

Chapter 1

The Canadian Tax System

UNDoubtedly, ONE OF THE MOST UNPOPULAR POLICIES in Canadian history was the introduction of the Goods and Services Tax (GST) in 1991. In part, its political unpopularity was due to the fact that many Canadians thought that this was a new tax that would increase the tax burden. But, it also reflected a deep-seated concern on the part of citizens about the process of government and revealed the belief held by many that the government was collecting too many tax dollars while accomplishing too little in the way of public services.

The most significant revelation in the reaction to the GST, however, was that the Canadian public has very little real information about the tax system. Very few knew that the GST was replacing a tax already in place and fewer still realized that the federal government's main ambition was not to raise more revenue but rather to replace the Manufacturers' Tax. Everyone who had studied the Manufacturers' Tax had concluded that it was a terrible tax that had many unintended negative effects. It was a tax that needed to be replaced but Canadians' ignorance about it was a significant barrier to its removal. While some would say that there is no such thing as a good tax, it is the case that, as long as there is a demand for public expenditures, there will have to be taxes to finance them. We now know that taxes distort people's decisions, leaving opportunities for mutually beneficial exchanges unexploited. The task, then, is to design an efficient set of taxes, one that does not unduly interfere with the types of decisions people make in the marketplace.

There is, then, something worse than a tax and that is a badly designed tax, which, in addition to taking spending power from the

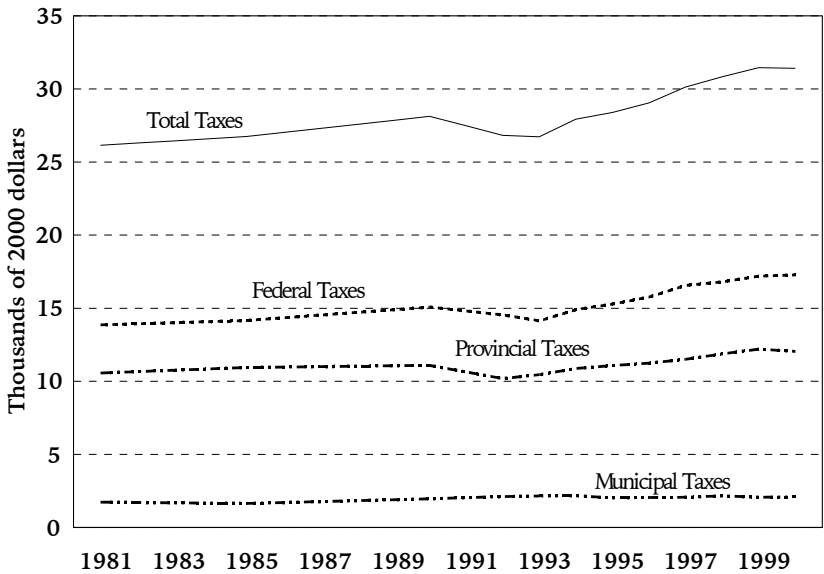
private sector, also distorts everyday decisions in a way that is neither desirable nor necessary. As free international trade becomes a reality, it is increasingly important that governments implement efficient and sensibly designed tax systems. A prerequisite to being able to debate and design such taxes is a base of information about them. The purpose of this book is to provide a basic tool kit of knowledge about taxation in Canada in order to enhance the opportunity for rational debate about these issues.

This book is an important resource for everyone concerned about the extent and relatively rapid growth of taxation in this country. Between 1981 and 2000, the total tax bill of the average Canadian family from all three levels of government increased in real terms by \$6,183 in 2000 dollars. Figure 1.1 charts the progress of taxes for selected years since 1981.

The many faces of the tax collector

The Canadian tax system is continually changing. To understand current developments it is important to know how the Canadian taxation system has evolved. Under the Canadian Constitution, the federal and provincial governments are essentially given unlimited powers of tax-

Figure 1.1: Federal, provincial, and municipal taxes collected from the average Canadian family, 1981-2000 (\$2000)



Source: The Fraser Institute, 2001.

tion. Under the *British North America Act*, the immediate predecessor of the Canadian Constitution, the federal parliament has the power to raise money by any mode or system of taxation while the provinces are limited to collecting taxes that are paid directly by the person being taxed—so-called direct taxes. But, because of the broad judicial interpretation of the meaning of the word “direct,” the provinces have been able to levy all sorts of taxes, except for import duties and taxes on sales that cross provincial borders. Given this unlimited scope for taxation and more than 125 years of ingenuity, it is not surprising that Canada now has a very complicated tax system. See Lewis (1978), J. Harvey Perry (1989) and David B. Perry (1997) for further information on the Canadian tax system’s evolution.

Figure 1.2 shows the 34 revenue categories used in the determination of Equalization¹ payments. Considering that many of these revenue sources are affected by multiple rates, depreciation allowances, tax credits, and surcharges gives some indication of the complexity of Canada’s tax system.

Income taxes predominate

Table 1.1 and figure 1.3 show that personal income taxes are the largest single source of government revenue. During 1999, some \$134 billion was extracted by federal and provincial income tax—40.1% of the total taxes that Canadians pay. Second as a source of federal and provincial revenues was sales tax—15.1% of tax revenue and \$50 billion in taxes. Taxes on corporate profits—10.3% of total taxes—accounted for a further \$34 billion, while taxes on property and natural resources accounted for \$41 billion, or 12.3%. Together, these five kinds of tax accounted for 77.8% of total government revenue during 1999. Slightly more than one-half of government tax revenue comes from personal income tax and the tax on corporate profits, which were implemented in 1916 and 1917 as “temporary” measures to finance World War I.

Table 1.1 also illustrates how the Canadian tax structure has evolved over the 38 years between 1961 and 1999. The most obvious change has been the increased reliance on the personal income tax. While always a prominent feature of the tax system, the income tax has in recent years become even more important. In 1961, income taxes represented only 22.7¢ out of every tax dollar Canadians paid but by 1999 income taxes accounted for 40.1¢—over two-and-one-half times the revenue generated by the next largest source, sales taxes.

