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The 2004 Business Tax Outlook: Lowering Business Taxes Would Spur Investment

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Some politicians like to paint business tax cuts as an either-or proposition. Reducing taxes, they say, would rule out increased spending on urban transit and other public programs. This argument is wrong-headed. If business taxes result in a lower standard of living, Canadians won't have the income needed to spend on private or public goods.

A competitive business tax structure is critical to Canada's prospects for prosperity. In the upcoming budget cycle, federal and provincial governments must acknowledge that Canada's tax system is non-competitive and will undermine prospects for economic growth in the future. Governments have to act swiftly to reform business taxes to a greater extent than has been accomplished in the past four years.

Business capital investment is critical to improving Canada's standard of living. Greater investment — often in the best technology available — lowers costs and spurs innovation. Businesses are then able to hire more workers and pay higher salaries.

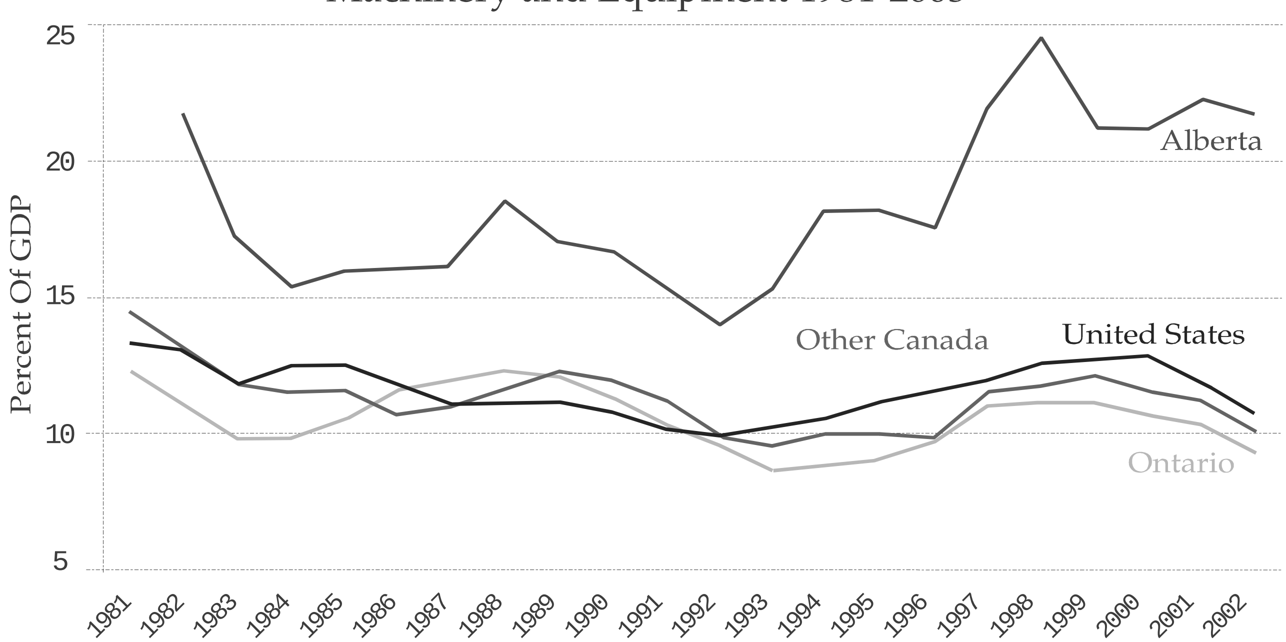
Canada's business investment has been falling steadily relative to GDP 1 for 20 years (Figure). Outside of Alberta, business investment in Ontario and other parts of Canada as a share of GDP is less than that of the United States.

Figure 1: Effective Corporate Tax Rates on Capital for Large Corporations: 2004 and 2008 (in percentages)

	Canada 2003	Canada 2004	United States 2004	Canada 2008	United States 2008
Forestry	30.1	28.7	17.6	25.7	22.5
Manufacturing	28.4	28.8	21.3	25.2	25.1
Construction	34.9	33.8	23.2	30.8	25.3
Transport	31.9	30.5	14.8	26.6	20.9
Communications	28.8	28.3	5.4	23.9	14.1
Electrical Power	25.7	24.3	2.3	19.2	13.4
Whole Trade	38.3	37.2	24.1	34.5	26.2
Retail Trade	40.2	39.7	24.2	37.0	27.4
Other Services	34.2	33.3	23.8	30.2	25.8
Structures	24.2	24.1	16.3	20.2	19.0
Machinery	34.4	34.2	24.9	30.8	32.2
Inventory	38.1	37.3	18.7	34.3	18.7
Land	21.2	20.3	18.3	17.2	18.3
Aggregate	31.8	31.5	20.1	28.0	24.0

