



C.D. Howe Institute
Backgrounder

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Tax Competitiveness Program

**Federal and Provincial
Tax Reforms:**

Let's Get Back on Track

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The Backgrounder in Brief

Provinces increasingly target favoured business sectors or activities for special tax treatment. Getting back on track to broad-based tax relief would make Canadians better off, without starving governments for tax revenue.

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Springtime brought forth April showers and May flowers — and also federal and provincial budgets that, for this year, had mixed tax policies. Although some tax measures aimed to reduce rates and broaden tax bases, many governments increasingly rely on targeted tax credits, which complicate the tax system without necessarily improving the prospects for economic growth or fairness.

If governments remain on this tax reform path, the accumulation of targeted tax relief measures will have a significant fiscal cost, which could be better used to finance broad rate reductions. Tax rate reductions encourage greater work effort, investment and risk-taking without governments putting themselves in the position of picking winners from losers, a task at which they rarely succeed.

Credits have been adopted or enhanced in the past two years for activities such as sports, transit passes, film making, research, labour training and manufacturing and forestry equipment. Tax reductions have also been targeted to small businesses, thereby creating greater opportunities for personal and corporate tax avoidance. A notable exception: New Brunswick, which is revising its far-too-low small business corporate income tax rate, boosting it from 1 to 5 percent.

The general philosophy that we need to reduce tax rates and broaden tax bases is being eroded by federal and provincial targeted tax relief. We should get back on track and pursue the objective of having a simple, transparent and fair tax base with low, internationally competitive tax rates.

The most important federal tax change this year has been a range of increased capital cost allowances for structures, computers, natural gas distribution lines and liquefied natural gas facilities and clean energy generation. A two-year write-off for manufacturing equipment will be available on a temporary basis until 2009.¹ Previous commitments by Liberal and Conservative governments mean that federal corporate income tax rates will decline from 22.12 to 18.5 percent by 2011.

Given the federal government's innovative approach, in its March budget, to helping cover the cost of capital tax reductions, virtually all provinces are now phasing out general capital taxes within the next few years.² In most cases, personal tax changes focus on tax credits. However, several provinces delivered broad personal tax cuts, including British Columbia, Newfoundland and Labrador, and Quebec, the latter in its controversial May budget.

In this Backgrounder, we assess for the first time federal and provincial tax policies in terms of their impact on the cost of doing business.³ In our assessment,

The authors wish to thank several reviewers for their comments that helped improve the analysis.

- 1 The accelerated capital cost deduction for oil sands is also being appropriately phased out. As we focus on non-resource industries, the effect of this provision is not included in our analysis.
 - 2 The federal government is providing a transfer based on additional federal corporate taxes resulting from the elimination of provincial capital taxes that are deductible from corporate income. Nova Scotia is to eliminate the general capital tax in 2012. Manitoba will eliminate its capital tax by 2011 if fiscally able to do so. Several provinces are maintaining capital and insurance premium taxes on financial and insurance companies.
 - 3 As discussed below, the tax competitiveness analysis is based on the assumptions that labour taxes cause production costs to rise by 30 percent of taxes paid (the rest borne by workers as lower wages) and investment-related taxes cause costs to rise by the full amount of taxes since large companies must earn profits sufficient to cover financing costs determined in
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we find that income, payroll, capital and sales taxes on labour and capital account for an extraordinary share of tax-inclusive incremental (marginal) production costs: 24.3 percent in 2007, which is 2.6 percentage points less than in 2006. In 2007, Ontario is the most highly taxed province with levies accounting for 30.2 percent of tax-inclusive production costs. At the other extreme, New Brunswick and Alberta are the most fiscally advantaged provinces with taxes tallying up to 15.9 and 18.7 percent of the cost of doing business, respectively. Alberta's advantage is primarily the result of low personal income taxes and the absence of a general payroll and sales tax. For its part, New Brunswick has received a helping hand from the federal government's Atlantic investment tax credit, but the province has also been cutting business taxes in the past several years. Such differences can have a dramatic impact on business location — a 40 percent difference between Alberta's effective tax rate on the cost of doing business and that of Ontario, results in roughly 12 percent more firms operating in Alberta (Beaulieu, McKenzie and Wen 2004).

Growth-oriented service sectors face the highest tax rates with communications the most heavily taxed industry — at 32.5 percent of tax-inclusive costs. By comparison, the export-challenged forest industry has the greatest advantage on the tax front, with taxes accounting for 19.6 percent of costs. Manufacturing is the second-least taxed industry at 22.8 percent.