1 For a thorough analysis of Canada’s equalization system, see Usher 1995. For a brief overview of the determination of equalization payments, see Emes 1998.

Figure 1.2: Revenue sources used in determining equalization payments

- 1 personal income taxes
- 2 business income revenues
- 3 capital tax revenues
- 4 general and miscellaneous sales taxes
- 5 tobacco taxes
- 6 gasoline taxes
- 7 diesel fuel taxes
- 8 non-commercial vehicle licenses
- 9 commercial vehicle licences
- 10 revenue from the sale of alcoholic beverages
- 11 hospital and medical insurance premiums
- 12 race track taxes
- 13 forestry revenues from Crown lands
- 14 forestry revenues from private lands
- 15 new oil revenues less rebates and credits
- 16 old oil revenues less rebates and credits
- 17 heavy oil revenues less rebates, credits, and oil export charge
- 18 mined oil revenues less rebates and credits
- 19 light and medium third-tier oil revenues
- 20 heavy third-tier oil revenues
- 21 natural gas revenues (domestic and exported) less rebates and credits
- 22 sales of Crown leases less rebates and credits
- 23 other oil and gas revenues less rebates and credits
- 24 mineral resources (asbestos, coal, potash, etc.)
- 25 water power rentals
- 26 insurance premium revenues
- 27 payroll taxes
- 28 provincial and local property taxes less regular property-tax credits and related tax credits
- 29 lottery ticket revenues
- 30 revenues from other games of chance
- 31 miscellaneous provincial and local taxes and revenues from the sale of goods and services, including local water revenues
- 32 shared revenues: offshore activities/Newfoundland
- 33 shared revenues: offshore activities/Nova Scotia
- 34 shared revenues: preferred share dividend

Source: Canadian Tax Foundation, *Finances of the Nation*, 2000, table 8.4.

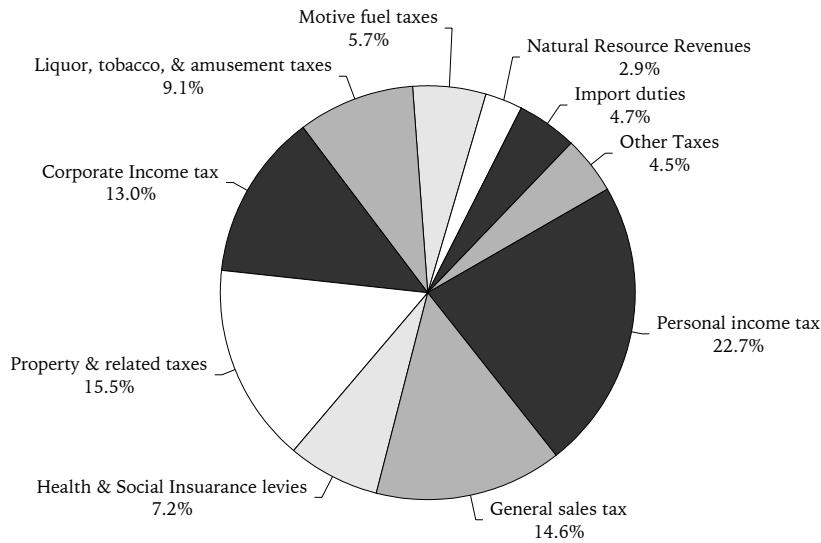
Table 1.1: Taxes paid and percent of total taxes, 1961 and 1999

| | 1961 | | 1999 | |
|------------------------------------|--------------|---------|----------------|---------|
| | \$ millions | percent | \$ millions | percent |
| Personal income taxes | 2,099 | 22.7 | 133,561 | 40.1 |
| General sales taxes | 1,351 | 14.6 | 50,377 | 15.1 |
| Health & social insurance levies | 663 | 7.2 | 34,765 | 10.4 |
| Property & related taxes | 1,435 | 15.5 | 31,466 | 9.4 |
| Corporate income taxes | 1,199 | 13.0 | 34,331 | 10.3 |
| Liquor, tobacco, & amusement taxes | 837 | 9.1 | 13,742 | 4.1 |
| Motive fuel taxes | 525 | 5.7 | 11,561 | 3.5 |
| Miscellaneous taxes | 55 | 0.6 | 3,874 | 1.2 |
| Natural resource taxes & royalties | 266 | 2.9 | 9,450 | 2.8 |
| Privileges, licences & permits | 190 | 2.1 | 3,744 | 1.1 |
| Customs duties | 438 | 4.7 | 2,200 | 0.7 |
| Other consumption taxes | 173 | 1.9 | 929 | 0.3 |
| Non-resident taxes | 0 | 0.0 | 3,300 | 1.0 |
| Total | 9,231 | | 333,301 | |

Sources: Statistics Canada, Public Institutions Division, cats. 68-211, 68-204, 68-207, 68-212, 68-512; calculations by the authors.

