

TAXING FOR GROWTH:

A close look at tax policy
in Ontario



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 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.

Research by the Institute is intended to inform the work of the Task Force and to raise public awareness and stimulate debate on a range of issues related to competitiveness and prosperity. It is the aspiration of the Task Force and the Institute to have a significant influence in increasing Ontario's and Canada's competitiveness, productivity, and capacity for innovation. We believe this will help ensure continued success in creating good jobs, increasing prosperity, and building a higher quality of life. We seek breakthrough findings from our research and propose significant innovations in public policy to stimulate businesses, governments, and educational institutions to take action.

Comments on this report are welcome and should be directed to the Institute for Competitiveness & Prosperity. The Institute is funded by the Government of Ontario through the Ministry of Economic Development, Trade and Employment.

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TAXING FOR GROWTH:

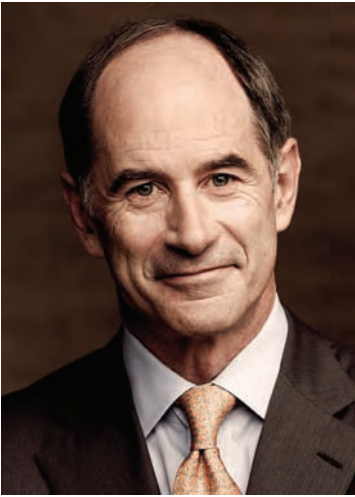
A close look at tax policy
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I AM PLEASED TO PRESENT WORKING PAPER 18 of the Institute for Competitiveness & Prosperity. The Institute has long advocated for “smart taxation” in Ontario as a means to improve the province's prosperity. In this Working Paper, *Taxing for growth: A close look at tax policy in Ontario*, the Institute provides a detailed analysis of particular tax credits and polices with an eye on the impact they have on economic activity.

Tax policy is one of the most powerful public policy levers available to government. Not only do taxes generate the revenue necessary for the purchasing of public goods, they also create incentives and barriers for personal choices and business investments. It is important that governments have an accurate understanding of the costs and benefits associated with certain tax expenditures. Some tax expenditures were generated by good intentions or political reasons, and they may no longer be fit for those purposes.

For the Institute, a smart taxation system is equitable, efficient, and effective. Rather than getting into theoretical debates around “higher versus lower” taxes, the Institute advocates for smart taxation that enables governments to raise money, while also enhancing the standard of living of all Ontarians.

The analysis focuses on two key areas: personal income tax, and business taxes. In 2011–12, personal income tax revenues contributed approximately \$24.5 billion to Ontario’s total revenues. This amounted to approximately 22.4 percent of total revenues in 2011–12. Governments of all political stripes, and at all levels, have had an impact on personal income taxes, with one of their favourite playthings – tax credits. This vehicle is used often to “get money back in peoples’ pockets.” While this is a laudable goal, there may be a more effective and efficient way of doing so. This Working Paper calls for a revision to the basic personal allowances, the conversion of the tuition and education credits to grants, and a reassessment of federal and provincial personal tax credits.

Since the Institute was created in 2001, taxation reform at both the provincial and federal levels has reduced the cost of new business investment and made Ontario more competitive internationally. Ontario’s marginal effective tax rate on business investment was reduced from 43.4 percent in 2005 to 19.8 percent in 2012. The Institute advocated for, and applauds, governments’ efforts to make the province more competitive and prosperous. However, there is more to do. One of the most persistent problems plaguing the Ontario economy is the failure to encourage and grow large businesses. Large companies export more, invest more in R&D, and compete on a global stage, all of which enhance

Ontario can continue to be the standard bearer for progressive taxation that makes the province more competitive and prosperous.

the competitiveness of Ontario's economy. The Institute strongly advocates for the phase out of the small business tax deduction, which rewards "smallness." Overall, governments should encourage greater corporate taxation neutrality, consider adopting a cash-flow taxation approach, and support R&D that drives innovation and prosperity.

Ontario has done much in recent years to "tax smarter." As a result, the instinct might be to move away from this area of reform. This would be a mistake. This Working Paper is meant to ignite a conversation and inspire action in this complex and politically difficult policy realm. Ontario can continue to be the standard bearer for progressive taxation that makes the province more competitive and prosperous.

We gratefully acknowledge the ongoing funding support from the Ontario Ministry of Economic Development, Trade and Employment. We look forward to sharing and discussing our work and welcome your comments and suggestions.



Roger L. Martin

Institute for Competitiveness & Prosperity



TAXING SMARTER RAISES PROSPERITY

SINCE 2001 THE INSTITUTE FOR COMPETITIVENESS & PROSPERITY has explored opportunities for strengthening Ontario's competitiveness and prosperity. The work has identified a significant prosperity gap with a peer group of US states and concluded that most of this gap stems from the lower level of labour productivity in Ontario. To raise productivity, Ontario needs to strengthen its capacity for innovation.

TO HELP UNDERSTAND THE FACTORS BEHIND UPGRADING AND INNOVATION, the four components of the AIMS framework have guided the research:

- **Attitudes** toward 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.

The Institute's previous research using the AIMS framework found that lags in investment in education, machinery and equipment, and information and communications technology have been key drivers of the productivity and prosperity gaps.

This Working Paper focuses on the motivations component of the AIMS framework, which addresses the impact of taxes, regulations, and government support programs on economic activity. Moving to "smart taxation," with the objective of both simplifying our taxation system and expanding the income base from which tax revenues derive, is the prime focus. By expanding the tax base Ontario can raise revenues with lower rates and improve the efficiency by which different activities are taxed.

At the personal income level, provincially and federally available tax credits are assessed, with a push for the removal of those that cannot be justified as smart taxation. Some of these suggestions are timely; for instance, this Working Paper calls for the reform of the federal Children's Fitness Credit when the federal government plans to double the size of the credit.

At the business level, some of the supports available are reviewed with the objective of increasing neutrality among different industries. This is important because it encourages businesses to pursue opportunities based on their profitability potential rather than the level of government support.

Taxing smarter can benefit all of those who live and work in Ontario and this can be accomplished through tax policy changes at the personal and corporate levels. Reform requires that both provincial and federal governments curb tax expenditures that provide unjustifiable preferential treatment for certain activities at the expense of alternatives.

Taxes contribute most of Canada's government revenues

While many Canadians do not like paying taxes, they are necessary for public spending in areas such as health care, education, and infrastructure. Individuals and businesses benefit from the public provision of these social goods, because they do not have to make comparable expenditures themselves.

Taxes, however, have important disincentive effects that reduce their effectiveness. Higher taxes on corporate and capital income discourage business activity and encourage firms to locate in alternative jurisdictions with more favourable business rates. This is particularly the case for highly mobile businesses like call centres, which can open or shut down as taxation changes. At the personal income level, higher tax rates reduce wage income and affect the willingness of individuals to enter the work force and work additional hours. These examples illustrate that there are tradeoffs in tax system design.

Objectives for an effective system of taxation were laid out in the Mirrlees Review, a comprehensive report on 21st century tax reform. These are that: the influence of the tax system on welfare and economic efficiency should be minimized; administrative costs should be minimized; and taxes should be as transparent and fair as possible.¹ Taxes that are "simple, neutral and stable" most likely fit within these objectives, compared with alternatives that are "complex, non-neutral, and frequently changing."²

These objectives apply regardless of a society's preference toward income redistribution, which is fundamentally linked to tax design. A tax is progressive if the average tax rate (total tax liabilities divided by total income) increases as the amount taxed increases. Members of society with lower incomes pay a smaller percentage in tax than those with higher incomes. While a tax system with

1 Institute for Fiscal Studies, *Mirrlees Review: Reforming the tax system for the 21st century*, 2010, p. 22.

2 *Ibid.*, p. 23.

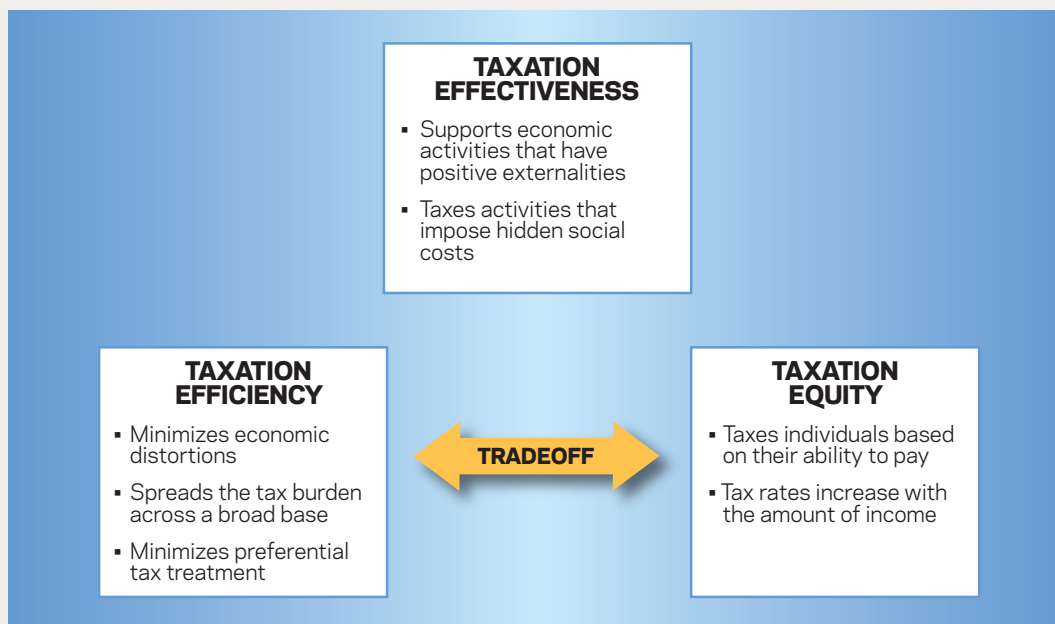
increasingly higher income bracket tax rates is characterized as progressive, a flat or constant tax with an initial tax-free allowance is also progressive, because the average rate increases once the initial allowance amount is surpassed.

A smart taxation system is equitable, efficient, and effective

When taxes are levied on different activities, they affect the motivations for individuals to work and to save. A smart taxation system does not discourage individuals from working or investing in the economy and raises tax revenues while minimizing the distortionary aspects of a tax. A smart taxation system is **equitable**, **efficient**, and **effective** (Exhibit 1).

Income redistribution ties into the notion of fairness, or equitability, in tax system design. A smart tax system is **equitable**, raising revenues from those with the greatest ability to pay and where it is least likely to impose financial hardship. While for the majority of the population a lower tax burden is borne in the beginning of their working lives, this is balanced in later years when a correspondingly higher burden is borne. Equity also ensures that individuals with equal income face a similar tax burden regardless of income source.

Exhibit 1 A smart tax system comprises effectiveness, efficiency, and equity



Source: Institute for Competitiveness & Prosperity.

