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# C.D. Howe Institute COMMENTARY

TAX COMPETITIVENESS PROGRAM

## Limited Horizons:

The 2008 Report on Federal and Provincial  
Budgetary Tax Policies

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### **In this issue...**

A rise in near-sighted policies that place unequal tax burdens on different industries is undermining progress on other fronts.

## THE STUDY IN BRIEF

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Canadian governments are undercutting progress in reducing corporate income and capital taxes with counter-productive policies that impose unequal tax burdens across assets and industries.

Overall, Canada's 2008 marginal effective tax rate on capital has fallen from 31.9 percent in 2007 to 29.1 percent in 2008. With further business tax reductions at the federal and provincial levels, the marginal effective tax rate will fall to 25.8 percent by 2012. That is good news indeed, since such changes will increase capital stock by \$62 billion within five years time and improve worker annual incomes by \$2.9 billion.

However, some provinces continue to levy high marginal effective tax rates on capital. Ontario and Manitoba impose the highest effective tax rates on capital in 2008: 34.8 and 33.8 percent, respectively. As well, in many provinces the variation of tax burdens on business activities is increasing, thereby interfering with boardroom decisions on steering resources to the most profitable opportunities.

As measured by a dispersion index, inter-asset and inter-industry distortions have risen sharply in the past two years. The dispersion index has doubled from 24.7 percent in 2006 to 50.3 percent in 2008. Much of the increase in the dispersion index owes to tax policy supporting forestry and manufacturing businesses. In some cases, tax policies are geared to support structurally declining industries to the detriment of those that will be important to Canada's industrial future.

The study highlights priorities for improving the tax system by reducing taxes on capital investment and labour. They include: (i) a reduction in provincial corporate income tax rates to 10 percent, which would bring Canada's overall statutory corporate income tax rate to 25 percent in 2012; (ii) the removal of targeted preferences for specific industries; (iii) sales tax harmonization with the federal GST by the hold-out provinces (British Columbia, Manitoba, Ontario, Prince Edward Island and Saskatchewan); and (iv) further reductions in personal income taxes to relieve the tax burden on labour income.

Canada needs tax policies that both reduce the tax burden on investments and create a level-playing field to promote economic growth.

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**W**hen it comes to business tax policy, federal and provincial 2008 budgets are a version of the Asian proverb about a frog in a well. The frog was pleased with the patch of blue sky above the well that he called his own, but was oblivious to the wider horizons beyond its walls.

Like the frog, our governments need to leap higher to get out of a well created by counter-productive policies and expand their horizons for economic growth.

Federal and provincial governments continue to reduce corporate income and capital taxes but this is not sufficient to scale the walls. With a commodity boom favouring Canada, a rising dollar and governments rich with surpluses, business tax policy could do better. Governments need to remember that the best business tax policies are those that are neutral among business activities. As we show in this report, the variation of tax burdens on business activities is increasing, thereby interfering with boardroom decisions on steering resources to the most profitable opportunities. In some cases, tax policies are geared to support structurally declining industries to the detriment of those that will be important to Canada's industrial future. Canada needs tax policies that both reduce the tax burden on investments and create a level playing field to promote economic growth.

Some governments are making significant structural changes for the betterment of the economy: the federal corporate income tax rate is set to decline from 19.5 percent in 2008 to 15 percent in 2012. British Columbia is reducing taxes on investment, work and savings in favour of consumption taxes, albeit a carbon tax that will

affect fuel prices for consumers and producers. Newfoundland and Labrador and Manitoba have further lowered personal and payroll taxes this year, which will encourage work effort and the hiring of both skilled and unskilled labour. And New Brunswick has released a discussion paper proposing sweeping reforms, including a flatter personal income tax structure and sharp reductions in corporate income tax rates, to be partly offset by a higher Harmonized Sales Tax increase or the introduction of a carbon tax.

