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Federal Corporate Tax Cuts Would Lift Canada's Standard of Living

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Recent negotiations between Prime Minister Paul Martin and New Democrat Leader Jack Layton over changes to the federal government's business tax proposals point up the critical importance of business taxes in general. Overall, taxation of businesses reduces their incentive to invest in capital and restricts their ability to expand and innovate, making it harder to hire new workers or pay existing ones higher salaries. Provisions in the 2005/2006 federal budget to cut corporate taxes by 2010, along with further reductions set out in earlier budgets, will stimulate $56 billion in capital investments by Canadian businesses. Those investments will boost Canada's gross domestic product (GDP) by $5 billion annually and create 340,000 jobs at little fiscal cost to Canadian governments.

Meanwhile, the additional jobs and incomes that the reductions produce for Canadians by creating a more internationally competitive corporate sector will more than offset any small direct revenue loss to the government. In an open economy such as Canada's, corporate taxes are not absorbed by large businesses; they get passed on in the form of higher consumer prices or lower real wages paid to Canadians. That process makes corporate taxes regressive, often hurting lower-income Canadians the most. As well, unlike such tax incentives as accelerated depreciation, statutory corporate income tax rate reductions actually help governments because multinational businesses will shift income into Canada and pay more taxes in this country.

The proposed federal budget will reduce the federal statutory corporate income tax rate by two points, to 19 percent from 21 percent, and eliminate the federal corporate surtax of 1.12 percent of profits by 2010. As a result, the federal-provincial statutory corporate income tax rate will decline to 32 percent from 35 percent, roughly matching reductions in U.S. corporate rates for selected industries. The planned budget measures will also double capital cost allowances for pipeline and electrical transmission and fulfil a 2003 pledge to eliminate the large corporations levy on taxable capital by 2008.

In this e-brief, one of the *Tax Competitiveness Program* publications, we provide our estimates by industry for effective corporate tax rates on capital for 2005 and 2010. The effective corporate tax rate is the amount paid as a percentage of the pre-tax rate of return on capital that is needed to cover not only taxes but also the cost of attracting financing from owners of shares and bonds in the corporation. The

Table 1: *Effective Corporate Tax Rates by Industry for Medium and Large Corporations in Canada and the United States 2005 and Planned in 2010*

	2005		2010	
	Canada	U.S.	Canada	U.S.
	percent			
Forestry	28.0	21.5	23.8	20.6
Mining	7.9	14.8	3.5	14.7
Oil and gas	6.3	16.8	5.1	16.3
Manufacturing	28.6	25.9	24.5	24.9
Construction	33.2	24.4	29.2	23.3
Transportation and storage	30.2	24.3	26.0	24.3
Communications	27.8	15.6	23.5	15.6
Electrical Power, Gas & Water	23.3	13.8	18.7	13.6
Wholesale Trade	37.2	27.1	33.7	27.1
Retail Trade	40.0	30.4	36.4	30.4
Other Services	33.5	27.1	29.7	27.1
Aggregate	28.8	24.1	25.0	23.6

analysis includes federal and provincial corporate income taxes, capital taxes, and sales taxes on capital inputs.

As we reported in an e-brief in January, Canada's effective corporate tax rate on capital investments in 2004 was the third highest among 20 representative industrial countries, with only Germany and China having higher ones. (Germany recently announced it will reduce its federal corporate income tax rate to 17 percent from 25 percent). In this e-brief, we report Canadian effective tax rates by industry, including non-renewable resource companies, and compare them to the levies on similar industries in the United States (Table 1).

Although the federal government plans to phase in the cuts over a relatively long period, at least Ottawa is on the right track towards making Canada's corporate sector more internationally competitive. The aggregate effective corporate tax rate on capital will decline to 25.0 percent by 2010 from 28.8 percent in 2005. The U.S. effective tax rate on capital will decline to 23.6 percent from 24.1 percent. By 2010, Canada will be closer to competitiveness with the United States, although the President's Panel on Tax Reform will issue recommendations this year that could lead to dramatic changes in the U.S. tax system within two years.

By industry, Canada's 2005 business tax regime is uncompetitive relative to the United States for all but the non-renewable resource sector. By 2010, that competitive disadvantage will be significantly reduced, although construction and service industries will remain more highly taxed than similar U.S. industries. Effective tax rates for marginal investments in the non-renewable resource industries — treating royalties as an expense paid to governments that own the resource — are especially low. That is primarily because of the importance of exploration and development expenditures that account for 45 percent of mining investments and 70 percent of oil and gas investments. Exploration costs are expensed and development expenditures are written off at a 30-percent rate.

Mining businesses also claim a 10-percent mineral exploration credit and accelerated depreciation for capital investments.

Business tax burdens thus vary sharply across industries, with the highest rates on wholesale trade and the lowest on non-renewable resource industries. Such differences generally result in a misallocation of capital across business activities, harming the economy because the tax system discourages investment in some profitable industries more than others. In some cases, non-neutral tax treatment — as with research and development and exploration — may be economically beneficial because companies under-invest in capital when they cannot fully capture the returns that others earn by their discoveries. In general, however, non-neutral taxation of business activities should be a focus for business tax reform by making sure that companies are similarly treated.

The reduction in corporate income tax rates will help reduce the incentive for companies to shift income to low tax-rate jurisdictions from Canada. Recent studies on multinationals' shifting of income from high- to low-tax jurisdictions indicate that a percentage point reduction in corporate income tax rates results in an expansion in the corporate tax base by at least 4 percent (Grubert and Slemrod 1998, Jog and Tang 2001, Mintz and Smart 2004).

By helping reverse income-shifting, the federal corporate tax cuts will cause little overall loss of revenue. The reduction in federal-provincial corporate income tax rates to 31.88 percent from 35 percent (about 9-percent reduction in rates — 3.12 percent divided by 35 percent) will be fully offset by an expansion in the corporate tax base of 12 percent.

While the federal government in its early and 2005 budgets is doing its bit to improve competitiveness, the provinces have been too timid to address Canada's lagging investment climate through business tax reform. The only one to make any significant changes in a recent budget is Quebec; beginning in 2006, it is phasing in an increase in the provincial corporate tax rate to 11.9 percent from 8.9 percent and reducing in its capital tax rate by a half. Ontario is yet to be heard from.

The 2005 federal budget, providing further corporate tax cuts, is the right approach to improving Canada's investment climate. With significant economic benefits that pay for themselves, corporate tax rate cuts are a slam-dunk in public-policy terms.

References

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