Smart taxation is also **efficient** in that it limits the economic distortions that accrue from the imposition of a tax. Taxes come between market supply and demand and influence the price and quantity of the object being sold. For instance, with a sales tax, retailers sell a product for a higher price than without a sales tax, and this in turn reduces the quantity consumers buy. By increasing the price and reducing the quantity sold, a tax imposes losses on both producers and consumers.³ A smart taxation system minimizes the distortions of taxes by applying them to a broad base while ensuring that they are as low and uniform as possible to meet revenue raising requirements.

Governments face a tradeoff between equity and efficiency in the formulation of taxation policy. Whereas a progressive income taxation system would increase income redistribution within an economy and would be more equitable, it would have important disincentive effects that would reduce overall economic efficiency. While some taxes are efficient but inequitable, others are both inequitable and inefficient. Smart taxation involves finding the appropriate tax mix that minimizes the negative effect taxes have on economic decisions, while ensuring that taxes are borne by those in society with the greatest ability to pay.

A smart taxation system is also **effective** in that it encourages things that are beneficial to citizens of a jurisdiction and discourages things that are not. Higher taxes are warranted when negative externalities occur from a particular action – for instance, smoking related health costs, which are borne by taxpayers in Canada, or environmental degradation from a polluter. In contrast, tax breaks are warranted when positive externalities occur from a particular action – for instance, investment in research and development has a broad impact on prosperity when developments spillover and lead to innovations in related areas.

This paper focuses on taxation expenditures such as credits, exemptions, and other forms of special treatment that reduce government revenues. The analysis is in two parts: the first examines some of the tax expenditures that are available for individuals and assesses whether they are consistent with a “smart” taxation system; the second looks at the effectiveness of different forms of business support in Ontario.

By taxing smarter, governments can improve the way they 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.

³ *Ibid.*, p. 29.



HIGHLIGHTS FROM WORKING PAPER 18: **TAXING FOR GROWTH**

SMART TAXATION

Equity: A smart taxation system is equitable, raising revenues from those with the greatest ability to pay and where it is least likely to impose financial hardship.

Efficiency: A smart taxation system is also efficient, limiting economic distortions that accrue from the imposition of a tax.

Effectiveness: A smart taxation system is also effective, encouraging actions that are beneficial for citizens of a jurisdiction and discouraging those that are not.

REVIEW PERSONAL INCOME TAXATION CREDITS

Revise the Basic Personal Allowance. This benefit is poorly targeted and disproportionately benefits middle and higher income groups.

Convert tuition and education credits to grants. These credits could be more effective at encouraging Canadians to pursue higher education as student grants.

Review targeted tax policy measures. Review the effectiveness of the Children's Fitness Credit and eliminate the Ontario Clean Energy Benefit.

RE-EVALUATE BUSINESS SUPPORT MEASURES

Phase out the small business deduction. This benefit creates an economic inefficiency by discouraging growth beyond the small business income threshold.

Implement a cash-flow system of corporate taxation. This would enable the expensing of capital investments immediately, which would encourage capital investment.

Pursue taxation neutrality as a guiding principle. Industry targeted business supports reduce the neutrality of corporate taxation. Neutrality is an important objective because it encourages firms to pursue investments based on their perceived profitability rather than the level of business support.



TAXATION EXPENDITURES ARE A MAJOR COST TO GOVERNMENTS

GOVERNMENT POLICY IS TYPICALLY IMPLEMENTED IN TWO WAYS. First, governments can direct expenditures toward social programs, income transfers, and other areas. Second, governments can impose taxes to achieve similar policy objectives. While the latter are not expenditures directly, they reduce revenues below the level that would be received in their absence. These “tax expenditures” result in a loss in revenues for governments and in turn a reduction in tax liability for certain taxpayers.⁴

The downside of a system rife with these expenditures is that it results in a reduced taxation base, or the sum of taxable income sources, and necessitates a higher rate overall to raise a given level of revenue. This can be problematic, because higher tax rates create more disincentives for individuals to engage in activities, like working or saving, which are beneficial from an economic standpoint. A lower tax rate on a broader base is the preferable alternative.

If tax expenditures have disincentive effects, why are they used?

There is typically a legitimate reason for a tax expenditure that falls within the “effectiveness” component of smart taxation. When there is a valid case for government intervention to encourage an activity that would otherwise be under engaged in, a tax expenditure can be a suitable policy.⁵ This can occur when the social cost or benefit of an activity is not totally reflected in its market price; examples include tax provisions encouraging physical activity, research and development, and the use of public transit.

Certain tax expenditures have been successful in encouraging economically and socially desirable actions that have been beneficial to Canadians. The partial exemption of capital gains and the incentives provided for retirement savings have encouraged Canadians to invest in the economy and save for their future. Removing these would be a poor decision.

There are two main criticisms of tax expenditures:

First, they can have important disincentive effects when they influence the behaviour of individuals

and businesses to engage in activities that otherwise would not be viable. Subsidies that support certain industries can reduce government revenues when firms choose to locate in these industries over alternatives that do not have the same level of support. The impact associated with this sort of economic distortion is difficult to quantify in practice. Tax expenditures also tend to be reviewed less than direct expenditures.⁶

Second, another issue concerns the fairness of expenditure programs toward both taxpayers of different income levels and those with the same income level but with different means of income. For instance, certain expenditures provide a bigger tax advantage for individuals with income from investments or self-employment rather than from wages. Tax expenditures can have important income distributional effects when they are more likely claimed by those from certain income groups over others. This concerns the equity component of smart taxation.

It is important that the government has an accurate understanding of the costs and benefits associated with certain tax expenditures. While some tax expenditures are consistent with smart taxation, others fail this assessment and are in existence for political rather than social or economic reasons. This Working Paper focuses on the latter.

There has been an expansion in tax expenditures at the federal and provincial levels in the last decade. While the analysis relies on Canadian Revenue Agency (CRA) tax filing data which are only available until 2009, some important trends emerge.

4 “Tax Expenditures in OECD Countries,” *OECD Publication* (2011), p. 13.

5 *Ibid.*, p. 24.

6 *Ibid.*, p. 29.

Federal tax expenditures increased as a percentage of GDP in the last decade from about 5.8 percent in 2001 to 7.5 percent in 2009 (Exhibit 2). Growth was primarily in the early 2000s and stalled from 2006 to 2009. The number of total federal expenditures increased from 171 in 2001 to 189 in

2009, and the bulk of this increase was from 2005 on.

The Office of the Parliamentary Budget Officer found that the expansion as a percentage of GDP was primarily driven by an uptake in retirement savings (Exhibit 3).

The number of retirement taxation provisions has been constant, but the increase in the number of expenditures has been driven by measures targeting lower income individuals and encouraging post-secondary education. These fall into the “Other” category.

Exhibit 2 Federal taxation expenditures increased, 2001–2009

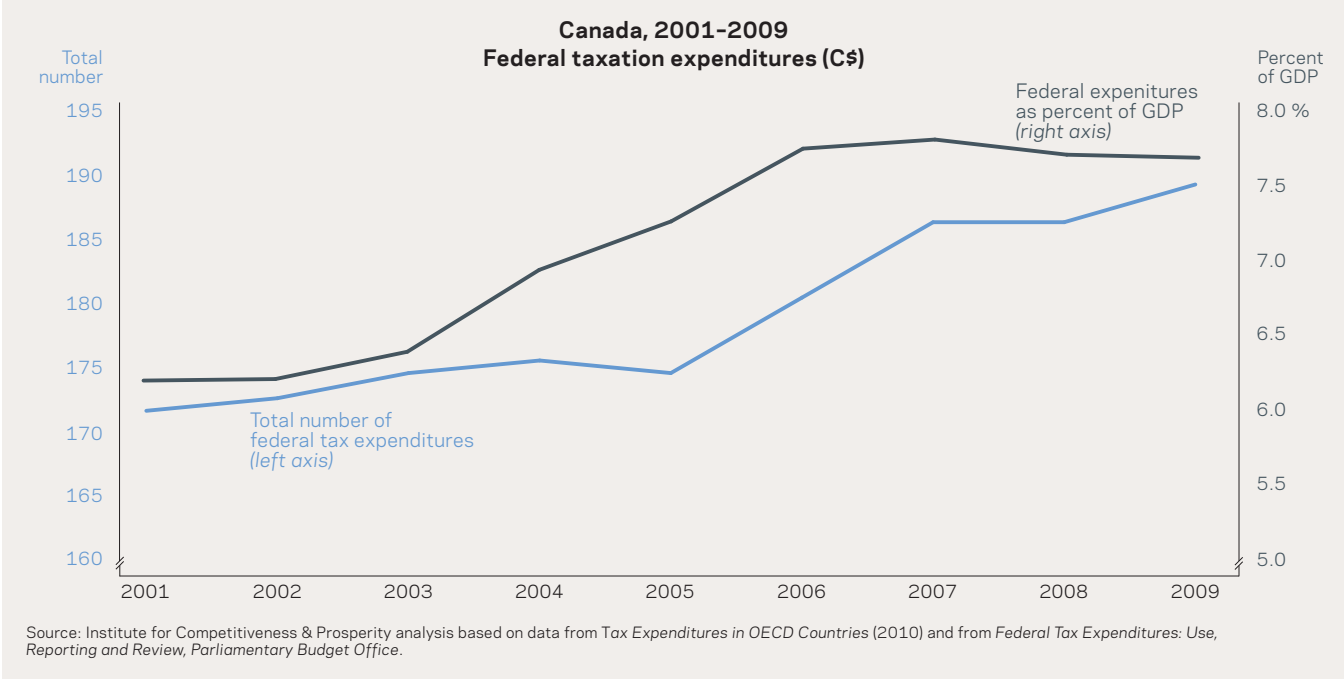
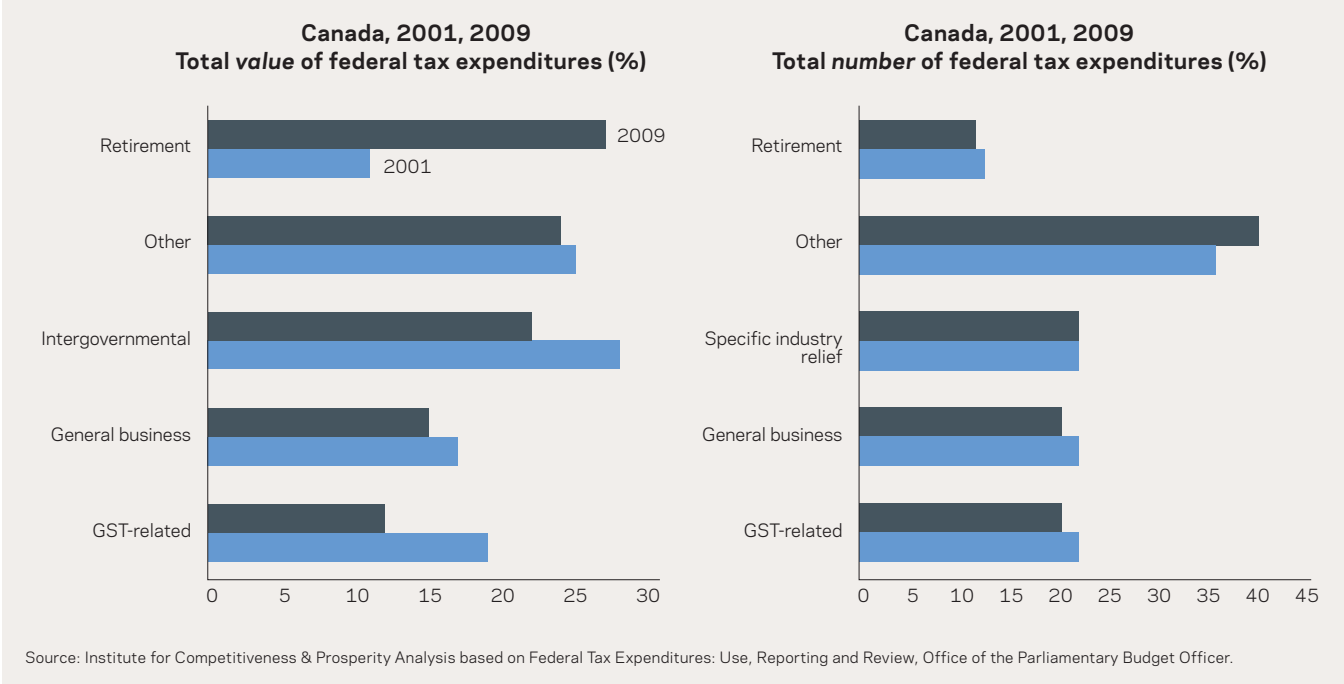