Taxation of capital is particularly important since it directly affects the ability of businesses to invest in new technologies. Canada lags its international peer group, with investment per worker \$700 below the OECD average and \$1,300 below the United States (Banerjee and Robson 2007). Even with a sharp reduction in the Canada-wide effective tax rate on marginal investment projects⁴ — from 36.6 percent in 2006 to 30.9 percent in 2007⁵ — much of the relief has been targeted at two sectors, forestry and manufacturing, which have been provided accelerated capital cost deductions. The most important provisions, related to manufacturing and processing equipment and the Quebec capital tax credit, are only temporary. They thereby significantly affect the timing of investment rather than having a long-run impact on competitiveness (House and Shapiro 2006). If the federal and Quebec governments had accelerated permanent tax reductions instead, the manufacturing and forestry sectors would be almost as well off in the short term

footnote 3 cont'd

.... international markets. Mintz (2001) estimated the effect of both taxation and spending on the cost of doing business for Canada and the United States but not for each province. In this paper, we only examine taxation impacts across the provinces. We also do not include research development grant subsidies and tax credits, given that grant data are not easily available by province and industry.

- 4 Marginal investment projects are those that earn a profit rate just sufficient to cover the cost of capital and taxes.
 - 5 In Quebec, the province increased investment tax credits under the capital tax for manufacturing and forestry equipment in 2007. The credits can be claimed up to the amount of capital tax paid by a company. In our "base" case, we assume that credits cannot be fully claimed resulting in no capital tax paid by the forestry and manufacturing company. However, if credits are fully claimed, the effective tax rate on marginal investment is substantially reduced in Quebec for manufacturing and forestry since additional investment drives down capital taxes paid not just on marginal, but also infra-marginal projects (see footnote 17 for further elaboration).
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and would have benefited far more from a long-run reduction in their cost of capital. Other industrial sectors, too, would have faced less taxation on their capital investments.

A New Approach to Measuring Tax Competitiveness

We compare effective tax rates on the cost of doing business by province and industry, using certain assumptions. Businesses, when maximizing their profits, produce output at the point which the price is equal to marginal (incremental) cost of producing one more unit of a product or service. The marginal cost of production depends on the cost of hiring labour and capital, including taxes. All else equal, business will shift production to the location where incremental costs are least. With lower taxes, businesses will be willing to produce more goods and services in those jurisdictions.

For example, suppose it costs \$2.00 to produce a widget, inclusive of all taxes that apply to income, sales, payroll and capital. If taxes were eliminated, suppose the cost of production would fall by 50 cents. This implies that taxes make up a quarter of the cost of doing business (50 cents divided by \$2.00). Following McKenzie, Mintz and Scharf (1997), we compute effective tax rates on capital and labour as the two factors used in producing goods and services in an industry and aggregate these effective tax rates to measure the effective tax rate on the cost of doing business.⁶

When increasing taxes, costs may not go up by the full amount of the tax, depending upon its economic incidence (who bears the tax). Businesses must absorb the tax as a cost and charge higher prices to make up for the loss in profits, or bargain for lower input prices, implying that wages paid to employees and profits paid to owners of capital would earn less after-tax income. For large companies that finance capital from international markets, the presumption is that taxes only result in higher production costs. There is little alternative because Canadian businesses cannot bargain for lower international financing costs. Investors easily shift funds to markets where after-tax returns on investments are higher. As for labour, higher taxes would result in either higher wage costs borne by employers or lower income paid to employees. Given labour's bargaining power, worker mobility within Canada, and losses in the demand for and supply

⁶ The effective tax rate on marginal costs of production is estimated as $T = \alpha t_L + (1-\alpha)t_K$ with α denoting the labour cost share of production, t_L denoting the effective tax rate on labour costs and t_K denoting the effective tax rate on capital. This formulation is based on the so-called Leontief production functions with a fixed ratio of capital to labour (an alternative would be a geometric average of effective tax rates based on the Cobb-Douglas production function, which would make little difference to the analysis). The effective tax rate on labour is equal to the difference between the gross wage paid for labour, including employer payroll taxes and the net-of-tax wage received by workers divided by the gross-of-tax wage (income, employee payroll taxes, and sales taxes on goods and services reduce gross wages). The effective tax rate on capital is equal to the difference between the gross and after-tax rates of return on capital as a proportion of the gross-of-tax rate of return on capital. All effective tax rates on costs are expressed as a proportion of tax-inclusive costs.

of effort owing to taxation, we assume that 30 percent of labour taxes are borne by employers.⁷

We measure effective tax rates as the amount of taxes paid as a proportion of the pre-tax income earned by employees from additional effort. For these effective tax rates, we include personal income taxes, employer and employee federal and provincial payroll taxes,⁸ and sales taxes on income spent on goods and services currently or in the future. Our estimates are based on the earnings distribution of workers across provinces and industries, which result in a variation of marginal tax rates across income levels.⁹

Effective tax rates on capital include federal and provincial corporate income taxes, provincial capital taxes and retail sales taxes on capital inputs.¹⁰ We estimate these effective tax rates as the annualized value of taxes paid as a proportion of the gross rate of return on capital that would be sufficient to cover taxes and the cost of financing capital (see Chen 2000).

The estimates below focus on effective tax rates for large companies, which raise capital from international markets. Using labour earnings data, we calculate weighted-average marginal personal tax rates on workers who are employed by these large companies.