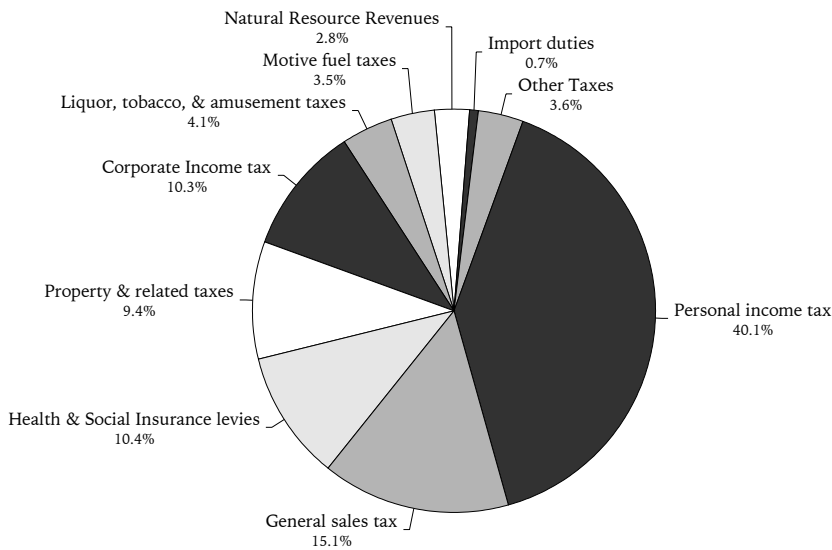
This increase came about largely through passive interaction between the progressive income tax system and money incomes swollen by inflation. This interaction is often referred to as “bracket creep” because taxpayers can be pushed into higher tax brackets when their income goes up to compensate them for an increase in the general price level. Until the income tax system was indexed to the inflation rate in 1974, all income increases were taxed at progressively higher rates in spite of the fact that much of the increased income represented illusory inflation-based gains. From 1974 to 1985, brackets and exemptions were increased by an “indexing factor” based on the consumer price index. From 1986 through 2000, the income-tax system was only partially indexed because the indexing factor was set at the amount by which the inflation rate exceeded 3.0%. Partial indexing meant that, although the inflation rate was 5.6% in 1991, personal income-tax exemptions and brackets increased by only 2.6% between 1991 and 1992. Exemptions and brackets stayed at their 1992 level until 1998 because inflation has been below 3.0% in every year since 1992. The Organisation for Economic Cooperation and Development (OECD) estimates that

Figure 1.3a: Where government obtained its revenue, 1961



Source: Table 1.1. Note: percentages may not add up due to rounding.

Figure 1.3b: Where government obtained its revenue, 1999



Source: Table 1.1. Note: percentages may not add up due to rounding.

between 1988 and 1998, 18% of tax filers were pushed into a higher tax bracket because of partial indexation. In other words, 1.4 million Canadians became taxable because inflation adjustments were made to their incomes but not to their exemptions. Another 1.9 million taxpayers jumped from the 17% to 26% bracket and 0.6 million moved from the 26% to the 29% bracket. The 1998 and 1999 federal budgets increased the amount of money that could be earned before income tax applied and the 2000 federal budget brought back full indexation to the personal income-tax system.

As a consequence of this growth in revenue from personal income taxes, government was able to rely less on other forms of taxation and to allow the burden of some of these taxes to fall. However, in some important cases—notably sales tax and health and social insurance levies—the rate of tax was increased despite rapidly growing revenues from personal income tax. Table 1.2 presents the share of GDP that the top nine taxes represent.

Sales taxes

While revenue from income tax poured into the federal government's coffers, the provinces were prompted by their desire for additional tax revenue to boost their sales-tax rates. Two general exceptions are Alberta, which has no sales tax, and British Columbia, where the sales tax has been adjusted up and down.

In British Columbia, sales tax was reduced from 7% to 5% on April 11, 1978 and was further reduced to 4% on April 1, 1979. On March 10, 1981, however, it was raised to 6% and, in July 1983, raised again to 7%. In the 1987 budget, the tax was once again dropped to 6% but, in the 1993 budget, raised once more to 7%, where it remains.

The federal government also sought to increase its revenue from indirect sources in the early and mid-1980s by increasing its takings from the Manufacturers' Sales Tax and, in 1991, by replacing this tax with the more comprehensive GST. The Department of Finance hoped to raise an extra \$10 billion annually from this new source.

Taxes on natural resources

The rise in resource taxation in the 1970s and 1980s resulted primarily from increases in the price of oil and gas, triggered by the oil embargo and subsequent cartelization of oil pricing by the OPEC countries in 1973. In the normal course of events, these increases in price in Canada would automatically have meant a sharp rise in the return to Canadian producers. But, the provincial governments absorbed much of this so-called "windfall" or "rent" in the form of higher taxes or royalties. The federal government, for its part, imposed a further tax on producers

Table 1.2: Total taxes as a percentage of Gross Domestic Product, 1961 and 1999

| | 1961 | 1999 |
|------------------------------------|-------------|-------------|
| Personal income taxes | 5.1 | 13.9 |
| General sales taxes | 3.3 | 5.3 |
| Health & social insurance levies | 1.6 | 3.6 |
| Property & related taxes | 3.5 | 3.3 |
| Corporate income taxes | 2.9 | 3.6 |
| Liquor, tobacco, & amusement taxes | 2.0 | 1.4 |
| Customs duties | 1.1 | 0.2 |
| Motive fuel taxes | 1.3 | 1.2 |
| Natural resources & other taxes | 1.7 | 2.2 |
| Total | 22.5 | 34.8 |

Sources: Statistics Canada, Canadian Economic Observer, cat. 11-010 and Public Institutions Division, cats. 68-211, 68-204, 68-207, 68-212, 68-512; calculations by the authors.

who were exporting oil. This tax, the oil export charge, amounted to the difference between the controlled Canadian price per barrel and the world price. Proceeds from the federal tax were then used to subsidize imports of foreign oil into the eastern provinces.

From 1974 to 1984, provincial governments and, especially, the federal government escalated their taxation of natural resources. The National Energy Program and the subsequent Energy Agreement allowed the federal government to earn about \$4 billion from petroleum during 1984.

The 1985 federal budget incorporated a number of changes to energy taxes as agreed upon in the Western Accord with the governments of Saskatchewan, Alberta, and British Columbia. Both the oil export charge and the petroleum compensation charge were eliminated. Other energy taxes, such as the Petroleum and Gas Revenue Tax, were revised, reduced and, in some cases, phased out.² These changes, combined with the decline in world oil prices, resulted in a decline in energy-related revenues in both relative and absolute terms. The recent increase in oil and gas prices is responsible for the relative and absolute increase in natural resource tax revenue.

