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# Corporate Tax Changes, 2004: Federal and Provincial Governments Part Ways — Canadians Pay a Price

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*October 6, 2004*

Canada's tax levels on business investments are declining, primarily as a result of federal initiatives. The trend augurs well because it means that Canada is improving its investment competitiveness in North America. However, the federal tax reductions have been blunted by tax increases in Nova Scotia, Ontario and Saskatchewan, with the latter two provinces, along with Manitoba, becoming relatively high tax regimes in North America. Only in Alberta and British Columbia has investment as a share of GDP increased since 1999, as both provinces cut corporate taxes the most.

The federal government completed the final stage of corporate income tax cuts in 2004 — a two-point reduction in rates to 22.12 percent, including the corporate surtax, finally removing the differential between manufacturing and processing and other business income. The federal government has passed legislation that will reduce corporate income tax rates on resource companies to 22.12 percent by 2007. Ottawa also began to reduce the large corporations tax in 2004. It will disappear entirely by 2008. As well, in the interest of improving productivity, the federal government raised the capital cost allowance for computers to 45 percent from 30 percent and for broadband to 30 percent from 20 percent.

Several provinces, for the first time in five years, parted ways with Ottawa's plan to improve business tax competitiveness. Although Alberta lowered its corporate income tax rate to 11.5 percent from 12.5 percent in 2004, three provinces increased taxes on business investment directly or indirectly.

- Ontario increased the general corporate income tax rate to 14 percent from 12.5 percent and the manufacturing and resource income tax rate to 12 percent from 11 percent. Ontario will continue to apply differential rates on manufacturing, resource and other business income, unlike the federal government and most provinces that realize that such practices result in complexity and tax avoidance.
- Saskatchewan increased the retail sales tax rate to 7 percent from 6 percent, which also affects businesses because they must pay the tax on many business components.

- Nova Scotia increased its capital tax rate to 0.30 percent from 0.25 percent, the first provincial increase in capital taxes in the past several years.

The impact of both federal and provincial 2004 budget changes is provided in the attached table. We calculate the effective tax rate on investments for medium and large-sized companies, defined as the amount of federal and provincial corporate income, capital and sales taxes on investments as a percentage of profits sufficient to attract equity and bond finance from Canadian and international markets. One new change we have incorporated in this update is a revision in Finance Canada's estimated economic depreciation for computers to 41.2 percent from 27.5 percent.

Canada's effective tax rate on capital investments has declined to 31.7 percent in 2004 from 33.1 percent in 2003. Alberta showed the largest reduction — almost 3 percentage points to 24.2 percent, as a result of both federal and provincial cuts. By contrast, Ontario had the smallest reduction in the effective tax rate as a result of provincial increases in corporate tax rates.

In 2004, the highest effective tax rate on business investments will be in Saskatchewan (37.2 percent), followed by Manitoba (35.3 percent), and Ontario (32.8 percent). In contrast, the effective tax rate on investments is 25.8 percent in the United States after the 50 percent bonus depreciation was discontinued in September 2004.

Effective tax rates range widely by type of capital and industry, distorting business decision-making and creating an uneven playing field among industries. Inventory and machinery investments are most highly taxed at 37.3 percent and 34.8 percent, respectively, while structures and land investments are taxed least at 24 percent and 20.3 percent.

Among the provinces, Alberta and British Columbia have cut corporate taxes the most. Alberta reduced its general corporate income tax rate by 4 percentage points to the current 11.5 percent from 15.5 percent in 2000, eliminated capital taxes on financial institutions and removed property taxes from machinery investments. British Columbia reduced the corporate tax rate since 2000 by three percentage points to 13.5 percent, eliminated capital taxes on non-financial businesses and reduced sales taxes on capital components. Both provinces have had an increase in investment in machinery and non-residential structures relative to GDP, while all other provinces experienced a reduction.

The good news for all industries is that effective tax rates on capital investments are expected to sustain their declines. With the elimination of the federal large corporations tax by 2008 and a committed small reduction in Manitoba's corporate tax rate, Canada's effective tax rate will decline by almost 2 percentage points to 28.9 percent by 2008. Canada, however, will still have a higher effective tax rate on business investments than the United States. Provincial capital taxes and retail sales taxes on capital components, as well as less favourable write offs for depreciation and inventory costs more than offset the advantage Canada provides with a lower general corporate income tax rate than that of the United States. At the same time, both U.S. presidential candidates pledged tax reforms that could lead to cuts in corporate tax rates on domestic investments in 2005.

Federal and provincial governments must co-ordinate their actions in future to ensure that Canada's business tax system encourages companies to locate and create jobs in Canada. Otherwise, the policies instituted by the federal government can be continually compromised by provincial tax increases that undermine the country's ability to compete internationally.

**Table 1** *Effective Tax Rates on Capital Investment for Medium-and Large-Sized Companies*

| | 2003 | 2004 | 2008 |
|---|---|---|---|
| | | *percent* | |
| Newfoundland | 22.5 | 20.1 | 16.1 |
| Prince Edward Island | 28.3 | 26.1 | 22.7 |
| Nova Scotia | 29.6 | 27.9 | 24.7 |
| New Brunswick | 25.8 | 23.8 | 20.4 |
| Quebec | 31.7 | 30.2 | 27.5 |
| Ontario | 33.6 | 32.8 | 30.0 |
| Manitoba | 37.6 | 35.3 | 32.4 |
| Saskatchewan | 38.8 | 37.2 | 34.7 |
| Alberta | 27.3 | 24.2 | 20.7 |
| British Columbia | 31.1 | 29.0 | 26.0 |
| Structures | 25.0 | 24.0 | 20.8 |
| Machinery | 37.1 | 34.8 | 32.2 |
| Inventories | 38.1 | 37.3 | 34.7 |
| Land | 21.2 | 20.3 | 17.6 |
| Aggregate | 33.1 | 31.7 | 28.9 |

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