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The Big Picture*

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Introduction

Tax policy determines how a country allocates the burden of its taxes—the taxes necessary to support government expenditure. But tax policy also deals with the effects, short- and long-term, of the tax system on incomes and investments, the allocation of resources, and social policies. Tax policy in Canada involves complex considerations about the ultimate role of governments and the interplay of responsibilities in a federal state.

Why Should We Study Tax Policy?

Taxes matter: they have an effect not only on who bears the burden of paying for government expenditures but also on the level of economic activity and incomes in a country. Moreover, tax policy reflects social concerns as well as economic choices, such as how the burden of tax is spread over income classes, and how taxes are used to influence personal choices (about everything from saving, labour supply, and investment to the consumption of alcoholic beverages and the preservation of traditional activities, such as farming). Taxes have a powerful effect on the behaviour of individuals. Indeed, taxation is perhaps the principal means by which modern governments influence the lives and economic well-being of their citizens; it is therefore a central feature in political and economic debate.

The study of tax policy reflects some notable difficulties. It is necessary to determine the short- and long-term economic effects of different tax alternatives in order to assess which system will maximize economic well-being, output, and incomes. But because the taxation system is used for many non-economic purposes, it is also necessary to consider how the system meets citizens' preferences about non-tax issues (such as health and education) and how much these preferences cost. Further, the tax system itself is used to distribute social welfare subsidies and grants. And, above all, in a democracy the tax system must be fair and be seen to be fair.

An important issue to note at the outset, and one discussed in the landmark *Report of the Royal Commission on Taxation* in 1966, is that ultimately the tax burden in a country is borne by its residents.¹ Taxes may be paid by corporations, trusts, and other entities, but these entities do not ultimately bear the burden of taxes; instead, they can only pass on the burden to others in the form of higher prices for goods, lower returns for labour, and lower capital inputs. In the end, and bearing in mind the relatively minor exception of taxes that may fall on non-residents, the weight of domestic taxes is borne, in one way or another, by the individuals in a country.

The purpose of this opening chapter is to set the stage for the policy discussions that follow in other chapters: to provide a macro view of just what taxes Canadians pay, how these burdens have changed over time, how in broad outline Canada compares with other countries, and how the Canadian tax structure reflects the diversified and federal nature of Canada. Our aim is to describe rather than to debate Canada's tax policy choices, but inevitably we make some reference to Canada's principal choices and to the fact that strictures

1 Canada, *Report of the Royal Commission on Taxation* (Ottawa: Queen's Printer, 1966).

on good policy choices have had only a gradual and partial impact on Canada's tax structures. We point out here and throughout the book that effective tax burdens differ from nominal (statutory) rates, that the burden of taxes sometimes falls on those who do not actually pay the taxes, that tax policy is frequently the most effective means available to governments to influence economic and even social outcomes, that taxation is frequently used for purposes other than raising revenue, that the right choice among alternative tax structures is sometimes ambiguous, and that desirable tax structures and policies change over time.

Good tax policy is policy that maximizes economic well-being and reflects the views of citizens. A tax system that reflects sound policy is generally competitive internationally, employs tax bases that are as broad and inclusive as possible, has relatively low tax rates, and is for the most part neutral among different types of economic activities (and hence avoids distortions in effort, consumption, and investment).

However, tax policy in Canada is determined not just by the somewhat complex and occasionally contradictory arguments of economists, but also by considerations of the practicalities of administration and harmonization in a federal state, and by the highly pragmatic views of Canadians themselves. The setting of tax policies is therefore not only an academic art but also an exercise in practical democracy.

Canada has made remarkable improvements in the structure of its tax system over the past 25 years. The major reduction of corporate income taxes (with the virtual end of capital taxes), the adoption of a value-added sales tax system by the federal government and many provinces, and the levelling of personal income tax rates have remarkably improved the competitiveness and efficiency of our economy. We highlight these changes in the discussion that follows.

Aggregate Tax Burdens: An International Comparison

How the overall weight of taxes in Canada compares with that in other countries is a question that frequently arises in tax policy discussions. Aggregate tax burdens—that is, taxes of all sorts as a proportion of gross domestic product (GDP)—vary considerably from country to country. (GDP may be defined as the sum of compensation paid to labour and investment income paid to resident and non-resident owners of capital.) In general, countries with highly developed social support services have high ratios of taxes to GDP, because they must levy taxes to pay for these services. Poor and developing countries have low ratios, since average incomes are low and administrative systems are underdeveloped, making it difficult to raise substantial tax revenue. However, some of the variation in tax burdens among countries also reflects national choices.

The simple ratio of taxes to GDP does not tell the whole story, and does not necessarily reveal which country has high tax burdens. One country may choose to pay for the health, welfare, and pension costs for its citizens through state programs and to impose taxes to cover the costs. Another country may ask citizens to pay for most of these costs themselves and have lower tax rates as a consequence. There are differences in these approaches: the citizens of the second country have far more flexibility in “purchasing” social benefits, and the distribution of the burden of these costs by income level probably differs substantially. However, the net difference in tax burdens (that is, tax as a percentage of GDP) for the two countries does not recognize the differences in state-provided benefits.

Table 1.1 reports gross taxes in recent years as a share of GDP for the Organisation for Economic Co-operation and Development (OECD) countries. In the past three decades, tax-to-GDP ratios have risen in most countries, although with considerable variation, with the fastest rise in Italy and virtually little change in Germany. Canada's tax-to-GDP ratio rose unevenly from 31.0 percent in 1980 to 32.2 percent in 2008, although the 2008 ratio was lower than the peak in 1990. Overall, Canada is somewhere in the middle of the pack of developed countries, having a lower ratio than many European states but a significantly higher one than the United States, our main trading partner.

What Is a Tax?

Taxes are compulsory payments made by individuals and businesses to government treasuries to finance public services. Some taxes are directed to specific purposes, however, and these are often called "benefit taxes." As an example of a benefit tax, consider the social security payments made by individuals to fund public pensions and unemployment insurance (employment insurance in Canada), which are made available to the whole population. Individuals must pay the tax (and then receive the benefit as determined by law) without choice.

Taxes are not the only source of government revenue. Governments also use non-tax revenues, including royalties paid by companies for the extraction of resources from public lands, profits from Crown corporations, fees paid for use of public services, grants (such as foreign aid), investment income, fines, and voluntary transfers to the state. In some countries, non-tax revenues can make up a significant share of total revenues raised by governments.

Table 1.2 shows that total revenues raised by the OECD countries are uniformly higher than the taxes paid. For example, in 2005 Canada's total government revenues as a share of GDP were 40.8 percent, while taxes made up only 33.4 percent. Tax revenues account for the bulk of payments made by individuals and businesses, but non-tax revenues constituted 7.4 percent of the GDP in 2005, which is about one-fifth of total revenues. A significant part of non-tax revenues are resource royalty payments and user fees, such as tuition fees at public universities and colleges.

As a broad generalization, government expenditures and aggregate taxes have been rising fairly steadily in almost all developed countries for upward of three centuries. In the early years, these increases reflected the growth in the power of centralized nation states as well as the rising costs of wars. But while the costs of military preparedness has historically been an important factor in explaining the growth of governments, the rapid growth of welfare and social services has been more critical, especially since the Great Depression of the 1930s.

The relatively high ratio of government spending and taxes to GDP in most Western European countries is a reflection of high and growing social welfare costs. This ratio has been reinforced by demographic trends: most countries have an aging population, which tends to consume more health and pension benefits than a youthful one. Indeed, in many countries high social spending plus continuing military costs have led to rising deficits, because government revenues have not risen to cover increased expenses. However, in the 1980s and 1990s, a number of governments in developed countries began to decrease

TABLE 1.1 Total Taxes as a Percentage of GDP, OECD Member Countries, Selected Years, 1980-2008

Jurisdiction	1980	1990	2000	2005	2007	2008
Australia	26.7	28.5	31.1	30.8	30.8	—
Austria	38.9	39.7	43.2	42.3	42.3	42.9
Belgium	41.3	42.0	44.9	44.7	44.0	44.3
Canada	31.0	35.9	35.6	33.4	33.3	32.2
Czech Republic	—	—	35.3	37.6	37.4	36.6
Denmark	43.0	46.5	49.4	50.8	48.7	48.3
Finland	35.7	43.5	47.2	44.0	43.0	42.8
France	40.1	42.0	44.4	43.9	43.5	43.1
Germany	36.4	34.8	37.2	34.8	36.2	36.4
Greece	21.6	26.2	34.0	31.4	32.0	31.3
Hungary	—	—	38.0	37.3	39.6	40.1
Iceland	29.6	30.9	37.3	40.6	40.9	36.0
Ireland	31.1	33.1	31.3	30.4	30.8	28.3
Italy	29.7	37.8	42.3	40.8	43.5	43.2
Japan	25.4	29.1	27.0	27.4	28.3	—
Korea	16.5	18.1	22.6	23.9	26.5	26.6
Luxembourg	35.6	35.7	39.1	37.6	36.5	38.3
Mexico	14.8	15.8	16.9	18.1	18.0	20.4
Netherlands	42.9	42.9	39.7	38.5	37.5	—
New Zealand	30.8	37.4	33.6	37.4	35.7	34.5
Norway	42.4	41.0	42.6	43.5	43.6	42.1
Poland	—	—	32.8	33.0	34.9	—
Portugal	22.9	27.7	34.1	34.7	36.4	36.5
Slovak Republic	—	—	34.1	31.4	29.4	29.3
Spain	22.6	32.5	34.2	35.7	37.2	33.0
Sweden	46.4	52.2	51.8	49.5	48.3	47.1
Switzerland	24.7	25.8	30.0	29.2	28.9	29.4
Turkey	13.3	14.9	24.2	24.3	23.7	23.5
United Kingdom	34.8	35.5	36.3	35.8	36.1	35.7
United States	26.4	27.3	29.9	27.5	28.3	26.9
OECD: Europe	33.3	36.0	38.4	37.9	38.0	—
OECD: United States	24.0	26.3	27.5	26.3	26.5	26.5
OECD: Pacific	24.8	28.2	28.5	29.9	30.4	—
OECD: total	30.9	33.7	36.0	35.7	35.8	—

— Not available.

Source: Organisation for Economic Co-operation and Development, *OECD Statistics Database* (Paris: OECD, 2010).

tax burdens, particularly for business, in an effort to improve competitiveness and spur economic activity. Some of these countries also made efforts to restrain expenditures, but others did not.

