MLI Policy Briefing

Tax Reform Needed in Upcoming Federal Budget

By Jason Clemens

Introduction

As Canada and much of the industrialized world struggles with slow economic growth, there is an opportunity in the coming federal budget to improve domestic economic incentives, and by doing so, improve the prospects for economic growth. While the focus to-date on the Conservatives' first majority budget has been on spending cuts to balance the budget and the more recent frenzy on suggested changes to Old Age Security (OAS), there is a real opportunity for tax reform.

Simply put, tax reform entails changing the way in which government raises the resources (i.e. revenues) needed to finance government spending. This briefing explores two key aspects of tax reform: (1) assessing the current state of tax complexity, and (2) the costs to comply with the current tax system. In addition, the briefing offers some general recommendations on how best to pursue and implement tax reform in the coming budget.

I. Current State of Tax Complexity

Most economists agree that the best tax system is the one that imposes the lowest possible costs on society while providing sufficient revenues to finance government programs and services. The result of such principles is that the tax system should have the broadest tax base possible, which allows for the lowest tax rates possible.

In simple terms, the tax base refers to the underlying economic activity that is being taxed. It can include labour income (payroll and income taxes), business income (corporate and business taxes), property values (property taxes), and consumption (sales and consumption taxes), to name but a few. Every time a portion of the underlying tax base is exempted from tax, regardless of the worthiness of the exemption, higher tax rates are required to raise the same amount of revenue.

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Tax rates influence decisions by individuals and firms to expend work effort, save, invest, and undertake entrepreneurial activities, which form the basis of a productive and prosperous society. More specifically, tax rates influence these decisions by affecting the rewards individuals receive from undertaking these activities and in particular, marginal tax rates, which apply on the next incremental dollar of earnings, influence such decisions. Simply put, low marginal tax rates minimize the disincentives faced by individuals when considering decisions for work effort, savings, investment, and entrepreneurship.

The introduction of tax credits, deductions, and other allowances (also known as carve-outs) narrow the tax base, which means a higher tax rate is required to raise the same amount of revenue. The higher tax rates, and in particular the higher marginal tax rates, create disincentives, or barriers, for productive activities such as investment and entrepreneurship.

Tax reform offers the opportunity to rationalise, either by reducing or outright eliminating some of these tax credits and other special treatments in exchange for lower marginal tax rates. By expanding the tax base through the reduction or elimination of these special privileges, lower tax rates can be introduced that raise the same amount of revenues.

There are two additional issues to consider in examining tax credits, allowances, and other deductions, which are generally referred to as tax expenditures. The first consideration is that there are many programs classified as tax expenditures that yield enormous economic benefits to the Canadian economy. For example, the reduction in the general capital gains tax is counted as a tax expenditure rather than simply a tax reduction. The Canadian economy would be ill-served to reduce or eliminate this tax expenditure, which would increase taxes on capital gains.

Similarly, tax deferred pensions and registered savings accounts as well as the new Tax Free Savings Plan are also all counted as tax expenditures. All three programs have made savings more attractive and accessible for Canadians, thus improving the incentives for savings and investment. Put simply, tax reform should not aim to eliminate all tax credits and other carve-outs but rather focus on those that provide little or no benefit to the economy.

Indeed, the second consideration, which is key when assessing tax expenditures, is whether they improve the economy as described above or simply reward activities that were already underway. The worst outcome is when these credits and deductions simply lower the tax burden for certain individuals, businesses, or activities without necessarily improving incentives or behaviour. Indeed, in many cases they simply benefit individuals and businesses for what they were already doing, which implies a cost but no net benefit.

Sampling Personal Income Tax Credits

Reviewing the tax credits and related exemptions for personal income taxes in the most recent Tax Expenditure Report (2011)[1] provides insights on the breadth and depth of tax credits and other exemptions now present in the tax system. Recall that these carve-outs narrow the tax base and therefore require higher tax rates to raise the same amount of revenues.

