C.D. Howe Institute
Institut C.D. Howe
e-brief

How To Become Seductive: Make Canada More Investment-Friendly

By Duanjie Chen and Jack M. Mintz

January 19, 2005

Federal and provincial finance ministers need a wake-up call during this budget season. They have to make Canada a far more attractive location for investment capital. As it stands, Canada's business investment taxes are the third highest in the world, using a representative selection of 20 industrialized and large developing countries. That is a potentially self-destructive status. Because of the importance of business capital investment for productivity improvement, technological advancement and the country's standard of living, it is urgent that federal and provincial governments put together a new action plan to improve Canada's business tax competitiveness.

Many analysts define tax competitiveness using only one element of the business tax system — the statutory income tax rate that applies to corporate income. That approach can lead to an illusionary result that, more often than not, creates complacency among the nation's governments. In fact, the taxes that businesses actually pay depend on the rules that define income, such as depreciation and inventory cost deductions, as well as many other taxes directly related to capital investment. A better measure of the overall business-tax structure is the marginal effective tax rate (METR) for investments. The METR is the amount of corporate income and other capital-related taxes as a percentage of pre-tax profits for marginal investments — investments that earn a rate of return on capital that is just sufficient to attract savings from international markets. The METR calculation takes account, for example, of the lower income taxes payable in countries that allow higher depreciation charges than other jurisdictions, even if the statutory rate is the same or higher. As well, a low statutory tax rate can produce a high effective tax rate if the definition of taxable income permits few deductions. A summary of the 2004 tax provisions is available upon request.

Canada's METR on capital investments in the manufacturing and services industries was 31.3 percent in 2004, the third highest among the 20 countries examined (Table 1). Specific disadvantages in Canada include:

- The sixth highest general corporate income tax rate, surpassed only by Japan, the United States, Germany, Italy and France;
- Less advantageous cost deductions for inventory and depreciation expenses compared to others, and
- Capital taxes and provincial sales taxes on capital purchases

Table 1: *Marginal Effective Tax Rates on Capital Investments by Country, 2004 by Percent*

	General Corporate Income Tax Rate	Marginal Effective Tax Rate		
		Manufacturing	Services	Average
China	24.0	42.9	32.5	37.7
Germany	38.4	32.8	32.6	32.7
Canada	34.9	28.8	33.8	31.3
Japan	41.9	27.6	32.1	29.8
Brazil	34.0	27.0	31.4	29.2
France	35.4	28.1	27.6	27.8
Italy	37.3	24.4	27.6	26.0
US	39.5	22.0	23.9	23.0
India	35.9	22.9	22.0	22.5
Finland	29.0	18.6	21.2	19.9
Netherlands	34.5	16.3	22.0	19.2
UK	30.0	18.2	19.2	18.7
Australia	30.0	16.5	19.2	17.8
Russia	22.0	25.2	10.0	17.6
Denmark	30.0	16.8	16.2	16.5
Mexico	33.0	12.3	13.2	12.8
Ireland	12.5	11.7	11.4	11.5
Sweden	28.0	9.8	12.6	11.2
Singapore	22.0	3.9	11.3	7.6
Hong Kong	16.0	3.2	8.2	5.7

Only China and Germany have higher effective tax rates than Canada. China has the highest METR at 37.7 percent — though it has a relatively low income tax rate because machinery and equipment purchases are subject to a non-refundable value-added tax (VAT), unlike the typical practice in other countries. When a VAT exemption is provided — as is sometimes permitted — the effective tax rate on capital investments in China falls to 15 percent. The second highest effective tax rate on capital investment is in Germany — 32.7 percent. Germany's tax disadvantages include high federal and municipal corporate income tax rates and an inadequate deduction for inventory costs that does not account for the impact of inflation on valuations.

The four lowest effective tax rates on capital investments are Ireland (11.5 percent), Sweden (11.2 percent), Singapore (7.6 percent) and Hong Kong (5.7 percent). A combination of relatively low corporate income tax rates, fast write-offs for capital depreciation and the absence of significant other capital-related taxes are the primary reasons for the relatively low rates in these countries. In the period 1997-to-2001, these four countries and Belgium-Luxembourg were the five top destinations of foreign direct investment, measured as a share of their gross domestic product (GDP) (Mintz 2004).

Within North America, Canadian businesses are at a significant disadvantage. In the U.S. the METR is 23 percent (including state and local level corporate income and franchise taxes). In Mexico, it is 12.8 percent.

In future, additional business tax cuts are forecast for most countries. Canada will eliminate its federal capital tax by 2008, reducing the effective tax rate to 29 percent. Finland is cutting its corporate income tax by three percentage points, lowering its effective rate to 17.5 percent. India is proposing to adopt a 30-percent corporate income tax and lower depreciation deductions, reducing the effective tax rate to 21 percent.

The Netherlands is lowering the corporate income tax rate to 30 percent from 34.5 percent by 2007, resulting in an effective rate of 16.5 percent. At the same time, the United States, by cancelling its bonus depreciation to be softened by a 3 percentage point corporate rate cut for selected industries will actually raise the effective rate on capital to 25.3 percent from 23 percent, though it will be still be well below Canada's effective tax rate in 2008. Still, with President Bush pledging tax reform in the next two years, it is difficult to predict where the United States may end up.

Federal and provincial governments should be alarmed by these findings. Typical Canadian workers had some $1,600 less in gross investment in new structures and equipment than their U.S. counterparts in 2003, and $650 less than the average OECD worker (Robson and Goldfarb 2004).

To improve Canada's position, federal and provincial governments should pursue a strategy that would include:

- Acceleration of capital tax reductions and removal of provincial sales taxes on capital and other business inputs which would be especially important to those businesses that might be experiencing financial difficulty because of the stronger dollar; eventual reduction in the statutory corporate income tax rate to at least the OECD average of 30 percent;
- Increased capital and inventory capital cost allowances to reflect better the true cost of replacing assets, and
- Reduction in ineffective targeted tax preferences and industrial subsidies that result in governments choosing specific industries for support rather than taking a more general approach to improve business performance.

Without these changes to Canada's business tax structure, the country will become increasingly less attractive to business investments. The cost of the existing system will be a high one for Canadian workers, indeed for all Canadians, if the country eventually becomes an international investment wallflower.

References

Robson, William B. P. and Danielle Goldfarb. 2004. *Tools for Workers: How Canada is Faring in the Competition for Capital Investment*, C. D. Howe Institute Backgrounder No. 87, December.

Mintz, Jack M. 2004. "Conduit Entities: Implications of Indirect Tax-Efficient Financing Structures for Real Investment", *International Tax and Public Finance*, 11(4), 419-434.

This e-brief is a publication of the C.D. Howe Institute's Tax Competitiveness Program. A unique source of independent, authoritative research on tax policy, the centre is led by Jack M. Mintz, President and CEO of the C.D. Howe Institute and Deloitte & Touche LLP Professor of Taxation at the Joseph L. Rotman School of Management, in collaboration with Finn Poschmann, the Institute's Associate Director of Research, and Duanjie Chen, George Weston Tax Analyst at the Institute. For more information, call: 416-865-1904, or visit www.cdhowe.org.