C.D. Howe Institute
Institut C.D. Howe

Backgrounder

March 23, 2000

The February 2000 Federal Budget's Business Tax Measures: Is Canada Missing the Boat?

by

Jack M. Mintz

The February 28, 2000, federal budget makes significant progress toward providing, for the first time, a comprehensive five-year plan for expenditure programs, debt reduction, and tax cuts. As part of the plan, the budget begins the reform of business taxes with several recommendations taken from the report of the 1998 Technical Committee on Business Taxation. The most important of these is to reduce the general federal corporate income tax from 28 percent to 21 percent over five years, but with only a 1 percentage point reduction legislated over the next two years. Although the measures will make Canada's business tax system more competitive with that of the United States, the extent and pace of reform is inadequate. Canada is only now catching up to trends in other countries, yet Ottawa still plans to take five years to remove some of the worst features of the business tax system. And even then, the system will remain a barrier to economic growth and job creation in Canada. More important, Canada is forgoing a great opportunity: rather than simply trying to match US corporate tax rates, Canada should aim to create a distinctive Canadian advantage for businesses to locate here to serve the North American market, while providing sufficient funds to ensure that public services are provided to Canadians. This means that Canada should adopt its own unique tax policies that generate better jobs and higher incomes for Canadians.

The February 28, 2000, federal budget provides, for the first time, a comprehensive, multi-year approach to expenditure plans, debt reduction, and tax cuts. The budget enacts some changes now; others are to be put in place by fiscal year 2004/05. Much to the surprise of many analysts, the budget incorporates a number of measures for business tax reform even though, at the time of the November 1999 Economic and Fiscal Update, the minister of finance indicated that corporate tax measures would only

I wish to thank Duanjie Chen for her assistance in developing the statistics provided in the text. Bill Robson provided very helpful comments.

follow tax cuts for low- and middle-income taxpayers.

As I pointed out in an earlier *Backgrounder* (Mintz 1999), Canada must move ahead with business tax reform. Many countries, among them Australia, Denmark, Finland, Germany, Ireland, Italy, and Sweden, have already undertaken significant tax reforms in recognition of the rapid increase in the global integration of economies. Corporate income tax rates have been substantially lowered — the average rate in countries of the Organisation for Economic Co-operation and Development (OECD) is about 34 percent — and ineffective tax incentives have been curtailed.

The world economy is changing quickly. Business inputs have become much more mobile and therefore more sensitive to differences in public services and taxes across countries. Income can easily be shifted from high- to low-tax-rate jurisdictions through transfer pricing and financial transactions. With the growth of electronic technologies that allow for purchases over the Internet, even the once "nontradable" distribution sectors of the economy are increasingly subject to international competition. Most countries have realized that business tax systems must be reformed. Even with the changes introduced in the 2000 budget, however, Canada is merely catching up to world trends.

Growth: Canada's Foremost Economic Problem

For Canada, tax reform is urgent. Canadians' standard of living has fallen behind that of Americans, with the result that entrepreneurs and businesses that need skilled labor are finding it increasingly easier to locate in the United States and serve Canadian markets from that country. The United States provides a much larger market for products, a greater pool of capital to finance business investment, and a more heterogeneous skilled labor market. Moreover, Canada faces the danger of falling even further behind. Already, personal incomes in Canada are more than $10,000 per capita less than those in the United States, and the emigration of highly skilled workers to the United States has picked up in recent years in response to such wage differentials.

More important, despite this country's "low-wage" environment, Canada has not attracted sizable new foreign direct investment as its share of North American foreign direct investment has fallen. And the jobs that are being created in Canada, including those in the growing high-technology sector, tend to be lower-wage production jobs rather than high-wage managerial and scientific jobs (Schwanen forthcoming). Given the diverging economic growth experience of Canada and United States in recent years, the Canadian economy must not only grow, but grow faster than the US economy, over the next decade to close the gap and reduce the incentive for businesses to move south.

The Role of the Federal Budget

The 2000 federal budget offers an opportunity to move ahead to generate the level of economic growth that Canada needs. As Fortin (1999) suggests, the key to economic growth is to improve not just the skills of Canadian workers but also the availability of jobs with good incomes. Education and innovation are important, but insufficient in themselves to attract businesses to this country. Instead, Canadians must create the "winning" conditions that will entice businesses to locate their production here and employ Canadian workers. A smart tax system, one that includes competitive business taxes, can help provide those conditions.