Source: International Tax Program, Institute of International Business, University of Toronto

Private Investment in Non-Residential Structures, Machinery and Equipment 1981-2003



Sources: Statistics Canada and U.S. Bureau of Economic Analysis (BEA)

Taxes levied on capital investments — corporate income, capital and sales taxes on capital purchases — significantly affect investment. Several studies, after taking into account the size of the market, interest rates, labour costs and infrastructure, generally find that a one-percentage point drop in the corporate tax rate increases a country's capital stock by between a half percent and two percentage points. A recent study showed that a one-percentage point reduction in the effective tax rate on capital would increase foreign direct investment by 3.3 percent.[1]

In this e-brief, we provide the latest analysis of effective tax rates on capital for large corporations in Canada in comparison to the United States by industry. In our analysis, we do not include resource companies and research and infrastructure subsidies.

Canada's business taxes have fallen slightly to 31.5 percent on average from 31.8 percent since 2003 due to cuts in the federal tax rate on non-manufacturing income by 2 percentage points and capital taxes by 0.025 percent of taxable capital. However, manufacturing effective tax rates have increased slightly to 28.8 percent from 28.4 percent as a result of Ontario's corporate tax hikes.

Canada's effective tax rate on capital of 31.5 percent in 2004 is substantially higher than that in the United States, where it is 20.1 percent. Canada's average federal-provincial statutory corporate income tax rate, after the latest Ontario increase, is 35 percent, below the U.S. rate of 39.5 percent.[2] However, the Canadian advantage relative to the U.S. with respect to the corporate income tax rate is more than fully offset by other tax disadvantages in Canada: (i) Lower depreciation allowances are provided in the U.S., which offers a 50-percent bonus depreciation for shorter-lived assets; (ii) The U.S. provides higher inventory cost deductions; (iii) Canada has higher capital taxes, and (iv) Canadian provinces have somewhat higher sales taxes on capital inputs than U.S. states.

Figure 2 shows the provinces with the highest and lowest effective tax rates on capital.

1 De Mooij, Ruud A. and Sjef Ederveen. 2003. "Taxation and Foreign Direct Investment: A Synthesis of Empirical Research", *International Tax and Public Finance*, 10(6), 673-694.

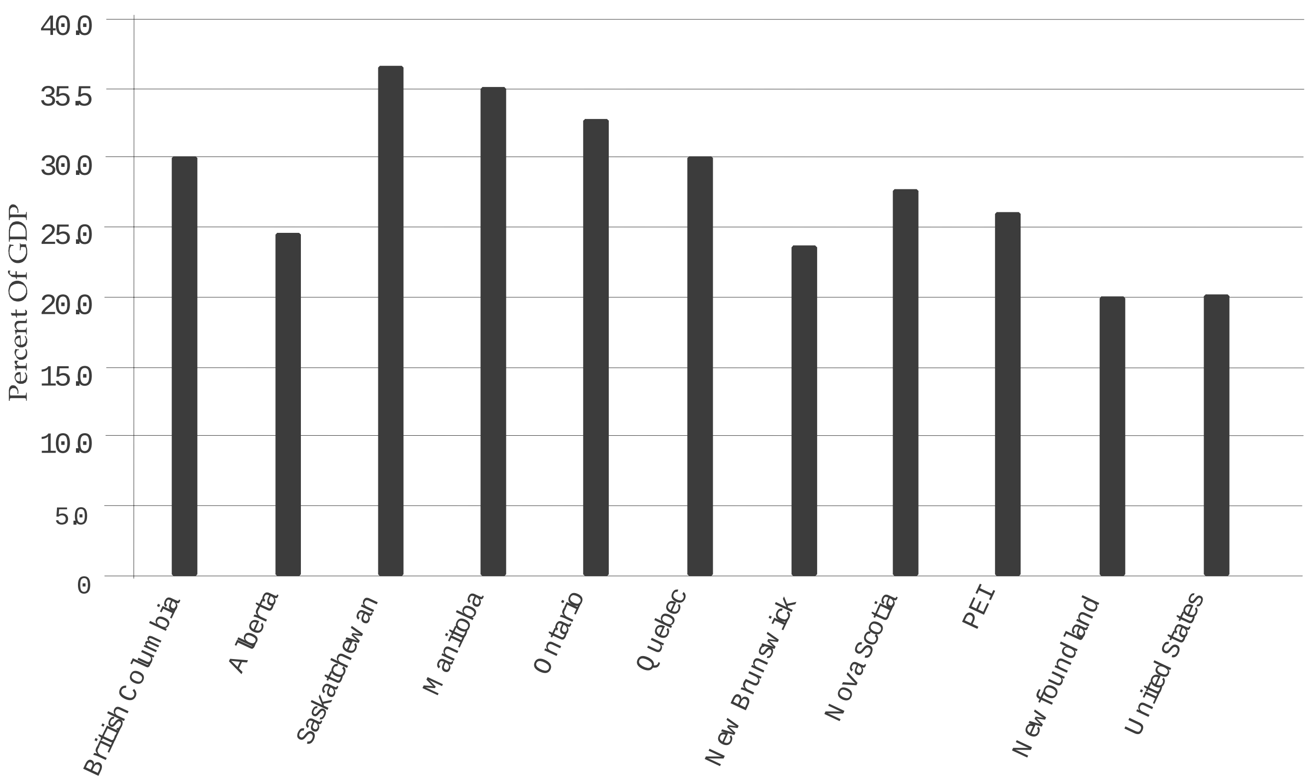
2 Canada's general corporate income tax of 35 percent is four points higher than the average OECD rate. Only three OECD countries — Germany, Japan and the United States — had a higher corporate income tax rate than Canada in 2003.