2 For more information on oil pricing and taxation, see Watkins and Walker 1977, Watkins and Walker 1981 and chapter 8 of Perry 1997.

More efficient taxation

The late 1980s and early 1990s saw the federal government trying to make income, corporate, and sales taxes more efficient and less of a burden to Canadians competing in the international marketplace. While corporate and income tax rates fell, many deductions were eliminated in order to expand the tax base. These changes were supposed to diminish the degree to which taxes enter into Canadians' decisions. If this principle seems strange, consider a flat tax. The rate of such a tax is not related to any economic activity in which the individual may engage. Government simply takes a fixed proportion of total income no matter how it is earned. The amount that the government takes may be huge but, since the tax is not related to how much an individual works or spends, it will not directly affect decisions between, for example, spending and saving or working and not working. Moreover, since the taxation rate is the same regardless of income, there is no tax disincentive to discourage an effort to move to higher income levels from any given starting income.

Lowering tax rates, however, did not lead to less tax being collected: in the past 15 years, due to the expanding tax base and, more recently, to bracket creep, federal collections from the average family have risen by \$3,617 in 2000 dollars. That the federal government has not collected even more taxes is due to its declining commitment to provincial projects such as welfare, education, and health care. In reaction, the provinces have made up the shortfall not by reducing spending but by increasing taxes. Since 1985, provincial collections from the average family have increased by \$1,487 in 2000 dollars.

Dividing the spoils

How is total tax revenue is divided among different levels of government? Table 1.3 provides a breakdown of major taxes by federal, provincial, and municipal levels of government for the years 1961 and 1999. Total taxes collected now amount to 34.8¢ out of every dollar of GDP, a 54.6% rise since 1961 (see table 1.2).

These figures give a somewhat distorted impression about which level of government is doing the taxing because some municipal and provincial government revenue comes from other levels of government. For example, in 1961, fully 30% of provincial and municipal revenues were derived from other levels of government. Provinces received transfers from the federal government while municipalities received transfers from both levels.

In the case of provincial revenues, the figures for 1961 reflect the tax agreement that was in effect between the federal and provincial governments. Under the agreement, the federal government rented

Table 1.3a: Taxes collected by federal, provincial and municipal governments (\$billions)

| | Federal | | Provincial | | Municipal | |
|----------------------------------|------------|--------------|------------|--------------|------------|-------------|
| | 1961 | 1999 | 1961 | 1999 | 1961 | 1999 |
| Personal income taxes | 2.0 | 82.5 | 0.1 | 51.1 | 0.0 | 0.0 |
| Corporate income taxes | 0.2 | 22.5 | 1.0 | 11.8 | 0.0 | 0.0 |
| General sales taxes | 0.3 | 24.9 | 1.0 | 25.5 | 0.0 | 0.1 |
| Property & related taxes | 0.0 | 0.0 | 0.0 | 7.7 | 1.3 | 23.7 |
| Health & social insurance levies | 0.5 | 18.7 | 0.2 | 16.1 | 0.0 | 0.0 |
| Natural resource revenues | 0.0 | 0.2 | 0.3 | 9.2 | 0.0 | 0.0 |
| Customs duties | 0.5 | 2.2 | 0.0 | 0.0 | 0.0 | 0.0 |
| Other taxes | 0.6 | 12.0 | 1.1 | 24.6 | 0.1 | 0.5 |
| Total | 4.8 | 163.0 | 2.9 | 146.0 | 1.4 | 24.2 |

Sources: Statistics Canada, Public Institutions Division, cats. 68-211, 68-204, 68-207, 68-212, 68-512; calculations by the authors.

Table 1.3b: Taxes collected by federal, provincial and municipal governments (% of total)

| | Federal | | Provincial | | Municipal | |
|----------------------------------|-------------|-------------|-------------|-------------|-------------|------------|
| | 1961 | 1999 | 1961 | 1999 | 1961 | 1999 |
| Personal income taxes | 95.2 | 61.8 | 4.8 | 38.2 | 0.0 | 0.0 |
| Corporate income taxes | 16.7 | 65.5 | 83.3 | 34.5 | 0.0 | 0.0 |
| General sales taxes | 23.1 | 49.4 | 76.9 | 50.5 | 0.0 | 0.1 |
| Property & related taxes | 0.0 | 0.0 | 0.0 | 24.6 | 100.0 | 75.4 |
| Health & social insurance levies | 71.4 | 53.7 | 28.6 | 46.3 | 0.0 | 0.0 |
| Natural resource revenues | 0.0 | 2.5 | 100.0 | 97.5 | 0.0 | 0.0 |
| Customs duties | 100.0 | 100.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Other taxes | 33.3 | 32.4 | 61.1 | 66.4 | 5.6 | 1.3 |
| Total | 52.7 | 48.9 | 31.9 | 43.8 | 15.4 | 7.3 |

Sources: Statistics Canada, Public Institutions Division, cats. 68-211, 68-204, 68-207, 68-212, 68-512; calculations by the authors.

the provinces' rights to tax personal incomes: in effect, the provinces relinquished their right to tax personal incomes in return for cash payments from the federal government, which collected all the taxes. Accordingly, the tax-collection statistics for 1961 do not reflect the division of the revenues produced but only which level of government actually collected them.