On the other hand, some provinces have not addressed serious shortcomings in their business tax policies. They maintain high taxes on growth-enhancing industries while cutting capital-tax burdens on others. In the face of a bleak export market in the United States, five provinces have failed to address the problems arising from an outdated retail sales tax and, in the case of Ontario, Nova Scotia and Prince Edward Island, a relatively high corporate tax rate.

Overall, Canada's 2008 marginal effective tax rate on capital has fallen from 31.9 percent<sup>1</sup> in 2007 to 29.1 percent in 2008. With further business tax reductions at the federal and provincial levels, the marginal effective tax rate will fall to 25.8 percent by 2012. That is good news indeed since such changes will increase capital stock by \$62 billion within five years time and improve worker annual incomes by \$2.9 billion.<sup>2</sup>

Nevertheless, other findings are discouraging. Some provinces continue to levy high marginal effective tax rates on capital. Ontario and Manitoba impose the highest effective tax rates on capital in 2008: 34.8 and 33.8 percent, respectively. Like most other provinces, Ontario and Manitoba impose relatively high taxes on service companies, including growth-enhancing, knowledge-based industries where earnings are rising faster than the rest of the economy (4.3 percent annually for communications and 3.2

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- 1 Due to the change in capital weights by industry and by type of assets, this estimate is different than that presented in our previous reports published in 2007.
- 2 Based on Finance (2007), we estimate that large corporate capital stock is equal to \$1.84 trillion in 2007 and the user cost of capital declines by 4.79 percent from 2008 to 2012.

percent for other services for the period 2003–2007). For example, Ontario's marginal effective tax rate on capital is a punishing 46.2 percent on communications and 42.4 percent on business services. Manitoba's rates are similar. Both provinces have effective tax rates on capital that are higher than the worldwide average, and higher than rates in the United States, which reintroduced temporary bonus depreciation in 2008. Their tax policy responses have been to introduce weak and ineffective targeted incentives, such as investment tax credits and preferential rates. Manitoba has enhanced the investment tax credit for manufacturing machinery and several other preferences, including an exceedingly low small-business tax rate with a questionable effect on business growth. Ontario has introduced an ill-designed 10-year corporate income tax holiday for commercialized intellectual property developed by qualifying research institutions.<sup>3</sup>

Manitoba and Ontario are not alone in trying to micromanage the economy through business tax policy. Quebec exemplifies governments that target preferences narrowly (such as to pig manure farming) and get poor results as measured by investment performance – Quebec's investment per worker is the second lowest, and only Prince Edward Island stands lower (Banerjee and Robson 2007).

Another troubling trend is a rise in economic distortions owing to policies that impose unequal tax burdens across assets and industries. As measured by a dispersion index, inter-asset and inter-industry distortions have risen sharply in the past two years.<sup>4</sup> The dispersion index (calculated as the ratio of variation in effective tax rates as a percent of the average marginal effective tax rate) has doubled from 24.7 percent in 2006 to 50.3 percent in 2008. Much of the increase in the

dispersion index owes to tax policy supporting forestry and manufacturing businesses, including the resurrection of the archaic two-year write-off for capital investments, originally introduced in 1972 and eventually eliminated a decade and half later. Further, Ontario, Quebec and Manitoba accelerated capital tax reductions – for the manufacturing and processing sectors only.

The dispersion index will fall by 25 percent in 2012, primarily because of a much lower federal corporate income tax rate and the cancellation of several manufacturing and processing preferences. However, given recent trends in business tax policy, it is reasonable to expect that governments

Quebec exemplifies governments that target preferences narrowly (such as to pig manure farming) and get poor results...

will make further attempts at economic micromanagement by way of targeted preferences. Two economic studies have shown that inter-asset and inter-industry distortions have important effects on economic growth. Jorgenson and Yun (2001) find that large economic

gains can be obtained by equalizing tax burdens on assets and industries. Hamilton, Mintz and Whalley (1991) also find that inter-asset distortions are especially large in Canada, with negative consequences for growth since they push resources to less productive uses.