What We Have Found

We begin with a review of the effective tax rates on the cost of doing business, which is then followed by an examination of the tax components for labour and capital.

Taxes on the Cost of Doing Business

The effect of taxation on the cost of doing business is strikingly high across provinces, as shown in Figure 1, despite some progress as a result of the 2007 round of budgets. There has been some reduction of the effective tax rate on tax-inclusive costs, from 26.9 to 24.3 percent, across Canada.¹¹ The promised reductions in corporate taxes and the expected personal income tax reductions will further reduce the effective tax rate on costs to 23.0 percent in 2011.

Effective tax rates on tax-inclusive costs vary sharply by province. In 2007, Ontario is the most highly taxed province, with an effective rate of 27.6 percent. The next highest-taxed province is Manitoba, at 25.2 percent, followed by Prince

7 See a recent study by Bingley and Lanot (2002) who suggest over 30 percent of income taxes are shifted forward. This result is consistent with past studies in Canada, as discussed in Bird and Mintz (1992).

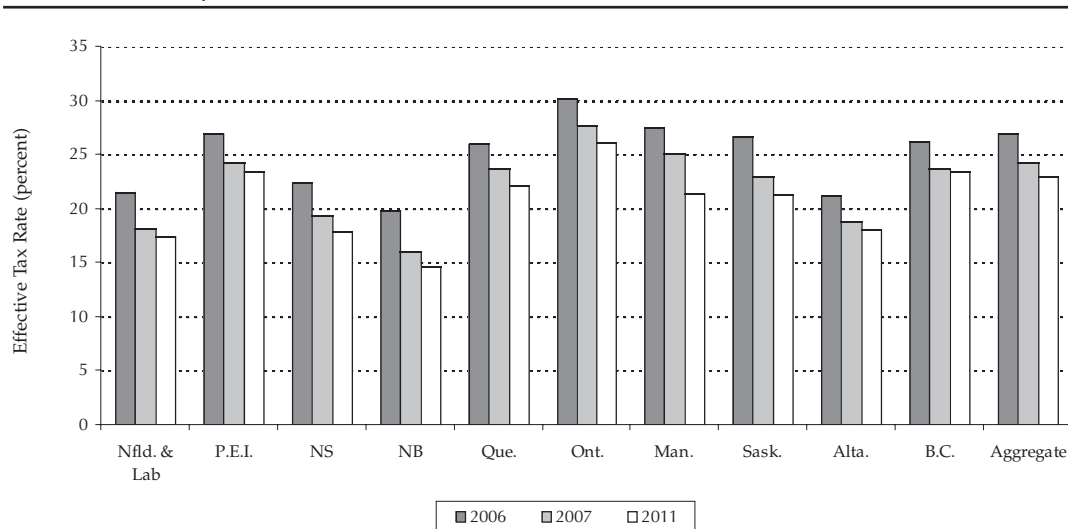
8 We do not include workers' compensation premiums as most provinces use experience-rating to determine risks and premium rates.

9 The analysis does not take into account the effect of income-tested benefits on effective tax rates on labour.

10 Due to lack of data by industry, no non-residential property taxes are included although a significant amount of property tax is reflected in lower real estate prices.

11 If all labour taxes are borne by employers, the marginal effective tax rate on costs would be about 41.1 percent in 2007, down from 43.0 percent in 2006.

Figure 1 *Effective Tax Rates on Cost of Doing Business by Province – A Comparison between 2006, 2007 and 2011*



Note: Assuming 30 percent of taxes on labour are borne by employers.

Source: C.D. Howe Institute and International Tax Program, University of Toronto.

Edward Island at 24.3 percent. New Brunswick is the least-taxed jurisdiction at 15.9 percent, followed by Newfoundland and Labrador at 18.2 percent.¹²

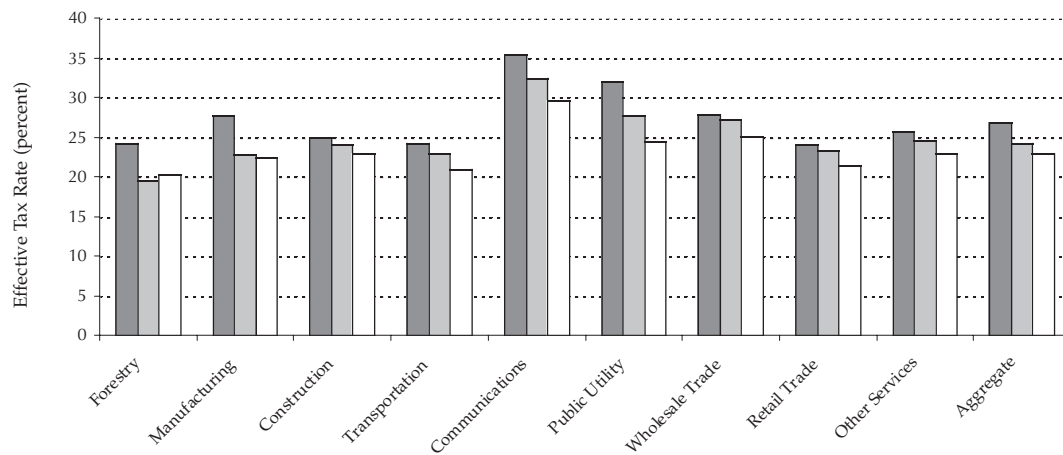
These budget changes are welcome in improving Canada's tax competitiveness, even if they are not as large as they could be. For 2007, the largest reductions are in New Brunswick (4 percentage points) followed by Saskatchewan (3.8 percentage points), reflecting not just federal but also provincial tax reductions.