Figure 2: Effective Corporate Tax Rates on Capital for Large Corporations: All Provinces 2004

	British Columbia	Alberta	Saskatchewan	Manitoba	Ontario	Quebec	New Brunswick	Nova Scotia	Prince Edward Island	Newfoundland
Forestry	28.6	23.6	36.8	35.4	32.7	29.3	27.9	29.4	31.3	24.5
Manufacturing	26.7	23.5	26.3	27.0	29.6	29.7	17.7	19.6	14.0	5.8
Construction	32.0	27.5	36.5	38.3	35.7	32.1	25.3	27.3	28.4	18.3
Transport	29.1	22.6	36.5	35.5	33.2	28.3	26.8	28.2	32.3	23.5
Communications	25.2	21.4	33.4	31.9	29.2	26.9	25.6	26.9	27.7	22.4
Electrical Power	23.8	20.7	32.0	30.5	27.8	26.1	24.7	25.9	26.1	21.6
Wholesale Trade	35.0	29.8	40.4	41.2	38.4	34.4	32.3	34.2	32.7	26.2
Retail Trade	37.7	31.0	44.3	43.4	41.3	35.1	34.6	36.5	40.9	31.9
Other Services	31.1	25.7	38.1	37.1	34.7	30.4	29.5	31.1	34.0	26.7
Structures	21.6	20.8	27.7	28.7	25.2	26.2	21.6	23.0	18.7	16.6
Machinery	32.5	21.9	32.5	30.7	36.2	28.4	14.5	16.3	25.2	6.1
Inventory	35.0	33.7	41.7	42.0	38.1	38.0	37.9	39.9	34.6	31.5
Land	17.8	17.6	24.9	23.8	20.9	21.8	20.7	21.6	18.6	17.1
Aggregate	30.1	24.6	36.6	35.1	32.7	30.1	23.6	27.6	26.1	19.9

Source: International Tax Program, Institute of International Business, University of Toronto.

Provincial Aggregate Effective Tax Rates
in Comparison with the United States, 2004



In the large corporate sector, the most highly taxed areas are wholesale trade (37.2 percent) and retail trade (39.7 percent), followed by construction (33.8 percent). The lowest-taxed sector is forestry.

The federal government is eliminating by schedule the federal capital tax by 2008. Alberta is committed to lowering its corporate tax rate to 8 percent, although no scheduled reduction has been put in place. As announced in the recent Bush budget proposals, the United States will discontinue bonus depreciation after 2005. Overall, Canada's effective tax rate on capital will fall by more than 3 percentage points, while the U.S. comparable rate will rise by almost 4 percentage points. By 2008, however, Canada's effective tax rate on capital will be four points higher than that of the U.S., assuming no other changes take place in tax policies in either country.

We estimate that Canada's capital stock will increase by $22 billion if the effective tax rate falls by one percentage point.[3] Seen in that light, the planned federal and Alberta tax reductions will result in an increase in capital invested by businesses in production by close to $90 billion by 2008.

The effect of reducing corporate taxes will be to make Canada more competitive. However, even with planned changes and the cancellation of bonus depreciation in the United States, Canada's effective tax rate will remain above that of the U.S. for most industries. Of course, a lot can happen in four years and it is probable that the U.S. will undertake business tax reform as it moves to replace its special incentives for manufacturing exports that have been successfully challenged as contrary to free trade by the World Trade Organization.

3 Canada's business capital stock is $1.1 trillion. Excluding the small-business sector, the capital stock is estimated to be $785 billion held by large corporations. Assuming that a one-percentage point drop in the effective tax rate increases capital held by one percentage point, we estimate that a reduction in the effective tax rate would increase the business capital stock by $26 billion. If the capital stock held increases 3.3 percentage points with each point reduction in the effective tax rate, the estimate would climb to $85 billion.