THE CANADIAN CHAMBER OF COMMERCE
LA CHAMBRE DE COMMERCE DU CANADA

Business Tax Relief Is Crucial to Canada's Economic Success

Policy Brief
Economic Policy Series – February 2011

Introduction

As a national, nonpartisan organization, the Canadian Chamber of Commerce works with governments of all political stripes to foster sound economic and social policies that aim to improve Canada's international competitiveness and Canadians' standard of living.

To preserve our economic future, the Canadian Chamber believes it is important to return to budget balance over the medium term. Left unchecked, deficits drive up interest rates and drain national savings. They reduce our flexibility to respond to unexpected circumstances and our capacity to meet the challenges of an aging population.

The actions we take to eliminate deficits can strengthen the economy or weaken it. We have to get it right.

The Canadian Chamber believes the federal government should rein in spending and improve the effectiveness and efficiency of government programs to ensure Canadians receive value for their money. The Canadian Chamber recognizes that across-the-board slashing of government programs without underlying structural reforms will generate little in the way of sustained savings. "The federal Program Review of the mid-1990s resulted in significant short-term savings, but once these savings were secured and surpluses emerged, the machinery was abandoned. Close scrutiny of spending must be an ongoing process."[1]

The Canadian Chamber is committed to fostering a strong, competitive and profitable economic environment that benefits all Canadians. This paper is one of a series of independent research reports covering key public policy issues facing Canada today.

We hope this analysis will raise public understanding and help decision-makers make informed choices. The papers are not designed to recommend specific policy solutions, but to stimulate public discussion and debate about the nation's challenges.

Increasing taxes on Canadian families and businesses is the wrong way to eliminate deficits. In a highly integrated global economy, the tax base is constantly on the move. Skilled workers, businesses, jobs and capital move easily across national borders, seeking the best economic opportunities. They are drawn to low-cost, low-tax environments.

The Canadian Chamber finds it particularly troubling that some politicians are proposing both higher business taxes (by scrapping and even reversing legislated cuts in the federal general corporate income tax rate) and more program spending. Tax and spend policies are not the basis for sustainable economic growth and will do nothing to reduce the deficit. In fact the opposite is the case—low business taxes promote better economic performance and lead to more tax revenue of all types in the long-run, not less.

In the last decade, Canada has made steady progress in improving its business tax competitiveness, and it has not gone unnoticed. In January, both the *Wall Street Journal* and the *Washington Times* lauded Canada's business appeal. "Canada's international reputation as a destination for capital and investment is better than it has been for a generation," said C.D. Howe Institute's Vice President of Research Finn Poschmann.[2]

We cannot turn back now.

1 Burleton, Derek and Don Drummond. (2009). "New era of restraint." FP Comment. *The Financial Post*. October 20.

2 Ivison, John. (2011). "Thanks to a low corporate tax rate, prospects for the economy are high." Full Comment. *The National Post*. January 6.

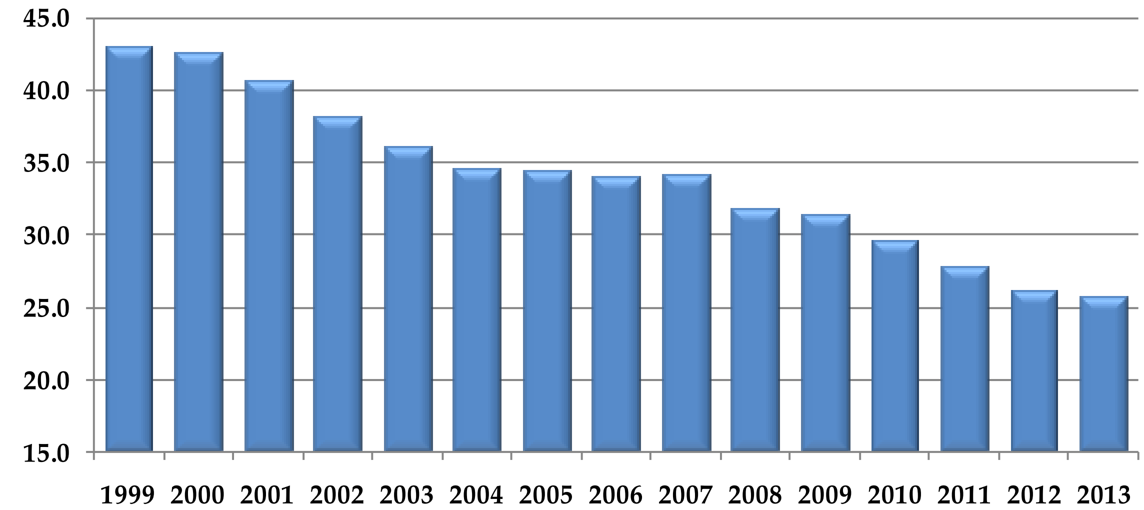
Canada Has Witnessed a Remarkable Transformation in the Business Tax Landscape