Exhibit 3 Retirement savings have driven the increase in expenditures as a percentage of GDP



Provincial tax expenditure data for Ontario indicate that a variety of provisions exist that are similar to those available at the federal level. A sampling of these provisions reveals that they cost both government levels a significant amount of revenues (Exhibit 4). The largest expenditure for both levels of government was the Basic Personal Allowance which exempts taxation on an initial, basic income amount. This was followed by the deduction for RRSP contributions and the partial exemption of capital gains from taxation.

Tax expenditures are a major cost to both levels of government and collectively reduce the size of the taxation base. This Working Paper assesses a sampling of these expenditures in greater detail. By reforming expenditures that are not consistent with “smart taxation” both levels of government can tax smarter for prosperity.

At the federal level the largest expenditure items were for the one-time Home Renovations Credit and the Canada Employment Credit. At the provincial level, the Ontario Clean Energy Benefit was the most costly item.

Exhibit 4 Provincial taxation expenditures are costly from a revenue standpoint

A sampling of tax expenditures, Ontario and Federal Cost in 2012 (\$ millions)

	Ontario	Federal
Personal Income Tax		
Basic Personal Amount	3,995	30,740
Registered Retirement Savings (RRSP)*	2,100	12,750
Tuition and Education Credits	335	551
Partial inclusion of Capital Gains	765	4,155
Children’s Fitness Credit	7.5	35
Federal Measures		
Canada Employment Credit	NA	2,085
Home Renovations Credit**	NA	2,265
Public Transit Tax Credit	NA	155
First-Time Home Buyers’ Credit	NA	110
Provincial Measures		
Ontario Clean Energy Benefit	1,030	NA
Corporate Income Tax		
Ontario Small Business Deduction	1,515	2,935

* Deduction for contributions

** This was a one time 2009 taxation measure.

Source: Institute for Competitiveness & Prosperity Analysis based on data from *Transparency in Taxation, Ontario Fall Economic Statement 2012* and *Tax Expenditures and Evaluations 2012*, Department of Finance.



PERSONAL INCOME TAX CREDITS CAN BE INEQUITABLE, INEFFICIENT, AND INEFFECTIVE

IN WORKING PAPER 16, *MAKING SENSE OF PUBLIC DOLLARS*, the Institute examined the different sources of government revenues in Ontario in 2011-12 and found that personal income tax revenues contributed approximately \$24.5 billion, or 22.4 percent, to total revenues. This ratio varied in other provinces, which have different taxation schedules and a different mix of revenues. In Québec, which has higher marginal taxes on income than in Ontario, personal taxation revenues were about 28.7 percent of total revenues in 2011-12. It is difficult to make comparisons between Ontario and the peer states, which on average have lower levels of state taxation.

Personal income tax credits exist at both the federal and provincial levels in Canada. Some credits, such as those for education and the basic personal exemption, are common to both levels of government and could be modified so that they more efficiently meet their objectives.

Revise basic personal allowance

The Basic Personal Allowance (BPA) is a non-refundable tax credit on the first \$11,038 of taxable income federally and on the first \$9,574 in Ontario. The credit ensures that individuals who make up to this amount, and who correspondingly have the lowest ability to bear income taxes, are tax exempt. The BPA is projected to cost the federal government about \$30 billion in forgone taxation revenues and the province of Ontario around \$4 billion in 2012.⁷

There are two fundamental flaws with the current BPA approach:

- The credit is non-refundable. Therefore, those who make less than the BPA limit are not entitled to the full amount of the credit. In Ontario, approximately 20 percent of tax filers had income in 2009 (the latest CRA data available) less than \$10,000.
- The BPA accrues disproportionately to middle and higher income groups in comparison to lower income individuals. Only 29 percent of the total BPA tax benefit accrued to individuals in Ontario who made less than \$15,000, the rest went to those above this income level. The 29 percent figure is overstated, because it assumes that individuals under the BPA limit receive the full amount of the benefit. The BPA is poorly targeted, and modification of the current arrangement has drawn support even from a leading left leaning policy group.⁸

The government should consider scaling back the BPA and diverting the resulting funds toward better targeted income support measures. For instance, funds from scaling back the BPA could be converted into an income tested transfer targeted at low-income Canadians. The downside of this approach is that the income based claw back of the transfer would reduce the returns to working, so policy makers would have to ensure that this benefit is scaled back gradually as incomes increase.

Convert tuition and education credits to grants

Both the federal and provincial governments provide non-refundable tax credits that subsidize tuition and the cost of post-secondary education. A full-time post-secondary student is able to claim a credit for tuition and an additional education amount for being in school. In 2012, for the average student in Ontario, these credits were valued at approximately \$9,600 federally and \$9,300 provincially. Students typically do not have a sufficient income level to make full use of these credits, so they are deferrable and can be used to reduce taxable income upon graduation.

A study from the Canadian Millennium Scholarship Foundation examined these credits and found them ineffective at encouraging young Canadians to pursue higher education.⁹ As a \$1.8 billion dollar annual expenditure, they do a poor job of supporting those who are financially constrained and most in need of the income support, because their benefits are realized in the future.

A more sensible policy is to convert the credits into student grants that would be available immediately for students. This would reduce the upfront cost of tuition in Ontario by about \$1,900 per year. When coupled

with the Ontario 30 percent tuition rebate, this would halve the price of higher education.

Reassess federal personal income tax credits

A select group of federal non-refundable tax credits available to Canadians should be reassessed.¹⁰ While there are positive social benefits to the activities the credits target, the tax benefits associated with these credits are skewed toward middle and higher income individuals. Lower income individuals are less likely to claim the credits and are ineligible for their full benefit when they have insufficient income. These federal credits include:

- **Children's Fitness Credit:** This provides a credit of up to \$500 toward registration and membership fees for each child involved in qualifying fitness programs.
- **Children's Art Credit:** This was introduced in the 2011 Budget and is similar to the Fitness Credit. It provides up to a \$500 credit for registration and enrollment fees for programs of "artistic, cultural, recreational or development activity."¹¹ Data are not yet available on the number of tax filers who claimed this credit or the amount it cost the government, though the government forecast in the 2011 Budget that it would cost approximately \$100 million per year.

7 Department of Finance Canada, "Tax Expenditures and Evaluations 2012" <http://www.fin.gc.ca/taxexp-depfisc/2012/taxexp1201-eng.asp> Ontario Ministry of Finance, "Transparency in Taxation, 2012" <http://www.fin.gov.on.ca/en/budget/fallstatement/2012/transparency.html>.

8 Marc Lee and Igljika Ivanova, *Fairness by Design*, Canadian Centre for Policy Alternatives, 2013.

9 Christine Neill, *Canada's Tuition and Education Tax Credits*, the Canadian Millennium Scholarship Foundation, 2007.

10 The distributional analysis follows a similar approach as a Frontier Centre for Public Policy paper, *Harper's Tax Boutique*, 2011.

11 Government of Canada, 2011 Budget: *A Low-Tax Plan for Jobs and Growth*, pg. 113.

- **First-Time Home Buyers' Credit:** This affords first-time home buyers a \$5,000 tax credit for the purchase of a qualifying home, yielding a maximum total tax benefit of \$750.
- **Public Transit Credit:** This credit allows individuals to claim the cost of the public transit passes they use on their own behalf or their spouses' or children's use. A public transit user in Toronto would qualify for a tax credit of \$1,542 in 2012.
- **Canada Employment Credit:** This credit allows individuals to claim up to \$1,095 in employment income to cover things like uniform expenses, safety gear, and home computers.
- **Home Renovations Credit:** A temporary federal tax credit in 2009

for housing renovations with a maximum credit of \$9,000.

The Institute examined data from the Canadian Revenue Agency (CRA) to identify how the benefits from each of these tax credits accrued to different income groups within Ontario. In 2009, using the latest available data, about 28 percent of tax filers had incomes in excess of \$50,000, and only 6 percent had incomes in excess of \$100,000. Those with incomes between \$50,000 and \$100,000 are classified as middle income earners and those with income over \$100,000 as higher income earners.

The Relative Claiming Ratio (RCR) makes it possible to compare how the benefits are dispersed among the income groups. It measures the share

of tax credit claimants relative to their share in the total tax filer population. An RCR ratio greater than 1 indicates a particular group claimed a credit by a higher proportion than their representation in the total tax filer population. The Children's Fitness Credit and the Home Renovations Credit had RCRs for higher income individuals of 3.4 and 3.1, respectively.

Convert Children's Fitness and Arts Credits to grants

The tax credits examined are disproportionately claimed by middle and higher income individuals. Approximately 62 percent of individuals who claimed the *temporary* home renovations tax credit had total income in excess of \$50,000, and 19 percent had income in excess of \$100,000. The figures are similar for the Children's

Exhibit 5 Federal non-refundable tax credits are claimed disproportionately by higher income Ontarians

Federal non-refundable tax credit	\$50,000-\$100,000			\$100,000+			\$50,000+		
	Number	Share of total	Relative claiming ratio	Number	Share of total	Relative claiming ratio	Number	Share of total	Relative claiming ratio
Home Renovations Credit*	602,830	43.6%	2.0	263,230	19.0%	3.1	866,060	62.6%	2.3
Canada Employment Credit	1,819,640	28.5%	1.3	523,330	8.2%	1.3	2,342,970	36.7%	1.3
Public Transit Credit	159,900	27.4%	1.3	47,700	8.2%	1.3	207,600	35.6%	1.3
Children's Fitness Credit	272,410	44.3%	2.1	128,800	21.0%	3.4	401,210	65.3%	2.4
First-Time Home Buyers' Credit	31,180	44.2%	2.1	3,600	5.1%	0.8	34,780	49.3%	1.8

Note: This was a one-time taxation measure.
Source: Institute for Competitiveness & Prosperity analysis based on data from the Canadian Revenue Agency: "T1 Final Statistics (2009)," <http://www.cra-arc.gc.ca/gncy/stts/t1fnl-eng.html>.