Labour taxation has changed little, with the effective tax rate on labour falling from 46.2 in 2007 to 45.3 percent in 2008. The biggest reduction in the effective tax rate on labour has been in Newfoundland and Labrador, with a 2.6 percentage point decline to 45.7 percent. Alberta has cancelled its health premium, a measure with little impact on marginal work decisions, and remains the province with the lowest tax burden on labour.

Taking into account the share of labour and capital in production costs, and given that labour taxes tend to be shifted forward by 30 percent into wage costs, the marginal tax burden on the cost of doing business

3 Tax holidays, also used in Quebec, are high-cost, low-impact policies, typically found in Third World countries and well proven to be ineffective (Shah 1995).

4 To put it in technical terms, the dispersion index is calculated as the coefficient of variation, which is equal to the weighted standard deviation of marginal effective tax rates divided by the weighted-average marginal tax rate. We prefer using this measure in order to separate out the influence of dispersion as a measure of inter-asset and inter-industry distortions from the size of the effective tax rate that is related to the inter-temporal distortion – a standard deviation of 1 percent, for example, implies much more variability when effective tax rates are low.

in Canada has declined from 24.9 percent in 2007 to 23.4 percent in 2008. Ontario has the highest effective tax burden on costs at 26.4 percent and New Brunswick the lowest at 17.2 percent.

Some smart tax policies to improve taxation would help spur economic growth. Further corporate income tax rate cuts at the provincial level to 10 percent or less would be important in lowering effective tax rates on capital and reducing tax-rate dispersion. A shift in the tax burden away from investment, savings and work effort and on to consumption would be appropriate. Recent studies have suggested that jurisdictions with high corporate income tax rates above 30 percent (which is currently the case in Canada) would not lose large amounts of corporate tax revenues with rate reductions. The revenue cost to corporate rate reductions<sup>5</sup> is small because businesses become more willing to book income in jurisdictions with lower corporate income tax rates.

These rate cuts, however, should be accompanied by base-broadening measures to reduce economic costs induced by business tax policies that favour some business activities over others. Governments should aim to reduce inter-asset and inter-industry distortions, not increase them as they have done quite dramatically in the past two years.

Further, conversion of retail sales taxes in British Columbia, Ontario, Manitoba, Prince Edward Island and Saskatchewan to a value-added tax similar to the federal Goods and Services Tax would improve competitiveness since businesses would be able to recover tax paid on intermediate and capital goods. Overall, sales tax harmonization in the hold-out provinces would have a dramatic impact in reducing effective tax rates on capital (but have less impact on the cost of doing business since the taxation of labour would increase).

All in all, Canadian governments are whittling away the gains from reducing tax burdens on

capital investment by creating an uneven playing field among businesses. At some point, major tax reform will be needed just to undo the harm caused by politicians who believe they, rather than business managers, know best how to run the business sector.

## Taxes on Capital Investment

Taxes on capital investment reduce the incentive for companies to invest in Canada and, to the extent they vary by capital type, distort decisions on the most efficient technologies to produce goods and services. Many recent studies have shown that increases in tax burdens on capital investment do not fall so much on capital in open economies. Instead they reduce substantially the income paid to workers when business productivity is impaired (Arulampalam, Devereux and Maffini 2007 and Gentry 2007).

As in our previous reports, we measure the marginal effective tax rate on capital for medium and large corporations in forestry, manufacturing, construction, transportation, communications, utilities, trade and business and household services. The marginal effective tax rate is calculated as the annualized value of corporate income tax, capital tax and sales tax paid on capital purchases as a share of the gross rate of return on capital (Chen 2000). We do not include research and development tax credits or grants in our assessment; their impact on effective tax rates is relatively small except for communications.<sup>6</sup>

### *Effects of Budget Changes in 2008*

The most important changes in business taxes affecting capital decisions are the federally legislated reductions in corporate rates to 19.5 percent in 2008 and to 15 percent by 2012. Several

5 Mintz and Smart (2004) find that a 1 percent reduction in the corporate income tax for a Canadian province would result in a 2.3 percent increase in the corporate tax base if companies allocate income among provinces, or 4.9 percent if they operate a separate multi-jurisdictional company in the province. A recent European study (Huizinga and Laeven 2008) suggests that a reduction in the corporate rate by 1 percentage point increases the corporate tax base by 1.3 percentage points on average among European countries. Using the Mintz-Smart results, a 1 percent reduction in the Ontario corporate income tax rate of 33.72 percent in 2008 would increase federal and provincial revenues by 18 percent if such income shifting is taken into account.

