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C.D. Howe Institute COMMENTARY

TAX COMPETITIVENESS PROGRAM

Limited Horizons:

The 2008 Report on Federal and Provincial
Budgetary Tax Policies

Duanjie Chen
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In this issue...

A rise in near-sighted policies that place unequal tax burdens on different industries is undermining progress on other fronts.

THE STUDY IN BRIEF

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Canadian governments are undercutting progress in reducing corporate income and capital taxes with counter-productive policies that impose unequal tax burdens across assets and industries.

Overall, Canada's 2008 marginal effective tax rate on capital has fallen from 31.9 percent in 2007 to 29.1 percent in 2008. With further business tax reductions at the federal and provincial levels, the marginal effective tax rate will fall to 25.8 percent by 2012. That is good news indeed, since such changes will increase capital stock by \$62 billion within five years time and improve worker annual incomes by \$2.9 billion.

However, some provinces continue to levy high marginal effective tax rates on capital. Ontario and Manitoba impose the highest effective tax rates on capital in 2008: 34.8 and 33.8 percent, respectively. As well, in many provinces the variation of tax burdens on business activities is increasing, thereby interfering with boardroom decisions on steering resources to the most profitable opportunities.

As measured by a dispersion index, inter-asset and inter-industry distortions have risen sharply in the past two years. The dispersion index has doubled from 24.7 percent in 2006 to 50.3 percent in 2008. Much of the increase in the dispersion index owes to tax policy supporting forestry and manufacturing businesses. In some cases, tax policies are geared to support structurally declining industries to the detriment of those that will be important to Canada's industrial future.

The study highlights priorities for improving the tax system by reducing taxes on capital investment and labour. They include: (i) a reduction in provincial corporate income tax rates to 10 percent, which would bring Canada's overall statutory corporate income tax rate to 25 percent in 2012; (ii) the removal of targeted preferences for specific industries; (iii) sales tax harmonization with the federal GST by the hold-out provinces (British Columbia, Manitoba, Ontario, Prince Edward Island and Saskatchewan); and (iv) further reductions in personal income taxes to relieve the tax burden on labour income.

Canada needs tax policies that both reduce the tax burden on investments and create a level-playing field to promote economic growth.

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INDEPENDENT • REASONED • RELEVANT

When it comes to business tax policy, federal and provincial 2008 budgets are a version of the Asian proverb about a frog in a well. The frog was pleased with the patch of blue sky above the well that he called his own, but was oblivious to the wider horizons beyond its walls.

Like the frog, our governments need to leap higher to get out of a well created by counter-productive policies and expand their horizons for economic growth.

Federal and provincial governments continue to reduce corporate income and capital taxes but this is not sufficient to scale the walls. With a commodity boom favouring Canada, a rising dollar and governments rich with surpluses, business tax policy could do better. Governments need to remember that the best business tax policies are those that are neutral among business activities. As we show in this report, the variation of tax burdens on business activities is increasing, thereby interfering with boardroom decisions on steering resources to the most profitable opportunities. In some cases, tax policies are geared to support structurally declining industries to the detriment of those that will be important to Canada's industrial future. Canada needs tax policies that both reduce the tax burden on investments and create a level playing field to promote economic growth.

Some governments are making significant structural changes for the betterment of the economy: the federal corporate income tax rate is set to decline from 19.5 percent in 2008 to 15 percent in 2012. British Columbia is reducing taxes on investment, work and savings in favour of consumption taxes, albeit a carbon tax that will

affect fuel prices for consumers and producers. Newfoundland and Labrador and Manitoba have further lowered personal and payroll taxes this year, which will encourage work effort and the hiring of both skilled and unskilled labour. And New Brunswick has released a discussion paper proposing sweeping reforms, including a flatter personal income tax structure and sharp reductions in corporate income tax rates, to be partly offset by a higher Harmonized Sales Tax increase or the introduction of a carbon tax.

On the other hand, some provinces have not addressed serious shortcomings in their business tax policies. They maintain high taxes on growth-enhancing industries while cutting capital-tax burdens on others. In the face of a bleak export market in the United States, five provinces have failed to address the problems arising from an outdated retail sales tax and, in the case of Ontario, Nova Scotia and Prince Edward Island, a relatively high corporate tax rate.