Over the last decade, the Canadian Chamber of Commerce has led the call for a more competitive business tax system, and both the Liberals and Conservatives in power have delivered. At the federal level, the corporate surtax for all corporations and the capital tax have been eliminated; the small business tax rate has been reduced to 11 per cent and the income eligible for the lower rate raised to $500,000; and, capital cost allowance rates for a number of assets have been aligned to better reflect their useful life.

Liberal Prime Minister Jean Chrétien gradually reduced the federal general tax rate on corporate income earned by large firms from 28 per cent in 2000 to 21 per cent in 2004. Prime Minister Stephen Harper's conservative government further reduced the rate from 21 per cent in 2007 to 16.5 per cent in 2011 with a further 1.5 percentage point reduction legislated for 2012.

Several provincial and territorial governments of various political stripes have also moved to lighten the tax burden on the business sector. The combined federal-provincial/territorial corporate income tax rate has been reduced from 42.6 per cent in 2000 to 27.8 per cent percent in 2011, and further legislated reductions will bring the combined rate to 25.7 per cent in 2013, one of the lowest in the Group of Seven (G7) and about equal to the average of member countries of the Organisation for Economic Co-operation and Development (OECD) in 2010.[3]

Combined Federal-Provincial/Territorial General Corporate Income Tax Rate (%)



Source: Department of Finance Canada, "Tax Expenditures and Evaluations 2010"; The Canadian Chamber of Commerce.

3 Source of Data: Department of Finance Canada. (2011). "Tax Expenditures and Evaluations 2010." Ottawa: January 18.

While the general corporate income tax rate influences where businesses locate, the marginal effective tax rate (METR) on capital—which includes the general corporate income tax rate, capital taxes, sales taxes on capital inputs as well as deductions or credits associated with purchasing capital goods—influences capital investment decisions. Further planned tax relief will reduce the METR in Canada to 18.4 per cent by 2013 (a substantial reduction from the 36.2 per cent rate that prevailed in 2006) putting Canada at the OECD average.[4]

The tax reductions "were gradual, but deliberate. And the changes took place regardless of the fact that political parties on both the left and the right have governed the country over the past two decades. Fundamentally, political rhetoric and dogma gave way to pragmatism and statesmanship, with long-term public policy taking precedent (generally) over short-term political gain."[5]

Canadian Chamber of Commerce President and CEO Perrin Beatty recently told members that, "All Canadians lose when the political parties squabble over this issue. Our job is to help secure sustainable economic growth. We have a weak recovery underway, and we need the help the business tax strategy provides. The issue is too serious to be left to political game players."[6]

4 Source of Data: Chen, Duanjie and Jack Mintz. (2011). "Federal-Provincial Business Tax Reforms: A growth agenda with competitive rates and a neutral treatment of business activities." *SPP Research Papers*. Volume 4, Issue 1. Calgary: School of Public Policy, University of Calgary. January.

5 Robertson, David. (2010). "Why the HST drives business to Canada." *The Lawyers Weekly*. July 16.

6 Hon. Beatty, Perrin. (2011). "Raising business taxes would give the economy a "blind side hit" says Canadian Chamber of Commerce President and CEO." Media Release. Ottawa: Canadian Chamber of Commerce. January 26.

The Global Race for Lower Corporate Tax Rates

Many countries have overhauled their tax systems to improve their global competitiveness. Over the 2006 to 2011 period, 90 countries reduced their statutory corporate income tax rate. Despite the recession ravaging public finances, 37 economies reduced corporate income tax rates in the last two years.[7]

The U.K., for example, is cutting taxes on business at the very same time as it has to make very painful cuts to public spending—demonstrating the priority the U.K. gives to it.

