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e-brief

Business Tax Reform: More Progress Needed

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In the past 10 years, federal, provincial and territorial governments have adopted several policies to reform business taxation in Canada. Their 2006 budgets have continued in the direction of improving business tax competitiveness, with the most significant rate reductions at the federal level and in the provinces of New Brunswick and Saskatchewan. Such steps are laudable: We can expect a much-needed increase in business investment in coming years as a result. Overall, Canada's investment in capital stock — non-residential structures and machinery — will be boosted within five years by $45 billion, due to the 2006 changes. There could be a further boost of $90 billion if governments fully implement proposed tax reductions by 2010.[1] Given Canada's poor productivity performance and low capital investment rates, these policy changes are welcome indeed, as they will improve Canadians' standard of living.

Base-broadening measures that would contribute to a more neutral and efficient business tax regime have been slow to come at both federal and provincial-territorial levels. Quebec has become the most egregious case by re-introducing many targeted regional and industrial credits of questionable effectiveness. Other provinces, such as Ontario, have also been generally using targeted preferences and subsidies rather than looking at broad-based relief.

This *e-brief* documents the historical evolution of business tax policies in Canada since 1997, showing that some good progress has been made at the federal level. Meanwhile, some provinces and territories, especially Ontario, have shown little interest in improving business tax competitiveness. While federal tax cuts boost investment in the provinces, action is required by them as well. Those provinces that have shifted tax structures from investment to other revenue sources

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[1] Estimate is based on capital stock invested in machinery and non-residential structures with the assumption that a 10 percent cut in the pre-tax cost of capital boosts capital stock by 7 percent within five years.

will achieve better labour productivity and growth rates, as seen in Alberta, British Columbia and New Brunswick. Given Ontario's size and importance to the Canadian economy, the province's lack of focus on tax competitiveness is of particular concern. It significantly impacts on other parts of Canada.

Critical 2006 Federal and Provincial Business Tax Changes

Ottawa's 2006 budget confirmed the corporate tax reductions in the fall 2005 mini-budget. The general federal corporate income tax rate will be reduced from 21 percent to 19 percent by 2010. The federal corporate tax surtax will be eliminated in 2008 and the large corporations tax is to be fully phased out as of January 1, 2006.

Saskatchewan changed most business taxes this year. It will be reducing the general corporate income tax rate from 17 percent to 12 percent by 2008, with an initial 3 percentage-point cut in 2006. It is also eliminating its capital tax by 2008. New Brunswick is cutting its corporate income tax rate by a point to 12 percent in 2007 and its capital tax will be fully phased out by 2008, beginning with a cut this year. It also introduced a special credit against property taxes for investments by forest companies in manufacturing machinery.

Other provincial changes were more modest:

- Alberta reduced its general corporate income tax rate from 11.5 percent to 10 percent, effective April 1, 2006.
- Manitoba is reducing its general corporate income tax rate by 1.5 points to 13 percent by 2008 and its capital tax from 0.5 to 0.4 percent beginning in 2008, as fiscal conditions allow.
- Ontario will begin cutting its capital tax in 2007, and fully phase it out by 2012.
- Quebec is introducing a one-year, 5 percent investment tax credit against capital taxes for manufacturing machinery. As well, it will continue to adjust corporate income and capital taxes according to the schedule announced last year until the corporate income tax rate reaches 11.9 percent and the capital tax is halved to 0.29 percent by 2009. It has reversed the 2004 philosophy of curtailing targeted incentives by introducing new, very targeted credits for regional and certain industrial sectors.
- The Northwest Territories is cutting its corporate income tax rate from 14 percent to 11.5 percent in 2006.