Overall, Canada's 2008 marginal effective tax rate on capital has fallen from 31.9 percent¹ in 2007 to 29.1 percent in 2008. With further business tax reductions at the federal and provincial levels, the marginal effective tax rate will fall to 25.8 percent by 2012. That is good news indeed since such changes will increase capital stock by \$62 billion within five years time and improve worker annual incomes by \$2.9 billion.²

Nevertheless, other findings are discouraging. Some provinces continue to levy high marginal effective tax rates on capital. Ontario and Manitoba impose the highest effective tax rates on capital in 2008: 34.8 and 33.8 percent, respectively. Like most other provinces, Ontario and Manitoba impose relatively high taxes on service companies, including growth-enhancing, knowledge-based industries where earnings are rising faster than the rest of the economy (4.3 percent annually for communications and 3.2

The authors wish to thank participants in Tax Competitiveness Council of the C.D. Howe Institute for their comments on the paper. We are especially indebted to Finance Canada for information needed for the analysis.

- 1 Due to the change in capital weights by industry and by type of assets, this estimate is different than that presented in our previous reports published in 2007.
- 2 Based on Finance (2007), we estimate that large corporate capital stock is equal to \$1.84 trillion in 2007 and the user cost of capital declines by 4.79 percent from 2008 to 2012.

percent for other services for the period 2003–2007). For example, Ontario's marginal effective tax rate on capital is a punishing 46.2 percent on communications and 42.4 percent on business services. Manitoba's rates are similar. Both provinces have effective tax rates on capital that are higher than the worldwide average, and higher than rates in the United States, which reintroduced temporary bonus depreciation in 2008. Their tax policy responses have been to introduce weak and ineffective targeted incentives, such as investment tax credits and preferential rates. Manitoba has enhanced the investment tax credit for manufacturing machinery and several other preferences, including an exceedingly low small-business tax rate with a questionable effect on business growth. Ontario has introduced an ill-designed 10-year corporate income tax holiday for commercialized intellectual property developed by qualifying research institutions.³

Manitoba and Ontario are not alone in trying to micromanage the economy through business tax policy. Quebec exemplifies governments that target preferences narrowly (such as to pig manure farming) and get poor results as measured by investment performance – Quebec's investment per worker is the second lowest, and only Prince Edward Island stands lower (Banerjee and Robson 2007).

Another troubling trend is a rise in economic distortions owing to policies that impose unequal tax burdens across assets and industries. As measured by a dispersion index, inter-asset and inter-industry distortions have risen sharply in the past two years.⁴ The dispersion index (calculated as the ratio of variation in effective tax rates as a percent of the average marginal effective tax rate) has doubled from 24.7 percent in 2006 to 50.3 percent in 2008. Much of the increase in the

dispersion index owes to tax policy supporting forestry and manufacturing businesses, including the resurrection of the archaic two-year write-off for capital investments, originally introduced in 1972 and eventually eliminated a decade and half later. Further, Ontario, Quebec and Manitoba accelerated capital tax reductions – for the manufacturing and processing sectors only.

The dispersion index will fall by 25 percent in 2012, primarily because of a much lower federal corporate income tax rate and the cancellation of several manufacturing and processing preferences. However, given recent trends in business tax policy, it is reasonable to expect that governments

Quebec exemplifies governments that target preferences narrowly (such as to pig manure farming) and get poor results...

will make further attempts at economic micromanagement by way of targeted preferences. Two economic studies have shown that inter-asset and inter-industry distortions have important effects on economic growth. Jorgenson and Yun (2001) find that large economic

gains can be obtained by equalizing tax burdens on assets and industries. Hamilton, Mintz and Whalley (1991) also find that inter-asset distortions are especially large in Canada, with negative consequences for growth since they push resources to less productive uses.

Labour taxation has changed little, with the effective tax rate on labour falling from 46.2 in 2007 to 45.3 percent in 2008. The biggest reduction in the effective tax rate on labour has been in Newfoundland and Labrador, with a 2.6 percentage point decline to 45.7 percent. Alberta has cancelled its health premium, a measure with little impact on marginal work decisions, and remains the province with the lowest tax burden on labour.

Taking into account the share of labour and capital in production costs, and given that labour taxes tend to be shifted forward by 30 percent into wage costs, the marginal tax burden on the cost of doing business

3 Tax holidays, also used in Quebec, are high-cost, low-impact policies, typically found in Third World countries and well proven to be ineffective (Shah 1995).

4 To put it in technical terms, the dispersion index is calculated as the coefficient of variation, which is equal to the weighted standard deviation of marginal effective tax rates divided by the weighted-average marginal tax rate. We prefer using this measure in order to separate out the influence of dispersion as a measure of inter-asset and inter-industry distortions from the size of the effective tax rate that is related to the inter-temporal distortion – a standard deviation of 1 percent, for example, implies much more variability when effective tax rates are low.

in Canada has declined from 24.9 percent in 2007 to 23.4 percent in 2008. Ontario has the highest effective tax burden on costs at 26.4 percent and New Brunswick the lowest at 17.2 percent.