U.K.'s corporate tax rate will drop by one percentage point in April 2011 and in each year of the next four years to 24 per cent in 2014. "I want a sign to go up over the British economy that says 'Open for Business' … Corporation-tax rates are compared around the world, and low rates act as adverts for the countries that introduce them. Our current rate of 28 pence is looking less and less competitive," stated U.K. Chancellor of the Exchequer George Osborne.[8]

Japan has also announced that it will cut its corporate income tax rate by five percentage points. "There may be doubts over why Japan must lower its corporate tax rate when its tax revenues are insufficient … But to maintain and stimulate corporate activity and gross domestic product, it is imperative to attract people, products and funds to Japan," stated Teruhiko Mano, a researcher at Mitsubishi UFJ Research and Consulting.[9]

"In the past, governments saw corporations as cash cows that could be milked for money anytime politicians wanted to buy votes. But because of capital mobility, lawmakers are being forced to curtail their greed lest the geese that lay the golden eggs fly across the border."[10]

Governments worldwide recognize that low-tax jurisdictions attract businesses and jobs, spur domestic investment and invite foreign direct investment (FDI). FDI is crucial—it generates jobs and can lead to an infusion of innovative technologies, management strategies and transfer of skills and workplace practices, all of which are important for productivity growth. Canada is competing with developed, developing and transition economies for FDI. In 2010, for the first time, developing and transition economies absorbed more than half of global foreign direct investment flows.[11]

7 PricewaterhouseCoopers and the World Bank Group. (2010). "Paying Taxes 2011: The Global Picture." November.

8 *Bloomberg Businessweek*. (2010). "Osborne to Cut U.K. Company Tax Rate to 24% by 2014 (Update1)". June 22.

9 Tabuchi, Hiroko. (2010). "Japan Will Cut Corporate Income Tax Rate." *The New York Times*. December 13.

10 Mitchell, Daniel J. "The Global Race for Lower Corporate Tax Rates." Washington: The Cato Institute. June 21, 2007.

11 United Nations. (2011). "Global and Regional FDI Trends in 2010." *UNCTAD Global Investment Trends Monitor*. January 17.

The Rationale for Cutting Business Taxes

Why are so many countries around the world vigorously cutting rates, even when faced with significant budget deficits?

Because they want to grow their economy and create jobs, and they recognize corporate income taxes are the most economically destructive form of taxation. They certainly do not want to stifle the fragile economic recovery.

Relative levels of taxation matter because companies and investors send capital where it can achieve the highest returns. Business taxes (corporate income tax, sales tax on capital inputs and other capital-related taxes) reduce the after-tax return on investment; therefore, businesses in higher tax environments have less of an incentive to invest in structures and productivity-enhancing machinery, equipment and new technologies. It has been estimated that "a 1 percentage point increase in the effective tax rate on capital investment reduces investment in plant, equipment and non-residential structures by 0.5 to 1.0 percentage points."[12] As a result, worker productivity stagnates and economic growth suffers.

Extensive research by the OECD indicates corporate income taxes are the most harmful tax for economic growth. Corporate income taxes reduce productivity of firms and industries[13] and have the most negative effects on GDP per capita.[14]

Other economic literature highlights the destructive effects of corporate taxation.

- Economists Duanjie Chen and Jack Mintz at the School of Public Policy, University of Calgary, estimate that giving up a three-point reduction in the federal general corporate income tax rate (i.e. maintaining it at 18 per cent instead of reducing it to 15 per cent) would result in a loss of $47 billion in capital investment and 233,000 jobs in the long-run.[15]
- The American Enterprise Institute for Public Policy Research found that an increase in statutory tax rates and effective tax rates reduces both inbound foreign direct investment and entrepreneurial activity. It also found that higher corporate taxes are associated with a larger informal economy.[16]
- "On average, a tax rate increase of one percentage point results in a 3.3% decrease in FDI inflows and that, while statutory tax rates have a statistically significant effect on investment, both average effective tax rates and METRs affect investment even more."[17]

12 Chen, Duanjie and Jack M. Mintz. 2008. "Still a Wallflower: The 2008 Report on Canada's International Tax Competitiveness." *e-brief*. Toronto: C.D. Howe Institute. September.