Exhibit 6 Benefits from federal non-refundable tax credits accrue to higher income individuals

Federal non-refundable tax credit (amounts in thousands)	\$50,000-\$100,000		\$100,000+		\$50,000+	
	Value	% of total	Value	% of total	Value	% of total
Home Renovations Credit*	\$2,938,465	44.1%	\$1,596,527	23.9%	\$4,534,992	68.0%
Canada Employment Credit	\$1,855,973	29.0%	\$538,684	8.4%	\$2,394,657	37.4%
Public Transit Credit	\$178,863	33.3%	\$57,672	10.7%	\$236,535	44.0%
Children's Fitness Credit	\$156,288	44.7%	\$91,672	26.2%	\$247,960	70.9%
First-Time Home Buyers' Credit	\$146,900	44.9%	\$17,295	5.3%	\$164,195	50.2%

Note: This was a one-time taxation measure.
Source: Institute for Competitiveness & Prosperity analysis based on data from the Canadian Revenue Agency: "T1 Final Statistics (2009)," <http://www.cra-arc.gc.ca/gncy/stts/t1fnl-eng.html>.

Fitness Credit. Approximately 6.4 million Ontarians claimed the Canada Employment Credit in 2009, and almost 37 percent had incomes in excess of \$50,000. The Public Transit Credit was claimed by a similar percentage of middle and higher income earners, but by far fewer Ontarians overall. About 50 percent of individuals claiming the First-Time Home Buyers' Credit had incomes in excess of \$50,000. Despite higher income individuals making up only 6 percent of total tax filers in Ontario, in some cases they were more than three times as likely to claim these credits than if the credits were claimed at an equal percentage by all income groups.

How the resulting tax benefits were distributed among middle and higher income individuals is also revealing. The proportions accruing to these groups are downward biased, because they assume that those with lower incomes receive the full non-refundable tax benefit, which is not the case if they have insufficient total income.

The tax benefits from these credits accrue predominately to middle and

higher income individuals, and the proportions are slightly larger than the shares in Exhibit 5. Almost 71 percent of the tax benefit from the Children's Fitness Credit went to those with income in excess of \$50,000, and almost 26 percent went to individuals with income in excess of \$100,000. Similarly, 68 percent of the benefit from the Home Renovation Credit went to individuals with income in excess of \$50,000. Comparable figures for the Canada Employment Credit, the Public Transit Credit, and the First-Time Home Buyers' Credit were 37 percent, 44 percent, and 50 percent, respectively.

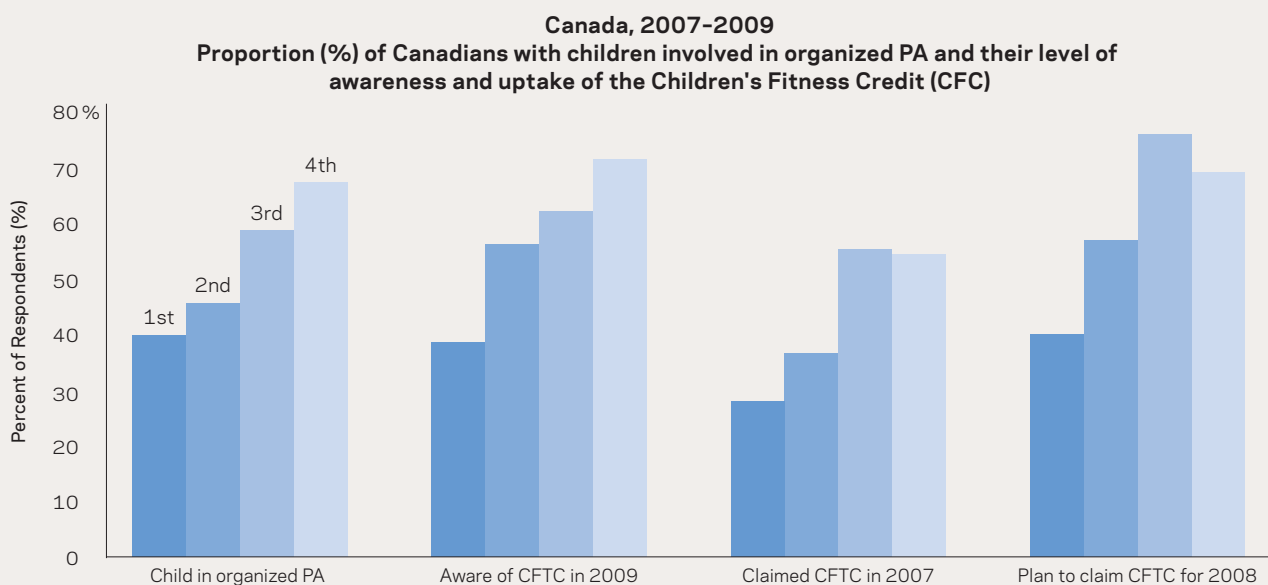
Middle and higher income individuals were not only more likely to claim these credits but also more likely to be the recipients of their full tax benefit (Exhibit 6). This speaks to a broader issue of income redistribution within Ontario, because the credits undo some of the progressiveness of our taxation system.

While these credits target socially desirable behaviours and for the most part fulfill the effectiveness

component of the smart tax framework, there is evidence against their equitability and their ability to influence behaviours. What if the benefit from the credits is not large enough to influence the decision for individuals to undertake the activities for which the credits target? Or what if there is imperfect information on the availability of the credits which varies based on income level? These are important questions, yet there has been only limited research that critically assesses the tax credits.

One study evaluating the effectiveness of the Children's Fitness Credit (CFC) found some significant results, which could also apply more broadly to the recently introduced Children's Arts Credit that is structured similarly. The authors conducted an online survey of 2,145 Canadian adults who were asked a series of questions about their awareness of the CFC. They noted demographic information from each respondent, and the survey was statistically weighted to match the actual Canadian population. The authors examined the response to each question by income quartile (Exhibit 7).

Exhibit 7 Higher income individuals were more likely to benefit from the Children's Fitness Credit



PA = physical activity, sport, or dance
 Note: Household income only includes parents with children aged 2 to 18 years
 Source: Institute for Competitiveness & Prosperity analysis based on data from BMC Public Health, Spence et al. "Uptake and effectiveness of the Children's Fitness Tax Credit in Canada: the rich get richer." 2010

Of parents with children (55.5 percent of total respondents), those in the highest income quartile were almost 28 percentage points more likely to have a child in organized physical activity and were around 33 percentage points more likely to be aware of the CFC. Awareness of the credit is important, because that determines whether the credit influences the behaviour of parents on the margin between registering their child in an activity. For instance, a family contemplating enrolling their child in a soccer league would be faced with two different fees – the normal registration fee of \$200 and the reduced rate of \$170 if they could foresee claiming the CFC. This awareness matters because the CFC influences financially constrained families who could afford the reduced \$170 fee but not the regular \$200 normal fee. The study established that this awareness is higher among families in higher income quartiles.

On top of these issues, higher income families were more likely to claim the CFC and to plan to claim it in the following tax year. And the amounts claimed are larger in higher income groups. Whereas almost 40 percent of families in the lowest income quartile reported that they spent \$0 to register their children in physical activities, around 30 percent of families in the top income quartiles claimed the full amount of the credit (Exhibit 8).

Previous research has shown that children from lower income families are less likely to be physically active than children from middle and higher income families.¹² This is of significant policy concern because non-active lifestyles drive healthcare costs.

Encouraging physical activity is a worthwhile pursuit, yet the CFC should be modified so that it is more broadly available and in turn more equitable. Instead of individuals having to claim the CFC on their tax return allowing accredited non-profit organizations simply to deduct the tax benefit from their fees makes more sense. This recommendation also applies to the Children’s Arts Credit.

Reassess Public Transit Credit

The government should consider replacing the Public Transit Credit (PTC) with a benefit that is directly applied to the cost of public transit. Under this arrangement, transit authorities would submit receipts for each purchase of a monthly pass to the federal government for reimbursement. An agreement would have to be made to ensure that fares would stay constant rather than being increased after the credit became available. This would also reduce administrative and compliance costs on behalf of the CRA.

Unfortunately, the stated objective of increasing ridership has not really been fulfilled by the PTC, and the calculations the government has put forward on the resulting reduction in greenhouse gases are optimistic.¹³ Although ridership increased overall from 1.9 percent of the total population on average from 2001-2005 to 2.9 percent on average from 2006-2010, it is difficult to determine the causal impact of the PTC as there is an overall upward trend in ridership.¹⁴

The Institute has shown that the tax benefit from this credit is not distributed equitably, as it accrues disproportionately to higher income tax filers. Awareness of the credit is another important issue that should be examined in light of the research questioning the effectiveness of the CFC.

12 John C. Spence et al., “Non-refundable Tax Credits Are an Inequitable Policy Instrument for Promoting Physical Activity Among Canadian Children,” *Canadian Journal of Public Health*, Vol. 103, No. 3, 2012.
 13 Thomas Appleyard, “Disparate Groups Unite to Oppose Transit Pass Tax Credit,” *Canadian Centre for Policy Alternatives*. October 2012.
 14 Department of Finance “Tax Expenditures and Evaluations 2011,” <http://www.fin.gc.ca/taxexp-depfisc/2011/taxexp1103-eng.asp>

Exhibit 8 Higher income individuals were more likely than others to claim a larger Children’s Fitness Credit

% of income quartile group reporting amount spent on registration fees by household income

	\$0	Less than \$100	\$100 to \$499	\$500 or more
Lowest quartile	39.8	23.8	27.7	8.7
2nd	33.6	20.5	34.1	11.8
3rd	20.9	14.5	35.9	28.6
Highest quartile	12.9	11.0	45.3	30.7

Note: Light to dark colours denote increasing value claimed.
 Source: Institute for Competitiveness & Prosperity analysis based on data from BMC Public Health, Spence et al. “Uptake and effectiveness of the Children’s Fitness Credit in Canada: the rich get richer,” 2010.

Phase out the Canada Employment Credit

This credit encourages employment by providing a maximum tax benefit in 2012 of \$164.25. It is doubtful that this benefit is enough to influence individuals to join the labour force. This would require that individuals carried out the rather complex calculation of comparing after tax income with the addition of this benefit to the cost associated with the disutility of working. In actuality, this credit simply serves as a transfer from the employed to the not employed and is claimed to a greater percentage by middle and higher income individuals.