Some smart tax policies to improve taxation would help spur economic growth. Further corporate income tax rate cuts at the provincial level to 10 percent or less would be important in lowering effective tax rates on capital and reducing tax-rate dispersion. A shift in the tax burden away from investment, savings and work effort and on to consumption would be appropriate. Recent studies have suggested that jurisdictions with high corporate income tax rates above 30 percent (which is currently the case in Canada) would not lose large amounts of corporate tax revenues with rate reductions. The revenue cost to corporate rate reductions⁵ is small because businesses become more willing to book income in jurisdictions with lower corporate income tax rates.

These rate cuts, however, should be accompanied by base-broadening measures to reduce economic costs induced by business tax policies that favour some business activities over others. Governments should aim to reduce inter-asset and inter-industry distortions, not increase them as they have done quite dramatically in the past two years.

Further, conversion of retail sales taxes in British Columbia, Ontario, Manitoba, Prince Edward Island and Saskatchewan to a value-added tax similar to the federal Goods and Services Tax would improve competitiveness since businesses would be able to recover tax paid on intermediate and capital goods. Overall, sales tax harmonization in the hold-out provinces would have a dramatic impact in reducing effective tax rates on capital (but have less impact on the cost of doing business since the taxation of labour would increase).

All in all, Canadian governments are whittling away the gains from reducing tax burdens on

capital investment by creating an uneven playing field among businesses. At some point, major tax reform will be needed just to undo the harm caused by politicians who believe they, rather than business managers, know best how to run the business sector.

Taxes on Capital Investment

Taxes on capital investment reduce the incentive for companies to invest in Canada and, to the extent they vary by capital type, distort decisions on the most efficient technologies to produce goods and services. Many recent studies have shown that increases in tax burdens on capital investment do not fall so much on capital in open economies. Instead they reduce substantially the income paid to workers when business productivity is impaired (Arulampalam, Devereux and Maffini 2007 and Gentry 2007).

As in our previous reports, we measure the marginal effective tax rate on capital for medium and large corporations in forestry, manufacturing, construction, transportation, communications, utilities, trade and business and household services. The marginal effective tax rate is calculated as the annualized value of corporate income tax, capital tax and sales tax paid on capital purchases as a share of the gross rate of return on capital (Chen 2000). We do not include research and development tax credits or grants in our assessment; their impact on effective tax rates is relatively small except for communications.⁶

Effects of Budget Changes in 2008

The most important changes in business taxes affecting capital decisions are the federally legislated reductions in corporate rates to 19.5 percent in 2008 and to 15 percent by 2012. Several

5 Mintz and Smart (2004) find that a 1 percent reduction in the corporate income tax for a Canadian province would result in a 2.3 percent increase in the corporate tax base if companies allocate income among provinces, or 4.9 percent if they operate a separate multi-jurisdictional company in the province. A recent European study (Huizinga and Laeven 2008) suggests that a reduction in the corporate rate by 1 percentage point increases the corporate tax base by 1.3 percentage points on average among European countries. Using the Mintz-Smart results, a 1 percent reduction in the Ontario corporate income tax rate of 33.72 percent in 2008 would increase federal and provincial revenues by 18 percent if such income shifting is taken into account.

6 The effect of the research and development credits is to lower effective tax rate by about two points on average.

provinces have reduced corporate income tax rates this year: British Columbia by one point to 11 percent (as of July 1, 2008, with a possible further rate cut to 10 percent by 2011); Manitoba by one point to 13 percent (as of July 1, 2008, with further rate cuts of two percentage points planned by 2011); and Saskatchewan by one point to 12 percent (as of July 1, 2008). Quebec, on the other hand, is raising its corporate income tax rate by 1.5 percentage points, to 11.4 percent in 2008, with a further increase to 11.9 percent in 2009 as part of a package to eliminate capital taxes.

Capital taxes continue to decline in several provinces – Nova Scotia, New Brunswick, Manitoba, Saskatchewan and Quebec. For their part, Ontario, Quebec and Manitoba accelerated the elimination of capital taxes for manufacturing and, in some cases, primary and resource sectors in 2008.