Across industries (Figure 2), the 2007 effective tax rates on tax-inclusive costs vary, with forestry facing the lowest effective tax rate, at 19.6 percent, followed by manufacturing at 22.8 percent. The communications sector is the most heavily taxed sector, at 32.5 percent, followed by public utilities at 27.8. In part, these differences in effective tax rates across sectors reflect labour intensity since effective tax rates on capital have a stronger impact on costs than labour taxes (even though overall effective tax rates on labour are higher than on capital as shown in Figures 3 and 4).

By 2011, taxes on the tax-inclusive cost of doing business will have changed little from 2007 levels in most provinces (Figure 1). The largest reduction will be in Manitoba, with a 3.8 percentage point reduction to 21.4 percent (assuming that Manitoba does eliminate its capital tax), followed by Saskatchewan, with a 1.7 percentage point reduction to 21.2 percent, and Ontario, with a 1.6 percentage point reduction to 26.0 percent. Ontario will remain the highest-taxed province in 2011, and New Brunswick will remain the lowest, at 14.7 percent.

¹² If employers bear the full cost of labour taxes, Alberta would be the least-taxed province at 34.3 percent, followed by New Brunswick at 36.5 percent. Ontario would be the highest taxed no matter how much labour taxes are shifted forward as higher costs to businesses.

Figure 2 *Effective Tax Rate on Cost of Doing Business by Industry – A Comparison between 2006, 2007 and 2011*



Note: Assuming 30 percent of taxes on labour are borne by employers.

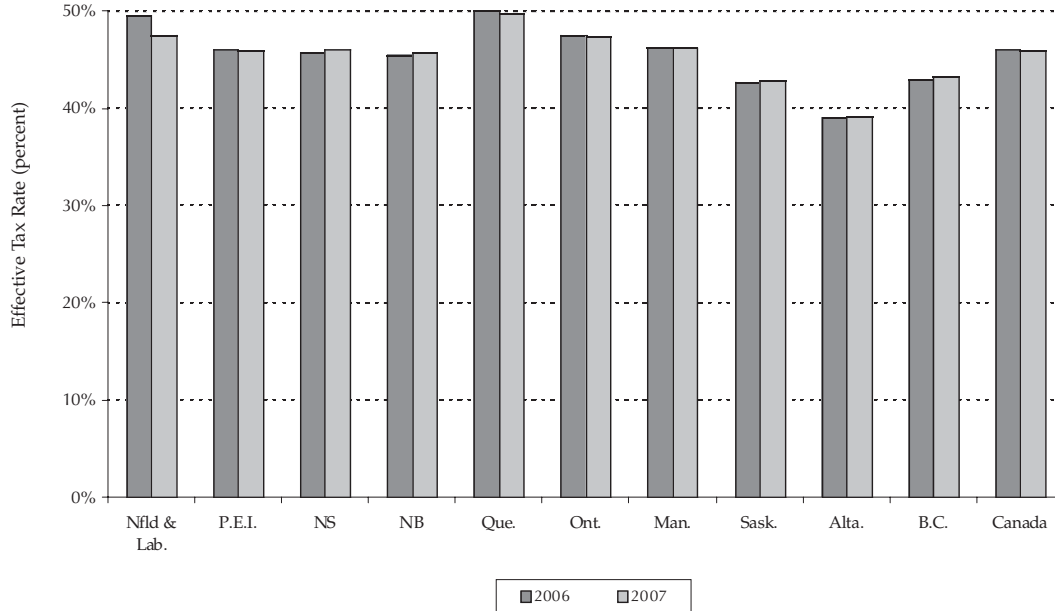
Source: C.D. Howe Institute and International Tax Program, University of Toronto.

Quebec's tax on the tax-inclusive cost of doing business does not budge as much as expected, despite the passing of the February and May 2007 budgets. Assuming that the enhanced capital tax credits in 2007 for manufacturing and forestry do eliminate overall capital tax payments, Quebec's effective tax rate by 2011 falls from 23.7 to 22.1 percent (Figure 1). However, if capital taxes are not fully eliminated by credits in these two industries, there would be little change in the effective rate on costs. Personal tax reductions will modestly reduce the tax cost of labour, but these could be offset by an increase in the effective tax rate on capital. Even with the reductions in the federal corporate rate and the welcome elimination of the provincial capital tax, the expiration of accelerated deduction for manufacturing equipment and investment capital tax credits for forestry and manufacturing will offset the relief.