For 1999, the collection figures match the revenue as it was divided between federal and provincial governments more closely because revenue-sharing agreements have been gradually modified to eliminate tax-rental arrangements and shared-cost programs. In the years following 1978, the provinces have had, increasingly, to find their own revenues. As a consequence, tax receipts from different levels of government reflect the actual sharing of tax revenues more closely. To a considerable degree, this evolution reflects the changing attitudes of the partners in Canadian confederation: changing tax arrangements may be the first steps towards a more decentralized federation. For the 1999/2000 fiscal year, Alberta expects to receive about 7.9% of its revenue from the federal government. This gives Alberta considerably more flexibility when they decide whether or not to participate in new or ongoing federal programs than, for example, Nova Scotia, which receives about 40% of its revenue from federal sources. Zelder (2000) shows how Alberta and Ontario could reform their health-care systems and save money, even if the reforms contravened the Canada Health Act and caused the federal government to stop all Canada Health and Social Transfers to the two provinces.

The relationship between provincial and municipal government revenues reflects a different process. Municipalities now collect much less of their total revenue in the form of taxes than they did in 1961: fully 40.2% of municipal revenue is now accounted for by transfers from federal and provincial governments, mainly the latter. In large part, the emerging role of municipalities as dependencies of the provincial governments is a result of decreasing reliance on property taxation as a form of finance (see table 1.1 and figure 1.3). Property taxes accounted for only 9.4% of total taxes in 1999, down from 15.5% in 1961.

The fifth column—hidden taxation

Most people are aware of the prominent direct taxes that they pay—income tax and property tax. Many others correctly regard contributions by employees and employers to the Employment Insurance fund and the Canada and Quebec Pension Plans as taxes. Moreover, many people know how much of these taxes they pay as the information is provided on pay stubs, (e.g. income tax and contributions to EI and CPP/QPP) and annual property-tax assessments. There is, however,

another class of taxes of which Canadians, by and large, are unaware. These taxes are built into the price of goods and services and are often not identified to the final consumer as a tax. These are known as “indirect” or “hidden” taxes.

Indirect taxes

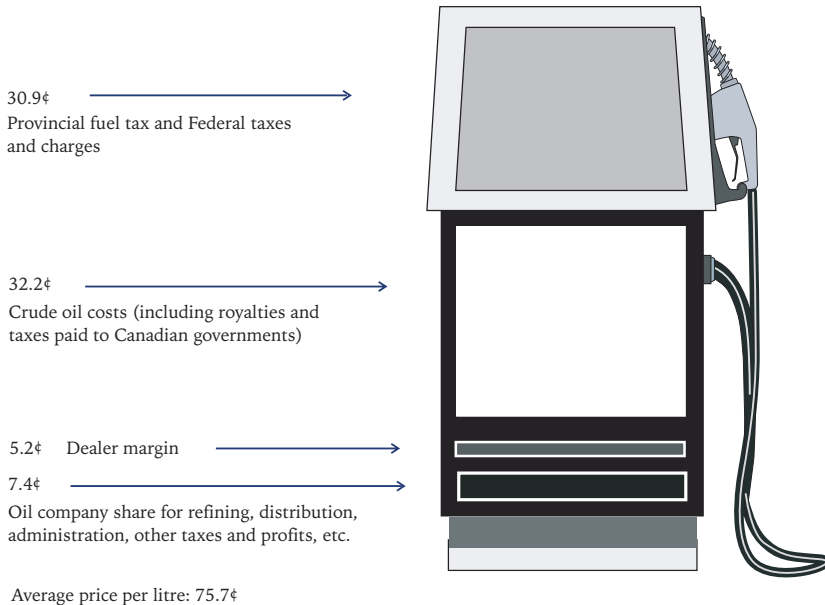
The most well known of the indirect taxes are import duties, the excise taxes on items such as tobacco and alcohol, and the federal Goods and Services Tax (GST). GST legislation requires sellers to make it clear to purchasers whether the GST is included in the listed price or if it will be added when the sale is totalled. Although consumers are made aware of the tax because of this requirement, few will have a good idea of the total amount of GST they pay in a year. Other, less familiar, indirect taxes are levied on many common products. The excise taxes on such items as tobacco, alcohol, and gasoline are good examples. See figures 1.4 and 1.5 for a break-down of taxes paid for a litre of gasoline and for a bottle of liquor. Table 1.4 shows the province-by-province break-down of the pump price of gasoline. In the case of liquor, the federal rate of indirect tax is 118%. In addition, alcohol bears the provincial government’s mark-up as well as a provincial sales tax. The final delivered price of alcohol is 539% above the price received by the distiller. The taxes on tobacco were so high that they led to widespread smuggling and tax evasion until 1994 when taxes were sharply reduced east of the Manitoba border; the western provinces stepped up enforcement instead of cutting taxes. Smuggling had become so bad that, as Ontario’s finance minister at the time put it, “It reached a point where the retail market in cigarettes in Ontario was in complete shambles.” (McInnes 1996: A1, A4). Most consumers of these products are aware that gasoline, alcohol, and tobacco are highly taxed but rarely do they know the actual rate of tax or the amount of tax that they are paying.

During 1999, total indirect taxes of all kinds amounted to \$110 billion in Canada. This was 11.5% of total Canadian income and accounted for 33.1% of total government revenue from taxation. In other words, quite apart from the tax they pay when they receive their incomes, Canadians pay, on average, a further 11.5% in indirect taxes when they spend their income. Furthermore, almost one-third of all government revenue is collected in this indirect, hidden form.