As other countries have recently found, business tax systems must follow two important principles:

- *Business taxes should be more competitive*. This does not imply a "race to the bottom": there will always be some country that exempts certain businesses from taxation altogether. What it does mean is that taxes on businesses should not be out of proportion to the value of public services that are provided.
- *The business tax system should be neutral*. Governments should not be in the business of picking winners and losers through selective tax cuts that are often wasteful and ineffective. Rather, they should levy taxes at rates that are as low as possible on broad tax bases so that businesses face similar tax burdens and a less complex tax system. Entrepreneurs are quite capable of choosing among the most profitable investments in today's global environment without direction from government.

Business taxes have a substantial impact on economic growth and productivity in terms of foregone revenue (Whalley 1997). Estimates show that, if Canada were to adopt a more neutral business tax structure, annual incomes could be increased through efficiency gains and less complexity by up to 20 percent of corporate income tax revenues, or $6 billion per year (Canada 1998, chap. 3). This would be equivalent to an increase of $200 per year in per capita income. And a modest 2 percentage point cut in the effective tax rate on capital could increase per capita income by $300 per year.[1] Combined, the two changes — a small reduction in the effective tax rate and a more neutral tax system — could result in a $500 per capita increase in income, or $2,000 for a family of four.

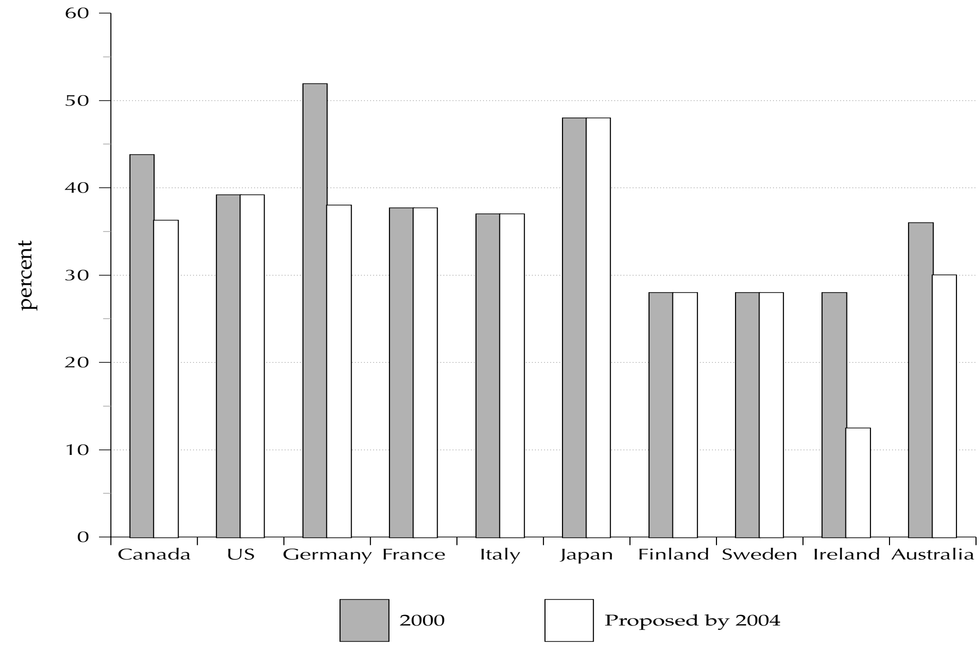
The February 2000 budget contains a number of reforms to Canada's business tax system — including several taken from the report of the Technical Committee on Business Taxation — that were either implemented immediately or are due to be phased in over the next five years:

- The general federal corporate income tax rate will be reduced from 28 percent to 21 percent by 2004 (the lower rate is already applied to income from manufacturing and processing); the rate reduction will not, however, apply to income from nonrenewable resources[2] or investment. The only change to be legislated so far is a 1 point reduction in the corporate income tax rate, effective January 1, 2001.
- The tax rate on earned income in the range of $200,000–$300,000 by Canadian-controlled private corporations will be reduced from 28 percent to 21 percent, effective January 1, 2001.
- Depreciation (capital cost allowance) deductions for rail assets will be increased from 10 percent to 15 percent, and those for qualifying utility equipment will be increased from 4 percent to 8 percent. Manufacturing equipment that depreciates at a rate faster than allowed for can be written off as a loss more quickly.
- Capital gains tax rates will be lower as a result of both the budget's reduction of personal tax rates (from 26 percent to 23 percent for middle-income earners and the eventual elimination of the surtax on high-income earners) and its reduction of the income inclusion rate for capital gains from three-quarters to two-thirds.

