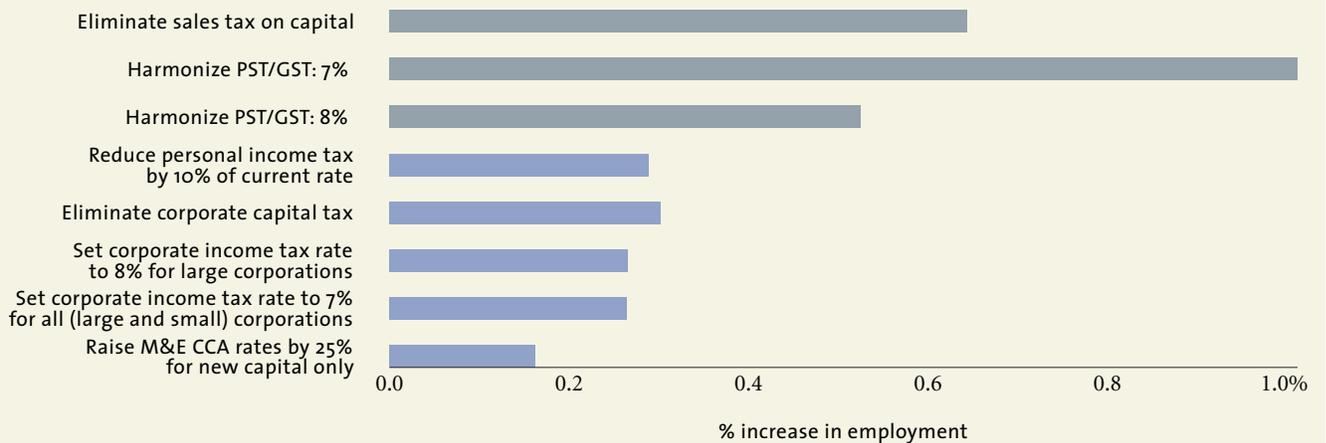
Impact of provincial tax measures on per capita personal disposable income (after 10 years)



Source: Centre for Spatial Economics (2004), "Tax Policy, Competitiveness and Prosperity in Ontario" Report prepared for the Institute for Competitiveness & Prosperity.

Exhibit 20 Sales tax reforms create the most employment

Impact of provincial tax measures on employment (after 10 years)



Source: Centre for Spatial Economics (2004), "Tax Policy, Competitiveness and Prosperity in Ontario" Report prepared for the Institute for Competitiveness & Prosperity.

This conclusion may seem at odds with our suggestion that corporate income taxes be eliminated entirely. However, the models we applied can only be used to compare relatively simple changes in rates. In effect, we are concluding that tinkering with corporate income tax rates would have less impact on competitiveness and prosperity than would reform of sales taxes and elimination of the corporate capital tax. Large-scale changes – up to elimination of the tax – have the potential for more substantial benefits, and we are encouraging the federal and provincial governments to explore these further.

Lowering average provincial personal income tax rates has low benefit and high cost

We find that small reductions in average personal income tax rates would have moderate impact on raising GDP per capita at relatively great expense to the provincial treasury. This option has the lowest fiscal multiplier. Nevertheless, it provides by far the greatest lift of personal disposable income. It ranks fifth of eight in its potential for job creation. But, as with corporate tax reductions, tinkering with the existing system has only a modest impact. We recommend that the federal and provincial governments explore bolder initiatives, such as the lifetime earnings approach.

Many of us would welcome individual tax relief, but we conclude that Ontario needs to focus on strengthening motivations for investment. By C4SE estimates the 10 percent reduction we modeled would cost \$1.7 billion in lost tax revenue in its first year.

Accelerating provincial capital cost allowances on new machinery and equipment has limited benefit

We modeled the impact of accelerated depreciation on new investments by increasing provincial expense rates by 25 percent. This faster depreciation improves the return on investment by speeding up the tax write-offs for the investment. Because it simply changes the timing of tax payments, and does not reduce them, it has the second highest fiscal multiplier. Nevertheless, accelerated depreciation for provincial tax purposes has the lowest impact on GDP per capita after ten years.

Reduce tax incentives and subsidies

As we have shown, there will be short-term costs to any significant tax reform undertaken in Ontario, unless the province harmonizes the PST with the GST at between 7 and 8 percent. We believe, however, that the costs of tax reform are affordable, if Ontario reduces its use of business subsidies and preferential tax treatment.

Ontario offers numerous *tax incentives* designed to promote particular industries by lowering the costs of capital and/or labour. These include incentives for R&D, film and television production, computer animation and special effects, co-operative education, apprenticeship training. These “tax expenditures” cost the provincial treasury hundreds of millions of dollars a year.⁴⁶ With respect to *subsidies*, Statistics Canada data indicate that the cost of business subsidies for Ontario was about \$600 million in 2001.⁴⁷

The effectiveness of these types of targeted incentives and subsidies is not well established. For example, both the federal government and Ontario offer tax incentives for R&D spending. However, research by the OECD indicates that even though they have one of the most generous tax incentive regimes for R&D among OECD countries, Canadian businesses invest less in R&D than the OECD average.⁴⁸ It has been estimated that the Ontario innovation tax credit costs about \$300 million a year.⁴⁹

Notably, two of the world’s leaders in R&D expenditures, Sweden and Finland, do not subsidize or offer preferential tax treatment to businesses to conduct R&D.⁵⁰ Instead, these two countries employ more researchers and R&D personnel than many other countries.⁵¹ They also have lower corporate income tax rates and lower marginal tax rates on capital investment.⁵² This evidence suggests that R&D tax incentives play a small role in encouraging R&D, and that there are more fundamental requirements to create an environment conducive to R&D.