In the years immediately before this publication (2008-2010), government spending (and deficits) in developed countries tended to spike, because a worldwide financial crisis occurred and antirecessionary spending rose dramatically, while tax revenues fell because of the recession. Ballooning deficits resulted in many countries. In 2010, many governments are beginning to cut back on the spending caused by counterrecessionary trends, and even more importantly, some governments have found that there are severe constraints

**TABLE 1.2 Total Government Revenue as a Percentage of GDP,
OECD Member Countries, Selected Years, 1990-2009**

Country	1990	1995	2000	2005	2008	2009
Australia	32.8	34.9	35.9	36.7	33.4	—
Austria	49.0	50.5	50.3	48.4	48.4	48.8
Belgium	45.5	47.6	49.1	49.3	48.9	48.2
Canada	43.0	43.2	44.1	40.8	39.8	38.5
Czech Republic	—	41.0	38.1	41.4	40.2	39.3
Denmark	54.1	56.4	55.8	57.8	55.3	55.9
Finland	53.5	55.3	55.1	52.7	53.7	53.4
France	47.0	48.9	50.1	50.5	49.5	48.1
Germany	43.4	45.1	46.4	43.5	43.6	44.3
Greece	—	37.5	43.0	38.5	39.1	36.9
Hungary	—	48.1	43.8	42.2	45.4	45.9
Iceland	—	39.8	43.6	47.1	44.2	42.4
Ireland	40.2	39.1	36.1	35.7	35.1	34.3
Italy	41.5	45.1	45.3	43.8	46.2	46.6
Japan	33.9	31.2	31.4	31.7	35.0	—
Korea	22.3	23.9	27.9	30.0	33.4	—
Luxembourg	42.0	42.1	43.6	41.5	40.1	42.3
Mexico	—	—	—	19.2	23.0	—
Netherlands	49.6	47.2	46.1	44.5	46.6	46.1
New Zealand	48.1	44.5	40.7	43.1	42.6	—
Norway	—	54.2	57.7	57.2	59.3	55.5
Poland	—	43.3	38.1	39.4	39.6	37.4
Slovak Republic	—	45.2	39.9	35.2	32.5	34.0
Spain	—	38.0	38.1	39.4	37.0	34.7
Sweden	—	57.6	59.1	56.5	54.7	53.8
Switzerland	30.2	33.0	35.2	34.6	34.7	34.8
United Kingdom	39.3	38.0	40.4	40.8	42.5	40.4
United States	32.9	33.7	35.2	32.9	32.4	30.5

— Not available.

Note: Data for Portugal and Turkey unavailable.

Source: Organisation for Economic Co-operation and Development, *OECD Statistics Database* (Paris: OECD, 2010).

on their ability to spend even at the rates that predated the financial crisis. It is now increasingly recognized that there are large costs and risks when governments continue to incur structural deficits² by failing to restrain spending or increase taxes. A number of European countries have moved into a financial crisis and are struggling to cut expenditures to put their affairs in order.

Canada too has recognized the dangers of structural deficits and the associated need to expand borrowings. However, both the federal and provincial governments have largely sought to deal with the problem without major increases in taxes and with some moderation in expenditures, thus relying on natural growth in revenues over time to overcome the deficit. This of course prolongs the period required to achieve balanced budgets and makes recovery less certain.

² Structural deficits are those that persist even if an economy is operating at full capacity.

Tax Burdens

Who Bears Them?

Tax burdens reflect the total cost of a tax, but the burden is not necessarily borne by the person that is legally liable to pay the tax if the tax can be passed on to others through higher prices, lower input payments, or lower returns on capital for investors. Economists measure the economic *incidence* of taxes taking into account how tax burdens are shifted forward as higher prices paid by consumers or backward as lower payments paid to labour, capital, and other factors used in producing goods and services.

Tax burdens also refer to the adverse consequences of taxes over and above the amount collected. These costs, referred to by economists as the “deadweight loss” or “excess burden” of taxation, are discussed at various points throughout the book, beginning in chapter 2.

In considering tax burdens at the personal level, it is frequently necessary to look to the burdens of taxpayers net of the benefits they receive, as in the case of payroll taxes for employment insurance and the Canada/Quebec Pension Plan. Also, in tax policy the intergenerational shifting of burdens is an important issue.

Tax burdens can be measured annually or (for individuals) over a lifetime. The burden of taxes is typically measured against “economic income,” which is defined broadly as the resources that people pay for goods and services over their lifetime. On an annual basis, and corresponding to the GDP, economic income is measured according to household receipts, such as wages and salaries, investment income, capital gains, and rents. The concept of economic income will receive more attention at various points in this book, where we compare it to other concepts of income, such as accounting and taxable income.

Varying According to Ability To Pay

Governments use both taxes and transfers to change the distribution of income. Transfers, such as those that fund public health care and education, family allowances, pension supplements, and child tax benefits, are intended to reduce poverty or provide basic income support for the population. Taxes may be levied according to “the ability to pay” principle, with higher burdens (measured as a percentage of income) assessed against those who have more resources to pay tax. A tax structure is said to be “progressive” if taxes as a percentage of ability to pay (often taken to mean income) increase as ability to pay increases, “regressive” if they decrease, and “proportional” if they are constant. Income taxes can be made progressive by providing exemptions or credits to low-income households and assessing tax rates that rise with the level of income earned by an individual or family. Sales taxes are often viewed as being regressive, but can be made progressive by exempting necessities or taxing them at a low rate or by providing a transfer or income tax credit to low-income taxpayers to alleviate the impact of the tax.

Income Equality: What Is the Role of Taxes and Transfers?

The degree of income equality in a society depends on many factors, including differences in the amount of wealth, training, skills, time, and circumstances of individuals. A progressive tax structure (in which higher-income individuals must contribute a larger percentage of their income in taxes than lower-income individuals) tends to reduce after-tax inequality.

Social benefits and transfers to lower-income individuals can reduce inequalities as well. Relative equality or inequality in a country is usually measured by the Gini coefficient, a calculation based on individual incomes. A Gini coefficient of 0 means that income distribution is perfectly equal, while a coefficient of 1 means that it is absolutely unequal, with the richest individual having all the income and everyone else having no income.

Figure 1.1 shows the Gini coefficients for Canada over time, both before and after taxes and transfers. The figure clearly illustrates how taxes and transfers make the distribution of net income more equal. The Gini coefficient for pre-tax income (a measure of income inequality) has gone up measurably from 0.45 to 0.51 between 1976 and 2006, implying that income distribution is less equal. However, on an after-tax basis, taking both taxes and transfers into account, the Gini coefficients are much lower in value (implying more equality) and rose less, from approximately 0.31 to 0.33 between 1976 and 2008. Further, the Gini measures in figure 1.1 would be even lower if the value of public services for health, education, and other major public services were included as part of personal income.

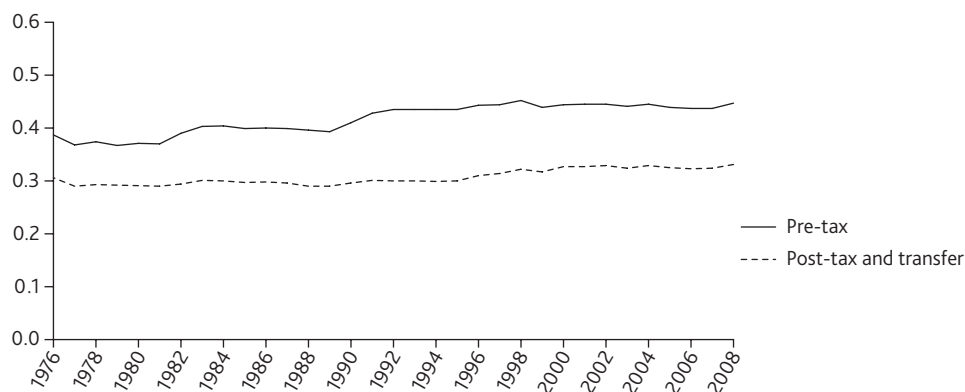
Government Deficits

Tax systems need to be analyzed in terms of their adequacy in achieving their basic purposes, the most fundamental of which is the provision of the revenue needed to run government programs. A vitally important objective of tax policy is delivering, in a very broad sense, a balanced budget (revenues being equal to expenses) over a fiscal cycle. Countries that run excessive deficits find that these deficits must be made up eventually, and are really just deferred taxes that must be recovered.

Further, deficits cause governments to borrow, resulting in growing and compounding interest expenses on the debt, and making it that much more difficult to achieve balanced budgets and surpluses. In addition, growing government deficits and borrowing can lead to other undesirable effects, such as inflation and a “crowding out” of private borrowers in capital markets. In theory, a country could rationally strive to balance its accounts over an economic cycle of several years, but it is not easy to project how long these cycles would last.

Debt is not inherently a negative matter. For example, countries can use debt to fund public capital expenditures in the early years if these expenditures will provide benefits to future taxpayers. It is therefore reasonable to use some public debt financing with the intent of paying it back in later years. In cyclical economies, using debt to pay for capital improvements can smooth tax burdens over time.

The federal government and a number of provincial and territorial governments in Canada have adopted an accrual accounting approach to government expenditures, which requires the inclusion of all receipts and expenses as long as they are invoiced or incurred, even though they are not paid in cash. Capital costs, such as expenditures on highways and bridges, are depreciated with amounts equal to the amount of money that would be needed to maintain the capital (based on the expected life of capital before it must be replaced). Instead of charging an entire capital expenditure against revenue in a single year, the relevant amount is added to a capital account (covering, for example, public roads and highways) and depreciated in accordance with the expected life of the capital.

Figure 1.1 Gini Measure of Inequality, Canada, Selected Years, 1976-2008

Source: Statistics Canada, *CANSIM Database* (Ottawa: Statistics Canada), economic families, two persons or more.

However, while it is possible for a budget to be balanced on an accrual basis (wherein surpluses cover depreciation costs), the government could still be in a cash deficit if the capital expenditures are more than the costs of depreciating capital in the year. Debt finance is then required to cover the cash deficit.

There is considerable evidence that governments tend to find it easier to spend and run deficits than to build surpluses to cover the lean years to come. Politicians have short-term electoral cycles, and pushing tax burdens to later years may make it easier for them to be re-elected. This gives rise to the so-called deficit bias in public finances. However, running a deficit only defers the inevitable need to balance the books and contain the debt.

Table 1.3 provides total government surpluses and deficits (–) for various years. Next to Italy and Belgium, Canada had one of the higher deficits among OECD countries in 1995, although its deficit has declined significantly since then.

Canada's debt burden grew substantially during the 1980s and 1990s until 1995, when federal, provincial, and territorial governments took strong action to balance budgets, by cutting spending and increasing some taxes. In the past decade (before the global financial crisis late in 2008), Canada has run surpluses, similar to those in certain other countries, such as Denmark and Finland. By 2010, Canadian surpluses had turned into large deficits for the federal and many provincial governments as the world recession hit Canada.

As shown in figure 1.2, total government net debt in Canada (financial liabilities net of government assets as a percentage of the GDP for all levels of government) peaked in 1995 at 71 percent. With the actions taken by Canadian governments, net debt fell to about 22 percent of the GDP by 2008. In figure 1.3, which focuses on gross debt, the debt burden peaked at 101 percent of the GDP in 1995-1996 and fell to 70 percent by 2008.

