Guidelines for Tax Reform in Canada

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Introduction

Since its mandate began in 1984, the government has been committed to a comprehensive agenda for economic renewal founded on a better framework for growth and increased self-reliance for Canadians. Improving the tax system is a key part of that agenda.

Over the past two years a number of tax changes have been implemented. The corporate income tax base has been broadened by eliminating the inventory allowance and phasing out the general investment tax credit. Statutory tax rates are being reduced. The personal income tax has been made fairer through the elimination of tax shelters and opportunities for tax avoidance, and through the introduction of a minimum tax. Small business tax compliance was simplified by the elimination of the dividend distribution tax. A detailed review of our antiquated and discriminatory sales tax system was begun.

On July 18, 1986, the government announced that it intended to proceed with a review of options for comprehensive tax reform.

In proceeding with this review, the government remains strongly committed to the goal of creating a simpler, fairer and more efficient tax system. The review is focused on the linkages between the three major elements of the federal tax system – the personal income tax, the corporate tax and the sales tax – and how they fit into the policy objectives of tax reform in Canada.

The purpose of this paper is to facilitate discussions and public input over the next few months by setting out the guidelines being followed by the government in its examination of options for tax reform.

Guidelines

Comprehensive tax reform presents an opportunity to improve the tax system in a number of important ways for the benefit of all Canadians.

The broad objectives of tax reform are complementary: we need a fairer tax system consistent with the commitment of Canadians to greater social justice. The tax system should be simpler for Canadians to understand and comply with. It should provide a tax environment that more efficiently encourages productive economic activity. It should more effectively serve Canada's need for reliable sources of revenue to finance essential public services.

The government believes that changes to the tax system should be based on the guidelines set out below and described more fully in the section that follows.

Fairness

The tax system must ensure fair sharing of the tax burden among taxpayers. This means that the tax system should treat people in similar circumstances in the same way; that all high-income individuals and profitable corporations should pay their fair share of tax; and that similar products should bear the same rate of sales tax. The sales tax burden should be shared more equally than it now is among goods and services and the sectors that produce them.

Simplicity and Compliance

A critical principle underlying Canada's tax system is the principle of self-assessment and voluntary compliance. This principle should be strengthened through changes to make compliance easier by making the tax system simpler so that it is more readily understood by more Canadians.

Balance

The government should rebalance its revenue sources to reduce the extent of its reliance on personal income taxes. This will increase the take-home pay of most Canadian workers.

Stability

Raising more federal tax revenues in total is not the objective of tax reform. Tax reform should increase the certainty of achieving the revenue goals that the government sets for itself.

International Competitiveness

The tax system should reinforce the ability of Canadians to compete internationally.

Economic Growth

The tax system should encourage economic dynamism and growth in a more efficient, effective way through lower tax rates on a broader tax base. Business opportunities, rather than tax planning, should be the driving force behind business and investment decisions.

Canadian Priorities

The tax system should provide an environment that assists in meeting national social and economic needs, including regional needs; an environment in keeping with distinctively Canadian priorities and values.

Transitional Implementation

Changes to the tax system should be implemented with appropriate transition provisions.

Consultation

The government will consult broadly before bringing forward final legislative proposals on tax reform for consideration by Parliament.

Considerations

Fairness

There is a growing public perception that the numerous tax changes introduced over the last two decades have resulted in a tax system that no longer meets the basic tests of fairness. In particular, the government shares the concerns of most Canadians that:

- our self-assessing system must not only be fair, it must also generally be perceived to be fair;
- high-income individuals and profitable corporations should pay a fair share of tax;
- individuals with similar ability to pay taxes should pay similar amounts of tax; and that
- fair sharing of the tax burden should apply broadly across sectors of the economy and across goods and services.

As a consequence of the proliferation of selective tax exemptions, write-offs and deductions, individuals or corporations in similar circumstances can face very different tax liabilities. The greater share of the benefits of such exemptions and deductions often accrues to larger corporations and individuals in higher-income brackets.

Similarly, because the current federal sales tax treats similar products very differently, and because different rates of tax apply to various goods and services, an important part of the overall tax burden is very unevenly distributed across the economy.

These inequities under our current tax system are unfair to all those bearing their full share of the tax burden. Thus, a key objective of tax reform is to sharply curtail tax preferences and to markedly reduce rates of tax.