1 This calculation assumes an average effective tax rate on capital for large and small firms of 20 percent (Canada 1998, chap. 3) and an after-tax rate of return on capital of 5 percent. The increase in per capita income depends on how much new capital businesses employ. The elasticity of capital demand with respect to changes in its cost is taken to be 0.5, a fairly conservative parameter given recent empirical studies.

2 A resource allowance in lieu of deductions for royalty payments reduces the tax rate on resource profits from 28 to 21 percent. The resource allowance is based on income gross of deductions for interest and exploration and development expenses. However, the allowance should not viewed as a reduction in rates similar to the general rate reduction, because resource companies must still pay resource royalties to the provinces, and because income under the allowance is structured differently from corporate taxable income.

Figure 1: ***General Corporate Income Tax Rates, Selected OECD Countries, 2000 and Proposed by 2004***



Note: Italy also levies a 4.25 percent origin-based tax on value added earned by corporations.

- Taxation of up to $100,000 of income earned per year from the exercise of stock options held in public corporations will be deferred.

The budget also includes a number of technical changes related to international transactions (such as thin-capitalization rules affecting interest deductions on indebtedness owed to foreign parents) and the interaction of federal and provincial research and development (R&D) tax preferences.

International Competitiveness

Given the sizable gains that can come from improving Canada's business tax structure, how does the budget's five-year reform plan stack up? In particular, how far do the reforms go in making Canada's business tax system internationally competitive?

As shown in Figure 1, Canada's general corporate income tax rate would decline from more than 43 percent to 36 percent by 2004 (resource income will continue to be taxed at the same rate). This is slightly below the prevailing US and German rates, but still well above those in Australia, Ireland, Sweden, or the United Kingdom. Indeed, even after the proposed reforms are implemented, Canada's corporate rate will remain higher than the OECD average (34 percent). Thus, although the reforms would reduce somewhat the incentive companies have to shift income from Canada to jurisdictions with lower tax rates, it is disappointing to note that in five years' time Canada's corporate income tax rates will remain among the highest in the world even if other countries do not reduce their rates still further.

It is not just the level of statutory tax rates that affects investment, however; other aspects of the tax system, such as deductions for capital costs, tax credits, and other taxes (such as federal and provincial capital taxes) are also relevant. For example, as shown in Figures 2 and 3, the effective tax rate on capital for services — including transportation, communica-

Figure 2: ***Effective Tax Rates on Capital in Manufacturing Sectors, Selected OECD Countries, 1996 and 2000, and Proposed by 2001 and 2004***

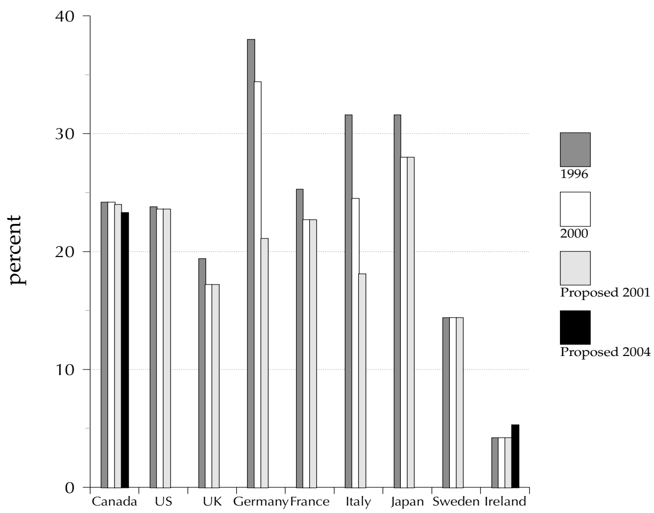
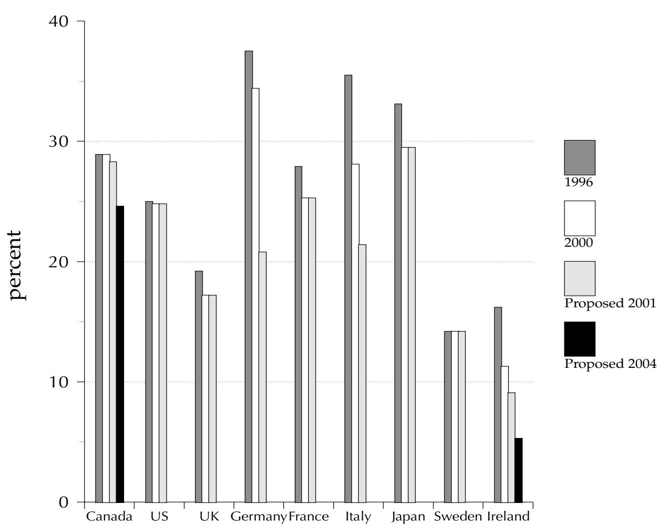