The Institute favours phasing out the Canada Employment Credit by initially halving its benefit. This would save the federal government approximately \$1 billion per year.¹⁵

Rethink one-time tax credits

The Home Renovations Credit was a one-time credit available in 2009 in the wake of recession. While this form of targeted support may have been warranted, in the future the government should take into account the distributional impact of “one-time” credits and make appropriate offsetting provisions. While only 6 percent of tax filers have incomes in excess of \$100,000, this group was responsible for roughly 24 percent of the tax benefit from the renovations credit. The credit also encouraged individuals who would not otherwise be able to afford renovations to take out loans to finance them. Increasing personal indebtedness is not an appropriate public policy.

The cost of the renovations credit was substantial. As a tax expenditure it was valued nationally at approximately \$15.4 billion, and about \$6.7 billion in Ontario. Aside from the Canada Employment Credit, the scope of the Renovations Credit was substantially larger than the other credits examined.

In summary, the federal non-refundable credits examined disproportionately benefit middle and higher income individuals. While the credits might encourage socially desirable activities, they are not equitable.

Revisit provincial tax credits

Similar refundable and non-refundable credits exist in Ontario. The vast majority of these credits, in contrast to the federal credits, are consistent with smart taxation. Several should be re-evaluated.

Skip filing process for Ontario Children’s Activity Tax Credit

This provides a 10 percent refundable benefit for registration and membership fees in fitness and non-fitness activities. In 2012, the total benefit for this \$526 credit was \$52.60. Ontario should allow accredited non-profit organizations to claim the tax benefit from this credit, which would skip the filing process for individuals.

Review Healthy Homes Renovation Tax Credit

This provides a 15 percent refundable benefit to seniors for up to \$10,000 in expenditures on renovations to improve housing accessibility. This credit could actually pay for itself if, by enabling seniors to remain in their homes, it reduced health care costs for things like long-term care. The government has estimated that the credit will cost \$60 million per year, yet has not provided an estimate of the resulting benefit from reduced healthcare costs. This credit was recently implemented and more research in this area is required.

Eliminate the Ontario Clean Energy Benefit (OCEB)

This provides a benefit of 10 percent on the first 3,000 kilowatt hours of electricity consumed per month and is available for families, farms, and small businesses. According to the government, the average family uses

800 kilowatts per month and would be eligible for the full 10 percent benefit.¹⁶ The benefit offsets the provincial portion of the harmonized sales tax (HST), which applies to hydro, unlike the previous provincial retail sales tax, which did not. By reducing the price of electricity the OCEB discourages conservation. It is also a regressive measure because electricity is a “normal” good, and higher income individuals consume comparably more than lower income individuals. The OCEB has cost the government approximately \$2.4 billion since 2010. The OCEB is a \$1.1 billion dollar a year subsidy that should be eliminated immediately, with the freed up funds being put against the provincial deficit.¹⁷ The OCEB is scheduled to be eliminated in 2015.

A variety of personal income tax credits at both the federal and provincial levels do not fit with smart taxation. These credits should be either reformed or removed, so that they benefit Ontarians more. Revenues from their removal can then be put toward expenditures more closely linked with increasing economic prosperity.

¹⁵ Department of Finance Canada, *Tax Expenditures and Evaluations 2012*. <http://www.fin.gc.ca/taxexp-depfisc/2012/taxexp-depfisc12-eng.pdf>

¹⁶ Ontario Ministry of Energy, Ontario Clean Energy Benefit. <http://www.energy.gov.on.ca/en/electricity-prices/clean-energy-benefit/>

¹⁷ Ontario Budget 2012: *Strong Action for Ontario*, Table 2.29, p. 196.



BUSINESS SUPPORT MEASURES REQUIRE NEUTRALITY

IN THE LAST DECADE, taxation reform at both the provincial and federal levels has reduced the cost of new business investment and made Ontario more competitive internationally. This is beneficial for attracting investments in things such as machinery equipment and information and communications technology – where Ontario currently lags its US peers and which have a positive relationship with productivity.¹⁸ Ontario currently has a productivity gap with peer regions and this contributes to the overall prosperity gap, which was \$7,500 in 2011.

Taxation reform reduced Ontario's marginal effective tax rate (METR)¹⁹ on business investment from 43.4 percent in 2005 to 19.8 percent in 2012.²⁰ Several factors contributed to this decrease:

- Federal and provincial corporate statutory rate reductions reduced the combined corporate rate in Ontario from 36.1 percent in 2005 to 26.5 percent in 2012.
- The capital tax in Ontario, which was levied on firms' taxable capital, even if they were not profitable, was eliminated in 2010.
- The provincial retail sales tax (RST) was eliminated in 2010 and replaced with a value added tax harmonized with the federal goods and services tax. The RST hurt business investment, because the tax cascaded through production processes by levying tax on top of

tax. The harmonized sales tax (HST) eliminated this economic distortion.

These changes were consistent with recommendations the Institute made in Working Paper 7, *Taxing smarter for prosperity*. Citing research from the Department of Finance, the Institute pushed for the repeal of the capital tax, the removal of the retail sales tax to be replaced with a value added alternative, and a reduction in corporate tax rates. These changes have all had a positive impact on long-term economic well-being. The Institute applauds the governments' actions on these objectives, which have made Ontario more competitive in attracting business investment.

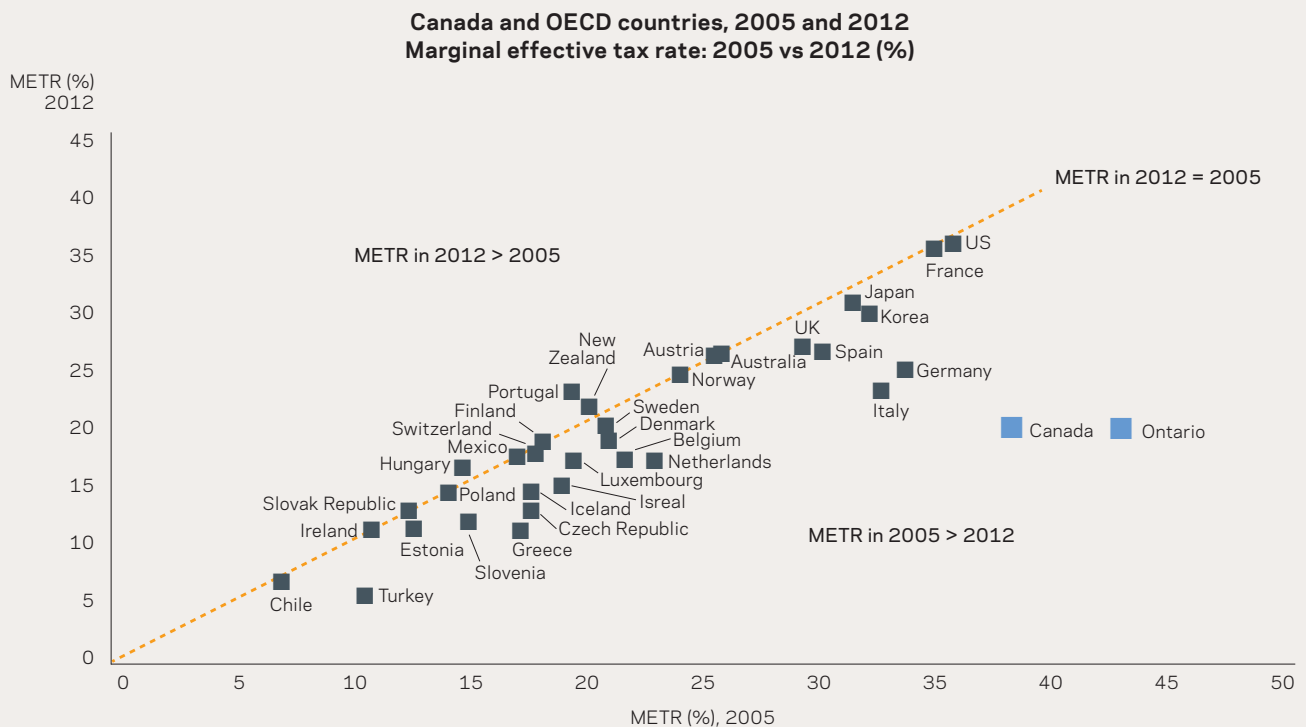
These measures are even more impressive when compared to changes over the same time period in other OECD countries. The diagonal line in Exhibit 9 represents a country where the METR on capital

18 Conference Board of Canada, *Investment and Productivity: Why is M&E investment important to labour productivity?* <http://www.conferenceboard.ca/hcp/hot-topics/investprod.aspx> Larry Summers and Bradford De Long, "Equipment Investment and Economic Growth," *Quarterly Journal of Economics*, Vol. 106, Issue 2, May 1991.

19 The Marginal Effective Tax Rate measures the portion of capital-related taxes paid as a share of the pre-tax rate of return on capital for marginal investments (see Mintz's Global Tax Ranking for a full definition).

20 Jack Mintz and Duanjie Chen, "2012 Annual Global Tax Competitiveness Ranking - A Canadian Good News Story," *University of Calgary School of Public Policy Research Papers*, Vol. 5, Issue 28, September 2012, p. 14.

Exhibit 9 Ontario's METR on capital investment decreased substantially, 2005-2012



Source: Institute for Competitiveness & Prosperity analysis based on data from Duanjie Chen and Jack Mintz, "2012 Annual Global Tax Competitiveness Ranking - A Canadian Good News Story" SPP Research Papers Vol. 5, Issue 28, September 2012

investment remained constant between 2005 and 2012. Countries above the line had a METR in 2012 that exceeded their METR in 2005. The opposite occurred in countries below the line; Ontario's 23.6 percent reduction is particularly notable.

Corporate rate reductions are beneficial in attracting mobile business capital and in encouraging multinational firms to locate within Ontario. Ireland, which once repeatedly slashed its corporate tax rate, attracted high levels of foreign direct investment, which appropriately raised the question whether this is achievable in Ontario given its proximity to the United States.²¹

Despite notable progress toward lowering the cost of business investment, the tax provisions that remain for Ontario businesses reduce the neutrality of the tax system overall.