Taxes on the cost of doing business in 2011 will fall from 2007 levels for most sectors except in forestry and to a limited extent in manufacturing. Although the latter two sectors benefit from federal cuts to corporate income taxes as do others, the expiration of temporary accelerated cost write-offs more than offsets the benefits from corporate income and capital tax reductions at the federal and provincial levels.

How High are Taxes on Work Effort?

Workers bear the brunt of taxation with high personal income, payroll and sales taxes. As shown in Figure 3, the Canadian effective tax rate on labour across sectors, provinces and employment incomes is 45.9 percent, down slightly from

Figure 3 *Effective Tax Rate on Labour by Province (2006 and 2007)*

Source: C.D. Howe Institute and International Tax Program, University of Toronto.

46.0 percent in 2006.¹³ Thus, a typical Canadian worker receives somewhat less than 55 percent of any additional pre-tax earnings that would be earned from extra work or bonuses.¹⁴ As economic studies have shown, the effect of such high effective tax rates on employment income is to reduce the incentive to work, especially for secondary workers in the family (de Mooij, Evers and van Vuuren 2006).

In 2007, labour effective tax rates are highest in Quebec at 49.8 percent and lowest in Alberta at about 39.2 percent (Figure 3). Newfoundland and Labrador this year introduced a set of tax reduction measures by lowering personal income tax rates and by eliminating a 9 percent surtax effective July 1, 2007, which reduces the provincial-only effective personal tax rate on labour by 2.5 percentage points, from 16.3 percent to 13.8 percent. The most significant contributors to effective tax rates on labour are federal and provincial personal taxes — about 35 percent of pre-tax income — followed by federal and provincial sales taxes — about 7 percent of pre-tax income (Tables 1 and 2).

13 Note that the effective tax rates on labour as reported in this section are the “full” rates. For effective tax rates on costs, we scale down effective tax rates on labour to reflect the assumption that 30 percent of the taxes are absorbed by employers as higher wages.

14 The marginal tax rates would be higher if we also accounted for clawback rates of income-tested benefits as discussed in Mintz (2006). However, in these calculations, we also include employer-paid payroll taxes, which have a similar impact on employment income available to workers as do employee payroll taxes.

Table 1: *Effective Tax Rates on Labour by Province – A Breakdown by Type of Taxes, 2007*

	Federal PIT only	Add provincial PIT	Add federal payroll taxes	Add provincial payroll taxes	Add GST	Add provincial sales tax
	(percent)					
Newfoundland & Labrador	21.1	34.9	38.8	40.0	43.5	47.6
Prince Edward Island	19.2	32.0	36.7	36.7	40.4	46.0
Nova Scotia	20.0	34.0	38.3	38.3	41.9	46.1
New Brunswick	20.2	34.1	38.0	38.0	41.6	45.8
Quebec	17.8	38.6	40.5	42.6	45.9	49.8
Ontario	23.0	36.4	38.8	39.9	43.4	47.4
Manitoba	20.3	33.9	37.7	38.9	42.5	46.2
Saskatchewan	20.5	32.8	36.3	36.3	40.0	42.8
Alberta	23.6	33.3	35.5	35.5	39.2	39.2
British Columbia	22.3	32.3	35.7	35.7	39.4	43.3
Aggregate	21.6	35.5	38.0	39.0	42.5	45.9

Source: C.D. Howe Institute and International Tax Program, University of Toronto.

Table 2: *Effective Tax Rates on Labour by Industry – A Breakdown by Type of Taxes, 2007*

	Federal PIT only	Add provincial PIT	Add federal payroll taxes	Add provincial payroll taxes	Add GST	Add provincial sales tax
	(percent)					
Forestry	23.8	39.5	40.6	41.7	45.1	48.4
Manufacturing	23.4	39.3	41.2	42.5	45.8	49.2
Construction	24.2	37.5	38.5	39.3	42.8	45.1
Transportation	22.2	36.6	38.3	39.5	42.9	46.2
Communications	23.9	39.5	41.7	42.8	46.1	49.4
Public utility	23.7	40.1	41.1	42.4	45.7	48.9
Wholesale Trade	22.7	36.8	39.0	40.2	43.6	46.9
Retail Trade	18.3	29.7	34.2	35.5	39.3	42.9
Other services	20.2	33.2	36.3	36.9	40.6	44.1
Aggregate	21.6	35.5	38.0	39.0	42.5	45.9

Source: C.D. Howe Institute and International Tax Program, University of Toronto.

The main reduction in personal tax rates taking place after 2007, leaving aside indexation of tax brackets,¹⁵ was introduced in the Quebec May budget; namely, personal tax relief beginning 2008. The effect of the May budget is to reduce the effective tax rate on labour in Quebec from 49.8 percent to 48.4 percent. The drop in effective tax rates is modest because Quebec is raising its personal income tax bracket thresholds. Broadening the tax brackets has only a limited impact in encouraging greater worker supply and employment since most workers would continue to face the same marginal personal tax rate on additional income received from extra labour effort even though their average tax rate (taxes as a

15 We have not included a possible federal cut to the GST rate because the tax reduction has not been legislated.

share of income) would decline. If marginal personal tax rates were cut instead, the effect on work effort would have a greater impact on competitiveness.