At the same time, fairness requires that we continue to recognize the position of those most in need. Canadians believe that a fair income tax system must be a progressive one. Our current income tax system is broadly progressive. Tax reform should reinforce this essential element of fairness. By reducing tax preferences that benefit the few and reducing tax rates to benefit a broad range of taxpayers, fairness can be substantially increased.

A key issue in tax reform is how support through the tax system for lower-income individuals and families can be achieved in better ways. The government has introduced an important innovation in the refundable sales tax credit and prepayment of the child tax credit. Tax reform offers the opportunity to build on these progressive initiatives.

Simplicity and Compliance

Some steps have already been taken to simplify the tax system, particularly for small businesses that are least able to cope with complex and rapidly changing policies and rules. More needs to be done.

A simpler tax system can be achieved by making progress in a number of important dimensions – from improved tax policies to simpler tax forms. Broadening tax bases and simplifying rate structures can make an important contribution to simplicity. The overall result should be less need for individuals and businesses to take tax factors into account in day-to-day business and financial decisions.

In the final analysis, easier compliance for individuals will make the greatest contribution to strengthening the self-assessment principle that is fundamental to our tax system. But simpler tax policies are the key to easier compliance. The more readily taxpayers can understand the incentives that remain in the system, the less time and effort will have to be directed to the unproductive task of complying with complex tax rules.

A simpler tax system will result from reducing both current tax preferences and future demands on the tax system for new preferences. This should lead to simpler tax statutes, although the goal of greater simplicity must always be balanced with the need to provide taxpayers with reasonable certainty about the application of the rules.

Balance

The government believes that income taxes should be reduced to leave more money in the pockets of Canadians to spend or save as they see fit. This means we will be seeking higher revenues from the corporate and sales tax systems. This should be done in a balanced, fair way.

Twenty-five years ago, sales and excise taxes were by far the largest source of federal revenues. They now account for only about one-fifth of tax revenues, despite historically high rates of tax. This erosion has occurred largely because the tax base has been narrowed further and further over the years. The sales tax now applies to only about one-third of consumer expenditures.

Corporate income taxes have also shrunk sharply as a share of federal revenues. In part, this results from a decline in profits as a share of national income and from the carry-forward of losses incurred during the recession. It is also caused by erosion of the corporate tax base through tax preferences in the form of special deductions and write-offs.

As sales and corporate tax revenues have declined as a share of revenues, personal income tax has increased. It accounted for less than one-third of federal revenues 25 years ago. It now accounts for about half. In the absence of reform, this reliance is projected to continue increasing in the future. Individual Canadians would take home less and less of their pay. This situation should be changed through comprehensive reform of the tax system.

Stability

The tax system has increasingly become a less stable and less predictable source of revenues. This hampers the budgeting process of the federal government, just as uncertainty about income can hamper the decision-making of Canadian firms and individuals. While some of the unpredictability is due to factors outside Canada's control, such as movements in commodity and oil prices, some is due to the nature of the current tax system itself.

Currently, the total value of unused corporate tax write-offs and tax credits is the major contributor to instability in revenue flows. In 1982, the last year for which detailed data are available, that total stood at $18.5 billion – then equal to about two years' revenues from the corporate tax. The existing antiquated federal sales tax also regularly results in cases of unanticipated revenue loss.

In the past, the reaction to these events has often been changes in tax legislation designed to block transfers of unused tax incentives from one taxpayer to others or to rectify erosions of the sales tax base. This cycle of action and reaction has led to undesirable levels of tax complexity and uncertainty for taxpayers.

In tax reform, it is the intention of the government to ensure a sounder, more predictable revenue base, not greater total revenues. While the tax reform exercise is proceeding, other tax action is not precluded, if necessary to meet fiscal management and economic and social policy goals.

International Competitiveness

Recent developments outside Canada provide further impetus for review of our tax system. In particular, personal and corporate tax rates in the United States have been lowered. Our close economic ties underline the need to ensure that our tax system allows Canadian producers to remain competitive with our major trading partner. But the Canadian and American tax systems are not identical. Tax reform in Canada is not a matter of duplicating changes in the U.S.

Our corporate tax system must be responsive to the need to ensure that investment, whether by Canadians or non-residents, takes place in Canada. We must ensure that the job-creating capacity of our economy is maintained and enhanced.