Neutrality is an important objective, because it results in equal tax burdens for different economic activities and

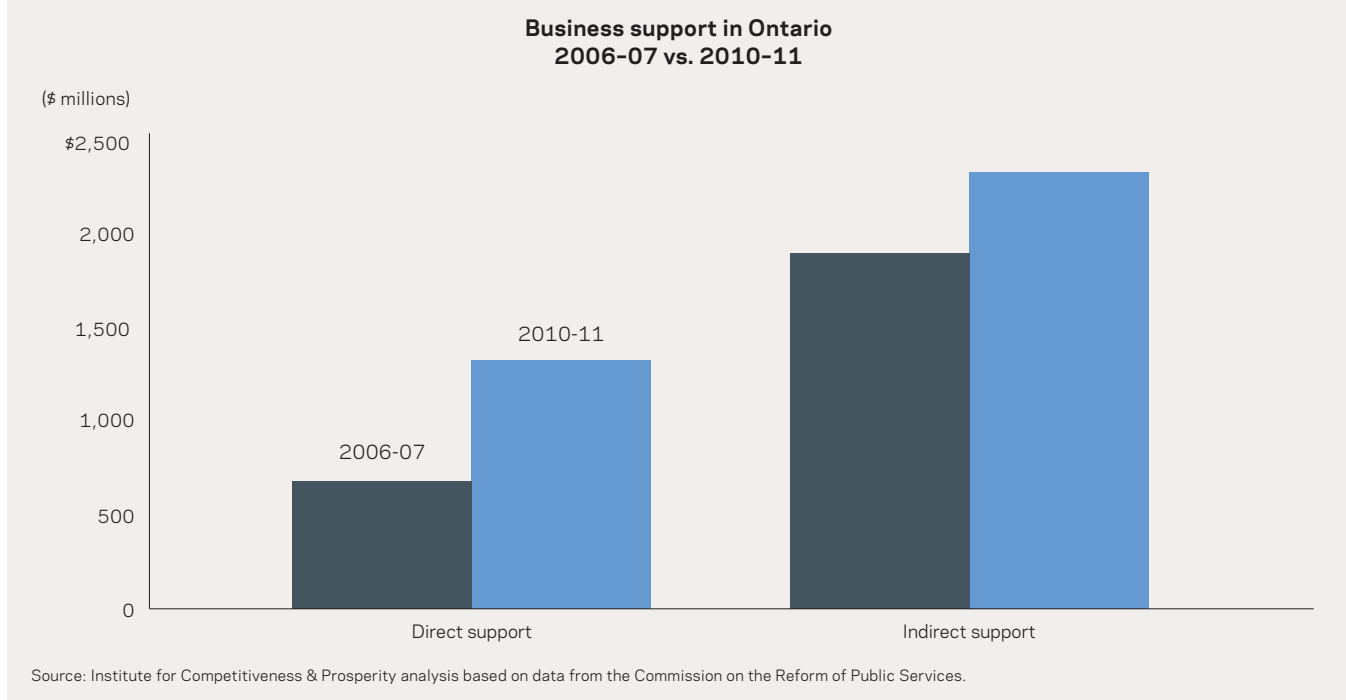
therefore minimizes the effect of the tax system on business decisions. A move toward neutrality results in tax revenues being collected from a larger base, allowing the lowest rate possible for a given level of revenues. It also encourages businesses to locate in industries, based on their perceived profitability rather than on the level of government support.

Business supports can be categorized into two ways: direct supports, which include grants and loans from the government; and indirect supports, which include tax expenditures such as tax credits and other preferential treatment (Exhibit 10).

In 2010-11, the Ontario government provided around \$1.3 billion in direct business support through loans, grants, and other funding programs. This amount is nearly double that in 2006-07. Indirect support in the form of non-refundable and refundable tax

21 George R. Zodrow, "Policy Forum: Corporate Income Taxation in Canada," *Canadian Tax Journal*, Vol. 56, No. 2. 2008. p. 450.

Exhibit 10 Both direct and indirect business support rose in Ontario from 2006-07 to 2010-11



credits also increased substantially from about \$1.9 billion in 2006-07 to about \$2.3 billion in 2010-11. These tax expenditures included lower corporate rates for small businesses and manufacturing and processing firms and a variety of other industry specific tax credits.

The Institute examined some of the industry specific tax credits available in Ontario and their evolution over time (Exhibit 11). Credits were classified into four broad categories: employment tax credits, cultural media tax credits, research and development tax credits, and business specific support. The scope of three of these supports dramatically increased from 2005 to 2011. Employment credits increased by 90 percent, driven by an uptake in firms claiming both the apprenticeship credit and the co-operative student credits. Cultural

media credits expanded by roughly 128 percent, and research and development credits increased by about 125 percent. While business specific support measures, such as the small business deduction and the credit for manufacturing and processing firms, accounted for the largest share of total support, they increased to a lesser extent on a percentage basis than the other measures.

In the most recent Ontario budget, the government estimated that private business investment was approximately 52 times the level of business support provided in 2013.²² While this might seem impressive, it neglects consideration of the causal impact of each of these support measures on subsequent investment. Not only could these measures support investments that would occur anyway, but they also

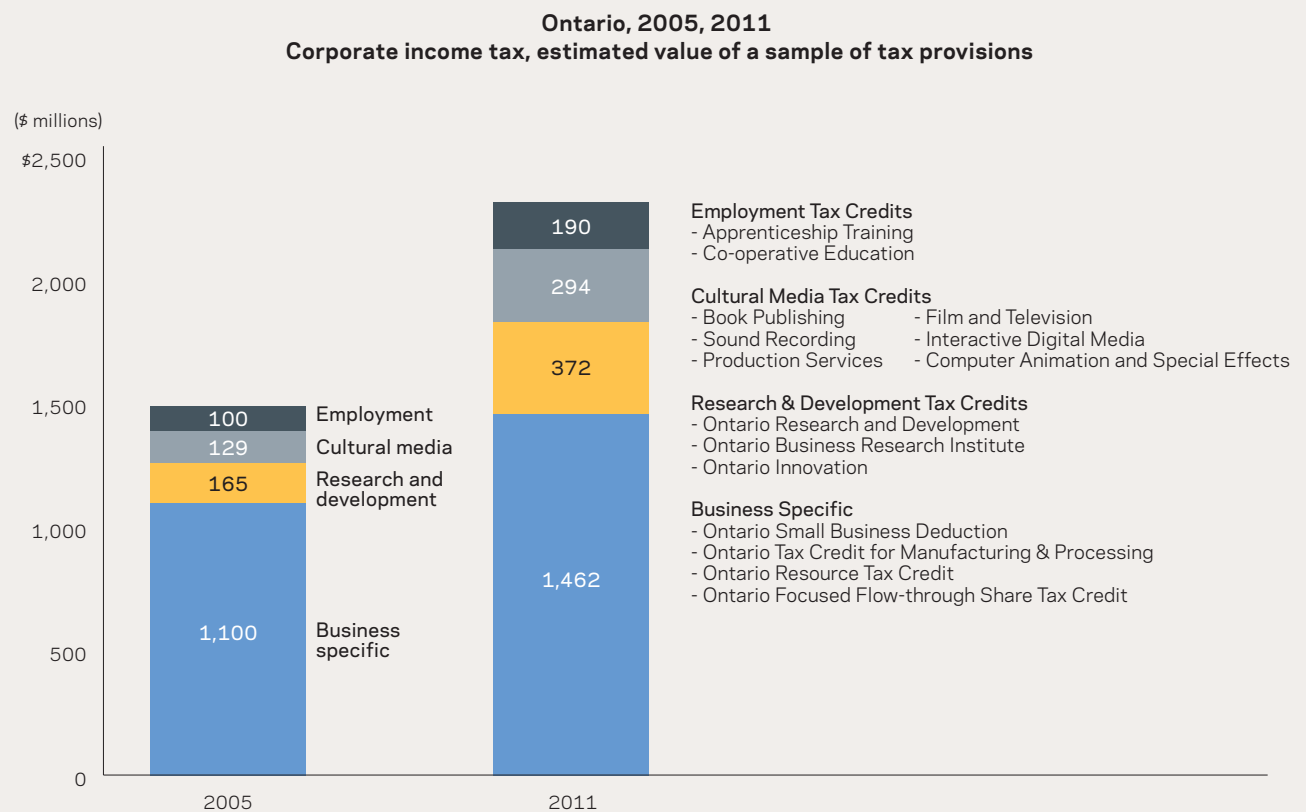
could encourage business activity in industries that would not be otherwise economically viable over alternatives where Ontario has a relative advantage.

Effective tax rates on capital in Ontario vary significantly

Preferential tax treatment affects the METR on business investment differently in different industries within Ontario. When some industries – for example, manufacturing and forestry – receive tax subsidies through support measures such as the accelerated capital cost allowances (ACCAs), which increase the rate with which capital investments can be deducted for income tax

22 2013 Ontario Budget: A Prosperous and Fair Ontario, p. 138.

Exhibit 11 Tax related business support within Ontario increased, 2005-2011



Source: Institute for Competitiveness & Prosperity analysis based on data from 2005 and 2011 Ontario Economic Outlook and Fiscal Review: Transparency in Taxation.

purposes, other industries are placed at a comparative disadvantage (Exhibit 12). The METR on capital investment was nearly twice as high in construction industries and wholesale and retail trade, than in manufacturing and forestry in 2012.

Industry support is warranted in certain circumstances; for instance, when the social costs of not supporting an industry exceed the cost of the level of support provided. But when these support measures are implemented, they need to be temporary and removed once appropriate growth and restructuring takes place. The government has proven reluctant to withdraw business support even when industries have become dramatically more competitive as a result of overall corporate rate reductions.

Although there has been a substantial reduction in METRs on capital investment overall, there remains more support for certain industries than for others. It is appropriate that governments wind down some of these non-

neutral measures, but the opposite has happened in recent years.

The Institute eagerly awaits findings from the technical panel the Ontario government put together to examine business supports, with an objective of reducing overall spending by 25 percent. The panel's reclassification of supports into three "policy filters," based on their contribution to innovation, productivity, and exports, will ensure a better understanding of their outcomes. Overall, more neutrality would be beneficial for the taxation of businesses within Ontario. Credits that depart from this objective without legitimate justification ought to be scrapped – this applies to the bulk of the support measures in Exhibit 11.