The world dramatically changed in 2008, when the financial crisis radically impaired the global economy. With the world recession, governments, including the Canadian government, faced falling tax receipts and higher spending associated with unemployment and stimulus expenditures. Canada's net debt is expected to climb to about 33 percent of the GDP in 2011 (and the gross debt to over 80 percent of the GDP) according to

TABLE 1.3 Total Government Surplus/Deficit as a Percentage of GDP, OECD Member Countries, Selected Years, 1995-2008

Country	1995	2000	2005	2008
Australia	-2.6	-0.7	1.8	-2.3
Austria	-5.9	-1.9	-1.8	-0.5
Belgium	-4.5	-0.1	-2.8	-1.2
Canada	-5.3	2.9	1.5	0.0
Chile	—	-0.2	5.3	3.3
Czech Republic	-13.4	-3.7	-3.6	-2.7
Denmark	-2.9	2.2	5.0	3.4
Finland	-6.2	6.8	2.5	4.2
France	-5.5	-1.5	-3.0	-3.3
Germany	-9.7	1.3	-3.3	0.1
Greece	-9.3	-3.7	-5.3	-7.7
Hungary	-8.9	-3.0	-7.9	-3.8
Iceland	-3.0	1.7	4.9	-13.5
Ireland	-2.1	4.8	1.6	-7.2
Israel	-4.2	-2.2	-2.2	-1.9
Italy	-7.4	-0.9	-4.4	-2.7
Japan	-4.7	-7.6	-6.7	-2.1
Korea	3.5	5.4	3.4	3.0
Luxembourg	2.4	6.0	0.0	2.9
Mexico	—	—	0.8	-1.1
Netherlands	-9.2	2.0	-0.3	0.5
New Zealand	2.7	1.9	4.5	0.4
Norway	3.2	15.4	15.1	19.1
Poland	-4.4	-3.0	-4.1	-3.7
Slovak Republic	-3.4	-12.3	-2.8	-2.3
Slovenia	-8.4	-3.7	-1.4	-1.7
Spain	-6.5	-1.0	1.0	-4.1
Sweden	-7.3	3.6	2.0	2.2
Switzerland	-2.0	0.1	-0.7	2.3
United Kingdom	-5.9	1.3	-3.3	-4.9
United States	-3.2	1.5	-3.2	-6.1

— Not available.

Source: Organisation for Economic Co-operation and Development, *OECD Statistics Database* (Paris: OECD, 2010).

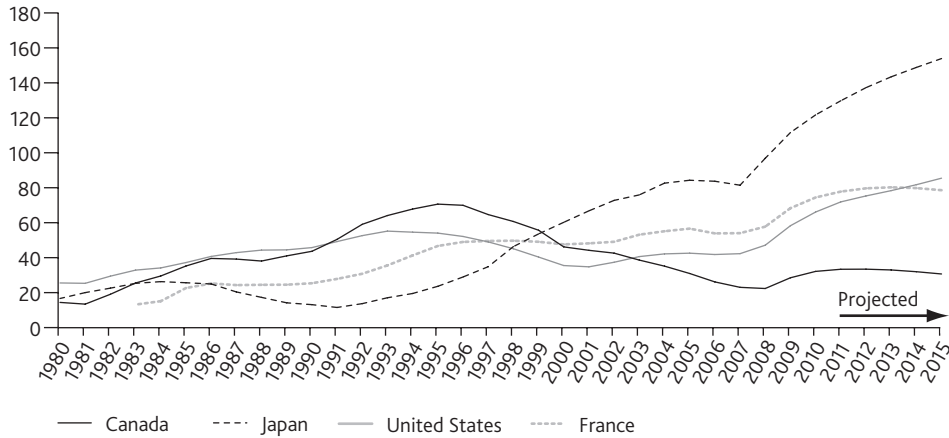
While up-to-date information for all countries is not available, many countries have recorded substantial deficits in 2009, 2010, and thereafter as financial market shocks and economic problems emerged.

forecasts of the International Monetary Fund; the debt is expected to trail off thereafter. While Canada is facing a higher debt burden associated with the global economic recession, its fiscal situation is not nearly as dire as that of many other major industrialized economies. The US debt burden is expected to approach levels similar to Canada's in 1995 by 2014. Japan's debt situation is reaching levels that not many countries would envy.

Government Spending

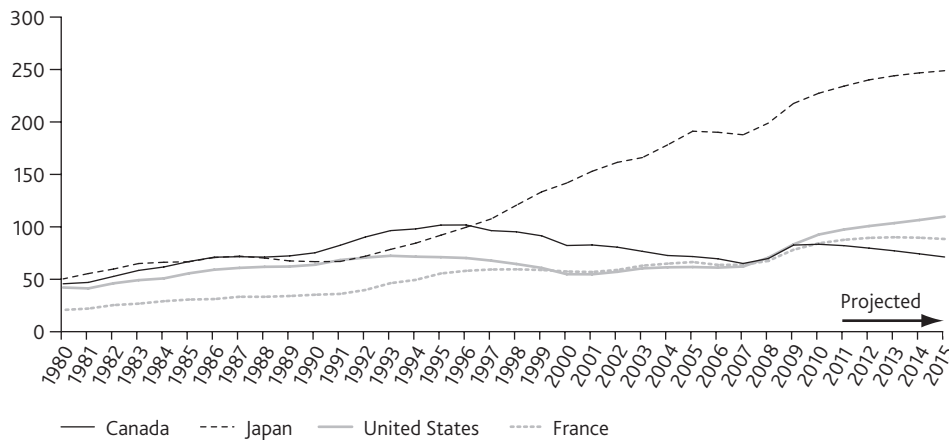
Governments need tax revenue to spend on the goods and services that they provide. They hire workers and managers as well as pay for capital goods to develop and administer programs. They provide transfers to individuals and businesses, such as employment insurance benefits,

Figure 1.2 Total Government Net Debt as a Percentage of GDP, Selected Countries, 1980-2015



Source: International Monetary Fund, *World Economic Outlook Database* (Washington, DC: IMF, 2010).

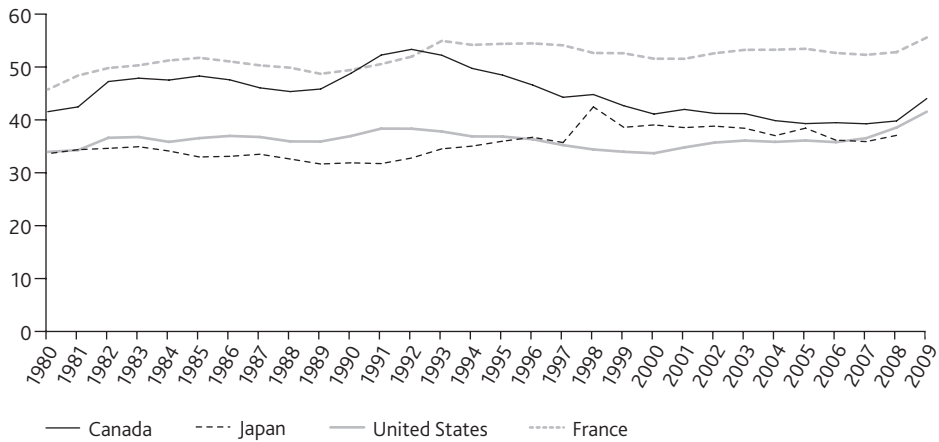
Figure 1.3 Total Government Gross Debt as a Percentage of GDP, Selected Countries, 1980-2015



Source: International Monetary Fund, *World Economic Outlook Database* (Washington, DC: IMF, 2010).

pension benefits, and business grants. They pay for military and police protection and provide transportation infrastructure, public health, and education. The goods and services bought by governments and transfer payments are known as “program expenditures.” In addition, governments make payments to cover interest expenses on debt (net of investment income earned on public assets) that are added to program expenditures to arrive at total expenditures. While interest on debt is a transfer paid to lenders, it is compensation for money borrowed from institutions and individuals.

Figure 1.4 Total Government Expenditure as a Percentage of GDP, Selected Countries, 1980-2009



Source: Organisation for Economic Co-operation and Development, *OECD Statistics Database* (Paris: OECD, 2010).

Figure 1.4 compares spending in Canada with spending in certain other Western economies. Total expenditures, including interest on debt, are relatively high in Canada compared with those of our most important trading partner, the United States, especially in the 1980s and 1990s. Since the mid-1990s and especially in recent years, budgetary constraints at the federal, provincial, and territorial levels of government in Canada have led to a reduction in total government spending, approaching that of the United States. After the global recession in 2008, the increased indebtedness in the United States could reverse the longstanding trend in which US governments historically spend less than Canadian governments in relation to the size of their economies.

Canadian governments have also incurred more expenditures as a share of the GDP compared with Japan, which until recently was the second largest economy in the world. However, as shown in figure 1.4, the relative size of government in Canada is now approaching levels in Japan. With large Japanese debt burdens forecasted for the future, it is possible that Canadian public expenditure as a share of the GDP may become less than that in Japan.

In later chapters of this book, transfer payments and the benefit of public services will be considered in more depth in relation to tax policy. Public goods and services provided by governments (such as highways, roads, and education) provide important benefits to the public. In some cases, public enterprises (such as postal services and power companies) operate alone or in competition with private companies or are owned by the private sector.

Governments also have a choice in supporting individuals and businesses with transfers (such as welfare payments or business subsidies) or with tax reductions (such as low-income tax relief or investment tax credits). Regulations can also be used as an alternative to government spending or tax policies to affect the behaviour of people and institutions. While we will not examine regulation in depth in this book, we will periodically discuss

the interaction between tax policy and public program spending in the context of economic and social policy.

Tax Revenue Sources

Not only the aggregate level of taxes but also the type of taxes imposed vary from jurisdiction to jurisdiction. In fact, there is considerable variation in the reliance that individual jurisdictions place on particular tax fields.

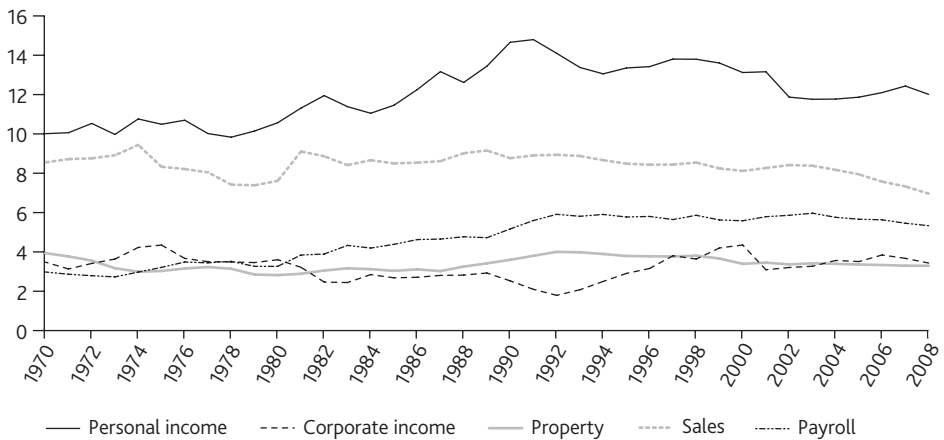
Governments across the world rely on five primary sources of tax revenue: personal income taxes, corporate taxes, sales and excise taxes, property and wealth taxes, and payroll taxes (typically as contributions for social security and other social benefits). In Canada, all five forms of taxes are used to finance public services, which will be discussed in some detail below and in more extensive detail in later parts of this book.