The hot potatoes—passing tax forward

Hidden taxes are hard to calculate because people try to pass them on to others—any tax that can be avoided is money in one’s own pocket. As a result, people throughout the economy are constantly avoiding situations in which they will have to pay taxes and seeking to pay as little tax as possible when they cannot avoid them. The moonlighting

Figure 1.4: Government take from a litre of gasoline
(Canadian average; in cents per litre)



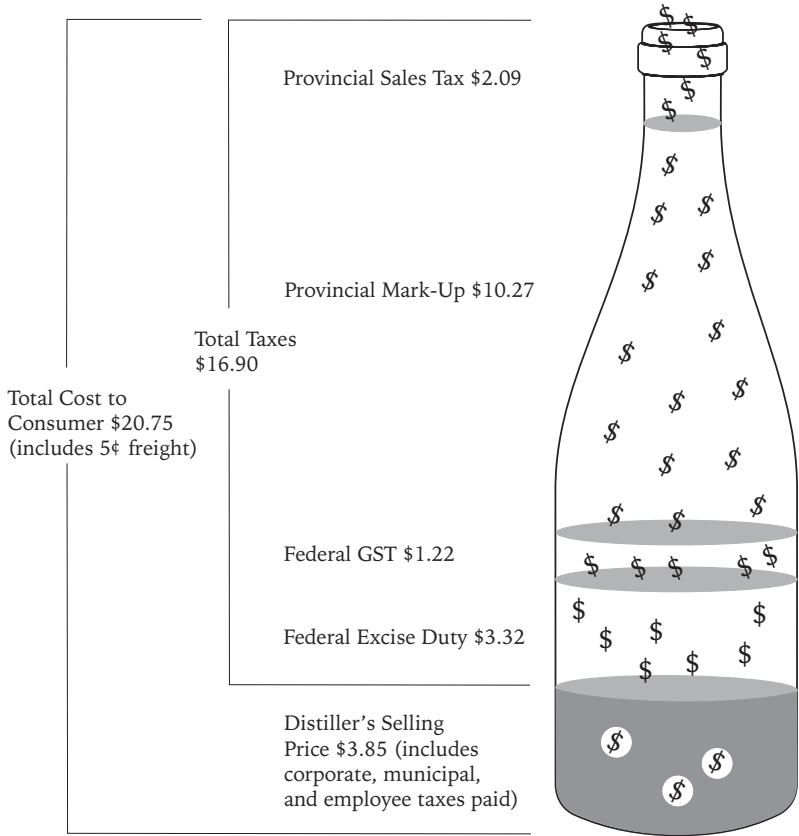
Source: Canadian Petroleum Products Institute.

Table 1.4: Components of the price of gasoline (in cents per litre for regular unleaded gasoline at self-serve pumps), by city

| | Crude cost (estimate) | Refiner Margin | Marketer Margin | Taxes | Pump Price |
|-------------------------|--------------------------|-------------------|--------------------|-------|---------------|
| Vancouver | 32.1 | 11.2 | 1.4 | 29.9 | 74.6 |
| Edmonton | 31.1 | 7.5 | 6.6 | 23.5 | 68.7 |
| Regina | 31.1 | 8.1 | 7.0 | 30.0 | 76.2 |
| Winnipeg | 31.1 | 8.5 | 4.2 | 26.1 | 69.9 |
| Toronto | 31.6 | 8.2 | 2.7 | 29.4 | 71.9 |
| Montreal | 31.2 | 7.4 | 5.8 | 37.3 | 81.7 |
| Saint John | 30.3 | 9.0 | 6.3 | 30.6 | 76.2 |
| Halifax | 30.3 | 8.5 | 6.7 | 33.9 | 79.4 |
| Charlottetown | 30.3 | 8.5 | 8.2 | 27.9 | 74.9 |
| St. John's | 30.3 | 10.7 | 7.2 | 37.7 | 85.9 |
| Canadian Average | 32.2 | 7.4 | 5.2 | 30.9 | 75.7 |

Source: Canadian Petroleum Products Institute, *Fuel Facts* 1, 17 (October 24, 2000) (all editions).

Figure 1.5: Typical government take from a bottle of liquor



Source: Association of Canadian Distillers, 1999 Annual Statistical Report.

tradesperson who engages in “cash only” transactions, the mechanic who fixes his neighbour’s truck in return for free cartage, the dentist who fixes the teeth of a fellow dentist’s family on a reciprocal basis, the tycoon whose business is incorporated in the Turks and Caicos Islands, all want to avoid taxes. In the end, though, when a tax is levied, somebody ends up paying. One of the most difficult and important questions in economics is to discover who that somebody is; this is known as the study of “tax incidence.”

How employees pass the tax on

To get an idea of the difficulties involved, consider the following. The average Canadian employee measures his welfare in terms of after-tax

dollars and in each new wage contract bargains for an increase in take-home pay. The fact that an increase in gross terms will imply a smaller increase in after-tax dollars motivates the employee or his union representative to demand a larger gross increase. By doing so, the employee is attempting to get the employer to bear the burden of the additional tax. For an example of this process, see table 1.5.

Expressed slightly differently, the employee who bargains in this manner is attempting to pass the tax forward. This behaviour is not unique; it is a general characteristic of all participants in the Canadian economy. Corporations attempt to pass the higher taxes on profits and payroll forward to the consumer in the form of higher prices or backward to employees in the form of lower wages. The difficulty in measuring the degree to which these attempts are or are not successful greatly complicates the study of tax incidence.

Who pays the indirect taxes?

While it is difficult to know where the burden of these taxes ultimately lies, it is not impossible. We need to make intelligent assumptions about how each tax is passed on. For example, a general sales tax is collected and remitted to government by retailers. It is clear, however, that in most cases the retailers do not actually bear the tax—they are merely the agents for collecting it. The actual effect of the tax is to increase the price of all goods and services affected by the tax and to cause a corresponding reduction in the purchasing power of family incomes. Accordingly, to the extent that a general sales tax causes an increase in the general level of prices, the tax is borne not by the collectors but by income earners in the economy, whose incomes now buy less. Indirect or sales taxes, therefore, burden all income earned in the economy.