While these rate reductions provide support to all sectors, federal and provincial governments have resorted to special preferences to support specific business activities. Some preferences have targeted “green” technologies to support better environmental practices – the success of these incentives will depend on whether they trigger new investments as opposed to causing an acceleration in capital-good input prices, such as for wind turbines, when supply is inadequate. Others measures have targeted support for the forestry and manufacturing industries, the latter being particularly challenged by long-term structural changes in the world economy. Federal and most provincial governments are extending the two-year write-off for machinery investments, which is to be phased out by 2011. Quebec is providing a refundable investment tax credit for manufacturing and processing equipment as well as several targeted preferences for resource regions, research, e-business, culture, and on-the-job training. Manitoba has extended its investment tax credit for manufacturing and processing equipment to 2011 – Manitoba has extended the provision in the past and may do so again.

Tax Burdens on Investment by Province and Industry

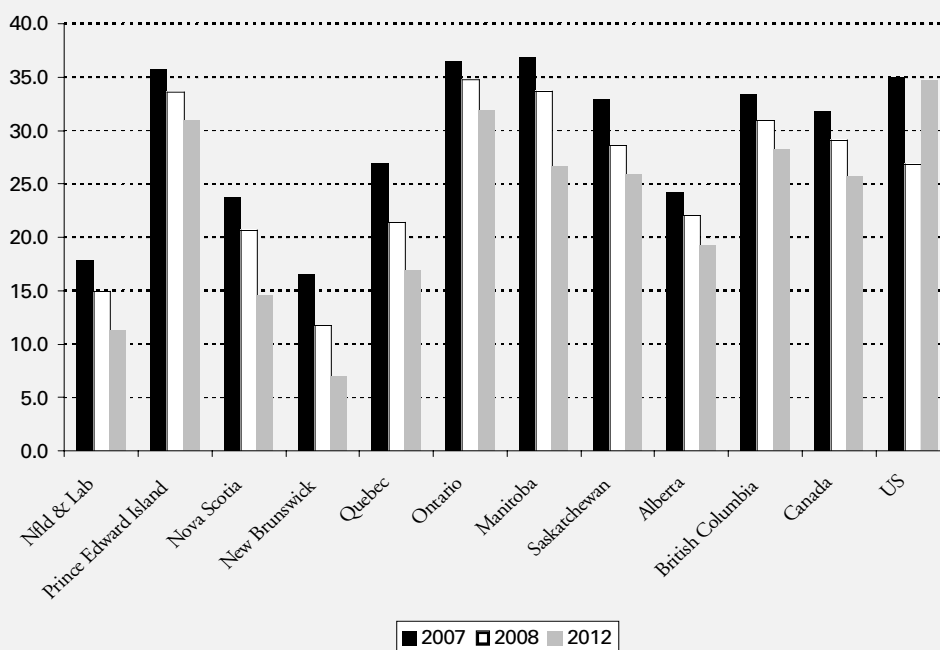
Taking into account budgetary changes in 2008 as well as those legislated from earlier years, the marginal effective tax rate on capital in Canada has fallen from 31.9 percent in 2007 to 29.1 percent in 2008, with a further reduction to 25.8 percent due by 2012 (Figure 1). Ontario continues to have the highest tax burden on investment, at 34.8 percent, followed by Manitoba at 33.8 percent. Except for Prince Edward Island, which continues to levy a high corporate income tax and has not reformed its sales tax, the Atlantic provinces generally have the lowest marginal effective tax rates on capital (New Brunswick has the lowest at 11.8 percent), in part driven by the federal Atlantic investment tax credit favouring primary, resource and manufacturing industries.

Surprisingly, the marginal effective tax rate on capital in Canada for 2008 is higher than in the United States, where a 50 percent bonus depreciation rate has been provided for 2008, holding the US rate at 26.9 percent. A further consideration: tax policy can be fickle when politicians respond to business cycles, and US tax reform is on the political agenda, with some Democrat and Republican leaders advocating a sharp reduction in corporate income tax rates in the future.

Effective tax rates vary widely by industry (Table 1). Tax policy heavily favours forestry and manufacturing industries, and places high tax rates on construction, trade, communications and other services, including business services. Marginal effective tax rates are actually negative for forestry and manufacturing in the Atlantic Provinces, implying that companies may not be able to use all their tax benefits if they cannot claim accelerated cost deductions and tax credits on marginal investments against income earned on infra-marginal profits.⁷

7 If companies are in a non-taxpaying position and must carry forward deductions and credits to claim against future income, the marginal effective tax rate will be less negative (and in the extreme case zero). However, it is also possible for marginal effective tax rates for non-taxpaying companies to be greater than for taxpaying companies when companies are starting up or face high degrees of risk. (See Mintz 1987.)