Canadian governments rely foremost on personal income taxes as a source of revenue, as figure 1.5 demonstrates. These taxes are assessed on individual incomes, which are composed of taxable worker earnings and income from savings, including interest, dividends, and capital gains. Personal income taxes as a share of the GDP have grown from 10 percent in the early 1970s to as high as 15 percent by 1990, because governments ramped up personal taxes to deal with rising deficits. As federal, provincial, and territorial governments returned to improved fiscal health after 1995, they reduced personal income taxes to about 12 percent of the GDP in 2008.

The second most important source of revenue for Canadian governments is sales and excise taxes. These revenues include general sales taxes (such as provincial sales taxes, the harmonized sales tax [HST], and the goods and services tax [GST]), as well as various specific duties on fuel, alcohol, cigarettes, carbon emissions, and other products. As a share of the GDP, sales and excise taxes have changed little over the years, generally fluctuating from around 8.5 percent (in 1970) to as low as 7 percent (in 2008) and as high as 9.3 percent (in 1989). Yet, as discussed in more detail later, Canadian governments have extensively reformed their sales tax regimes in the past two decades. The federal government replaced the manufacturers' sales tax with the GST on January 1, 1991. In the years that followed, a number of the provinces have also adopted a value-added tax coordinated with that of the federal government (the HST) so that over two-thirds of Canada's economic activity is carried on in provinces with fully integrated and modern value-added sales tax systems. Despite these significant changes, the percentage of sales and excise taxes to GDP has moved slightly downward in recent years, because the federal government reduced its GST rate from 7 percent to 5 percent.

The other three main sources of taxes levied by governments are payroll, corporate, and property taxes. Payroll taxes have grown somewhat in the past three decades, from 5.0 percent of the GDP in 1960 to 5.3 percent in 2008, in part reflecting the growth of provincial payroll taxes and increases in payroll contributions to the Canada/Quebec Pension Plans, employment insurance, and workers' compensation. Corporate taxes, which for the most part consist of income taxes assessed on corporate profits, tend to move with the business cycle. They reached their highest level in 2000 (4.5 percent of the GDP) and fell somewhat in the past several years, because federal and provincial governments reduced corporate income tax rates and taxes on corporate capital. Property taxes, which primarily

Figure 1.5 Type of Tax Revenue as a Percentage of GDP, Canada, Selected Years, 1970-2008



Source: Organisation for Economic Co-operation and Development, *OECD Statistics Database* (Paris: OECD, 2010).

go to municipal governments and are their major source of revenue, have fallen from 3.9 percent of the GDP in 1970 to 3.3 percent in 2008.

While all industrialized economies rely on taxes similar to those in Canada, there is significant variation in the combination of taxes in different jurisdictions, as shown in table 1.4. Compared with the United States, for example, Canada relies much less heavily on payroll taxes but much more heavily on sales taxes. European countries rely much more heavily on payroll and sales taxes than Canada. They rely on personal income taxes to varying degrees; in Denmark, for example, personal income taxes are 25 percent of the GDP, a higher ratio than in any other OECD country. Australia, Canada, the United Kingdom, and the United States tend to levy higher property taxes as a share of the GDP than many (but not all) European countries.

There are many economic, historical, cultural, and political factors that explain the variation in the relative importance of different types of taxes across countries. This topic is too extensive to discuss in our book on Canadian tax policy. As a brief generalization, however, raising revenues from a number of tax sources at relatively modest rates may prove less difficult than relying on only a very few taxes with higher rates. Further, developing countries that have only basic administrative systems find it easier to rely on simpler taxes, and may have difficulties collecting revenues from complex income or wealth taxes.

The World Economy and the Changing Canadian Tax System

The Canadian tax system has changed remarkably in the almost 150 years since Confederation, and even in the last 20 years, but so too has the Canadian economy, especially as a result of economic integration at the international level.

In the 19th and early 20th centuries, Canada was primarily a producer of basic commodities, including lumber, metals, and foodstuffs. But gradually Canadian manufacturing

TABLE 1.4 Tax Revenue by Source as a Percentage of GDP, Selected Countries, 2007

Jurisdiction	Personal income	Corporate income	Payroll	Property	Sales
Australia	11.3	7.1	1.4	2.7	7.5
Austria	9.5	2.4	16.9	0.6	11.0
Belgium	12.8	3.6	13.6	2.3	10.3
Canada	12.4	3.7	5.5	3.3	7.3
Czech Republic	4.3	5.0	16.2	0.4	10.4
Denmark	25.1	3.6	1.2	1.9	15.5
Finland	13.0	3.9	11.9	1.1	12.6
France	7.4	3.0	17.3	3.5	10.4
Germany	9.1	2.2	13.2	0.9	10.2
Greece	4.7	2.6	11.7	1.4	10.4
Hungary	7.2	2.8	13.5	0.8	14.6
Iceland	13.8	2.5	3.2	2.5	14.7
Ireland	8.7	3.4	5.0	2.5	10.6
Italy	11.1	3.8	13.0	2.1	9.9
Japan	5.5	4.8	10.3	2.5	4.5
Korea	4.4	4.0	5.6	3.4	8.0
Luxembourg	7.4	5.4	10.2	3.6	9.7
Netherlands	7.7	3.3	13.6	1.2	10.7
New Zealand	15.0	5.1	0.0	1.9	10.5
Norway	9.6	11.3	9.1	1.2	11.7
Poland	5.3	2.7	12.0	1.2	12.6
Portugal	5.7	3.7	11.7	1.4	13.4
Slovak Republic	2.5	3.0	11.7	0.4	10.5
Spain	7.4	4.6	12.1	3.0	8.8
Sweden	14.9	3.8	15.3	1.2	12.4
Switzerland	10.2	3.1	6.7	2.4	5.9
Turkey	4.0	1.6	5.1	0.9	10.8
United Kingdom	10.9	3.4	6.6	4.5	10.1
United States	10.8	3.1	6.6	3.1	3.9
European Union	9.2	3.5	11.9	1.8	11.3

Source: International Monetary Fund, *Government Finance Statistics* (Washington, DC: IMF, 2010).

assumed greater importance: shipbuilding, fashioning iron and steel products, and then manufacturing automobiles became important industries. Recently, service industries have grown more rapidly than goods-producing industries. Indeed, the growth in employment in Canada in the last several years has largely been the result of increases in jobs in the service sector, including construction, utilities, telecommunications, transport, trade and business, and household services. While primary products are still of vital importance to Canada (with oil and gas becoming prominent recently) the Canadian economy (and its exports) is now much more diversified than before. Canadian economic growth still relies heavily on foreign investment, although Canadian investment abroad has grown significantly and has generally surpassed direct investment inflows since 1995. The global changes have also resulted in a much greater global integration of services, especially in relation to communication, transportation, and other business services.

Canadian tax policy has similarly evolved. The national policy developed by the government led by John A. Macdonald in 1867 used tariffs to protect the manufacturing

industry of Central Canada. The Canadian Pacific Railway was built to link the outlying regions of Canada with Ontario and Quebec, and immigration to settle the West was encouraged. Elements of protectionism continued for the next century until the Progressive Conservative government led by Brian Mulroney negotiated a free trade agreement with the United States in 1987 (later expanded into the North American Free Trade Agreement in 1994 to include Mexico). With free trade, tariffs were reduced or eliminated on many products. Further, Canada has supported tariff reductions through the World Trade Organization multilateral negotiations.

Global economic integration also began to take hold during this period. Cross-country capital flows rose substantially. For example, cross-border foreign direct investment among OECD countries increased from about \$600 billion annually in 1990 to over \$2 trillion annually by the end of the decade.³

With a sharp increase in capital mobility, Canadian governments began to experience pressure to improve their business tax regimes. This pressure led to reductions in corporate income and capital taxes after 2000, a trend that will be discussed in more detail in chapter 7.

Global economic integration has changed not only corporate taxation but also other aspects of the tax system, especially sales taxation. As noted later, the federal manufacturers' sales tax, a single-stage archaic tax supposedly imposed at the wholesale level, was criticized for putting manufacturing companies at a competitive disadvantage since the tax increased the costs of manufactured goods produced in Canada relative to those in other countries. First the federal government and then six provinces adopted a value-added tax that removed these distortions, and greatly aided the competitiveness of Canadian producers. (However, and as noted later, British Columbia has voted in a referendum to revert to its previous provincial sales tax.)

These business and sales tax measures led to a more neutral treatment of industries and goods and services. Overall, corporate taxes on services declined relative to primary and manufacturing industries, because some preferences for the primary and manufacturing industries were reduced (although many tax preferences continue today). Sales taxes on business inputs have been removed or reduced in favour of a higher burden of sales taxes on goods and services sold domestically in Canada.

Globalization has affected not only business and sales tax regimes but also personal taxes on skilled labour. Over the years, the top federal-provincial-territorial personal income tax rates have fallen sharply from the 1960s (when they were over 80 percent) to just over 40 percent today, although the tax base has expanded over the same period. In 1972, the federal government lowered marginal rates in favour of broadening the personal tax system, especially with the introduction of capital gains taxes. In 1987, further reductions to the top personal tax rate and base-broadening measures were introduced largely in response to a sharp reduction in the top personal tax rate in the United States with the adoption of the Reagan reforms. Some provinces, however, increased personal tax rates

³ Organisation for Economic Co-operation and Development, *OECD Statistics Database* (Paris: OECD, 2010).

to help reduce government deficits. Because of the increased mobility of skilled labour at the global level, another round of personal tax rate reductions was implemented in Canada, beginning in the mid-1990s with reductions by several provinces and followed by personal tax rate reductions at the federal level after 2000.

Canadian Tax Policy Reforms

The complex history of tax policy in Canada since Confederation has a number of important landmarks that show how Canada has struggled to build a more efficient tax structure. Canadians have periodically reviewed their tax systems, sometimes making dramatic changes over the years.

In the years following Confederation, politicians who tried to combine a limited knowledge of tax policy issues with their perception of political sensitivities largely initiated tax changes. In the federal government, the Department of Finance gradually took on a central role of shaping Canadian tax policy, a step that was greatly aided by the appointment of Clifford Clark, an economist, as deputy minister. Clark came to office in 1932, at a time when most of the employees of the department were engaged in counting redeemed coupons clipped from government bonds. He began to apply economic analysis to the formulation of tax policy, and to improve the comprehension of fiscal issues. He was in good part responsible for the remarkable job of financing Canada's spending during the war years, when government expenditures soared but inflation was kept well under control.

Perhaps the next landmark was the *Report of the Royal Commission on Taxation* in 1966, known as the Carter report after its chairman, Kenneth Carter. The report was a comprehensive survey of the total tax structure in Canada, and contained recommendations for a complete change in this structure.

The Carter report adopted the basic approach that “a buck is a buck”—that all additions to personal wealth (command over goods and services) rank as income, and should be taxed as such. The report therefore proposed that not only earned income and the return on investments (including capital gains) but also bequests and gifts be taxed as income. The reports also recommended a complete (and complex) integration of personal and corporate income, so that income earned by companies would be taxed at the personal rates of its shareholders. The report also recommended lower tax rates that could be achieved because of the broader base.

