

THE 2006 BUDGET AND TAX REFORM: A MISSED OPPORTUNITY?

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INTRODUCTION

Thesis

- **The Canadian tax system is in need of reform and rationalization**
- **Revenue-neutral tax reform creates losers and gainers necessarily**
- **Tax reform ideal when cash available: the 2006 Budget would have been ideal**

OVERVIEW

- My talk will focus on what kind of a tax reform would have been suitable: it is time for a discussion of fundamental tax reform
- Most attention will be devoted to the tax system as it applies to households rather than businesses, although implications for the latter will be mentioned

A CATALOGUE OF THE MAIN PROBLEMS

- **Capital income taxed too highly on economic grounds**
 - *Redistributive taxation should be based on advantages that are outside household control (luck versus choice)*
 - *Labor income more related to advantages (talent), and capital income to choice (saving)*
 - *Some capital income based on inheritance, so maybe we do not want zero capital tax*

- **Different assets treated very differently**
 - *Some capital income sheltered: housing, pension savings, human capital*
 - *Taxable assets treated differently: capital gains versus dividends and interest*
- **System of saving for retirement inefficient and inequitable**
 - *Punitive effective taxation of RRSP/RRP savings by low-income persons*

- **Limited averaging**
- **Limited loss offsetting**
- **Tax credits inconsistent and work to the disadvantage of low income persons: some refundable, some not**
- **Rate structure is of limited progressivity, partly because of worries about capital income**

- **Excise taxes not well designed for their tasks and are very regressive**
- **Harmonization of taxes unfinished business**
- **Implicit decentralization of GST a move in the wrong direction: will reduce the incentive for harmonization and tip the tax mix toward the income tax**

- **Business taxation system flawed**
 - *Preferential treatment of some sectors*
 - *Absence of full loss offsetting*
 - *Imperfect integration*
 - *Incentives to park profits in low-tax provinces*
 - *High property and capital taxes on business*
 - *Income trusts both a symptom and a problem*

A TAX REFORM MANIFESTO

- **Addressing these issues involves some fundamental, but do-able tax reform**
- **Models exist elsewhere that could be adopted to Canada and ameliorate some of the most egregious problems**
- **But no panacea or perfect solution exists**

THE PROPOSAL

- **The model for household taxation involves two main components**
 - *A dual income tax at the personal level*
 - *The GST at pre-budget rates.*
- **Rationalization of business taxation, particularly as it applies to resources**
- **Rationalization of the federal-provincial tax system**

Dual Income Taxation

- **Separate rate structures apply to capital and non-capital income**
- **Non-capital income (labour income, pensions and transfers) is subject to a progressive rate structure, with full refundability of all credits**
- **Capital income taxed uniformly at the lowest rate on non-capital income**

- **Capital income taxed fully as possible**
- **If sheltered, retirement savings should be both registered and pre-paid**
- **Income of small businesses split between labour and capital by a rule**
- **Corporations taxed at capital income rate and integrated (including sheltered savings)**

- **Capital income could be federal, and provinces could co-occupy the non-capital income base**
- **The treatment of bequests and inheritances would need to be reevaluated**
 - *Deemed realization of capital gains at death partially fulfils that, but with a lower capital tax rate, estate taxation needs revisiting*

Advantages of Dual Taxation

- **Collection & compliance cost reduced (use of financial intermediaries)**
- **Wasteful tax planning eliminated,**
- **Excessive taxation of capital income reduced**
- **Progressivity of labour income taxation unconstrained**

Sales Taxation

- **Lack of sales tax harmonization a pressing but difficult problems**
- **Skeptical that a harmonized federal-provincial VAT system is feasible or desirable**
- **Reducing the federal GST rate is not conducive to sales tax harmonization, even if tax room taken by the provinces**

PROPOSAL

- **Restore the federal GST rate of 7 percent**
- **In the longer run, combine expanded GST with a revenue-sharing system giving provinces a share of revenue**
- **Provinces may balk, but the quid pro quo could be a guaranteed provincial share of revenues**

Business Taxation

- **Dual income tax addresses part of the business income tax reform agenda**
 - *Full integration of personal and business income taxes*
 - *Smooth transition from unincorporated to corporate business forms*
- **Still, some unfinished business with respect to business tax reform**

PROPOSAL

- **Remove preferential treatment of resource industries, to reduce inefficient allocation and increase the federal resource revenues**
- **Eliminate deduction of provincial resource levies from the corporate income tax base to provide the federal government access to resource revenues for equalization**

THE FISCAL BALANCE ISSUE

- **The form of the tax system is of integral importance to resolving fiscal balance**
- **Turning over tax room to the provinces promotes disharmonization and precludes meaningful reform**
- **Dual income taxation facilitates addressing the fiscal balance**

PROPOSAL

- **Uniform national GST with revenue sharing for provinces**
- **Dual income tax with capital taxation federal, and provinces with access to non-capital tax**
- **Harmonization of non-capital tax base**
- **Turn over payroll taxes to provinces**
- **Ideally, corporate tax federal**

PROBLEMS!

- *Provinces may not accept national GST even with guaranteed revenues: fallback is status quo*
- *Provinces may not abandon capital tax or corporate tax: fallback is federal dual income tax*
- *Need to renegotiate tax harmonization agreements*