People – their knowledge, skills and drive – are the key to a successful modern economy. We must ensure that the tax system is not a deterrent to retaining and attracting key people.

In setting the rate of corporate tax, we must also keep in mind the need to ensure that our domestic tax base is not undermined as income is shifted to countries with lower tax rates.

Our sales tax system is also in need of reform to remove the serious competitive biases that now deter our exports and favour imports. Canada is the only developed country whose sales tax system favours foreign producers at the expense of domestic producers. Currently, the sales tax content of exports averages about one per cent of sales price. This can be an important deterrent, given that the profit margin on these sales may often be very modest. As well, under the current system, imports are taxed roughly one-third less than comparable domestic goods. By moving to a broad-based business transfer tax, these biases that hurt us abroad and at home can be removed.

Economic Growth

Reducing selective preferences and lowering tax rates will provide an important boost to investment and other growth- and job-producing economic activity.

The current income tax system is characterized by relatively high marginal tax rates and narrow tax bases because of selective write-offs, deductions and credits. Under this system many decisions are being made on the basis of tax considerations rather than business opportunities. This can artificially encourage some activities at the expense of other, fundamentally more productive endeavours. The result is reduced prospects for economic growth. Canada needs firms and investors making decisions based on economic potential, not tax savings.

The federal sales tax is also subject to biases. It deters exporters and domestic manufacturing firms whose products compete with foreign goods. Tax rates also vary dramatically across different domestic product categories and among different producers of the same or comparable products. Aside from being unfair, this is inefficient.

It is thus essential to intensify our examination of tax preferences that have been piled up over the years, in both the income tax and the sales tax.

Reducing tax preferences will make possible a significant lowering of tax rates. This, in turn, will encourage investment and other productive economic activity more on the basis of economic rather than tax considerations. Lower tax rates will reduce the gains from tax planning. Imposition of taxes at reasonable rates will provide general incentives based on results. It will mean that selective incentives will be less necessary. Taxes will be less of an obstacle to decisions to save, invest and earn income.

Canadian Priorities

Removing or reducing selective tax preferences does not mean sacrificing distinctive Canadian priorities.

One of the key roles of the federal government in the Canadian Confederation is to redirect resources among regions, thereby ensuring basic national standards in all parts of the country. The principle of equalization is now entrenched in our Constitution.

The tax system must be sensitive to our commitment to build greater regional equality on a strong foundation of productive economic growth.

Canadians are committed to a concept of social justice that includes appropriate recognition through the tax system for those most in need. This recognition is a key part of the social transfer system as well. There are important linkages between the tax and transfer systems. These links are integral and will be taken into account as the government considers options for change in both the tax and transfer systems.

Canada is a relatively young country with many capital-intensive industries. Our capital requirements will remain large into the foreseeable future. And that means our tax system must encourage a high rate of domestic savings to finance these requirements.

Canada has a particular need to develop and maintain a positive climate for entrepreneurship and productive investment. Creative risk-taking should be encouraged in the interests of building a more dynamic, innovative economy.

Canada is a huge country with a small population, so the per-capita cost of maintaining a national infrastructure is relatively high. As well, Canadians have traditionally pooled their resources through the state to support important services such as post-secondary education and medical insurance, rather than requiring Canadians to finance the bulk of these costs out of after-tax earnings. Levels of taxation in Canada must continue to reflect these realities and broad social choices.

Transitional Implementation

Canadians must be able to rely on tax rules in making decisions. Appropriate transitional provisions are essential to permit stability of long-term planning for businesses and investors during a period of tax reform implementation. A measured transition will also allow taxpayers time to understand the new system and to adjust to it.

Consultations

The government is inviting public comment on the guidelines and directions set out in this paper. Canadians are encouraged to make specific suggestions for changes in the tax system.

Tax reform will be a key topic in the Minister of Finance's pre-budget consultations with business, labour, consumer and social policy groups. These consultations will play an important part in the government's assessment of the reform options.

The government will also consult extensively with provincial governments in an effort to ensure harmonized tax systems across the country.

The House of Commons Committee on Finance, Trade and Economic Affairs will also be asked to review these guidelines and make recommendations on how the government's goals for tax reform can best be achieved, while maintaining a system that suits Canada's needs.

It is the government's intention to set out specific directions for change at the time of the next budget. Further opportunities for consultation will be provided at key stages of the government's review.