Some commentators complained that the report was antibusiness, because it advocated the end of a number of business incentives and special treatments. However, it was careful to point out that business per se is not a separate source of revenue for governments: taxes on businesses must inevitably be passed on to others through lower wages to labour, lower prices for other inputs, lower returns on capital, or higher prices to customers. In the end, only people bear taxes.

While some of the report's recommendations were acted on, many others were not. However, the discussion and research of the committee has served to illuminate tax policy in Canada and elsewhere.

A further landmark of sorts was the budget introduced by Finance Minister MacEachen in 1981, which proposed major revisions in the tax system, including most notably reduced

“incentives” for business and a general tightening of the tax net. In fact, many of its proposals were withdrawn before being implemented. But the budget was an example of a general movement, in Canada and elsewhere, to achieve a fairer system by removing perceived loopholes and unjustified incentives. This trend has continued fitfully with the adoption of a general anti-avoidance rule in the tax statutes and continued efforts to plug perceived abuses in the system. More recently, new rules requiring greater disclosure of tax-planning schemes have been introduced.

During the 1980s, there was a growing realization that Canada’s tax burden and the tax structure for business income was undermining economic growth and that it was necessary to stabilize the unwieldy corporate tax base. The idea of lowering rates and moving to a new more neutral corporate tax base was consistent with the philosophy adopted by the new Mulroney government elected in 1984. With accelerated depreciation and other special preferences, many profitable companies were not paying corporate taxes, and a number of them engaged in practices to transfer their losses to taxpaying corporations. In May 1985, Michael Wilson, the new minister of finance, introduced a revenue-neutral corporate tax restructuring. The proposals included a reduction in the federal corporate rate (eventually from 36 to 28 percent) with the elimination of a general investment tax credit and inventory allowances, and a scaling back of corporate capital cost accelerated deductions. The first phase was adopted in the May 1985 budget.

In 1986, the Reagan government enacted a major tax reform in the United States with the aim of substantially lowering corporate rates to 35 percent and achieving a more neutral tax base. The federal government in Canada then decided that it needed not only to carry out the second phase of corporate tax reform as originally planned but also to undertake personal tax reform with the aim of lowering the federal rate. The Canadian reform led to lower personal income tax rates, a broader personal income tax base, and fewer tax brackets with many deductions turned into tax credits (generally based on the low-income tax rate and the qualifying amounts). The government argued that the use of tax credits increased fairness by equalizing the value of a deduction for the rich and the poor, although a significant reason for introducing the credits was simply to enable the government to cut personal income tax rates as much as possible.

BOX 1.1 What Are Tax Expenditures?

A tax expenditure is a tax provision that allows particular activities or goods to bear less than the usual tax. Frequently governments have used these measures to exert control over economic development and personal preferences. They have been used over the years to allow small businesses to pay much less than the usual rate of corporate tax, to grant special concessions (such as accelerated writeoffs) to manufacturing and resource activities to encourage development, and to provide tax credits for charitable donations. Each of these provisions was designed to encourage a particular type of activity, but each also carried with it a reduction in overall tax revenues that had to be made up by other taxpayers. Further, tax expenditures can frequently distort business and consumer choices, making the economy less efficient than it otherwise would be by shifting resources from more to less economically valued activities.

The final landmark on the tax reform front was the publication of the *Report of the Technical Committee on Business Taxation* in 1997.⁴ The committee, chaired by Jack Mintz, undertook a complete review of the taxation of business in Canada and provided a large number of recommendations. The report's basic philosophy held that taxation measures should be as neutral as possible in relation to different activities and assets, and that the system should use low rates applied to a broad and neutral base. Measures that directly or indirectly favoured particular industries, specific types of capital structures, or the sizes or other characteristics of business inevitably led to a misallocation of resources and a less than optimum economic achievement. The report's basic thrust was therefore to advocate a neutral tax system with a broad base and internationally competitive rates: a system that would provide both fairness and opportunities for Canadians.

Some of the report's recommendations were criticized, but over time a significant number of its proposals have been enacted, and the advantage of broad and neutral tax bases with low rates is now widely acknowledged, even if not always acted on. After 1999, both federal and provincial governments began introducing substantial business tax reforms, including reduced corporate income tax rates, revised capital cost allowances to reflect economic costs, and phased-out capital taxes.

Ultimately, the reforms culminated in a general reduction of corporate tax rates, with the federal rate scheduled to fall to 15 percent by 2013. Four provinces (Ontario, British Columbia, Alberta, and New Brunswick) have adopted a 10 percent provincial corporate income tax rate. Therefore by 2013, the average federal-provincial corporate income tax rate will be somewhat more than 25 percent, sharply below the 43 percent that prevailed at the beginning of the century. Personal income taxes have also been reduced from 2000 to 2005 at the federal level to accompany business tax reform.

Federal Structure of the Canadian Tax System

To understand the structure of the Canadian tax system, it is also important to understand the role of the federal, provincial, territorial, and local (municipal) governments in Canada. Under Canada's Constitution Act, 1867 (formerly the British North America Act, 1867),⁵ the federal government has wide taxing powers with few limitations. The provinces are limited to imposing "direct taxation" within the province. With direct taxation, taxes are imposed on taxpayers that will not directly pass the tax on to others. (This limitation exists to prevent the provinces from enacting taxes that are designed to fall on persons that reside outside the province.) Despite these limitations, the provinces are able to levy the most important taxes, such as income and sales taxes, but they are not able to impose tariffs, export taxes, withholding taxes on payments to non-residents, and sales or excise taxes on intermediate goods and services intended to be passed on to other taxpayers.⁶ Municipalities, which are not sovereign governments under Canada's constitution, are limited to levying only those taxes that the province authorizes them to collect.

4 Canada, *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, April 1998) (the report was submitted to the minister of finance in December 1997).

5 Constitution Act, 1867, 30 & 31 Vict. (UK), c. 3.

6 Direct taxes for constitutional purposes differ from the economic incidence of taxes.

Over the years, provincial revenues (tax and non-tax revenues, including transfers from other levels of government) have grown particularly quickly. As a group, in 2009 the provinces and territories collected more revenue than the federal government (approximately 16.5 percent of the GDP compared with approximately 14 percent of the GDP for the federal government). Municipal revenues have not changed much in the past four decades, amounting to approximately 5 percent of the GDP. Figure 1.6 shows revenues on a net basis excluding intergovernment transfers. If the calculations were done on revenues including intergovernment subsidies, the relative rise in provincial revenues would be even more notable.

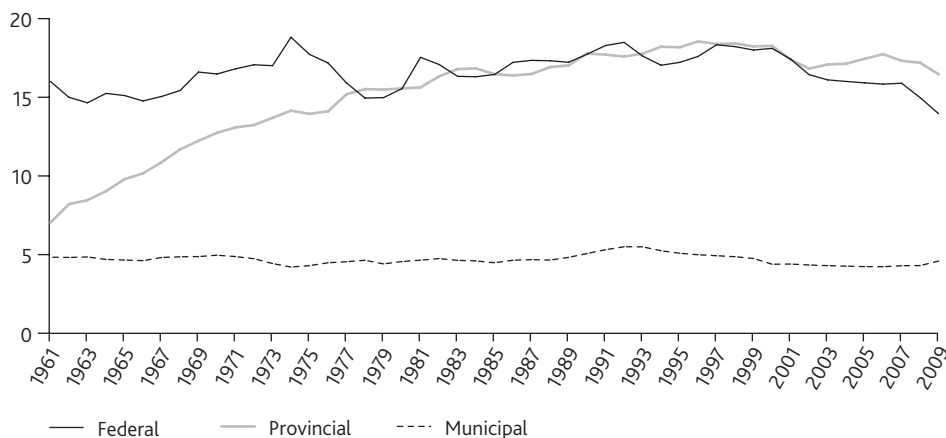
As observed, the five most important taxes in Canada are personal income taxes, corporate income taxes, sales and excise taxes, payroll taxes, and property taxes. In 2009, the federal government collected roughly \$190 billion in taxes, or 12.0 percent of the GDP, over half of which came from personal income taxes. The provinces and territories (excluding local governments) collect \$220 billion in own-source revenues or 14.3 percent of the GDP. Local taxes constituted approximately \$46 billion or 2.9 percent of the GDP.

During the Second World War, the provinces “rented” their income and estate tax fields to the federal government in lieu of intergovernmental transfers and debt relief (the federal government also took on unemployment insurance as a constitutional commitment). When the war ended, the provinces looked to achieve more autonomy and flexibility in their taxing power. Some provincial governments levied their own corporate income tax (beginning with Quebec and Ontario in the late 1940s and continuing with Alberta in May 1974). Quebec levied its own personal income tax. Other provinces signed tax collection agreements (TCAs) on personal and corporate income taxes with the federal government. Under a TCA, the federal government paid for collection costs, and the provinces agreed to accept federal policies, although some leeway existed in determining rates and credits. Originally, the provinces could levy personal income taxes only by charging a surtax on the federal tax payable and were therefore bound to the federal government’s personal income tax brackets. However, in 1997 the provinces were allowed more flexibility in assessing rates on income according to tax brackets that they themselves set. The provinces and territories generally levy their own rate of corporate income tax on the basis of the federally determined tax base. Quebec, Ontario, and Alberta originally did not sign on to a TCA for corporate income tax purposes, but in 2009 Ontario entered into such an agreement with the federal government.

While the federal government is the primary collector of income taxes (personal, non-resident taxes on income, and corporate income taxes), the provinces dominate sales tax collections as shown in table 1.5 for 2009. Payroll taxes are shared between federal and provincial governments. Property taxes are the primary source of tax revenue for local governments and are little used by upper levels of government.

In comparison with many federations, Canada’s taxation system is relatively decentralized; as we have indicated, regional and local governments collect more revenue than does the federal government. Table 1.6 presents the distribution of revenue by level of government in several federal countries. (Social security payments are separated since they are partly federal and partly provincial in Canada; the Canada Pension Plan is jointly administered.) Germany appears more decentralized, although the federal government does collect

Figure 1.6 Own-Source Revenue by Level of Government, Excluding Transfers, as a Percentage of GDP, Canada, Selected Years, 1961-2009



Source: Statistics Canada, *CANSIM Database* (Ottawa: Statistics Canada), table 380-0022.

TABLE 1.5 Sources of Tax Revenue by Level of Government (\$ Million) and as a Share of GDP (Percentage in Parentheses), Canada, 2009

Jurisdiction	Personal income	Corporate income	Sales	Property	Payroll
Federal	114,321 (7.4)	31,273 (2.6)	42,535 (3.1)	na	22,538 (1.4)
Provincial/territorial	74,901 (4.7)	19,005 (1.6)	64,499 (4.4)	8,689 (0.6)	23,316 (1.4)
Local	na	na	116 (0.01)	46,173 (2.8)	na

na Not applicable.

Source: Canada, Department of Finance, *Fiscal Reference Tables* (Ottawa: Department of Finance, 2010).