13 See Schwellnus, C. and J. Arnold. (2008). "Do Corporate Taxes Reduce Productivity and Investment at the Firm Level? Cross-country Evidence from the Amadeus Dataset." *OECD Economics Department Working Paper* No. 641. Paris: OECD. October. See also, Vartia, L. (2008). "How Do Taxes Affect Investment and Productivity? – Industry Level Analysis of OECD Coutries." *OECD Economics Department Working Paper* No. 656. Paris: OECD. July.

14 Arnold Jens. (2008). "Do Tax Structures Affect Aggregate Economic Growth? Empirical Evidence from a Panel of OECD Countries." *OECD Economics Department Working Paper* No. 643. Paris: OECD. October. See also Lee, Young and Roger H. Gordon. (2005). "Tax Structure and Economic Growth." *Journal of Public Economics* (89). June.

15 Chen, Duanjie, and Jack Mintz. (2010). "Canada's Tax Competitiveness After A Decade of Reforms: Still An Unfinished Plan." *SPP Briefing Papers*. Vol. 3, Issue 5. Calgary: School of Public Policy, University of Calgary May.

16 Djankov, Simeon, Tim Ganser, Caralee McLiesh, Rita Ramalho, Andrei Shleifer. (2007). "The Effect of Corporate Taxes on Investment and Entrepreneurship." Second Draft. Washington: The American Enterprise Institute for Public Policy Research. December.

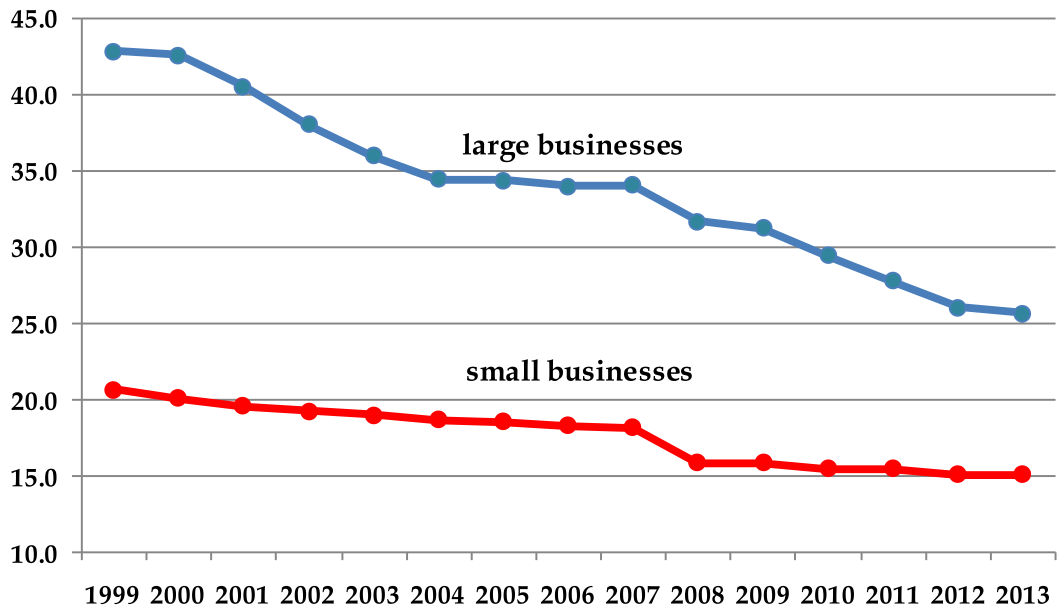
17 Chen, Duanjie and Jack Mintz. (2010). "Canada's Tax Competitiveness After A Decade of Reforms: Still An Unfinished Plan." *SPP Briefing Papers*. Vol. 3, Issue 5. Calgary: School of Public Policy, University of Calgary. May. See also De Mooij, Ruud and Sjef Ederveen. (2003). "Taxation and Foreign Direct Investment: A Synthesis of Empirical Research." *International Tax and Public Finance* 10(6): 673-693.