**Figure 1: Marginal Effective Tax Rate on Capital Investment: 2007, 2008 and 2012
A Comparison between Canada and the U.S.**



Sources: C.D. Howe Institute and School of Policy Studies, University of Calgary.

**Table 1: Marginal Effective Tax Rate on Capital Investment in Canada: 2008,
by Industry and by Province**

	Forestry	Utility	Construction	Manufacturing	Wholesale Trade	Retail Trade	Transp. Comm.	Other services	Aggregate	
	<i>Percent</i>									
Canada	11.0	30.7	38.5	19.3	35.1	33.7	28.1	39.3	36.5	29.1
Nfld & Lab	-42.7	NA	28.0	-14.1	26.6	28.0	23.7	27.3	26.5	15.0
P.E.I.	-58.2	NA	46.6	-30.1	42.2	40.1	38.0	49.8	45.3	33.6
Nova Scotia	-21.6	29.4	32.7	-3.1	32.8	32.7	27.8	31.8	30.7	20.7
New Brunswick	-27.5	25.8	28.8	-1.6	28.9	28.9	23.7	27.9	27.0	11.8
Quebec	3.0	27.9	30.8	10.4	31.3	31.1	25.4	30.0	30.8	21.5
Ontario	20.8	34.4	44.0	24.2	39.4	38.4	33.7	46.2	42.4	34.8
Manitoba	4.9	35.2	43.6	6.8	39.9	38.7	35.4	45.9	43.9	33.8
Saskatchewan	14.3	28.5	36.2	23.1	33.6	32.2	27.0	38.6	35.1	28.6
Alberta	15.7	21.9	24.7	21.3	24.8	24.8	20.3	23.9	23.2	22.0
British Columbia	19.6	29.5	38.7	24.1	34.2	33.0	27.1	41.0	36.3	30.9

Sources: C.D. Howe Institute and School of Policy Studies, University of Calgary.

Table 2: Dispersion Index (Coefficient of Variation) for Marginal Effective Tax Rates on Capital Investment

	2006	2007	2008	2012
	<i>Percent</i>			
Inter-industry	17.0	28.3	35.5	26.1
Inter-asset	27.2	37.7	48.7	39.3
Overall	24.7	39.9	50.3	39.0

Sources: C.D. Howe Institute and School of Policy Studies, University of Calgary.

Growing Dispersion and Economic Distortions

The variation in marginal effective tax rates by provinces and industries is layered over the considerable dispersion that arises from differential tax burdens by asset category, including machinery, structures, inventory and land (machinery and structures are also broken down according to more than 20 capital cost allowance classes). To measure economic distortions related to capital tax burdens, we calculate a dispersion index based on the coefficient of variation – the weighted standard deviation of effective tax rates divided by the average of marginal effective tax rates. The dispersion index has jumped up sharply from 2006, implying that distortions in the corporate tax system are larger, especially with respect to asset choices (Table 2). The effect of higher distortions is a higher economic cost of taxation for corporations, because business decisions regarding, for example, the choice of efficient technologies, are distorted by tax policy.

The dispersion index for the US in 2008 is 50.3 percent, the same as Canada's. However, in 2007, the US dispersion index was much lower at 30.5 percent compared to Canada's at 39.9 percent. The substantial increase in the US dispersion index from 2007 to 2008 is a result of the one-year 50 percent bonus investment allowance. The US dispersion index is set to decline to 31 percent by 2012, owing to further planned reductions in the corporate tax rate for manufacturing and other selected industries. With lower dispersion of effective tax rates in the US compared to Canada

(except for 2008), it would be expected that US businesses might operate at a higher level of productivity, a conclusion that warrants further study.

In 2006, the favorable tax treatment of the manufacturing and forestry sectors (e.g., federal and provincial investment tax credits, the reduced corporate income tax rates in Ontario, Saskatchewan and Newfoundland) were partially offset by inadequate capital cost allowance rates for certain assets used by the manufacturing and processing sector. For example, the economic depreciation rate for manufacturing plant was more than 9 percent, while the corresponding capital cost allowance rate was only 4 percent. As a result, the gap in tax burdens between the manufacturing and communication industries (the latter having the highest marginal effective tax rate) was 7 percentage points (35 and 42 percent, respectively).

In 2007, two changes helped reduce the marginal effective tax rate substantially for manufacturing. One was the increased capital-cost allowance rate for plant used by manufacturing to better reflect economic depreciation. The other was a temporary two-year fast write-off for equipment in the form of an economic depreciation rate of 19 percent (declining balance). As a result, the gap in effective tax rates between the manufacturing industry and the most highly taxed industry (communications) jumped to 18 percentage points in 2007 (23 percent for manufacturing vs. 41 percent for communications).