Payroll taxes such as Employment Insurance premiums and contributions to the Canada and Quebec Pension Plans are collected, in part, from the employer and, in part, from the employee. And, while no one would dispute that the employee pays the employee's portion, in most cases it is true that the employee also pays the so-called

Table 1.5: Take-home pay versus gross pay

In 2000, a single person in Ontario with an income of \$35,000 had to receive a 6.1% raise in pay to realize a 5.0% increase in after-tax pay. Comparable figures for the other provinces are presented below.

| NF | PE | NS | NB | QC | ON | MB | SK | AB | BC |
|------|------|------|------|------|------|------|------|------|------|
| 6.4% | 6.3% | 6.3% | 6.4% | 6.4% | 6.1% | 6.4% | 6.3% | 6.1% | 6.2% |

Sources: Canadian Tax Foundation, *Finances of The Nation 2000*; calculations by the authors.

employer's portion. This is because the payroll tax paid by the employer is included in the total amount of money the employer has available to pay labour-related costs. In other words, payroll taxes reduce potential wage and salary payments below what they would otherwise have been. Since no corresponding reduction can be expected in the price of the products that the employee will want to purchase, the payroll tax, in effect, burdens the employee.

While both of these arguments have been framed in terms of employees and their wages and salaries, it is clear that taxes burden capital income as well. For example, a general sales tax reduces the purchasing power of all income, not just wage and salary income. As a result, it is appropriate to view the burden of the general sales tax as falling on all forms of earned income, including interest income and dividends. All of the estimates of tax burden constructed in this study, therefore, allocate the burden of general sales taxes in proportion to all earned income received by a family. In practical terms, this means that if general sales taxes amount to 7% of total Canadian income in a particular year, we add 7% of a family's total earned income to the family's tax bill when we calculate how much tax the family pays.

In computing this burden of general sales tax, income that a family receives from government is explicitly ignored. This is because the payments received from government such as Old Age Security and the Canada Pension Plan have been, and currently are, either directly or indirectly indexed to the general level of prices to offset the effects of inflation. As the general price level rises in step with the sales tax, the purchasing power of transfers from government is not permitted to fall. As a consequence, the general sales tax does not have the effect of burdening income in this form, and it would be inappropriate to allocate any part of the burden of general sales taxes to this sort of income.

While the burdens of a general sales tax and payroll taxes are relatively straightforward to assign, the assignment of particular excise taxes is more elusive. Whereas a general sales tax increases all prices and hence reduces the purchasing power of all incomes not derived from transfers from government, particular taxes on commodities usually affect only the price of that commodity. For example, excise taxes imposed on liquor, motor vehicles, and fuels affect only the prices of those products. Ultimately, of course, they may affect a whole range of prices—fuel taxes and motor vehicle taxes affect the price of transportation. These taxes may, therefore, have an overall effect although levied only on a particular product.

In light of these considerations, it had been the usual practice when calculating tax burdens to allocate the burden of particular excise taxes according to the consumption of those items. Studies of the 1976

tax burden published by The Fraser Institute (Walker 1976; Pipes and Walker 1979) employed this methodology. Following this methodology, however, gives rise to a variety of problems. First, only the first-round effects of the excise tax are incorporated and, hence, the actual distribution of the tax burden may differ substantially from the estimate. Second, this method may not even provide good estimates of the first-round effects of the tax because the relative burden of a particular tax borne by a family is determined not by the family's consumption of the taxed item but by the fraction of the family's income spent on the item relative to the national average.

In view of these problems with the traditional approach, and given that the proportions of income spent on different items by various income groups do not vary widely from the average, we decided for the purposes of this study to distribute excise taxes in the same way as general sales taxes; that is to say, this study assumes that excise taxes burden total incomes—excluding government transfers to persons.

So, the answer to the question, "Who pays the indirect taxes?" is ultimately a straightforward one. Although indirect taxes appear in a variety of forms, they burden the income that the family earns.

Other taxes by other names

In addition to "formal" taxes levied by government, there are a variety of other government policies that have the same effect as taxes but are not normally identified as such: the regulations that restrict our activities every day, price support for producers of agricultural products, and import duties and quotas to assist clothing and textile manufacturers. There is no difference in principle between this sort of tax and other hidden taxes. These "taxes" do not show up in records of government revenue and precise estimates of their size are difficult to make but we cannot ignore their existence.

Regulatory taxation

In general, a government can achieve a given objective either by taxation and subsidization or by regulation. Rather than the current practice of imposing import quotas to help Canadian clothing manufacturers, the federal government could provide assistance by giving them a direct subsidy financed from general tax revenue. That the government uses regulation to convey the subsidy should not distract from the fact that a subsidy is being provided and that it is the Canadian consumer who is paying for it.

For governments, regulation seems a painless way of advancing their public policy without spending tax dollars directly. The reality of regulation is not so benign since it increases the cost of doing business.

Governments bear little of the cost of regulation: their costs are limited to the administrative share while businesses and consumers must bear the much larger cost of complying with the regulations. According to a recent study by The Fraser Institute, the compliance cost of all federal, provincial, and municipal regulations amounted to \$83.4 billion in 1995/1996 (Mihlar 1998). This works out to \$11,272 per family of four. The federal and provincial governments legislated over 100,000 regulations over the 22-year period investigated in the study; the federal government alone passed an average of 1,031 regulations per year.

The following quotation from the forthcoming 2001 edition of The Fraser Institute's study of the cost of regulation highlights how pervasive regulations are in Canada. "Regulation affects almost every aspect of our lives, including what we listen to on the radio, the prices and quality of the food we eat, the safety features in our cars, who is allowed to deliver our mail, where we are permitted to smoke and drink, and how we are restricted in the use of our property."

Marketing-board taxes

There are dozens of cartels controlling farm products in Canada. These cartels or marketing boards generally have the effect of suppressing competition in the production of the product subject to the cartel and, consequently, they cause the price of the product to be higher than it would otherwise have been. The amount by which the marketing board price exceeds the price that would prevail in its absence—that is, in the open market—is a tax on the consumer and marketing boards ought to be viewed as a device for transferring money from consumers to producers.

The Organisation for Economic Co-operation and Development (OECD) estimates that the implicit tax in the form of support for the market prices of agricultural products paid by Canadian consumers was \$3.4 billion in 1999. Total household spending on food in Canada is roughly \$66.3 billion; marketing boards and other implicit agricultural taxes add about \$301 (5.4%) to the cost of the average family's food bill.

