Institute for COMPETITIVENESS & PROSPERITY

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Institute urges Ontario to tax smarter for prosperity

Toronto, Ontario – Ontario can and should tax smarter in order to close the prosperity gap with its peer group of US states. For businesses, this means shifting taxation away from productivity-enhancing investments. For individuals, it means removing high marginal tax burdens on families with low incomes. This is the key conclusion of the seventh working paper, *Taxing smarter for prosperity,* released today by Ontario's Institute for Competitiveness & Prosperity.

"Smart taxation" creates the right balance between *equity*, when taxes are paid by those most able to afford them, and *efficiency,* when the negative impact of taxation on decisions to work, save, and invest is limited. Roger Martin, Dean of the Joseph L. Rotman School of Management at the University of Toronto and Chairman of the Institute observed that: "We know that many factors drive a province's prosperity, but we think that taxing smarter is an important way to achieve higher productivity and prosperity. We focus here on the mix of taxation, not the level."

The Institute draws on work by the federal Department of Finance and its own research to conclude that Ontario and Canada have opportunities to reduce taxation on business investment. As Martin noted, "Our businesses aren't investing at the same level as our US counterparts in machinery, equipment, and software. As a result our productivity is lower and our workers earn lower wages. Our tax rates on business investment in Ontario and Canada are among the highest in the world – even high-tax places like Sweden understand that taxing business investment at too high a rate isn't smart taxation."

For business, the key opportunity is reform of the provincial sales tax so that it is not levied on their investments and expenses. "Most of us experience the PST as the 8% that gets added on to our retail purchases. But the government reaps a quarter of the PST revenue from business investments on capital goods. And businesses pay another quarter on their operating expenses," observed Martin. The Institute also assessed faster depreciation schedules, but instead recommended basing taxation on a firm's cash profits, not its book profits. And it encouraged governments to explore the elimination of the corporate income tax altogether. As Martin said, "Corporations don't pay taxes, people do. Corporate income taxes are paid by workers through lower wages, by customers through higher prices, and by shareholders through lower returns. If you want to tax the wealthy, tax them directly, not the corporations."

The working paper also concludes that the federal and provincial governments should accelerate their planned phase-outs of the current tax on capital assets.

To replace revenue lost through reduced taxation on business investment, the Institute recommends that the Ontario government consider converting the provincial sales tax to a GST and apply it to the same goods and services as the federal tax. Research indicates that the average family's economic well-being would increase with this tax harmonization, as the additional investment that would ensue would create more high-paying jobs.

For individuals and families, the working paper focuses on the marginal tax burdens faced by lower income earners as they try to climb the economic ladder. Because social benefits, such as the Child Benefit supplement, are clawed back as incomes rise, families face perversely high effective tax burdens. For example, a single earner couple with two children faces a marginal effective tax rate of 60% as they pass $31,000 in taxable income – in other words they keep only 40 cents of every new dollar they earn. As earnings approach $36,000, the marginal effective tax rate reaches 90%. "Our challenge is not only to get help to those in need, but also to ensure that the tax and benefit system does not discourage families trying to progress through our system," said Martin.

The working paper proposes several options for governments, including closer integration of the tax and benefit system, new ways to encourage investment for retirement – as seniors also face high marginal effective tax burdens – and greater focus on taxation of consumption, instead of earnings or savings.

The Institute also encourages governments to investigate the benefits of shifting the basis of taxation away from annual incomes to lifetime earnings. Instead of giving taxpayers an annual exemption of around $10,000, as is currently the case, this approach would exempt the first $250,000 of lifetime earnings from taxation. Income taxes would be imposed after this hurdle is achieved, and the tax rate would rise as accumulated lifetime earnings passed other income levels. People with lower incomes could face zero taxation for years and even decades. Those with higher incomes would face lower tax rates than currently. This would occur because the basic personal exemption, which costs the federal government about $23 billion annually in forgone revenue, would be eliminated. Martin acknowledged that this would be a significant departure from current approaches. "It would take careful, deep thinking and rigorous logic. But we ought not to be deterred and simply accept the current counter-productive, complicated, and confusing system we have now."

Martin expressed his hope that, "the working paper helps Ontarians and Canadians think through ways of achieving a smarter tax system. Taxation is a complex issue; we're proposing some ideas that are worth exploring further because of their potential to contribute to higher prosperity for all."

The complete report can be downloaded directly from:
http://www.competeprosper.ca/public/wp07.pdf
For more information contact James Milway, Executive Director of the Institute for Competitiveness & Prosperity at 416.920.1921 ext. 222.

About the Institute
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. The Institute is supported through the Ontario Ministry of Economic Development and Trade. Reports 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. Visit the Institute's Web site www.competeprosper.ca for more information.