These distortions were further worsened in 2008 as several provinces (Ontario, Quebec and Manitoba) brought forward plans to eliminate capital taxes – but only for manufacturing and, in some cases, the resource and primary sectors.

For 2012, the reduction in the federal corporate income tax rate and the expected elimination of the two-year fast write-off for manufacturing equipment and provincial capital taxes will reduce the dispersion index, assuming governments do not introduce new measures whose effect is to steer resources to selected business activities.

Taxes on Labour

Several taxes affect labour demand by businesses and the work effort of individuals. Personal income, payroll, sales and excise taxes affect labour markets in that they reduce the real income earned by workers to buy goods and services. In our analysis, the marginal effective tax rate on labour is tax paid as a percentage of the pre-tax wage paid by employers on last hours of work.⁸

Few budgetary changes were made, in 2008, to labour taxes. The federal government reduced the GST rate by a percentage point, which reduces tax on labour income by lowering the purchase cost of consumer goods and services. As well, Ottawa and the provinces generally increased personal income tax thresholds to reflect inflation.

Newfoundland and Labrador reduced personal tax rates by one percentage point for each tax bracket. It also eliminated the retail sales tax on insurance premiums, a provision unchanged when the province adopted the Harmonized Sales Tax. Newfoundland and Labrador also reduced payroll taxes for smaller businesses with less than \$1 million in payroll. Likewise, Manitoba reduced rates for the middle personal income tax bracket, while Quebec implemented the previous year's announced tax bracket increases.

For its part, British Columbia reduced personal income tax rates on low-income brackets as part of its introduction of a new carbon tax that raises

fuel prices for consumers and businesses.

Assuming a full pass through of business taxes on consumer prices, the effective sales and excise tax rate in British Columbia rises by 0.45 percentage points and thus offsets some of the impact of the personal income tax reductions on labour.

Overall, Canada's marginal effective tax rate on labour changes little, from 46.2 percent in 2007 to 45.3 percent in 2008 (Figure 2a). The largest reduction, as expected, is in Newfoundland and Labrador where it falls by 2.6 percentage points to 45.7 percent. The Quebec marginal effective tax rate on labour declines by 1.8 percentage points, although it remains the highest in Canada at 49.9 percent. British Columbia's tax burden on labour declines by 1.4 percentage points. Alberta's marginal effective tax rate on labour changes little, by 0.5 percentage points, and remains the lowest in Canada at 38.6 percent.

Labour-Tax Burden by Industry

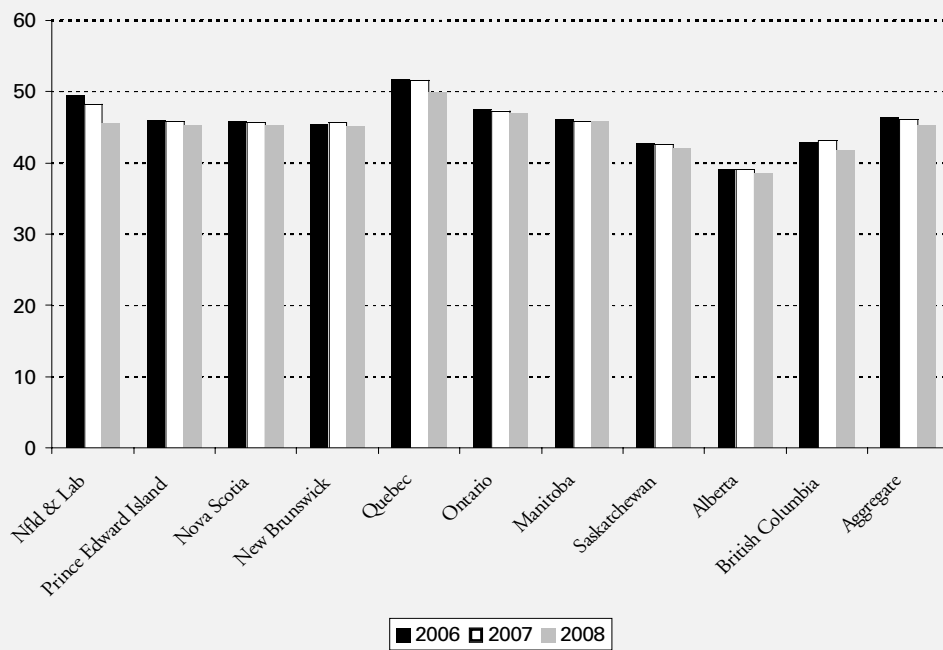
Industry-specific tax burdens on labour vary sharply, in part due to differences in earnings across workers. Those sectors with high-skilled labour tend to have high marginal effective tax rates on labour due to progressivity in Canada's tax structure. Communications and manufacturing companies are the most highly taxed with effective rates surpassing 48 percent. This burden is closely followed by that on forestry and utilities. Retail trade bears the least tax on labour (Figure 2b).