The tax credits sampled below have moved far beyond those discussed previously, which all have the potential to benefit every Canadian citizen while also improving the overall economy. Find below a few categories of activities where there are multiple tax credits and other exemptions.

• There are now tax credits that benefit specific job classifications, including artists, musicians, tradespeople, apprenticing vehicle mechanics, volunteer firefighters, caregivers, farming and fishing, and clergy.
• There are almost twenty tax credits dedicated to work-related expenses, such as child care, home relocation loans and expenses, union and professional dues, and both a general employment credit as well as the recently introduced Working Income Tax Benefit (WITB). (Total = $6.9 billion)
• A number of child-related tax credits exist, including the new child tax credit, children's arts tax credit, child care expenses, and the children's fitness tax credit. (Total = $2.6 billion)
• There are a number of tax credits designed to assist students as well as parents paying the cost of post-secondary education, including credits for attending school, tuition, savings for school, textbooks, and loan interest on loans accumulated while in school. (Total = $1.9 billion)

There are also a number of specific tax credits within the 100-plus tax credits and other special treatments for personal income taxes worth noting:

• The Age Credit is specifically designed to reduce taxes for lower-income seniors ($2.3 billion);
• Tax exemption for employer-paid health and dental benefits ($3.2 billion);
• Medical expense tax credit for those incurring qualifying medical expenses ($1.1 billion);
• Lifetime capital gains exemption for farm and fishing properties ($335 million);
• Capital gains exemption for principal residences ($4.2 billion); and
• Public Transit Tax Credit ($150 million);

And this is only a sampling of the 100-plus carve-outs or special treatments offered for personal income taxes through tax expenditures. These special preferences totalled $130.2 billion in 2011, which is significant given that the federal government only collected roughly $120 billion in personal income taxes.[2] In other words, the value of the various tax credits and other exemptions exceeds the value of the revenues collected in personal income taxes in 2011. This list ignores the value and nature of tax credits offered for corporate income taxes and the GST, which adds roughly another $44.6 billion in exemptions and carve-outs.

Far too many of these carve-outs benefit a small group or sector of the economy at the expense of the larger economy. Remember that every carve-out shrinks the tax base, which means a higher resulting tax rate to raise the same amount of revenues. A far better approach – and one whose time has come – would be to cull or even eliminate many of these special-interest tax credits and use the resulting revenues to reduce marginal tax rates.

Cost to Reduce Tax Rates

Thus far the briefing has explained the cost of tax credits and similar exemptions in the tax code. The benefit available from reform is the ability to lower marginal tax rates, specifically personal income tax rates without giving up any revenue. This balance can be achieved by simultaneously reducing or eliminating some tax credits and using the resulting savings to finance reductions in the personal income tax rates.

For illustrative purposes, a preliminary set of estimates were calculated for the cost of a one-percentage point reduction in each of the four personal income tax rates:

Table 1. Cost estimates[3]	
Bottom Rate (15% to 14%)	$6.1 billion
Second Rate (22% to 21%)	$1.9 billion
Third Rate (26% to 25%)	$0.5 billion
Fourth Rate (29% to 28%)	$1.0 billion

The cost of a one-percentage point reduction in personal income tax rates is greatest for the bottom rate, which applies to all income earners above the basic exemption. However, this reduction also provides the weakest improvement in economic incentives.

It would be much wiser for reductions in personal income tax rates to be targeted on the two middle income tax rates of 22 and 26 percent, respectively. Specifically, the funds generated from reducing and/or eliminating tax credits and exemptions through tax reform should be used to reduce, and ultimately eliminate the middle two personal income tax rates, leaving just two personal income tax rates; one for the majority of earners and a second rate for higher-income earners.

The self-financing reforms outlined above would improve the incentives for work effort, savings, investment, and entrepreneurship, and in doing so strengthen the Canadian economy.