Canada and the OECD countries adopted a set of principles for agricultural policy reform in 1987. Since then, there has been a decrease in support to the agricultural sector although the reform process has had some setbacks in recent years. Specifically, the OECD (OECD 2000) notes that "support to producers has mounted steadily over the last three years," and "progress in reforming policies and liberalizing trade in agriculture stalled, or even reversed, when market pressures emerged." In general, Canada's implementation of these reforms since 1987 has included a shift away from market-price support towards making direct payments to producers. The exception is in the dairy in-

dustry, Canada's most heavily supported and least reformed agricultural sector, which receives almost 70% of the dollar value of market-price support from consumers.

Due to trade liberalization and internal reforms, the level of agricultural support in OECD countries is lower than in 1987 and this means lower implicit taxes for Canadians. If the reform process gets back on track and, especially if the Canadian dairy sector is reformed, Canadian consumers will experience a further reduction in implicit taxes from market-price support.

Clothing and textile taxes

In November 1976, the federal government imposed a quota on imported clothing and textiles. Its purpose was to limit the importation of inexpensive clothing and textiles and so protect Canadian clothing and textile manufacturers from competition. The associated decline in competition for the Canadian consumer's clothing-expenditure dollar undoubtedly produced a higher price for clothing than would otherwise have existed. The difference between the price for clothing that would have prevailed in the absence of the quota and the price that actually prevails is a tax on the consumer. Proceeds from this tax go directly to producers who are, in effect, being subsidized by the consumers.

Some of the burden associated with tariffs and quotas has been eliminated as a result of the North American Free Trade Agreement (NAFTA) between Canada, the United States, and Mexico. However, in many cases the principal source of cheaper products is not the United States but less developed countries. In value terms, 77.4% of textile imports into Canada come from developed countries while 71.5% of clothing imports come from developing countries (Canadian Textiles Institute, personal communication to Joel Emes, 1998).

The authors of *Free Trade between the United States and Canada* estimated that the total amount of tax levied in the form of tariff protection or other barriers to international competition was as high as 10.5% of Canada's Gross National Product (Wonnacott and Wonnacott 1967: 299). More recent studies estimated the costs of tariffs at 8.2% of GDP in 1974 (Wonnacott 1975) and 8.6% of GDP in 1976 (Harris and Cox 1983). Canada has seen a significant reduction in tariff protection since these studies were completed. In 1981, import duties were equal to 3.6% of imports from other countries, by 1991 they were only 2.3%, and by 1999 they were down to 0.6%. However, a recent report by the World Trade Organization indicates concerns about market access for developing countries in certain areas of agriculture and textiles and clothing (World Trade Organization 1998), indicating that Canada continues to impose these hidden taxes on consumers.

Deferred taxation

During his budget statement in November 1978, the Honourable Jean Chrétien, then Federal Minister of Finance, made much of the fact that, because the personal income tax structure had been indexed to inflation, there had, in effect, been a reduction in personal income taxation compared to what would have prevailed in the absence of indexing. That is to say, exemptions had been increased by the rate of inflation and tax brackets had been shifted to ensure that incomes swollen by inflation would not be taxed more heavily on that account alone. While this change in the tax structure was indeed welcome, it did not represent a move towards a permanent reduction in the government's propensity to tax.

The "reduction" in personal income-tax revenues, in fact, was accompanied—starting in 1975—by deficits in the federal government's accounts that were unprecedented in peacetime. Although this situation is not entirely attributable to the relative decline in personal income-tax revenues, it is clear that continued growth in income taxation would have meant a smaller deficit and a reduction in net cash requirements to be financed by issuing debt.

Accordingly, it has been standard practice in assessing Canada's current level of taxation to take into account the extent to which tax collections are merely deferred by current tax "reductions." In other words, in addition to calculating the total tax burden of all government operations in a given year, we have in the past calculated the balanced-budget tax burden, which included not only taxes levied now but also taxes that must be levied in the future to discharge debts acquired by the government to finance the current deficit. In recent years, there has been a dramatic shift away from deficit financing, or deferred taxation, in favour of balanced or surplus budgets. This shift has made the continued calculation of a balanced-budget tax burden unnecessary. Nevertheless, the historical balanced-budget tax burden and the effect of debt repayment on the tax burden are discussed in chapter 4.

How much tax should Canadians pay?

In 1917, when he first introduced the Personal Income Tax, the Finance Minister, Sir Thomas White, was of the opinion that no Canadian should pay tax on income less than \$2,000 if he were single and had no dependents. Married taxpayers, he said, should pay tax on income in excess of \$3,000. The tax structure that ultimately evolved provided that single Canadians paid income tax on income in excess of \$1,500, while married Canadians were exempted from the tax until their in-

comes exceeded \$3,000. However, in the very next year, this was reduced to \$2,000 for a married taxpayer and \$1,000 for single Canadians (Government of Canada 1917).

While the tax structure has gone through many changes in the intervening years, it is interesting to ask how Canadians would be taxed if this initial view of the “ability to pay” had kept pace with developments in people’s incomes. To answer this question we have adjusted the original exemption levels by the increase in inflation over the period since 1917. This adjustment yields an exemption level for 2000 of \$18,044 for single taxpayers and \$36,088 for married taxpayers. But actual personal credits for single and married taxpayers amounted to \$7,231 and \$13,371 in 2000—significantly less than the level of income that would have been exempt if the 1917 standard had continued in force. The reason for the disparity is that, over the years from 1917 to 1974, exemption levels were not indexed to the cost of living or the increase in family incomes—in fact, in a few years during the Depression, exemption levels were actually reduced. In addition, exemption levels and tax brackets were only partially indexed to inflation between 1986 and 1999.