Once these changes are taken into account, Ontario will be left with the highest effective federal-provincial corporate tax rate on capital for non-resource industries[2] as of 2006 (Table 1). At 42.2 percent. Ontario's rate is also the highest among 36 industrialized economies excluding China (Mintz et al. 2005). Ontario has one of the highest corporate income tax rates among the provinces, an onerous

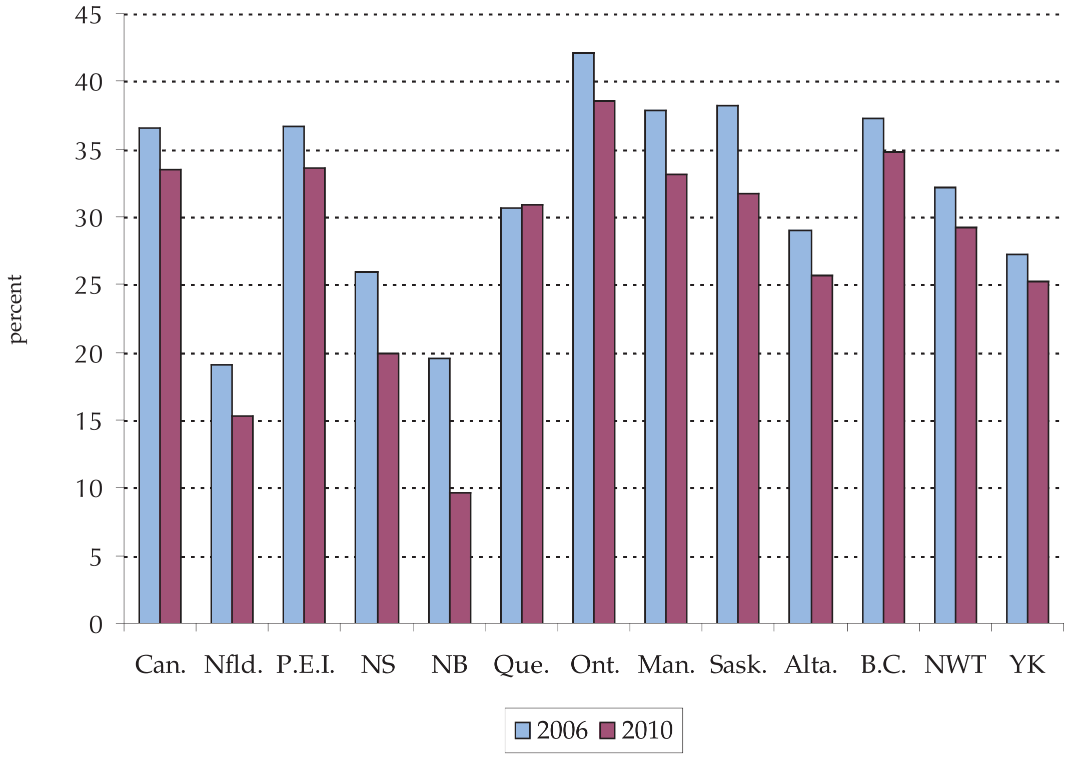
[2] The analysis below relies on our measurement of effective tax rates on investments made by medium- and large-size businesses facing the most global competition for their products and financial capital. For example, if a business earns a 10 percent pre-tax rate of return on capital and a 6 percent post-tax rate of return on capital, implying that taxes eat up 4 percentage points of the return on capital, the effective tax rate is calculated as 40 percent. The effective tax rate takes into account federal and provincial/territorial corporate income, capital- and sales-tax ...

Table 1: *Effective Federal and Provincial Corporate Tax Rate on Capital by Province/Territory and Industry, 2006*

	Forestry	Manufacturing	Construction	Transportation and Storage	Communications	Electrical Power, Gas & Water	Wholesale Trade	Retail Trade	Other Services	Aggregate
					Percent					
Canada	27.0	33.1	40.6	30.6	44.6	34.0	39.5	38.9	40.7	36.6
Newfoundland	-25.5	2.8	19.5	24.8	31.1	12.1	31.0	32.6	31.9	19.2
Prince Edward Island	-47.3	2.3	41.8	34.0	53.4	29.0	45.0	43.5	54.0	36.7
Nova Scotia	3.6	13.0	26.4	31.5	37.6	20.8	37.1	37.6	37.2	26.0
New Brunswick	-1.6	12.9	23.0	29.2	34.9	16.8	34.4	34.9	34.4	19.6
Quebec	24.1	27.8	35.8	29.1	35.4	34.6	35.5	35.3	35.6	30.8
Ontario	35.5	37.3	46.0	36.5	50.4	41.5	43.1	42.5	46.7	42.2
Manitoba	14.1	18.0	46.8	37.8	49.7	43.4	45.1	44.0	47.2	37.9
Saskatchewan	28.4	31.6	44.8	35.3	48.9	41.1	43.3	42.2	48.0	38.3
Alberta	26.2	31.6	27.3	23.3	29.5	29.2	28.9	29.5	30.1	29.0
British Columbia	31.4	34.3	40.9	31.0	45.8	37.1	38.1	37.4	40.9	37.3
Northwest Territories	NA	36.7	28.3	24.0	30.4	30.3	29.9	30.6	30.6	32.3
Yukon	NA	22.4	29.9	25.7	31.2	30.5	30.8	32.5	32.8	27.3