- As pointed out by the Royal Commission on Taxation (1966) and the Technical Committee on Business Taxation (1977), business taxes are borne directly or indirectly by people—workers through lower wages, consumers in the form of higher prices for goods and services and shareholders (including pensioners who own equity through RPPs, RRSPs and mutual funds) through lower returns.
- According to an Oxford University study, a $1 increase in corporate taxes tends to reduce real median wages by 92 cents.[18] The American Enterprise Institute for Public Policy Research found a one per cent increase in corporate tax rates is associated with nearly a 0.8 percent decrease in wage rates.[19] The latter study is particularly notable because it analyzed data from 72 countries spanning 22 years.

Mark Parson, an economist at the Department of Finance Canada, analyzed the impact of the seven-point reduction in the general corporate income tax cut rate (from 28 per cent in 2000 to 21 per cent in 2004) on investment in Canada and concluded that a one per cent reduction in the tax-inclusive cost of capital increased Canada's capital stock by approximately 0.7 per cent.[20]

A lower general corporate income tax rate will also improve tax neutrality by reducing the differential between large and small business tax rates. Small businesses are taxed at a combined federal and provincial/territorial income tax rate of 15.5 per cent while large corporations are taxed at 27.8 per cent (2011 figures), a 12 percentage-point difference.[21] The current business tax structure undermines growth by imposing higher taxes on businesses as they grow. Taxes on growth discourage investment and kill jobs.

Combined Federal-Provincial/Territorial General Corporate Income Tax Rate (%)



Source: Department of Finance Canada, "Tax Expenditures and Evaluations 2010"; The Canadian Chamber of Commerce.

18 Arulampalam, Wiji, Michael P. Devereux, and Giorgia Maffini. (2009). "The Direct Incidence of Corporate Income Tax on Wages." *Working Paper* No. 0707. Oxford: Oxford University Centre for Business Taxation. April 3.

19 Hassett, Kevin A., and Mathur Aparna. (2006). "Taxes and Wages." *AEI Working Paper*. No. 128. Washington: American Enterprise Institute for Public Policy Research. June.

20 Parsons, Mark D. (2008). "The Effect of Corporate Taxes on Canadian Investment: An Empirical Investigation." *Working Paper* 2008 01. Ottawa: Department of Finance Canada. May.

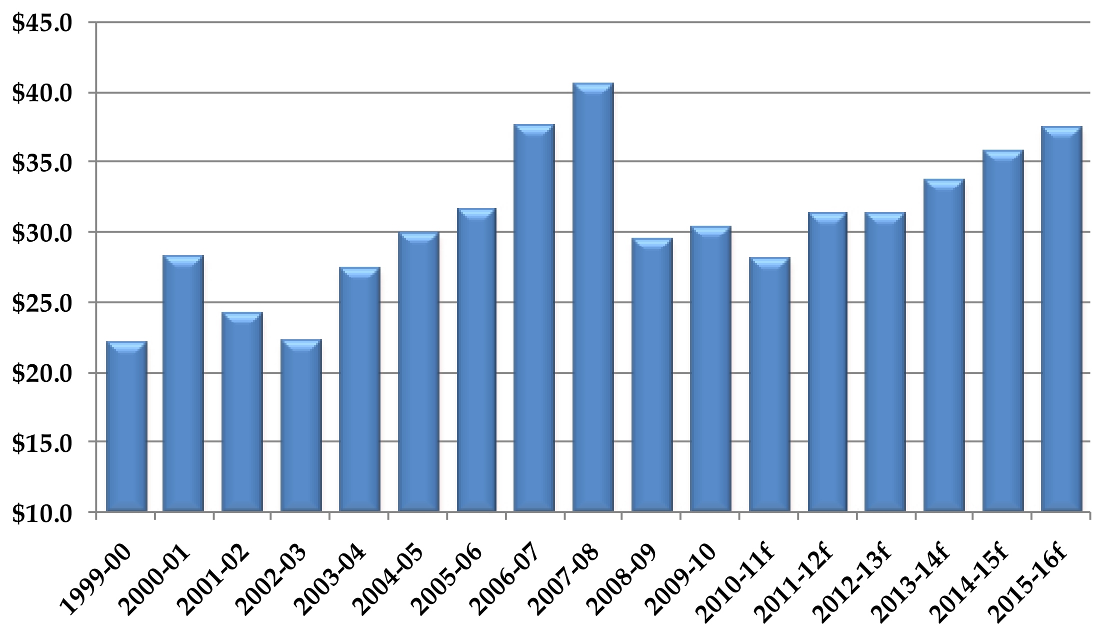
21 Source of data: Department of Finance Canada. (2011). "Tax Expenditures and Evaluations 2010." Ottawa: January 18.