Ironically, governments tend to reduce capital tax burdens on sectors where they are already low, as with ailing industries like forestry and manufacturing – even though high tax burdens are applied on workers' incomes in these industries. Given the importance of skilled labour to these industries, personal tax issues should perhaps be given greater emphasis.

As mentioned, New Brunswick recently issued a bold discussion paper (New Brunswick 2008) proposing to replace the current four-bracket income tax with a flat rate at 10 percent or a two-rate

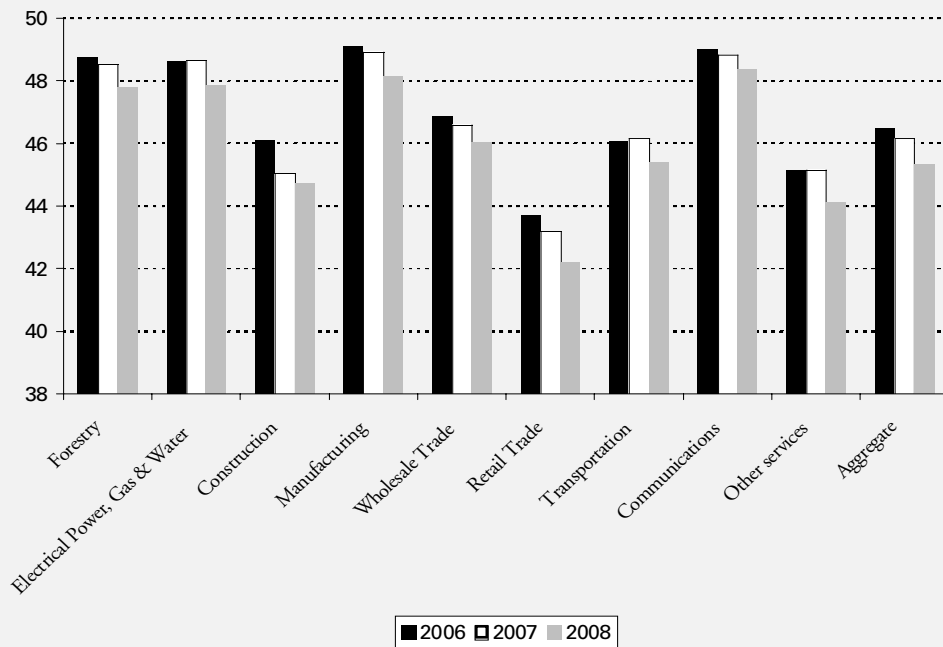
⁸ We compute the tax distortion in terms of the impact of taxes on the supply of effort. Labour taxes can also affect labour mobility although one should compare taxes paid as a share of total income since individuals would need to move from the province. Given the relatively low degree mobility for labour, we focus on the effect that labour taxes have on hours of work.

Figure 2a: Marginal Effective Tax Rate on Labour by Province:
A Comparison between 2006, 2007 and 2008



Sources: C.D. Howe Institute and School of Policy Studies, University of Calgary.

Figure 2b: Marginal Effective Tax Rate on Labour by industry:
A Comparison between 2006, 2007 and 2008



Sources: C.D. Howe Institute and School of Policy Studies, University of Calgary.

approach at 9 and 12 percent. This would be a significant change that would sharply reduce the tax on labour in New Brunswick. Even if New Brunswick made up some of the lost revenues with an increase in the Harmonized Sales Tax rate (taking back the federal two-point reduction), the overall effective tax rate on labour would be reduced.

Tax Burdens and the Cost of Doing Business

Tax burdens on labour and capital affect costs faced by businesses. Taxes on capital are assumed to fully increase costs since businesses in an open economy cannot shift taxes by reducing the cost of capital. With respect to labour, taxes increase business costs to the extent that such taxes are shifted forward in the form of higher wages – the portion shifted forward is assumed to be 30 percent.