Figure 3: ***Effective Tax Rates on Capital in Services Sectors, Selected OECD Countries, 1996 and 2000, and Proposed by 2001 and 2004***



Notes:

To single out the tax impact, interest rates and inflation were assumed to be 6.8 and 1.4 percent, respectively, across countries and periods.

The German marginal effective tax rate for 2001 reflects the federal corporate income tax reduction from the current 40 percent to 25 percent, beginning in January 2001. The municipal trade tax (16.66 percent on average and the solidarity surcharge (5.5 percent) will still apply.

The general corporate income tax rate for Ireland was 32 percent in 1996, 24 percent in 2000, and will be 20 percent in 2001. A lower rate of 10 percent is applicable for manufacturing and international services. The ccorporate income tax rate will be 12.5 percent on all income by 2003.

tions, utilities, trade, and other services — will decline from 28.9 percent to 24.6 percent, yet the rate will remain virtually unchanged for manufacturing income. Even in five years' time and in the absence of further reforms in other countries, Canada's services industries will still be more highly taxed than those of Ireland, Germany, Sweden, or the United Kingdom. Canada's manufacturing industries, too, will remain more highly taxed than those in many other countries — although US and Canadian effective tax rates will be almost the same by 2004, assuming no changes in US rates. Further, the proposed adjustments to capital gains taxes by 2004 do not go nearly far enough toward encouraging entrepreneurship. Much more could be done, as Tom Wilson and I have outlined (see Mintz and Wilson 2000).

In sum, the fact that Canada's tax system will remain relatively uncompetitive compared with that of the United States over the next five years is of concern. Given the United States' significant economic advantages, Canadian businesses will continue to be lured both south and abroad.

Toward a More Neutral Business Tax Structure?

The February 2000 federal budget reduces the disparity in effective tax rates on capital among industries, but a number of other disparities remain.

First, corporate statutory rates will continue to vary by industry and business activity. Canada, in common with such tax jurisdictions as Guyana and Egypt, levies taxes at multiple corporate income tax rates based on the type of income earned by the business. The budget proposes to eliminate the distinction between manufacturing and other forms of business income — a move in the right direction in that it makes little sense to draw boundaries around different sources of income in a world where companies operate many lines of activity at the same time. Distinctions will remain, however, at both the federal and provincial levels in the amount of tax levied on, for example, resource versus other income and investment versus active business income.[3]

Second, although the budget introduces some modest changes that broaden the tax base — such as the tax treatment of inbound investment and provincial incentives for R&D — a large number of preferences remain for capital investments. These include the Atlantic investment tax credit, accelerated depreciation, and far too easy access to tax benefits available for investments in foreign affiliates by Canadian-based companies. While some measures, such as R&D tax credits, are economically appropriate (since innovators cannot fully appropriate the returns on investments captured by other businesses), many special preferences are of limited use and serve only to erode the tax base. To the extent that such incentives are ineffective, it would be better simply to reduce corporate tax rates.