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

Figure 1: *Effective Federal and Provincial Corporate Tax Rate on Capital in Non-Resource Industries by Province and Territory, 2006 and 2010*



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

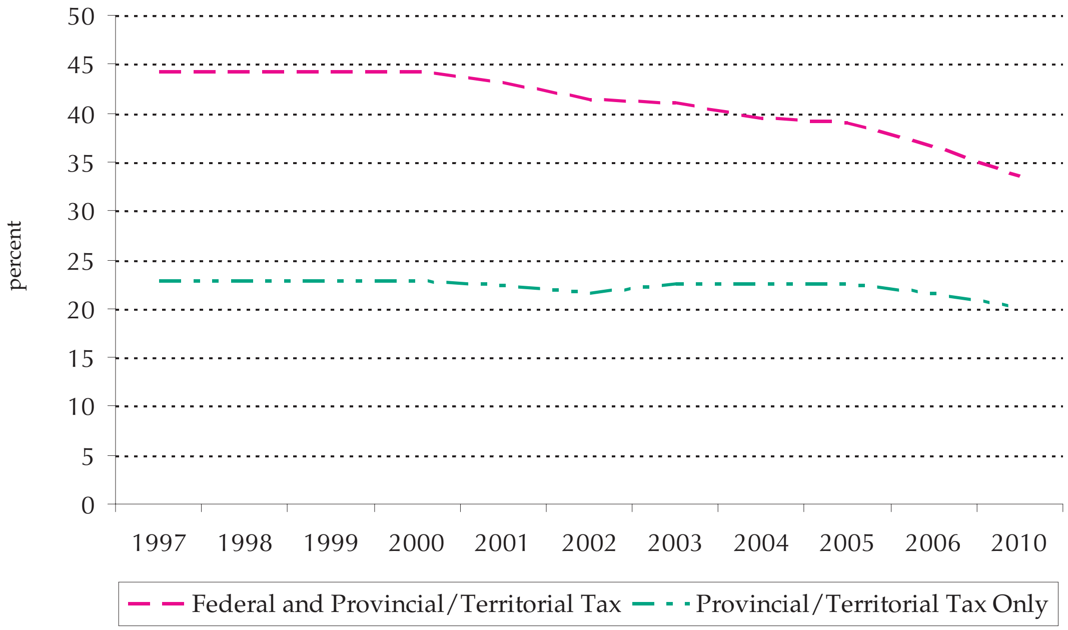
capital tax and high retail-sales tax on capital purchases. Given Ontario's lacklustre investment in business capital machinery and non-residential structures — at 9 percent of GDP compared to 11.3 percent on average for Canada in 2005 — the uncompetitive tax regime for businesses in Ontario must be a serious concern. It impacts not only Ontario's residents but the rest of Canada, given the province's size and importance. The picture is brighter by 2010 (Figure 1), with Ontario's effective tax rate dropping to 38.6 percent due to federal corporate tax changes and the promised Ontario capital tax cuts; however, the province will continue to have a relatively burdensome business tax regime compared to most jurisdictions in the world.

The lowest effective tax rate on capital for non-resource companies will be in New Brunswick by 2010, at 9.7 percent. This "Irish-type" business taxation is a

footnote 2 cont'd

policies as they affect business investments, adjusted for depreciation allowances, inventory cost deductions, investment tax credits and other provisions that impact on the amount of tax paid. The effective tax rate on capital is measured by calculating the annualized value of taxes paid as a proportion of the profits earned on an investment that earns a sufficient return on capital to attract financing from its owners. The data are based on capital stock, economic depreciation rates, effective sales-tax rates on capital, investment tax credits as provided by Finance Canada. We have also defined the forest sector broadly to include forest production, pulp and paper and wood-product sectors.