To be sure, governments in the United States provide targeted grants for R&D; but this accounts for a very small portion of our marginal effective tax burden disadvantage versus the peer states.

⁴⁶ Mintz and Wilson (2004), p. 18. For example, in 2003-2004, Ontario’s Media Tax Credits cost the provincial treasury \$112 million (Provincial Auditor of Ontario (2004) *2004 Annual Report* (Queen’s Printer for Ontario), p. 314).

⁴⁷ Poschmann and Robson (2004).

⁴⁸ OECD (2003a); Institute for Competitiveness & Prosperity (2004) *Reinventing innovation and commercialization policy in Ontario*.

⁴⁹ Mintz and Wilson (2004).

⁵⁰ OECD (2002) “Tax Incentives for Research and Development: Trends and Issues.”

⁵¹ OECD (2004d) *Main Science and Technology Indicators 2004/2*, (Paris: OECD).

⁵² Chen and Mintz (2005).

We must also recognize that special treatment for specific industries comes at a cost. That is, financing tax expenditures and subsidies requires higher overall tax rates for those not receiving preferential treatment or reduced government spending in other areas, such as education and infrastructure. Other costs include supporting inferior investments⁵³ and allocating subsidy programs based on political consideration.⁵⁴ Further, the effectiveness of some incentive programs is questionable, because many jurisdictions chase the same clusters and industries simultaneously. Expanding fundamental assistance programs is likely a better policy option than granting subsidies and preferential tax treatment to specific industries and firms.

Some researchers suggest that phasing out ineffective tax expenditures and other subsidy programs could save the provincial government \$1 billion.⁵⁵ The resources made available by this process could be used to finance tax reduction and tax reform, as well as basic infrastructure, education, health care, and other core public services.⁵⁶ To its credit, in 2004, the provincial government began reviewing a number of tax incentives and proposed “to eliminate or replace nine tax incentives that no longer serve their intended purpose, have little uptake or are not in line with current priorities, saving the province \$85 million over four years.”⁵⁷

In addition to these problems, Ontario’s tax incentive regime lacks transparency because, unlike the federal government, Ontario has no “tax expenditure” account that estimates the actual cost of tax initiatives on an annual basis. The Ontario government has already pledged to develop and publish an annual tax expenditure account. A similar annual expenditure account should also be made for other subsidy programs.

Two broad themes point the way to smarter taxation

Many forces are at play in the determination of our standard of living and quality of life: investments in public services and infrastructure, the quality of the environment, market structures, international trade, and the quality of the labour force. However, as this working paper has made clear, much can, and should, be done to improve our tax structure because “[e]ven the best taxes cannot make the poor rich, but bad taxes can, and do, make us all poorer.”⁵⁸

Smart taxation is about equitably and efficiently raising the tax revenue necessary to fund the public services and infrastructure that Ontarians value. Smart taxation is about limiting the disincentives faced by individuals to participate in productive economic activities. Smart taxation is about making the lives of all Ontarians better.

Our research and modeling suggest two broad themes for taxing smarter to enhance Ontario’s competitiveness and prosperity:

- On the business side, we should shift away from taxing productivity-enhancing investment. To do this, we should consider measures such as elimination of the capital tax and sales taxation of capital investment and even breakthrough options such as cash flow taxation or the elimination of corporate taxation. Revenue lost through these measures would be replaced by higher consumption taxes, in particular a provincial value-added tax that is harmonized with the federal GST.
- On the personal side, our focus needs to be on removing the perversely high marginal tax burdens on those with lower incomes. To do this, we should consider several options to fix this, including the breakthrough options of much greater taxes on consumption and taxation of lifetime earnings.

A shift to a smart tax structure will promote job creation, higher investments in physical and capital resources, innovation, and the adoption of new technologies. This environment will enhance future economic growth, laying the foundation for a dynamic and prosperous economy and a strong government financial position necessary to fund the quality public services and infrastructure that the people of Ontario value.

⁵³ Poschmann and Robson (2004), p. 10.

⁵⁴ Jack Mintz and Michael Smart (2003) “Brooking no Favorites: A New Approach to Regional Development in Atlantic Canada” C.D. Howe Institute Commentary No. 192, p. 7.

⁵⁵ Mintz and Wilson, (2004).

⁵⁶ Trebilcock, Daniels, Green and Hrab (2004), p. 167-9.

⁵⁷ Ontario, Ministry of Finance (2004b) “Elimination of Tax Expenditures” Backgrounder, November 22.

⁵⁸ Bird and Wilson (2003), p. 8.

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