6 The effect of the research and development credits is to lower effective tax rate by about two points on average.

provinces have reduced corporate income tax rates this year: British Columbia by one point to 11 percent (as of July 1, 2008, with a possible further rate cut to 10 percent by 2011); Manitoba by one point to 13 percent (as of July 1, 2008, with further rate cuts of two percentage points planned by 2011); and Saskatchewan by one point to 12 percent (as of July 1, 2008). Quebec, on the other hand, is raising its corporate income tax rate by 1.5 percentage points, to 11.4 percent in 2008, with a further increase to 11.9 percent in 2009 as part of a package to eliminate capital taxes.

Capital taxes continue to decline in several provinces – Nova Scotia, New Brunswick, Manitoba, Saskatchewan and Quebec. For their part, Ontario, Quebec and Manitoba accelerated the elimination of capital taxes for manufacturing and, in some cases, primary and resource sectors in 2008.

While these rate reductions provide support to all sectors, federal and provincial governments have resorted to special preferences to support specific business activities. Some preferences have targeted “green” technologies to support better environmental practices – the success of these incentives will depend on whether they trigger new investments as opposed to causing an acceleration in capital-good input prices, such as for wind turbines, when supply is inadequate. Others measures have targeted support for the forestry and manufacturing industries, the latter being particularly challenged by long-term structural changes in the world economy. Federal and most provincial governments are extending the two-year write-off for machinery investments, which is to be phased out by 2011. Quebec is providing a refundable investment tax credit for manufacturing and processing equipment as well as several targeted preferences for resource regions, research, e-business, culture, and on-the-job training. Manitoba has extended its investment tax credit for manufacturing and processing equipment to 2011 – Manitoba has extended the provision in the past and may do so again.

### *Tax Burdens on Investment by Province and Industry*

Taking into account budgetary changes in 2008 as well as those legislated from earlier years, the marginal effective tax rate on capital in Canada has fallen from 31.9 percent in 2007 to 29.1 percent in 2008, with a further reduction to 25.8 percent due by 2012 (Figure 1). Ontario continues to have the highest tax burden on investment, at 34.8 percent, followed by Manitoba at 33.8 percent. Except for Prince Edward Island, which continues to levy a high corporate income tax and has not reformed its sales tax, the Atlantic provinces generally have the lowest marginal effective tax rates on capital (New Brunswick has the lowest at 11.8 percent), in part driven by the federal Atlantic investment tax credit favouring primary, resource and manufacturing industries.

Surprisingly, the marginal effective tax rate on capital in Canada for 2008 is higher than in the United States, where a 50 percent bonus depreciation rate has been provided for 2008, holding the US rate at 26.9 percent. A further consideration: tax policy can be fickle when politicians respond to business cycles, and US tax reform is on the political agenda, with some Democrat and Republican leaders advocating a sharp reduction in corporate income tax rates in the future.

Effective tax rates vary widely by industry (Table 1). Tax policy heavily favours forestry and manufacturing industries, and places high tax rates on construction, trade, communications and other services, including business services. Marginal effective tax rates are actually negative for forestry and manufacturing in the Atlantic Provinces, implying that companies may not be able to use all their tax benefits if they cannot claim accelerated cost deductions and tax credits on marginal investments against income earned on infra-marginal profits.<sup>7</sup>

7 If companies are in a non-taxpaying position and must carry forward deductions and credits to claim against future income, the marginal effective tax rate will be less negative (and in the extreme case zero). However, it is also possible for marginal effective tax rates for non-taxpaying companies to be greater than for taxpaying companies when companies are starting up or face high degrees of risk. (See Mintz 1987.)



























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