Figure 2: *Effective Corporate Tax Rate on Capital in Canada, 1997 to 2006 and 2010*



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

result of the absence of sales taxes on capital inputs (with the adoption of the HST in 1998), the federal Atlantic investment tax credit for qualifying capital goods, which benefits forest and manufacturing sectors, and the elimination of the capital tax.

The federal government and several provinces are also cutting the corporate income tax rate on small businesses. This policy can encourage investment by small businesses but in the end has a perverse result in penalizing their growth, as companies that expand their profitability and size lose the benefits of preferential tax and regulatory regimes. Federal and provincial authorities need to examine more carefully the widening gap between small business tax rates and those applied to companies with more than $15 million in capital.

What Has Happened in the Past Decade?

Although Canada has one of the highest effective tax rates on capital in the world as of 2005, considerable progress has been made toward improving Canada's tax competitiveness since 1997. In other words, uncompetitive tax policies could have been a lot worse if no action was taken.

Most of the action in improving competitiveness has been due to federal policies adopted since 2000, when the Government of Canada cut corporate income tax rates, increased some capital-cost allowances and phased out the federal capital tax on non-financial businesses. Up to 2006, some provinces, particularly British Columbia and Alberta, have also cut corporate income tax and capital-tax rates substantially. (Figure 2) compares combined federal and provincial/territorial rates with provincial/territorial-only effective tax rates on capital on non-resource companies for the 1997–2006 period and for the year 2010. The combined federal-provincial/territorial effective tax rate has dropped from 44.3 percent in 1997 to 36.6 percent by 2006, about 8 points in the past 10 years. It will drop further to 33.5 percent by 2010 if the federal and provincial proposals are eventually adopted. However, on the whole, provincial/territorial-only effective tax rates on capital have fallen much less, from 22.9 percent in 1997 to 21.1 percent in 2006. The provincial/territorial effective tax rate will decline further to 20.5 percent by 2010.

The federal government, through its corporate income tax reductions and capital tax phase-out, has done more of the heavy lifting to cut business taxes compared to the provinces and territories. Most glaring is the scant progress that Ontario has achieved in making itself a more competitive economy. Ontario's provincial-only effective tax rate, the highest of all provinces and territories, has declined by only one point in the past 10 years, from 29.2 percent to 28.2 percent. That is the smallest reduction among all provinces. The greatest reductions in effective tax rates from 1997 to 2006 have been in British Columbia (from 27.6 to 21.2 percent) Alberta (by 14.1 to 8.9 percent) and New Brunswick (from 20.9 to 16.3 percent).

Need for More Action in Canada's Largest Province

Ontario is exceptional — in a bad sense, unfortunately — with the most burdensome business taxes in Canada. The federal government has been doing its bit to make Canada more tax competitive, although it still needs to address a number of base issues such as the tax treatment of depreciation and inventory cost deductions. As well, it needs to consider further cuts to income tax rates for large- and medium-sized corporations. However, unless Ontario, the province that accounts for over 40 percent of Canada's GDP, begins to reform its business taxes, it will make it difficult for Canada to be viewed as a favourable place to do business. If Ontario wishes to address its uncompetitive position, it needs to consider: phasing out its capital tax more rapidly (2012 is far too long to wait); reforming its sales tax by adopting a VAT; and reducing more dramatically its corporate income tax rate, which is high by international standards.

The challenge is not formidable. As the federal government and other provinces have demonstrated, a more competitive business tax regime can be achieved by concrete steps that encourage a more dynamic economy — the signal is important.

References

Mintz, Jack M., with Dunajie Chen, Yvan Guillemette and Finn Poschmann 2005, *The 2005 Tax Competitiveness Report: Unleashing the Canadian Tiger*, C. D. Howe Commentry 216, C. D. Howe Institute, Toronto.

Note: Specific effective tax rates by industry, year and province are available at www.cdhowe.org/pdf/e-brief_31_SI.pdf.

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.