How Much are Taxes on Capital?

Although politicians often claim that taxes levied on capital investments fall on the rich and powerful, more evidence suggests that workers bear the brunt of corporate taxation. A recent UK paper (Arulampalam, Devereux and Maffini 2007) estimated that 54 percent of the corporate tax reduces employment income in the short run while more than 100 percent of the tax falls on employment income in the long run due to reduced worker productivity. Corporate taxes have little short-run effect on the Toronto Stock Exchange after-tax profitability earned by shareholders (Mintz 2006), thereby implying that corporate tax ultimately falls primarily on labour incomes, consistent with the UK study.

Effective tax rates on capital have been sharply declining during 2006 and 2007 across the provinces (Figure 4a) but, as remarked, primarily in the case of two industries, manufacturing and forestry (Figure 4b). By 2011, the Canada-wide effective tax rate on capital will be further reduced to 27.8 percent, with further federal corporate rate and provincial capital tax reductions, whose impact will be blunted somewhat by the expiration in temporary tax preferences. Thus, the acceleration of broad corporate tax rate reductions would have achieved a greater and more sustained reduction in effective tax rates compared to temporary credits.

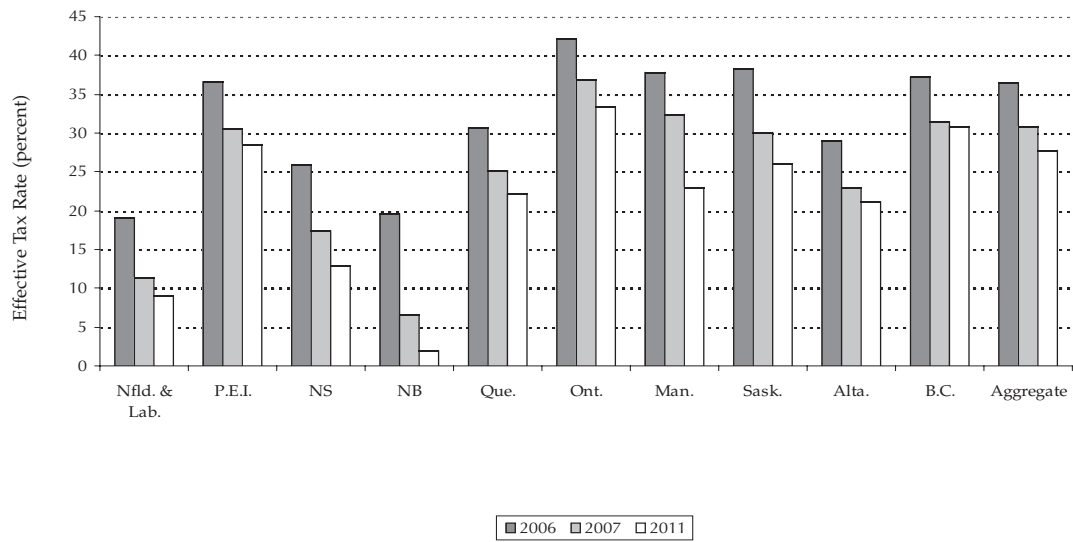
By 2011, New Brunswick will have the lowest effective tax rate on capital (2.0 percent). The province will benefit from the federal Atlantic investment tax credit for resource (including forestry) and manufacturing industries and the elimination of the provincial capital tax. Despite eliminating the capital tax by 2011, Ontario will continue to have the highest effective tax rate on capital (33.5 percent). This unfortunate distinction will be a result of a high provincial corporate income tax rate (14 percent) and high retail sales taxes on capital inputs.

Quebec's effective tax rate on capital will decrease from 25.2 to 22.3 percent during the period 2007 to 2011. The reductions in federal corporate income tax rates and the elimination of the Quebec capital tax improve competitiveness, but are partly offset by an increase in the Quebec corporate income tax rate from 9.9 percent in 2007 to 11.9 percent by 2011 and the expiration of special preferences. Quebec would have been better off to have accelerated the elimination of capital taxes and kept its corporate income tax rate closer to the Alberta rate of 10 percent, which is lowest amongst the provinces. To compensate for fiscal losses, Quebec could have scaled back or eliminated a substantial list of targeted tax measures aimed at particular business activities, small business and regional investments.