Third, as noted above, the federal budget fails to reduce corporate income tax rates for resource companies, the rationale being that, since the resources sector benefits from other tax preferences (including the resource allowance), it should not also enjoy the benefits of a lower tax rate. The issue is, however, highly complex. The resource allowance was introduced in place of letting resources taxes be deductible in order to reduce the impact of sharp increases in provincial royalties on federal corporate income tax revenues that were deductible prior to 1974. The Technical Committee on Business Taxation recommended not only restructuring the resource allowance but also imposing a much lower corporate income tax rate on resource companies as well as other companies. In effect, the Committee recommended low corporate income tax rates with a broader tax base. Instead, the budget maintains a higher corporate income tax rate with a narrow tax base. Given that such tax policy makes little sense in an environment of highly mobile capital income and a secular trend in declining resources prices, it seems appropriate to revisit the issue of deductibility of resource royalties. If such royalties were fully deductible, all business income could be taxed at the same rate, resulting in the simplest and most neutral system. Ottawa and the provinces would need to negotiate these issues after consultations with the industries that are affected by them.

Reforming the Tax Cut Agenda

The business tax reforms introduced in the February 2000 federal budget — should they be fully implemented by 2004 as planned — are clearly a move in the right direction. But the reforms are neither significant enough nor are they to be implemented quickly enough to make Canada's business tax system truly competitive with the systems in many other industrialized countries or to create significantly better conditions for investment in Canada. It is encouraging that Ottawa is willing to reduce business taxes by $3 billion over the next five years, but even after that time the general corporate income tax rate, including provincial rates, will remain higher than the OECD average, and the system will continue to harbor a number of unfortunate disparities. Canadians ultimately will benefit from the proposed changes, but the country is missing an important opportunity to achieve much greater benefits by reducing business tax rates still further and by making the business tax system even simpler and more neutral.

3 In its recent budget, Quebec followed the lead of some other provinces in introducing corporate income tax holidays for new enterprises (a favorite tax incentive in many Third World countries). These incentives create an uneven playing field for businesses that varies according to when they enter the jurisdiction. The revenue cost of tax holidays is high, however, and their impact on investments in durable assets is small (Shah 1995).

The world economy is undergoing rapid change, and Canada is falling behind other countries that are improving their tax systems to encourage investment in their jurisdictions. At the cost of a bit more than $3 billion in federal revenue, Canada's corporate income tax rates could fall below a highly competitive 30 percent — similar to the rates in Scandinavian countries. Ottawa should now consider improving on the thrust of the February budget by undertaking a more significant tax reform, which should include substantial rate reductions coupled with base changes that would help to pay for the rate reductions.

More generally, both the federal and provincial governments should be rethinking their approach to tax policy. Canada could have a much better tax system, one that is globally competitive. A reformed tax system would improve economic growth, increase Canadians' incomes, and, ultimately, increase government tax revenue. And that would make it easier to pay for the public services Canadians value so highly.

References

Canada. 1998. Technical Committee on Business Taxation. *Report*. Ottawa: Department of Finance.

Fortin, Pierre. 1999. *The Canadian Standard of Living: Is There a Way Up?* Benefactors Lecture, 1999. Toronto: C.D. Howe Institute.

Mintz, Jack M. 1999. "Why Canada Must Undertake Business Tax Reform Soon." *Backgrounder*, November 4.

———, and Thomas A. Wilson. 2000. "Capitalizing on Cuts to Capital Gains Taxes." *C.D. Howe Institute Commentary* 137. February.

Schwanen, Daniel. Forthcoming. "Putting the Brain Drain in Context." *C.D. Howe Institute Commentary*.

Shah, Anwar, ed. 1995. *Fiscal Incentives for Investment and Innovation* Oxford, UK: Oxford University Press for the World Bank.

Whalley, John. 1997. "Efficiency Considerations in Business Tax Reform." Technical Committee on Business Taxation Working Paper 97-8. Ottawa: Department of Finance.

Backgrounder © is an occasional publication of the C.D. Howe Institute. Its purpose is to comment briefly on policy issues of immediate concern to Canadians.

As with all C.D. Howe Institute publications, the views expressed here are those of the author and do not necessarily reflect the opinions of the Institute's members or Board of Directors. Jack M. Mintz, the author of this issue, is President and Chief Executive Officer of the C.D. Howe Institute and Arthur Andersen Professor of Taxation at the Joseph L. Rotman School of Management, University of Toronto.

Copies of *Backgrounder* are available free of charge from the C.D. Howe Institute: 125 Adelaide Street East, Toronto, Ontario M5C 1L7 (tel.: 416-865-1904; fax: 416-865-1866; e-mail: cdhowe@cdhowe.org; internet: www.cdhowe.org).