

Intelligence MEMOS



From: Kevin Milligan
To: Bill Morneau, Minister of Finance
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Re: **OTTAWA'S CORPORATE TAXATION OPPORTUNITY**

The US Congress finally passed the [Tax Cut and Jobs Act](#) (TCJA), the first major US tax reform in more than 30 years. The February 27 [Canadian federal budget](#) provides an opportunity to set new goals for Canadian tax policy.

How should Canada respond to the US tax changes? In this Intelligence Memo I make the case for a response to the corporate tax changes in the TCJA, and also set a clear path forward.

Most media coverage of the US corporate tax changes focused on the rate cut—a substantial 14-point reduction to a new rate of 21 percent. When considered with corporate income taxes levied by the states, the combined statutory rate in the US is now [roughly comparable](#) to the combined provincial-federal rate in Canada. The substantial corporate tax rate advantage we have enjoyed for nearly 20 years is now gone.

Need we respond? The case for Canada to just ignore the TCJA is worth considering. Canada has many other investment advantages, ranging from a more flexible and welcoming immigration system to a skilled workforce to world-spanning trade agreements from [Europe](#) to the [Pacific](#). Moreover, the sustainability of the US tax cuts is open to question—the US budget deficit is now projected to [reach 5.6 percent of GDP by 2019](#). It is easy to imagine a future US Congress ratcheting tax rates back up to shrink the deficit or to fund new spending priorities.

However, the TCJA also included a fundamental change to the tax structure which may have more long-run durability. The TCJA allows for some [full expensing of capital investment](#), meaning that investments can be deducted from taxable income immediately rather than strung out over several years following a mandated depreciation schedule. This major change, when combined with restrictions on interest expense deductions, is transformative to the corporate tax because it moves the base of taxation away from the traditional focus on corporate income to a much better system. Let's take a moment to explore why.

Consider first a world without taxes. Firms line up their potential investment projects from highest return to lowest, and then undertake projects starting at the top of the list until arriving at the project that just breaks even. This marginal investment project defines the desirable and efficient level of corporate investment—the present value of benefits exactly equals the costs.

Now we can see if the same efficient level of investment is achievable in a world with corporate taxes. For the marginal investment project, the net present value of future income exactly equals the expenditure outlay, so an immediate deduction exactly offsets the tax on all future income generated by the project. This completely relieves the normal return to investment from taxation. We still get tax revenue on any above-normal returns, but we also enjoy the social benefit of efficient investment decisions.

Beyond efficient investment incentives, moving to full expensing also brings two additional advantages. First, it simplifies the tax system by getting rid of complex depreciation schedules—no more need to worry about which asset class has what rate of depreciation. Second, because interest deductions are limited, equity and debt financing are placed on an even footing rather than the current system's distortionary bias toward debt financing.

Full expensing should have appeal across the political spectrum as it focuses our fiscal efforts directly where we want them—facilitating productive investment in the future capacity of our economy. If a firm doesn't invest, there's no benefit. In contrast, simply cutting corporate tax rates wastes our fiscal efforts by rewarding past investments and above-normal returns. This explains why economists such as [Jason Furman](#)—who served in the Obama White House—support corporate tax reforms that feature full expensing.

The enactment of the TCJA in the United States provides an opportunity for Canada to also recalibrate its approach to corporate taxation. Ottawa should seize this opportunity by taking steps toward implementing full expensing of corporate investment.

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