TABLE 1.6 Distribution of Tax Revenue by Level of Government, Selected Countries, 2007

Country	Federal	State/provincial	Local	Social security funds
Canada	44.6	38.4	8.6	8.5
Germany	31.9	22.9	8.4	36.7
Mexico	81.2	2.2	1.2	15.3
United States	43.0	19.7	14.0	23.4

Source: Organisation for Economic Co-operation and Development, *OECD Statistics Database* (Paris: OECD, 2010).

taxes that it shares with lower levels of governments (such as income and sales taxes). In Mexico, the federal government is the primary collector of taxes, which it transfers to the regional and local governments. Once social security is included, which is a federal program in the United States, the US federal government collects almost two-thirds of US taxes.

An important part of the relationship between federal, provincial, and local governments is the system of intergovernmental transfers. In many federations, central governments

tend to have more capacity to raise revenues than lower-level governments, particularly through income taxes and international taxes. The regional and local governments, being smaller, tend to be responsible for regionalized or local public goods that are supported by local voting populations.

In Canada and certain other countries, a potential mismatch of funding results in the central government having a greater ability to collect taxes and the regional or local governments having greater spending responsibilities. To compensate for the gap, central or provincial governments make substantial transfers to provincial or local governments to enable them to meet their responsibilities. Weighed against this procedure is the need for political accountability wherein governments responsible for spending decisions raise the revenue they require from their voting public. (In Canada, the provinces provide funding to the municipalities to support education, social services, and capital spending, although differences exist from jurisdiction to jurisdiction.)

In Canada, the federal government has made substantial payments to the provinces and territories to enable them to pay for social programs in the fields of health, education, and welfare. As well, the federal government provides equalization payments to the poorer provinces and territories to provide them with the fiscal capacity to supply public goods and services that are comparable to those provided by the wealthier jurisdictions. The grants typically take the form of cash, and are sometimes based on certain conditions agreed to by the recipient; the grants may also arrive in the form of tax point transfers, which involve an equivalent-value transfer of tax room to the recipient jurisdiction. Provinces typically make transfer payments to local governments in the form of cash grants.

Figure 1.7 shows that federal-provincial transfers have been highly variable over the years, with a sharp reduction in 1997, when the federal government reduced transfers in order to balance its budget. Provincial transfers to municipalities have been declining over the years, falling from 20 percent of the GDP to about 15 percent in 2009.

In general, the provinces have recently experienced pressures similar to those faced by the federal government with respect to revenue shortfalls and rising indebtedness. Municipalities have little debt, in part because of provincial requirements, but they too have felt themselves to be under fiscal pressure. Unlike the United States, where balanced budgets at the state level (and theoretically at the federal level) are typically (and sometimes rather nominally) required by statute, most Canadian provinces are not required by law to balance their budgets. On the whole, Canadian government indebtedness as a percentage of the GNP dramatically declined after the mid-1990s (see figure 1.8), although it is now rising again in 2008-2011.

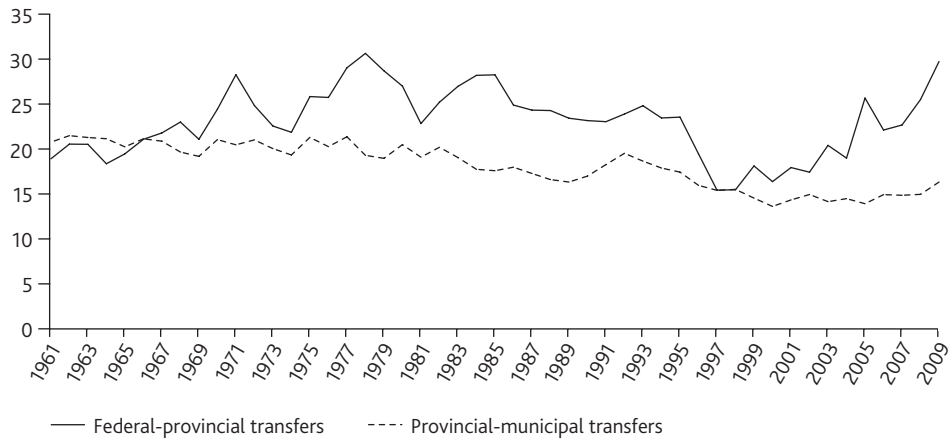
Principal Elements of the Canadian Tax System

Tariffs

At the time of Confederation, tariffs were the largest single source of federal revenue, because the new central government inherited the customs revenues and the approach of the previous colonies. Excise taxes, principally on alcohol, were the second most important source.

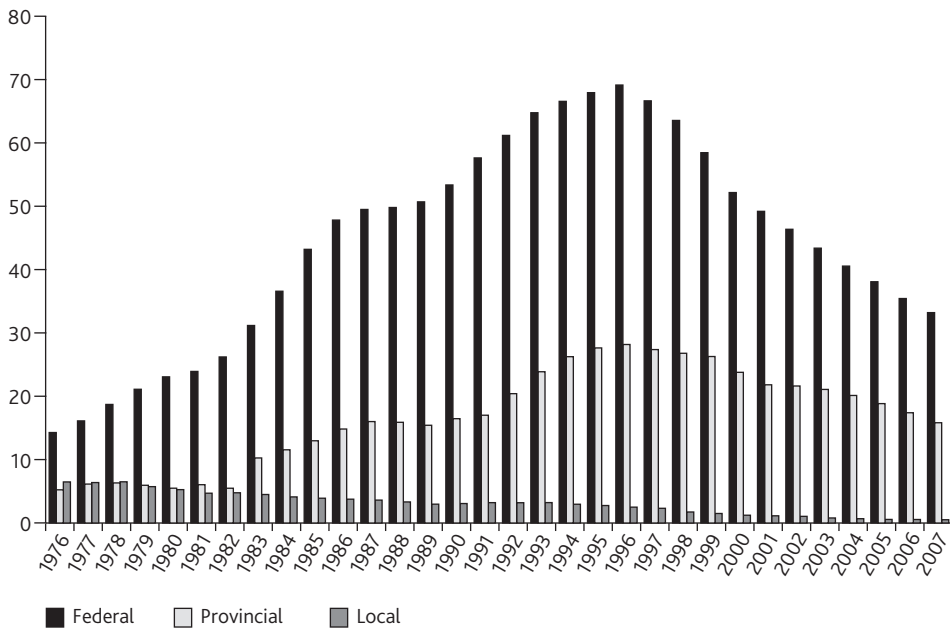
Tariffs were important for many years, not only as a source of revenue but also as the centre of a lively policy debate. The initial belief was that high duties would protect Canada's

Figure 1.7 Intergovernmental Transfers as a Percentage of Recipients' Total Revenue, Canada, Selected Years, 1961-2009



Source: Statistics Canada, *CANSIM Database* (Ottawa: Statistics Canada), table 380-0022.

Figure 1.8 Gross Debt-GDP Ratios by Level of Government, Canada, 1976-2007



Source: Statistics Canada, *CANSIM Database* (Ottawa: Statistics Canada), table 380-0022.

industries and producers. The argument used to justify tariffs was that young Canadian industries needed a period to grow and become efficient before being open to competition. But other views emerged, and there were tariff reductions for British Empire countries under the imperial preference regime. There were even discussions with the United States about mutual tariff cuts, but the idea of US reciprocity went down to defeat in the elections of 1911.

More tellingly, attitudes toward the protection of high tariffs began to change. Over the past century, it was increasingly recognized that high tariffs affected consumers directly, causing prices in Canada to be higher than would otherwise be the case, and therefore reducing personal spending power and welfare. The high tariffs on imported equipment and raw materials made domestic producers less competitive in world markets and led to other countries imposing high duties on Canada's exports. Further, the last 30 years have seen fitful but important efforts to reduce tariffs worldwide so that international trade would improve the world allocation of resources. The result is that tariff revenues, once the centrepiece of federal finance, now make only a modest contribution to overall government revenues.

Income Taxes

The first comprehensive income taxes in Canada were imposed under the Income War Tax Act in 1917, confirming the governmental tendency to use wars and other crises as a justification for expanding tax revenues. By present standards, the Act imposed a low tax on personal, corporate, and trust incomes, and it reflected influences from both the United Kingdom and the United States. For example, Canadian income taxes generally applied to the world income of taxpayers resident in Canada and to the Canadian-source income of non-residents. (Canada, however, did not follow the US approach of taxing the world income of its citizens.)

Like the UK system, the new Canadian system initially did not tax capital gains. However, the Canadian tax was integrated, based on all income, and followed the US administrative approach. While it may be more a result of judicial tradition than deliberate decision, Canada has failed to follow the US adoption of the "substance over form" doctrine; under this doctrine tax legislation tends to be interpreted according to the economic reality of transactions rather than the strict construction of the words of the statute. The Canadian approach gives more certainty in the application of taxing rules than the US method, but also tends to be rather inflexible and to allow certain types of tax avoidance that are not permitted in the United States.

The Income War Tax Act was initially relatively simple; however, as time went on it accumulated special features and complexities as a ship accumulates barnacles. Inevitably, specific rules had to be adopted to cover special situations, and there was considerable pressure to build incentives into the system—incentives involving favourable treatment for certain industries or classes of individuals. The very comprehensive nature of the tax meant that it could be used to raise larger and larger revenues through adjusting rates. In fact, during the Depression and the Second World War, marginal tax rates reached 90 percent or more.

Many of the provinces also imposed corporate and personal income taxes in addition to the federal levies. These taxes were largely uncoordinated with the federal regime. Further, each province had a tendency to try to appropriate for itself the largest possible share of the incomes of enterprises doing business across two or more provinces, resulting in businesses with income earned jointly in several provinces being liable for provincial taxes on more than 100 percent of their income. The Rowell-Sirois report of 1939 called the result a “tax jungle.”⁷ As discussed above, during the Second World War, the federal government rented the personal and corporate tax fields from the provinces to give it flexibility in financing the war. After the war, the provinces re-entered the field, but generally on a coordinated basis with federal taxes. All provinces and territories now impose their own corporate and personal taxes, but on a basis largely consistent with the federal system and with most provincial income taxes collected by the federal government.

PERSONAL INCOME TAX

As we have discussed, over the years federal, provincial, and territorial governments have reduced personal income tax rates with a view to improving incentives to work and attract skilled labour. Alberta now applies a flat tax of 10 percent on income and gives credits for lower incomes.

Basic federal personal tax rates are progressive over four brackets, with the maximum federal rate being 29 percent. Tax relief for basic personal exemptions and for health costs, charitable donations, and dependants are given by way of a fixed credit percentage that does not vary with income. Personal income includes wages and salaries and other employment income, self-employment earnings, investment income, and capital gains. (Capital gains are now included in income to the extent of 50 percent, which brings the capital gains tax rate close to the personal tax rate on dividends for high-income shareholders.) An important feature of the Canadian tax system is a dividend tax credit for individuals. This credit roughly equates the total taxes paid on distributed corporate income to the tax that would have been paid if the pre-tax corporate income had been received directly by the individual; years later, the general thrust of the Carter report has been implemented.

In table 1.7, we provide the current combined federal-provincial top personal income tax rates on general income by province. The lowest top rate is in Alberta, and the highest is in Quebec, but all rates are below 50 percent (as historically they were not).