Smart Tax Policy Is a Means to Achieving Fiscal Balance

Low business taxes promote better economic performance and lead to more tax revenue of all types in the long-run, not less.

Since the federal general corporate income tax rate was reduced from 28 per cent to 21 per cent, the amount the government collected in corporate income tax revenue rose from $24.2 billion in fiscal 2001 to almost $30.0 billion in fiscal 2004. Corporate income tax revenue continued to rise—it hit a historic high of $40.6 billion in fiscal 2007. Corporate tax revenue as a share of GDP increased from 2.2 per cent in 2001 to 2.7 per cent in 2007.[22] While the recession took a toll on government revenue, corporate tax revenue is projected to reach $31.1 billion in fiscal 2011, higher than what was collected in fiscal 2000.[23]

Federal Government Corporate Income Tax Revenue (billions)



Source: Department of Finance Canada, "Fiscal Reference Tables 2010" and "Update of Economic and Fiscal Projections 2010"; The Canadian Chamber of Commerce. f = forecast

22 Source of data: Department of Finance Canada. (2010). "Fiscal Reference Tables". Ottawa: October 12.

23 Source of data: Department of Finance Canada (2010). "Update of Economic and Fiscal Projections." Ottawa: October 12.

Duanjie Chen and Jack Mintz believe that a reduction in the statutory corporate income tax rate is "a job-creating measure that won't cost much money once businesses shift more profits into Canada."[24] Finn Poschmann at the C. D. Howe Institute agrees: "There is no reason to expect corporate income tax reductions to put any meaningful dent in tax revenue."[25]

In the final analysis, multinational corporations shift profits from high-tax jurisdictions to those with low tax rates using tax-planning techniques. The Cato Institute summed it up: "At the international level, tax cuts can induce companies to change their policies on dividend repatriations, transfer pricing, debt financing, foreign affiliate structure, intellectual property, and other items." Thus, "a modest tax rate cut would likely result in no government revenue losses in the long-term."[26]

Conclusion

Politicians tend to view taxes through a very narrow lens—as a means of raising revenue to allocate among competing priorities. Some advocate that keeping business taxes high will help attack deficits. They ignore the influence of taxes on a firm's decision to produce, create jobs, invest and innovate—all of which are necessary to grow the economy. They discount the economic literature that pinpoints business taxes as the most economically damaging mechanism for raising revenue.

While Canadian politicians spar over corporate tax cuts, governments around the world continue to demonstrate their engagement on tax reform. "The most popular reform continues to be reducing the statutory rate of corporate income tax and this has flowed through to a lower tax cost."[27] Governments recognize that vigorous growth stimulated by smart tax policies brings far more revenue as employment grows, consumer demand rises and investment increases—that smart tax policy *is* a means to achieving fiscal balance.

Internationally competitive firms generate jobs. They attract the best and brightest people to Canada and ensure that our young people can have a bright future here at home. If we turn back now, as other countries continue to improve their tax competitiveness, we will fall behind.

Businesses across Canada have invested for the future with the understanding that Canadian taxes would decline. A sudden change of course would constitute a broken promise to thousands of businesses and the many people they employ based on these promises.

24 Mintz, Jack M. (2010). "It is time to repair the damage done to balance sheets." FP Comment. *The Financial Post*. November 25.

25 Reynolds, Neil. (2011). "Proof is in the numbers for Flaherty's corporate tax cuts." *The Globe and Mail*. January 5.

26 Edwards, Chris. (2007). "Corporate Tax Laffer Curve." *Tax & Budget Bulletin* No. 49. Washington: The Cato Institute. November.

27 PricewaterhouseCoopers and the World Bank Group. (2010). "Paying Taxes 2011: The Global Picture." November.

For further information, please contact:
Tina Kremmidas, Chief Economist | tkremmidas@chamber.ca | 416.868.6415 (222)