Breaking down effective tax rates into components — federal and provincial corporate income taxes, provincial sales taxes and capital taxes (Table 3) — the federal effective tax rate on capital in 2007 in the four Atlantic Provinces is negative as a result of the Atlantic investment tax credit.¹⁶ In 2007, federal

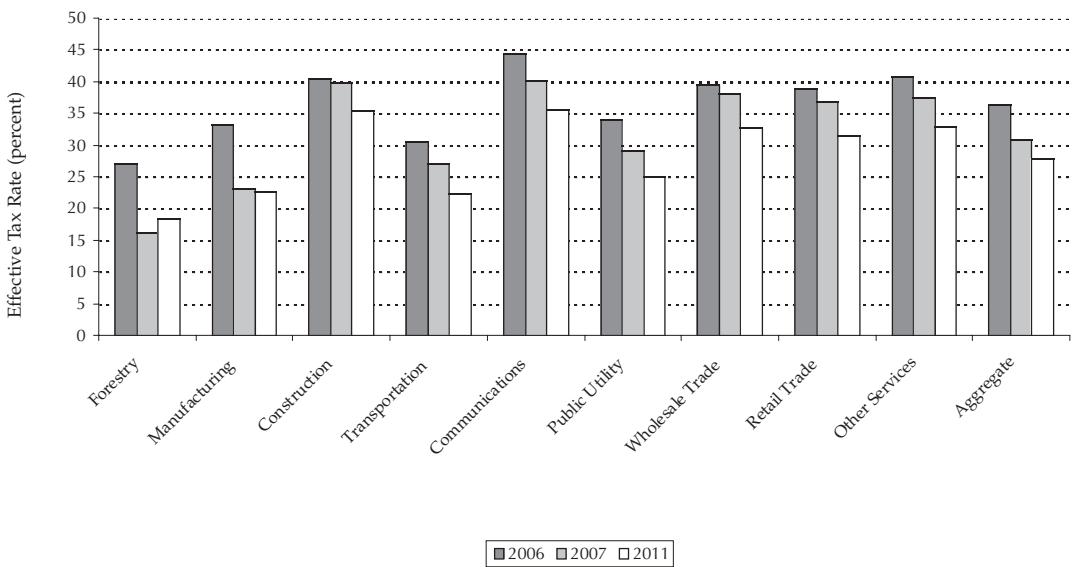
16 The underlying assumption in these calculations is that any accelerated deductions and investment tax credits are fully used to reduce taxes on infra-marginal investments, carried back to shelter past taxes, carried forward to shelter future taxes or are flowed-out to investors holding tax-shelter assets. However, when effective tax rates are highly negative, it is likely businesses ...

Figure 4a *Effective Tax Rates on Capital Investment by Province – A Comparison between 2006, 2007 and 2011*



Source: C.D. Howe Institute and International Tax Program, University of Toronto.

Figure 4b *Effective Tax Rates on Capital Investment by Industry – A Comparison between 2006, 2007 and 2011*



Source: C.D. Howe Institute and International Tax Program, University of Toronto.

Table 3: *Effective Tax Rates on Capital Investment by Province (in percent) – A Breakdown by Type of Taxes, 2007*

	Federal CIT only	Add provincial CIT	(percentage point change in parentheses)		Add provincial capital taxes	Add provincial sales taxes
Newfoundland & Labrador	-1.3	11.4	(12.7)	11.4	(0.0)	11.4 (0.0)
Prince Edward Island	-1.5	10.2	(11.7)	10.2	(0.0)	30.6 (20.3)
Nova Scotia	-4.6	13.4	(18.0)	17.5	(4.1)	17.5 (0.0)
New Brunswick	-13.6	2.2	(15.8)	6.6	(4.4)	6.6 (0.0)
Quebec	13.0	21.6	(8.6)	24.9	(3.3)	25.2 (0.3)
Ontario	13.8	24.1	(10.3)	28.1	(4.0)	37.0 (8.9)
Manitoba	13.8	15.3	(1.5)	23.4	(8.1)	32.5 (9.1)
Saskatchewan	13.5	19.1	(5.6)	21.5	(2.4)	30.2 (8.7)
Alberta	15.0	23.0	(8.0)	23.0	(0.0)	23.0 (0.0)
British Columbia	13.8	23.1	(9.2)	23.1	(0.0)	31.6 (8.6)
Aggregate	12.9	22.3	(9.4)	25.0	(2.7)	30.9 (5.8)

Note: * Quebec has increased its investment tax credit (ITC) against its capital tax for investment in Class 43 assets from 5% to 10% in general and to 15% for such assets used by forestry industry. The limitation for this ITC is the total capital tax payable. Since Class 43 assets account for 52% and 35% of capital used respectively by forestry and manufacturing industries, we assume that ITC available to these two industries is sufficient to offset all the capital taxes payable on the new capital investment. But in the case that such ITC is not sufficient to offset all the capital tax payable by these two industries, the effective tax rate on capital for Quebec would be 9 percentage points lower in 2007. Note that this ITC does not affect the effective tax rates for other industries since they virtually do not use Class 43.

Source: C.D. Howe Institute and International Tax Program, University of Toronto.

corporate income taxes also discriminate against service industries, which are taxed almost twice as highly as manufacturing and four times more than forestry (Table 4).