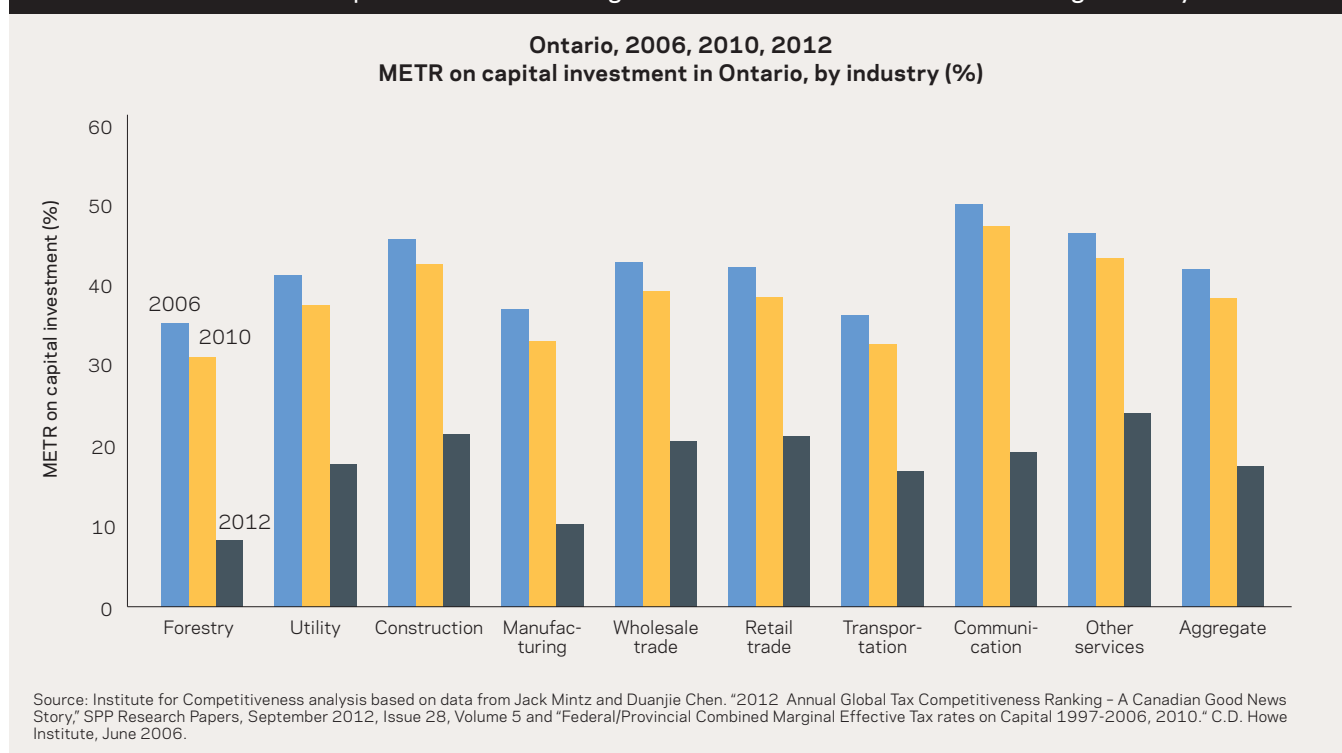
In particular, both the Ontario and federal governments should re-evaluate the efficacy of supporting foreign film shooting within Canada. Foreign film credits can be evaluated based on their economic impact in contrast to Canadian film credits, which are

designed to encourage the production of Canadian-content and therefore have broader benefits. The federal and provincial governments provided approximately \$470 million annually in tax incentives to encourage foreign filming in Canada in 2010. A recently published study conducted a cost-benefit analysis of these support measures and found that, while they are "successful in creating extra output and employment in the film industry, they have to be financed through higher taxes, or lower spending, which will reduce output and employment in other sectors." Furthermore, "Canadians are poorer, not richer, as a result of the film tax credits."²³

One of the larger departures from neutrality is the small business deduction, which reduces the general corporate tax rate firms pay on their first \$500,000 of active business

²³ John Lester, "Tax Credits for Foreign Location Shooting of Films: No Net Benefit for Canada" *Canadian Public Policy*, 2013, 39 (3), p. 452.

Exhibit 12 The METR on capital investment among different industries in Ontario varied significantly



income.²⁴ The combined federal and provincial small business rate in Ontario in 2013 was 15.5 percent, compared to the general corporate rate of 26.5 percent (Exhibit 13). While there has been convergence between the general and small business tax rates because of higher reductions in the former, there remains a large difference at the provincial level. Compared to large businesses, small businesses “typically lag in their research and development, productivity growth, export penetration and employee compensation.”²⁵

As a taxation expenditure, the small business deduction cost the province approximately \$1.5 billion in 2012.²⁶ Owners of small businesses are also eligible for the lifetime capital gains exemption of up to \$750,000 on the disposal of qualified small business shares and fish and farming property. This cost the province around \$180 million in revenue in 2012.

The preferential tax treatment of small business could lead to three distortionary outcomes:

“First, it could result in the breakup of companies into smaller, less efficient-sized units in order to take advantage of tax benefits even if there are economic gains to growing in size. Second, it could encourage individuals to create small corporations in order to reduce their personal tax liabilities

rather than grow companies. And third, it could lead to a ‘threshold effect’ that holds back small business from growing beyond the official definition of ‘smallness.’”²⁷

Mintz and Chen provide an example where a firm’s METR on capital investment increases 8 percentage points once the small business income threshold is reached under a set of assumptions about the small business.²⁸ They conclude that the small business deduction could discourage business growth by creating a “taxation wall” at the small business income threshold.

One commonly cited reason for a lower tax rate on small businesses is that it compensates for their limited ability to raise capital through financial markets. While this may be the case, it is questionable whether reduced corporate rates are an appropriate policy to remedy this issue. Tax policy should instead be designed with the goal of minimizing its influence on business activities, so that firms can pursue profitable opportunities without regard for their tax consequences.

In Working Paper 16, *Making sense of public dollars*, the Institute proposed that the small business deduction be phased out.²⁹ Under this proposal the marginal tax rate a small business would increase from the current rate

- 24 The federal small business deduction, which reduces the general rate to the small business rate, is unavailable once “taxable capital,” as defined under the Income Tax Act, surpasses \$15 million. The deduction is phased out between \$10 and \$15 million.
- 25 Jon Kesselman, “Tax Design for a Northern Tiger,” *Choices* Vol. 10, No. 1, March 2004, p. 33.
- 26 Ontario Ministry of Finance, “Transparency in Taxation, 2012” <http://www.fin.gov.on.ca/en/budget/fallstatement/2012/transparency.html>.
- 27 Jack Mintz and Duanjie Chen, “Small Business Taxation: Revamping Incentives to Encourage Growth,” *University of Calgary School of Public Policy Research Papers*, Vol. 4, Issue 7, May 2011, p. 2.
- 28 These concern the firm’s pre-tax profit ratio, debt-to-asset ratio, and dividend payout ratio. *Ibid.* 12.
- 29 Institute for Competitiveness & Prosperity, Working Paper 16, *Making Sense of Public Dollars*, May 2013.

Exhibit 13 General and small business corporate rates converged, 1997–2013

		1997	2005	2008	2010	2013
Federal corporate tax rate	General rate	29.1	22.1	19.5	18.0	15.0
	Small business rate	13.1	13.1	11.0	11.0	11.0
	Income threshold	\$200,000	\$300,000	\$400,000	\$500,000	\$500,000
Ontario corporate tax rate	General rate	15.5	14.0	14.0	12.0	11.5
	Small business rate	9.5	5.5	5.5	4.5	4.5
	Income threshold	\$200,000	\$400,000	\$400,000	\$500,000	\$500,000

Source: Institute for Competitiveness & Prosperity analysis based on data from Ontario Ministry of Finance; Canadian Revenue Agency; Duanjie Chen and Jack Mintz, “Small Business Taxation: Revamping Incentives to Encourage Growth,” *University of Calgary School of Public Policy Research Papers*, Vol. 4, Issue 7, May 2011.

until it reached the general corporate rate at the income threshold limit (Exhibit 14). While small businesses would be worse off under this proposal, they would be better off than if the small business deduction were removed and they were subject to the general rate. This proposal is a compromise between the current system and elimination of the small business deduction altogether.

An example helps illustrate how this phase out would work in practice. A small business with \$250,000 in taxable income would first have to calculate its average tax rate on income to calculate its provincial tax liability. This average rate depends on income; in this example, it is 6.25 percent. The firm's tax liability would be \$250,000 multiplied by the average rate of 6.25 percent, yielding \$15,625. Under the current small business tax rate, the firm's tax liability is \$11,250. If the small firm were subject to the general rate, its liability would be \$28,750.

This deduction phase out proposal should be implemented by the

Ontario government for two reasons. It would reduce the taxation wall that impedes small business growth beyond the small business income threshold. It would also strike a balance between the current system and that if the deduction were removed altogether.

If the Ontario government goes ahead with scheduled corporate rate reductions when the budget is balanced in 2017-18, the provincial differential between the small business and general corporate rate will narrow from 7 percent to 5.5 percent. Convergence would reduce the overall influence of the small business deduction on business decisions, moving the province toward greater neutrality in corporate income taxation.

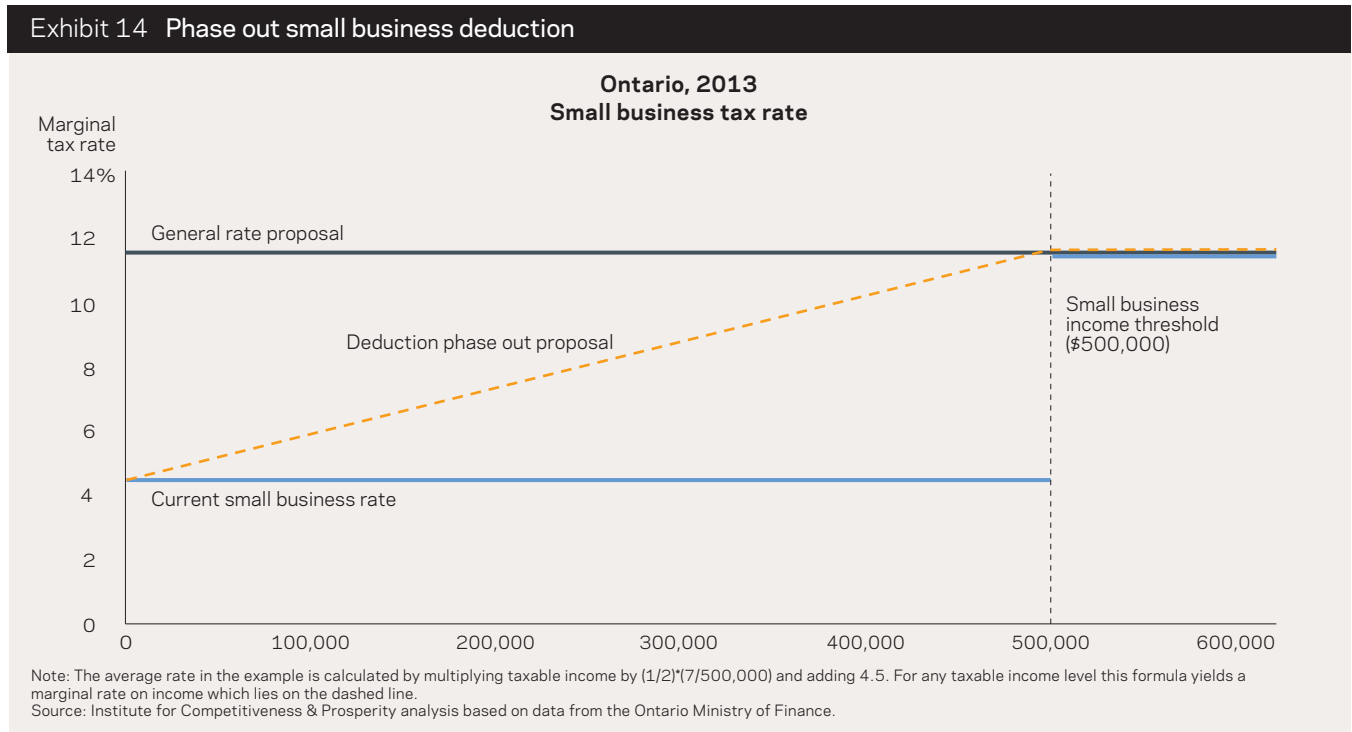
Another policy change the government should consider relates to the rate that business can write off different capital investments for income tax purposes. A general thrust from the Technical Committee on Business Taxation was that these investments should reflect their

respective underlying economic depreciation rates.³⁰ If allowances were set above the rate of economic depreciation, then the tax liability for firms in earlier years would fall and the overall tax liability would shift from the present to the future.