Chapter 4 describes Canada’s personal income tax system in more detail. The appendix to the book provides current tax rates for all provinces and territories.

CORPORATE TAXES

There are distortions in the present corporate tax system that have the effect of subjecting different industries or entities with different capital to different effective rates of taxation. The result is a less than optimum allocation of resources, at a considerable cost to overall productivity. (While effective marginal tax rates differ substantially by industry, in general tax burdens on resource and manufacturing sectors tend to be less than those on services.)

⁷ Canada, *Report of the Royal Commission on Dominion-Provincial Relations* (Ottawa: King’s Printer, 1940).

TABLE 1.7 Combined Federal-Provincial Highest Personal Income Marginal Tax Rate (Percentage), Canada, Selected Years, 1960-2010

Jurisdiction	1960	1970	1980	1990	2000	2010
Federal (only)	80	80.0	43.00	31.32	30.5	29.00
Alberta	80	86.4	59.56	46.38	43.7	39.00
British Columbia	80	82.4	61.92	46.26	51.3	43.70
Manitoba	80	91.2	66.22	50.4	48.1	46.40
Newfoundland (and Labrador)	80	86.4	67.94	49.30	51.3	42.40
New Brunswick	80	90.4	65.55	48.72	48.7	43.30
Nova Scotia	80	82.4	65.58	50.30	48.8	50.00
Ontario	80	82.4	61.92	48.23	47.9	46.41
Prince Edward Island	80	82.4	65.01	49.50	48.8	47.37
Quebec	80	84.8	68.42	48.23	50.7	48.22
Saskatchewan	80	87.2	68.07	49.80	49.7	44.00
Northwest Territories	na	na	na	44.08	43.5	43.10
Nunavut	na	na	na	na	43.5	40.50
Yukon	na	na	na	44.37	45.4	42.40

na Not applicable or not available.

Note: This table excludes the federal abatement of 13 percent in 1960, and 28 percent of the basic federal rate in 1970 (50 percent for Quebec) to make the rates without the abatement in 1960 and 1970 equal 69.6 percent and 60 percent (including a surtax) respectively (41.2 percent in Quebec for 1970). By 1970, the provinces were imposing their own income taxes in addition to the federal rates.

Source: *Provincial and Municipal Finances*, *The National Finances*, and *Finances of the Nation* (Toronto: Canadian Tax Foundation, various years).

As discussed above, the federal government and most provinces and territories have been reducing the general rate of corporate tax over the last few years as well as eliminating corporate capital taxes. The rationale is to improve the neutrality of the corporate income tax system and to make investment and production in Canada more competitive internationally.

The federal corporate income tax began in 1917 as part of the overall war income tax system, and the provinces levied their own corporate income tax until the Second World War, as discussed above. Corporate capital taxes on financial institutions and insurance premiums have been around for quite some time, with Ontario and Quebec levying these taxes to raise revenue from the two sectors in lieu of imposing higher corporate income taxes. The federal government introduced its own capital tax in the 1980s to help reduce the public deficit, as well as a capital tax (as a minimum tax) on banks and insurance companies. Corporate capital taxes, especially on non-financial corporations, have been largely phased out in recent years by federal and provincial governments.

Federal, provincial, and territorial corporate income taxes are assessed on “taxable income,” which is corporate income net of operating costs, depreciation (capital cost allowance), and interest costs, as determined by tax rules. All jurisdictions also provide tax credits based on the investment costs of qualifying activities, which reduce the amount of corporate income tax payable.

A critical issue that has garnered much attention in recent years is the taxation of multinational companies, in part as a result of the growth of international capital flows,

as previously mentioned. Canada has a generally favourable tax regime for Canadian multinationals, largely exempting dividends received from their foreign affiliates.

Canada now has tax treaties with 66 countries⁸ (an extraordinary number by international standards), which indicates that treaties are a major part of Canada's tax policy. These treaties are designed to reconcile the different tax rules in the two jurisdictions, as well as codify the tax provisions relating to international investment. The treaties therefore facilitate international investment by removing or simplifying tax impediments. They typically provide for reduced rates of withholding tax on certain income flowing between the two countries.

Under basic Canadian tax rules, amounts paid by residents of Canada on account of rents, royalties, or similar items to foreign entities are subject to a withholding tax. These taxes, including those on dividends, interest, royalties and rents, are frequently reduced under Canada's tax treaties when paid to residents of another treaty country. In general, there is no withholding tax on payments of portfolio (arm's-length) interest to any foreign entity, and the recent Canada-US treaty⁹ also exempts non-arm's-length interest from withholding tax.

Canada also has special tax provisions relating to the resource industries. In general, resource companies may claim accelerated depreciation on exploration and development costs. In addition, provincial resources royalties (the main source of provincial resource revenue) are deductible for corporate income tax purposes.

The federal general rate of corporate income tax was 18 percent in 2010, dropping to 16.5 percent in 2011, and 15 percent in 2012. Provinces levy their own rates on corporations, and some have plans for further rate reductions after 2010. The combined federal-provincial general corporate rates are shown in table 1.8. In the past, rate reductions were also given by the federal government to manufacturing and resource profits, although now all forms of income are taxed at the same rate.

Small Canadian businesses (Canadian-controlled private corporations) are eligible for a lower corporate income tax on qualifying business income than other companies. (Investment income tends to be taxed at a higher rate, with a special regime for dividends.) Small business rates are shown in table 1.9.

Chapter 7 provides a detailed overview of the corporate tax system, while chapter 6 examines the related topic of personal taxes on saving. Resource taxation is discussed in chapter 11, and international tax issues are examined in chapter 12.

8 Plus four new treaties negotiated but not yet ratified and a number of other treaties under negotiation. See the Department of Finance website at www.fin.gc.ca/treaties-conventions/treatystatus_-eng.asp.

9 The Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007.

TABLE 1.8 Federal-Provincial Combined Corporate General Tax Rates (Percentage), Canada, Selected Years, 1960-2013

Jurisdiction	1960	1970	1980	1990	2000	2010	2013 ^a
Federal (only) ^b	41	41.41	37.8	28.84	29.12	18.0	15.0
Alberta	50	52.41	48.8	44.34	44.60	28.0	25.0
British Columbia	50	51.41	52.8	42.84	45.60	28.5	25.0
Manitoba	50	54.41	52.8	45.84	46.10	30.0	27.0
Newfoundland (and Labrador)	50	54.41	52.8	45.84	43.10	32.0	25.0
New Brunswick	50	51.41	49.8	44.84	46.10	29.0	25.0
Nova Scotia	50	51.41	50.8	44.84	45.10	34.0	31.0
Ontario	52	53.41	51.8	44.34	43.10	30.0	25.0
Prince Edward Island	50	51.41	47.8	43.84	45.10	34.0	31.0
Quebec	52	53.41	50.8	43.79	45.60	29.9	26.9
Saskatchewan	50	52.41	51.8	43.84	46.10	30.0	27.0
Northwest Territories ^c	na	na	na	40.84	43.12	29.5	26.5
Nunavut	na	na	na	na	43.12	30.0	27.0
Yukon	na	na	na	38.84	44.12	33.0	30.0

na Not applicable or not available.

Note: The table includes all relevant surtaxes.

a Legislated rates. Federal rate is 15% in 2012 and thereafter.

b Net of the federal abatement. The federal abatement credit is a reduction of 10 percentage points in all years, except 9 percentage points in 1960 for all provinces except Quebec (10 percentage points).

c Includes Nunavut before 1999.

Source: *Provincial and Municipal Finances, The National Finances, and Finances of the Nation* (Toronto: Canadian Tax Foundation, various years).

Sales and Excise Taxes

Consumption or sales taxes have long been part of the Canadian tax scene. The federal government introduced a comprehensive sales tax (the manufacturers' sales tax) in the years following the First World War. This single-stage tax was in theory levied on the manufacturer-to-wholesaler price of goods. However, from the first the tax base proved to be arbitrary because it was difficult to determine when goods were sold by a manufacturer to an entity other than a wholesaler. Since fewer and fewer goods passed through wholesalers over the years, the tax became more and more arbitrary. Overall, the tax proved to be injurious to Canada's economy because it

- was a different percentage of the final selling price of various goods, thus distorting consumer demand;
- applied only to goods, not services, and it provided significant exemptions even for goods;
- applied to numerous inputs in the production process, thus compounding tax burdens;
- raised domestic manufacturing costs, thus encouraging imports; and
- was subject to a variety of extra legal adjustments in an effort to avoid some of its discriminatory effects, but ultimately proved to be arbitrary and difficult to administer.

TABLE 1.9 Combined Federal-Provincial Small Business General Tax Rates (Percentage), Canada, Selected Years, 1960-2010

Jurisdiction	1960	1970	1980	1990	2000	2010
Alberta.....	21	22.54	20.75	18.84	19.1	14.0
British Columbia.....	21	21.54	25.75	21.84	18.2	13.5
Manitoba.....	21	24.54	26.75	22.84	20.1	12.0
Newfoundland (and Labrador).....	21	24.54	27.75	22.84	18.1	15.0
New Brunswick.....	21	21.54	24.75	21.84	17.6	16.0
Nova Scotia.....	21	21.54	25.75	22.84	18.1	16.0
Ontario.....	23	23.54	25.75	22.84	20.4	15.5
Prince Edward Island.....	21	21.54	25.75	22.84	20.6	12.0
Quebec.....	21	23.54	27.75	16.29	22.1	19.0
Saskatchewan.....	21	22.54	26.75	22.84	21.1	15.5
Northwest Territories ^a	na	na	25.75	20.84	18.2	15.0
Nunavut.....	na	na	na	na	18.2	15.0
Yukon.....	na	na	25.75	17.84	19.2	15.0

na Not applicable or not available.

a Includes Nunavut before 1999.

Note: The table includes all relevant surtaxes.

Source: *Provincial and Municipal Finances, The National Finances, and Finances of the Nation* (Toronto: Canadian Tax Foundation, various years).

In 1991, the tax was finally abolished and replaced by the GST, a comprehensive and modern value-added tax at a rate of 7 percent (now 5 percent), applying to most goods and services other than food and a few other items. This tax is relatively neutral in its effects, and is similar to value-added taxes that have been widely applied elsewhere, but not in the United States. Its adoption was beneficial to Canada's economic efficiency.

The provinces had largely adopted single-stage retail sales taxes, with numerous exemptions. These taxes too were detrimental to the optimum allocation of resources and economic efficiency because they

- applied to numerous inputs in the production and distribution process, thus raising domestic costs, distorting demand, and favouring imports that did not have to bear such burdens; and
- applied only to some goods and a few services, thus distorting domestic demand.

Following the adoption of the GST by the federal government, some provinces moved to harmonize their consumption tax with the federal value-added tax under a common administration. Six provinces (British Columbia, Ontario, Quebec, Nova Scotia, New Brunswick, and Newfoundland and Labrador) now impose provincial value-added taxes on generally the same base as the federal value-added tax and at varying rates of between 10 and 7 percent. The provincial taxes are integrated with the federal tax in a largely uniform manner: they are included in an HST and collected along with the federal tax.¹⁰

¹⁰ The federal government collects the HST in all relevant provinces except Quebec.