II. Compliance Costs

The costs associated with a complex tax code go far beyond simply raising the resulting tax rates by narrowing the tax base. Indeed, one of the often overlooked aspects of a complex tax system is the cost imposed on individuals and businesses to comply with the tax code as well as the administrative costs incurred by governments in maintaining the tax system. Simply put, the more complicated the tax code, the more costly it is for both individuals and businesses to comply with it, and the more costly it is for governments to administer. Tax reform that simplifies the tax system offers additional savings in the form of lower compliance and administrative costs.

One sign of the degree of complexity in the current tax system is the degree to which individuals must rely on professionals to complete and file their income taxes. A 2010 survey of Canadian tax-filers found that 51 percent used a tax preparer such as an accountant or lawyer to complete their taxes while another 18 percent relied on friends or non-profit organizations.[4] In other words, less than a third of Canadian tax-filers were able to complete their tax returns without outside assistance.

When one compiles these costs along with the costs of organizing receipts, corresponding with tax preparers, and/or competing one's own taxes, the total annual cost to comply with just personal income taxes in Canada was estimated at between $4 and $5.8 billion.[5]

But as Canadians know all too well there are a plethora of other taxes that also impose compliance costs on individuals and businesses. The last comprehensive assessment of tax compliance costs was completed in 2008.[6] This study estimated that the total costs incurred by individuals and businesses to complete and comply with taxation were between $16.2 and $25.0 billion dollars.

An additional $2.7 to $5.8 billion was incurred to administer the tax system by the federal, provincial, and municipal governments. Thus, the total cost to comply with and administer Canada's tax code was estimated at between $18.9 and $30.8 billion. The costs to comply with and administer the tax code have likely increased as it has become more complicated over the last half-dozen years.

III. Conclusion and Recommendations

There are a large number of tax credits and exemptions that clearly benefit a small group of Canadians at the expense of higher tax rates. In addition, many of these carve-outs simply reward individuals and businesses for activities they were already doing, which implies no net benefit with substantial costs. The Canadian economy also incurs substantial costs, last estimated to be between roughly $19 and $31 billion annually to comply with and administer the tax code.

The Canadian government has an opportunity to introduce broad tax reform aimed at reducing the number and cost of tax expenditures with particular focus on those that benefit a narrow group of Canadians and/or do not improve the incentives in the Canadian economy. The proceeds from such reforms could be used to reduce marginal personal income taxes, and in doing so improve the Canadian economy through stronger incentives for work effort, savings, investment, and entrepreneurship.

[1] Department of Finance (2012). *Tax Expenditures and Evaluations, 2011*. Ottawa, ON: Department of Finance. Available at http://www.fin.gc.ca/purl/taxexp-eng.asp.

[2] The value of tax expenditures for personal income taxes was calculated using net values for various categories of expenditures. The data on personal income tax receipts was taken from the June 2011 federal budget estimate for personal income taxes for 2011-12. See Department of Finance (2011). *Budget 2011* (June Update). Ottawa, ON: Department of Finance. Available at http://www.budget.gc.ca/2011/home-accueil-eng.html.

[3] Please note that each estimate assumes no other rate reduction. In other words, the cost to reduce the top marginal personal income tax rate from 29 percent to 28 percent was calculated as if no other tax rate changes were introduced. In addition, the current thresholds for each marginal tax rate were maintained. The data was calculated using Statistics Canada's SPSD/M Version 19.0.

[4] Vaillancourt, Francois (2010). *The Cost to Canadians of Complying with Personal Income Taxes*. Vancouver, BC: The Fraser Institute. Available at http://www.fraserinstitute.org/publicationdisplay.aspx?id=15958.

[5] Vaillancourt, Francois (2010). *The Cost to Canadians of Complying with Personal Income Taxes*. Vancouver, BC: The Fraser Institute. Available at http://www.fraserinstitute.org/publicationdisplay.aspx?id=15958.

[6] Vaillancourt, Francois and Jason Clemens (2008). "Compliance and Administrative Costs of Taxation in Canada". In *The Impact and Cost of Taxation in Canada*. Edited by Jason Clemens. Vancouver, BC: The Fraser Institute.