Capital taxes on non-financial companies will be eliminated by 2011 in all provinces (except Nova Scotia, which will do so by 2012), resulting in a reduction in effective tax rates in Manitoba (8.1 percentage points), Ontario (4.0 percentage points), New Brunswick (4.4 percentage points) and Saskatchewan (2.4 percentage points). Quebec's capital tax elimination will reduce the effective tax rate for marginal investment by 3.3 percentage points, depending upon the impact of the capital tax credits on marginal investments.¹⁷

Retail sales taxes have a considerable impact on investments in some provinces (Tables 3 and 4). If governments chose to harmonize their sales taxes with the federal GST and eliminated sales tax on capital purchases, 2007 effective tax rates

footnote 16 cont'd

.... are unable to fully use accelerated deductions and credits so that the effective tax rate on marginal investments approaches zero depending on the use of tax losses and credits to reduce taxes elsewhere.

17 However, the effective tax rate on marginal investments would increase by 6 percentage points with the elimination of Quebec's capital taxes if the capital taxes credits for manufacturing and forestry in 2007 do not fully offset capital tax payments by manufacturing and forestry.

Table 4: *Effective Tax Rates on Capital Investment by Industry (in percent) – A Breakdown by Type of Taxes, 2007*

	Federal CIT only	Add provincial CIT	<i>(percentage point change in parentheses)</i>		Add provincial capital taxes	<i>(percentage point change in parentheses)</i>		Add provincial sales taxes
Forestry	4.5	12.1	(7.6)	13.7	(1.6)	16.1	(2.4)	
Manufacturing	9.4	17.1	(7.7)	20.0	(2.9)	23.1	(3.1)	
Construction	17.3	28.4	(11.1)	31.1	(2.7)	40.0	(8.9)	
Transportation	12.1	20.5	(8.4)	23.0	(2.5)	27.1	(4.1)	
Communications	15.1	25.1	(10.0)	28.7	(3.6)	40.2	(11.5)	
Public utility	12.8	23.4	(10.6)	24.8	(1.3)	29.0	(4.2)	
Wholesale Trade	18.3	29.5	(11.2)	32.7	(3.2)	38.1	(5.4)	
Retail Trade	18.2	29.5	(11.3)	32.3	(2.8)	36.8	(4.5)	
Other services	17.0	27.5	(10.5)	30.0	(2.5)	37.4	(7.4)	
Aggregate	12.9	22.3	(9.4)	25.0	(2.7)	30.9	(5.8)	

Source: C.D. Howe Institute and International Tax Program, University of Toronto.

on capital would noticeably decline in British Columbia (8.6 percentage points), Ontario (8.9 percentage points), Manitoba (9.1 percentage points), Prince Edward Island (20.3 percentage points) and Saskatchewan (8.7 percentage points). However, if provincial sales tax revenues are kept constant, the effective tax rate on labour would rise as sales taxes are shifted from capital investment. Nonetheless, competitiveness would improve overall, given the sharp reduction in effective tax rates on capital.

What Canadians Should Conclude

This round of federal and provincial budgets provided opportunities for governments to reduce taxes, especially for the federal government, which has the fiscal room to reduce taxes the most. Even though the provinces have growing commitments to fund health, education, welfare and social services, they too have been in position to offer some tax reductions this past year. However, tax relief has been targeted rather than broad in application. Canadians should be wary of all-knowing governments resorting to these targeted measures.

Although some governments have happily continued the course of reducing personal income tax rates (Newfoundland and Labrador), corporate income tax rates (the federal government) and provincial capital taxes (Manitoba, New Brunswick, Ontario, Quebec and Saskatchewan), far greater use of these special provisions for tax relief is a harbinger of a massive erosion of tax bases, creating inefficiency, unfairness and complexity.

Canadian governments should get back to an agenda of tax reform, looking to reduce personal and corporate rates to internationally acceptable levels while keeping tax bases broad and neutral. This is the only approach that makes sense if policies are to maximize economic growth while ensuring fairness in the tax system.

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Competitiveness is a central issue for Canadian tax policy; in the absence of fair taxes, people, businesses and capital will leave the country. As well, nations with high taxes, especially on capital investments, undermine productivity by discouraging businesses from buying new equipment and structures. The C.D. Howe Institute Tax Competitiveness Program's mission is to conduct studies of the tax system to ensure that Canadians understand how tax policies can be changed to better support economic growth and job creation in Canada. The Program periodically publishes data showing how various tax rates affect people and businesses, reviews specific aspects of the tax system and identifies needed policy changes.

This Backgrounder is a publication of the Tax Competitiveness Program. A unique source of independent, authoritative research on tax policy, the Program is led by Jack M. Mintz, one of Canada's foremost tax policy experts, a Fellow-in-Residence at the C.D. Howe Institute and Professor of Business Economics at the Joseph L. Rotman School of Management, University of Toronto. He works with Finn Poschmann, the Institute's Director of Research, and Duanjie Chen, George Weston Tax Analyst at the Institute. The Program also publishes research by prominent scholars from academia, associations and the private and public sectors. For more information, call: 416-865-1904, or visit www.cdhowe.org.

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