Three provinces (Prince Edward Island, Manitoba, and Saskatchewan) still impose single-stage retail sales taxes, while Alberta has no sales tax.

In British Columbia, the adoption of an HST in 2010 proved controversial, possibly as the result of poor communications. In a referendum held in August 2011, BC voters decided to scrap the provincial portion of the HST and revert to the previous single-stage provincial sales tax, with a likely effective date in 2013. This change represents a significant retrograde movement in BC's tax structure and is an illustration of the difficulties of modernizing tax systems.

The widespread although fitful adoption of value-added taxes in Canada, replacing archaic and inefficient single-stage taxes, resulted in substantial tax relief for business, and greatly improved Canadian competitiveness; it also removed tax distortions from domestic demand.

The evolution of sales tax rates are shown in table 1.10. Over time, some provincial sales tax rates have been rising while others have declined. Quebec announced further increases in its sales tax rates by 2 percentage points after 2010 in response to significant deficits. Nova Scotia had previously raised its rates for the same reason.

In addition, there are a number of specific ad valorem, excise, and other taxes levied by federal and provincial governments on designated goods and services. These taxes include levies on tobacco, alcohol, gasoline, and diesel fuels. Further, the monopoly profits obtained by the provinces from retailing liquor represent an additional tax. Rates are provided in an appendix to the book.

In chapter 8, we consider sales taxes in greater detail.

Aboriginal Taxation

The taxation of aboriginals (largely members of First Nations) provides an interesting example of pragmatic tax policy. Members of First Nations who live on reserves are by longstanding law exempt from taxation on income earned and goods purchased there. But in recent years, this exemption has resulted in the smuggling of untaxed goods out of reserves and has also created some definitional problems.

The federal government has entered into new treaty arrangements with a number of native bands, whereby tax is collected from members of First Nations living on the reserves, but is entirely turned over to the bands for their own use. The arrangements inhibit smuggling and also provide the bands with revenues to enable them to become more self-sufficient. Because the arrangements must be entered into on a band-by-band basis, the process is likely to be slow.

Payroll Taxes

There are a number of payroll taxes levied by federal and provincial governments, primarily to cover the cost of various benefit programs. The federal government levies premiums under the Employment Insurance Act, designed (in theory) to cover the cost of employment insurance and certain related programs. In addition, Quebec (within its jurisdiction) and the federal government (elsewhere in Canada) levy premiums under the Canada/Quebec Pension Plan, which are divided between employers and employees, and are designed to

TABLE 1.10 General Sales Tax Rates (Percentage), Canada, Selected Years, 1960-2010

Jurisdiction	1960	1970	1980	1990	2000	2010
Federal	11	12	9	13.5	7 ^a	5 ^a
Alberta	0	0	0	0	0	0
British Columbia	5	5	4	6	7	7 ^b
Manitoba	0	5	5	7	7	7
Newfoundland (and Labrador)	5	7	11	12	8	8 ^c
New Brunswick	3	8	8	11	8	8 ^c
Nova Scotia	5	7	8	10	8	10 ^c
Ontario	3	5	7	8	8	8 ^c
Prince Edward Island	4	7	9	10	10	10 ^c
Quebec	4	8	8	9	7.5	7.5 ^d
Saskatchewan	5	5	5	7	6	5
Northwest Territories ^e	0	0	0	0	0	0
Nunavut	0	0	0	0	0	0
Yukon	0	0	0	0	0	0

a GST; previously the tax rates were for the manufacturers' sales tax, which was imposed on a different and lower base.

b British Columbia changed to HST July 1, 2010; its previous PST was 7 percent. It plans to revert to PST at 7 percent in 2013.

c Provincial part of HST.

d Quebec sales tax applied to selling price, including GST.

e Includes Nunavut before 1999.

Source: *Provincial and Municipal Finances, The National Finances, and Finances of the Nation* (Toronto: Canadian Tax Foundation, various years).

cover the costs of pensions for retired Canadians. (The substantial reserves collected under these programs are invested independently.) There are also provincial levies to cover workers' compensation and certain other costs.

It has been argued that payroll taxes levied on employers and even employees discourage employment by raising the cost of labour. While this may be true in the short run, in the long run taxes on labour costs are likely to be substantially borne by workers, because labour markets adjust to the levies to maintain production and employment.

Chapter 5 discusses payroll taxes in more detail along with other taxes that affect employment.

Environmental Taxes

Widespread discussion about the use of environmental taxes has taken place in Canada, but to date there has been relatively limited action. In theory, environmental taxes can improve ultimate economic efficiency by imposing tax burdens that offset the general costs that certain goods and production impose on the economy through detrimental emissions (emissions that impose costs on national or global populations because they are toxic or contribute to global warming). By requiring these external costs to be recognized in the total costs of production, long-term economic efficiency can be enhanced.

The most important environmental taxes in Canada (as listed by the OECD) are fuel excise taxes, which are levied by both federal and provincial governments. In principle, provincial fuel taxes have been used to fund roads and highways, although there is no clear linkage between the tax and the spending. A federal fuel excise tax of 10 cents per litre was originally introduced to encourage self-sufficiency in Canadian energy markets. Today, the tax is called an environmental tax, as is the tax on air conditioners for automobiles, but these taxes are only very loosely linked to environmental objectives. There is no connection between the amount of tax and the amount of external environmental damage caused by the product or the amount of money spent by governments on remediation.

Proposed higher taxes on energy, which is believed to be a prime cause of environmental damage, have proven to be unpopular and difficult to fashion in effective ways.

Proposals such as cap-and-trade schemes are being discussed and have elements of a form of taxation, but these measures have not been widely adopted in Canada or elsewhere. British Columbia has imposed the first general carbon tax at \$30 per tonne to reduce greenhouse gas emissions. Alberta has a \$15 per tonne carbon levy on large business emissions in excess of a threshold. If one country (or political subdivision) or a few countries adopted tax measures that raised energy costs while their competitors did not, international distortions would obviously be created. However, securing global agreement on appropriate measures has proved difficult in the past and will continue to do so in the future. Governments will likely introduce new environmental taxes given the focus on global warming in the coming years, but the pace of change may be slow.

Chapter 11 provides an overview of resource levies, and chapter 10 examines environmental taxation.

Municipal and Other Taxes

The largest source of tax revenue for municipalities is real estate taxes on residential and commercial land and buildings. These taxes may discriminate in favour of homeowners in some provinces, and involve some difficulties in achieving a uniform assessment of values that reflects current price levels. When these taxes are used to cover the costs of services to property, they can be justified in tax policy terms. But when municipalities have to use real estate taxes to finance unrelated costs, there may be some reason to question their appropriateness.

There are a wide variety of other municipal and provincial levies, such as real estate transfer charges, automobile taxes, business licence costs, and so on.

Chapter 9 reviews municipal taxes in Canada.

Estate and Inheritance Taxes

Neither the federal nor the provincial governments in Canada levy estate or inheritance taxes, gift taxes, or wealth taxes. Since 1972, however, Canada has had a deemed realization of capital assets at fair value on the death of taxpayers for income tax purposes. (Transfers to a surviving spouse are exempt, but the assets are taxed when the spouse dies.)

At various times in the past, both federal and provincial governments have imposed estate taxes or succession duties. But some commentators believed that imposing both

an estate tax and a deemed realization at death, as under the present tax system, resulted in an onerous tax burden. And the repeal of succession duties in some provinces soon compelled other provinces to follow suit or see their own tax bases eroded.

In any event, Canada is now one of the few developed countries without death or wealth taxes.

Tax Collection and Administration

Canadian income and commodity tax administration, now primarily carried out by the federal government (and with Quebec exercising more jurisdiction than the other provinces), is comprehensive. The federal government alone has tens of thousands of employees in the field. Enforcement in Canada is said by some to be less vigorous than in the United States, but more vigorous than in a number of other countries. There is still an unknown but large “tax gap” filled with untaxed income.

Canada’s income and sales tax system involves substantial (but less than complete) coordination between the federal and the provincial governments, which jointly occupy most tax fields. The provinces are free to set their own tax rates in the jointly occupied fields of income and consumption tax, but they largely follow federal rules in determining their tax base:

- The federal government acts as agent in collecting corporate taxes for all but two provinces, and personal income taxes for all but one province.
- The tax base and the rules for determining taxable income are largely (but not completely) identical under federal and provincial law, because the provinces follow the lead of the federal government on tax changes.
- Federal and provincial sales taxes are coordinated and collected together in six provinces.

The interplay between federal and provincial taxes is, however, rather more complex. Federal action to introduce new deductions into the income tax system can reduce the revenues of the provinces that have adopted the federal tax base. And increases in provincial taxes, such as corporate and personal income taxes, can reduce federal revenues through lowering the tax base in a province. Even more complexity arises from the federal tax equalization measures, because a province that increases its tax rates can receive higher equalization payments from the federal government as a result.

Chapter 3 deals with various issues related to the tax policy process and tax administration in Canada.

Are Some Taxes More Efficient Than Others?

Most economists argue that consumption taxes are generally more advantageous than income taxes. A comprehensive consumption tax imposes a levy on all the goods and services that an individual consumes, but does not tax an individual’s savings. An income tax, on the other hand, taxes not only all of an individual’s income, including savings, but also taxes the return from investments made with savings. Therefore, an income tax involves a double tax on savings, while a consumption tax does not.

Again, the common view of economists is that cutting income taxes has a greater positive effect on economic activity than cutting consumption taxes, because it reduces the adverse double tax burden, and improves incentives and competitiveness. (The federal government recently reduced its GST rate from 7 to 5 percent in preference to reducing personal or corporate taxes. The stated reason for this choice was that the public was more likely to notice a cut in sales tax rates than in personal tax rates, which are contained within a complex income tax system.)

For similar reasons, a cut in corporate income taxes will tend to have a greater positive effect on economic activity than a cut in personal income taxes, because corporations are the main direct spenders on new investment. We consider efficiency at greater length in chapter 2.

Conclusion

Tax policy has a long, complex, and fascinating history. In Canada, tax policy has evolved over time in relation to the various forces working on it. At the turn of the 20th century, few would have predicted the adoption of an income tax in 1917. Nor would they have predicted the growth of value-added taxation, which began after the Second World War in France and Brazil. Dare we say it would be impossible to forecast what Canada's tax system will look like at the end of the 21st century?

While change has not always been for the better, the last 25 years have seen two major positive changes in the overall tax structure. First, the business tax system has undergone significant adjustment that has sharply reduced the tax burden on business investments and has made the tax base somewhat more neutral. Second, the sales tax levied by both the federal government and many of the provinces has been reformed by shifting to a value-added tax model. Both these changes have improved Canadian productivity. What further changes lie ahead in the next 25 years is open to debate, since tax reform often garners the criticism and resentment of groups of taxpayers, and the contentious issues can become politicized. However, while the Canadian tax system has undergone significant positive changes in the light of a developing economy, there is little doubt that it will continue to evolve as new political and economic events take place. Some of these trends are discussed in the concluding chapter of this book.