A report from the Certified General Accountants Association of Canada surveyed accounting professionals and found that the current system of depreciating capital investments (the Capital Cost Allowance-CCA) "does not respect the key principles of a sound tax system such as simplicity, equity and neutrality. Furthermore, the CCA system often does not represent economic reality and the economic life of the underlying assets."³¹

30 Report of the Technical Committee on Business Taxation, 1998. <http://www.fin.gc.ca/pub/pdfs/tsrep_e.pdf>

31 Certified General Accountants Association of Canada, *Issue in Focus: Is the Capital Cost Allowance System in Canada Unnecessarily Complex*, April 2013, p. 6.



Consider an alternative cash-flow approach to the taxation of corporate income

One consequence of the current approach to the taxation of corporate income is that it favours debt-financed over equity-financed investment, because the interest payments on debt are tax deductible. This “debt-bias” provides a tax advantage for taking on leverage, which inefficiently leads to higher debt-to-equity ratios among corporations, discriminates against “innovative growth firms,” and erodes public tax revenues.³²

An alternative is the cash-flow approach to corporate income taxation. A cash-flow approach allows for an immediate deduction for capital investment but no deduction for financing costs.³³ The expensing of capital investment under a cash-flow system is shifted into the current year rather than over future years, which is beneficial from a firm’s standpoint because of the time value of money. Another advantage of this system is that it is administratively simpler, as separate depreciation allowances for different investments do not need to be worked out. This cuts back on the accounting burden from expensing different depreciable capital investments. Under this system they would be expensed at the same rate – 100 percent.

Exhibit 15 indicates that the difference between normal corporate taxation and taxation of business cash flow

concerns the treatment of capital investments. Under the regular approach, both capital financing costs and a depreciation allowance reduce the corporate tax base. Under the cash-flow approach investments are immediately written off.

The main benefit of the cash-flow approach is that a firm’s choice between financing its operations through debt or equity would not be distorted at the corporate level.³⁴ This would be beneficial to business start-ups that face difficulty in raising debt financing, as they would not be placed at a relative disadvantage. This would improve corporate taxation from an economic efficiency standpoint.

Ensure tax effectiveness

Another aspect of smart taxation is effectiveness. Certain taxation expenditures at both the provincial and federal level represent forgone revenues, yet are important because they have far reaching economic benefits. Investment in research and development (R&D) is one of the best examples of where this occurs, as there are significant spillovers (benefits from R&D that accrue to those who do not pay for it) from R&D that lead to innovations in related areas. Government support for R&D in Canada is significant. The federal Scientific Research and Experimental Development (SR&ED) tax credit cost the federal government about \$3.6 billion in 2012. The equivalent research and development credit in Ontario cost the province about \$170 million in 2012.

32 Ruud A. De Mooij, “Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions,” *IMF Staff Discussion Note*, May 2011.

33 Jon Kesselman, “Tax Design for a Northern Tiger,” p. 10.

34 Organization for Economic Co-operation and Development, *Reforming Corporate Income Tax Policy Brief*, p. 5. <http://www.oecd.org/tax/tax-policy/41069272.pdf>.

Exhibit 15 Capital is treated differently in a cash-flow system

Direct business tax bases										
Business income tax	=	Sales	-	Intermediate input costs	-	Labour costs	-	Capital depreciation	-	Interest financing costs
Business cash-flow tax	=	Sales	-	Intermediate input costs	-	Labour costs	-	Capital depreciation		

Source: Kesselman (2004), “Tax Design for a Northern Tiger,” *Choices* 10(1).

The Technical Committee on Business Taxation found a number of supportive reasons for subsidizing R&D:

- “Social rates of return from R&D spending are at least twice the private rates of return. The difference between private and social rates of return is the extent of the positive spillover.
- Social rates of return on R&D spending range from 20 percent to 150 percent and vary significantly among industries and activities.
- R&D spillovers improve productivity, increase the demand for skilled labour and result in an expansion of output.”³⁵

The Federal Department of Finance found that the positive spillovers from R&D investment “amount to about 46 cents per dollar of tax expenditure and more than offset the costs of the credit, estimated to be 36 cents per dollar of tax expenditure. Thus the SR&ED tax credit creates a gross economic gain of \$1.11 for every dollar spent on it, and a net economic gain of 11 cents per dollar.”³⁶

Despite the extensive taxation support for R&D, business expenditure on R&D in Ontario has continuously lagged that in the United States over the last decade. “Between 2001 and 2010, Ontario’s business R&D as a percentage of GDP declined from 1.7 per cent to 1.1 per cent, while the U.S. declined from 2 per cent to 1.9 per cent.”³⁷

In 2010, the federal government put together an expert panel on research and development to examine how to strengthen federal R & D programs which support innovation within Canada.³⁸ The panel’s recommendations call for a more focused, direct approach to R&D funding and a simplification of the SR & ED program for small and medium enterprises.

While government support of R&D support in Canada was higher as a percentage of GDP than in most other OECD countries, this was primarily from indirect support measures like the SR & ED tax incentive. Direct government support measures in Canada lagged in comparison to those in other OECD countries. The panel called for increased direct business support for R&D, which the federal government acted on in the 2012 budget by doubling the size of the National Research Council’s Industrial Research Assistance Program (IRAP). The government also streamlined the SR&ED program, with the objective of increasing its accessibility and but reduced the credit rate from 20 to 15 percent.

An evaluation of these changes found that they “heavily favor small firms over large firms and labour intensive R & D over capital intensive R&D.”³⁹ Lester completed a comprehensive cost-benefit analysis that incorporated the impact R&D subsidies have on things like knowledge spillovers and on the costs of financing the subsidies through higher taxes, which in turn harm economic growth. He found that while the *general* SR & ED credit generates a net economic benefit, the *enhanced* credit for small and medium Canadian enterprises generates a net cost as a result of the higher credit rate and higher compliance costs. The IRAP program, which the government doubled, generated a net cost because of high administrative and compliance costs. These results contrast with policy changes the government made in 2012, which reduced the net benefit of both the SR & ED tax credit and the IRAP.⁴⁰

Enhancing the accessibility of R&D support is an important policy objective that the government has acted on while shifting from indirect to direct support measures. Compliance costs are important impediments that affect the accessibility of SR&ED

and the fees consultants charge to help their clients qualify for benefits erode the efficiency of the program.

Broadly speaking, taxation support for R&D is consistent with smart taxation, because the benefits accrue widely and support innovation in related areas. Innovation is an important policy objective, because it drives productivity and subsequent prosperity.

Governments should consider all options for smart taxation that will increase equity and efficiency. The review of business supports within Ontario is an important first step in this process. Governments should push for greater corporate taxation neutrality, consider adopting a cash-flow taxation approach, and continue to support R&D, that has broad spillovers which drive innovation and subsequent prosperity.

35 Report of the Technical Committee on Business Taxation, 1998. pp. 5.11-12.

36 Department of Finance Canada, Tax Incentives for Scientific Research and Experimental Development, October 2007. http://www.fin.gc.ca/activity/consult/sred_1-eng.asp.

37 2013 Ontario Budget: *A Prosperous and Fair Ontario*, p. 8.

38 Government of Canada, “Innovation Canada: A Call for Action.”

39 Kenneth McKenzie, “The Big and the Small of Tax Support for R&D in Canada,” *University of Calgary SPP Research Papers*, 2012, Vol. 5. Issue 22.

40 John Lester, “Benefit-Cost Analysis of R&D Support Programs” *Canadian Tax Journal*, 2012, 60:4.





SMART TAXATION GUIDES TAX REFORM

THERE HAS BEEN AN EXPANSION IN THE AVAILABILITY OF DIFFERENT TAX CREDITS for both individuals and businesses within Ontario. While many of these credits target socially desirable activities, they collectively reduce the total tax base and necessitate higher tax rates to raise a given level of revenues. Higher tax rates have important disincentive effects by reducing the returns to working and making productive investments within the economy.

Many of the credits examined in this report are not consistent with a “smart taxation” system that balances the objectives of equity, efficiency, and effectiveness. These credits most likely exist for political reasons rather than their economic merits. A number of important recommendations emerged from the research.

At the personal level:

- At the federal level, the benefits from many of the federal tax credits introduced by the government from 2006 and on are not equally distributed among Ontarians. For instance, individuals with income over \$100,000 per year were 3.4 times more likely to claim the Children’s Fitness Credit (CFC) than if the credit were claimed at the same rate by everyone. Awareness of the CFC is greater among higher income groups, which could help explain why the claiming ratio is higher for this group. These results are timely, and we strongly oppose the government’s plan to double the size of the CFC and to introduce an adult fitness tax credit. This would make Canadians overall worse off.
- At the provincial level, the Ontario Clean Energy Benefit reduces the price of energy consumption by 10 percent in Ontario. This benefit is a needless expenditure and should be eliminated.

At the business level:

- Business tax reductions in Ontario have dramatically increased Ontario’s competitiveness in relation to other OECD countries.
- Despite these reductions, targeted industry support measures continue to reduce the neutrality of business taxation within Ontario. Neutrality is an important objective, because it results in equal tax burdens for different economic activities and minimizes the influence of the tax system, and should be a guiding principle.
- Direct and indirect business support within Ontario have dramatically increased in the last five years. The government’s plan to review these measures is overdue.
- The government should phase out the small business deduction and implement a more effective system for depreciating capital investments.

Taxing smarter can reduce the influence of the tax system on economic decisions. And by removing some of the preferential taxation measures discussed in this Working Paper, the overall equitability, efficiency, and effectiveness of Ontario’s taxation system can be increased for the benefit of all.

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Should you have any questions or comments, you may
reach us through the website or at the following address:

The Institute for Competitiveness & Prosperity

105 St. George Street
Suite 9000
Toronto, Ontario M5S 3E6
Telephone 416 946 7300
Fax 416 946 7606

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EXECUTIVE DIRECTOR

Jamison Steeve
416 946 7585
j.steeve@competeprosper.ca

POLICY ANALYSTS

Marco Andrade
416 978 7841
m.andrade@competeprosper.ca

Matthew Johnson (Project Lead)
416 978 7843
m.johnson@competeprosper.ca

Linda Petersen
416 978 7843
l.petersen@competeprosper.ca

Ashleigh Ryan
416 946 3503
a.ryan@competeprosper.ca

Dorinda So
416 978 7859
d.so@competeprosper.ca

DESIGN

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