We estimate marginal effective tax rates on costs by aggregating the individual effective tax rates on capital and labour according to the relative shares of capital and labour in value-added (the sum of payments made to labour and capital used in production) by industry. The tax burden on the cost of doing business in Canada falls from 24.9 percent in 2007 to 23.4 percent in 2008 (Figures 3a, 3b). Businesses in Ontario, Manitoba and Prince Edward Island face the highest marginal tax rates on costs, while those in New Brunswick, Alberta and Newfoundland and Labrador face the lowest. Those low rates are explained in part by low taxes on capital investments and harmonization of sales taxes with the federal GST (or the absence of a retail sales tax in the case of Alberta).

Some Policy Imperatives

Canadian governments have been making considerable progress in reducing taxes that have impeded economic growth and job creation. However, a worrisome trend is evolving, whereby politicians are using the tax system increasingly to manage the economy, with targeted preferences for specific activities. This trend represents a troubling departure from the general approach of making the

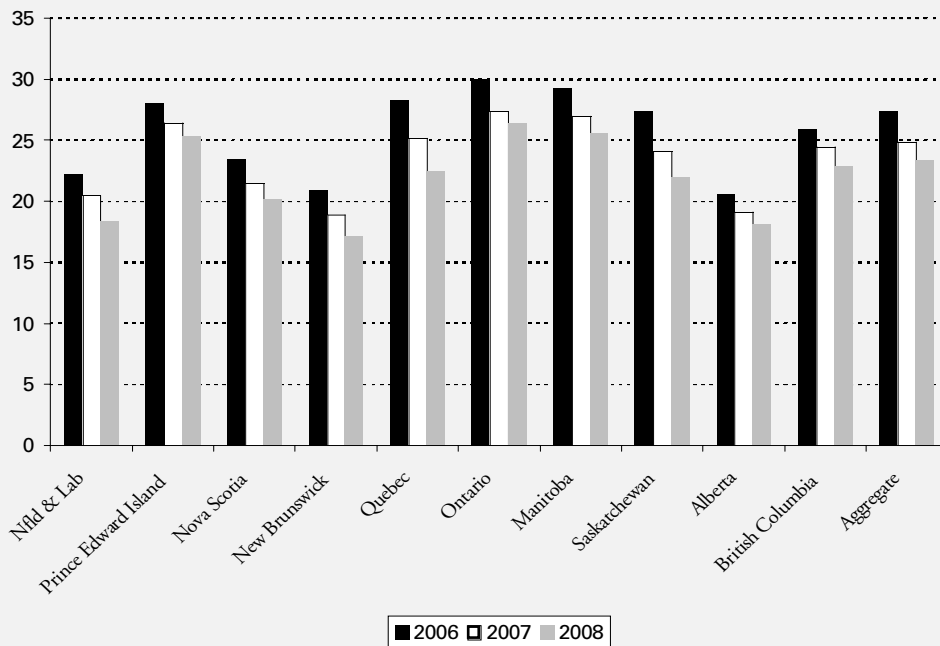
tax system more neutral, with internationally competitive tax rates. Governments should focus on removing barriers to growth instead of picking particular activities for incentives that are less effective in spurring a stronger economy.

The priorities for improving the tax system continue to be those that would reduce taxes on capital investment and labour. With respect to capital investment, provinces should consider reducing their corporate income tax rates to 10 percent, which would bring Canada's overall statutory corporate income tax rate to 25 percent in 2012. This reduction would be consistent with international trends – the average OECD corporate income tax rate is 28 percent in 2008, with further rate reductions planned in many countries. Among the large provinces, accounting for almost 90 percent of corporate taxable income in Canada, Alberta already has a 10 percent corporate rate and British Columbia is looking to achieve that rate in the next few years. On the other hand, Quebec is raising its corporate rate as part of a package to eliminate the capital tax. Quebec will soon have a relatively high corporate rate of 11.9 percent, which will eventually affect revenues as businesses shift income to lower tax jurisdictions.

Removing targeted preferences lacking proven effectiveness could permit a future reduction in Quebec's corporate income tax rate. Ontario, too, should address its 14 percent corporate income tax rate, as well as the continuing differential treatment given manufacturing and resource income compared to other sources of income. Applying differential corporate income tax rates on industries is not very sensible policy; it leads to excessive costs in administration and compliance and presents tax-planning opportunities that work to the disadvantage of the province. Of the smaller provinces, only New Brunswick is looking to substantially reduce its corporate income tax, bringing it from 13 percent to as low as 5 percent (other proposed rates include 7 and 10 percent). The New Brunswick business tax reform package, including adjustments to property taxation and the elimination of some special preferences, could serve as a model for other

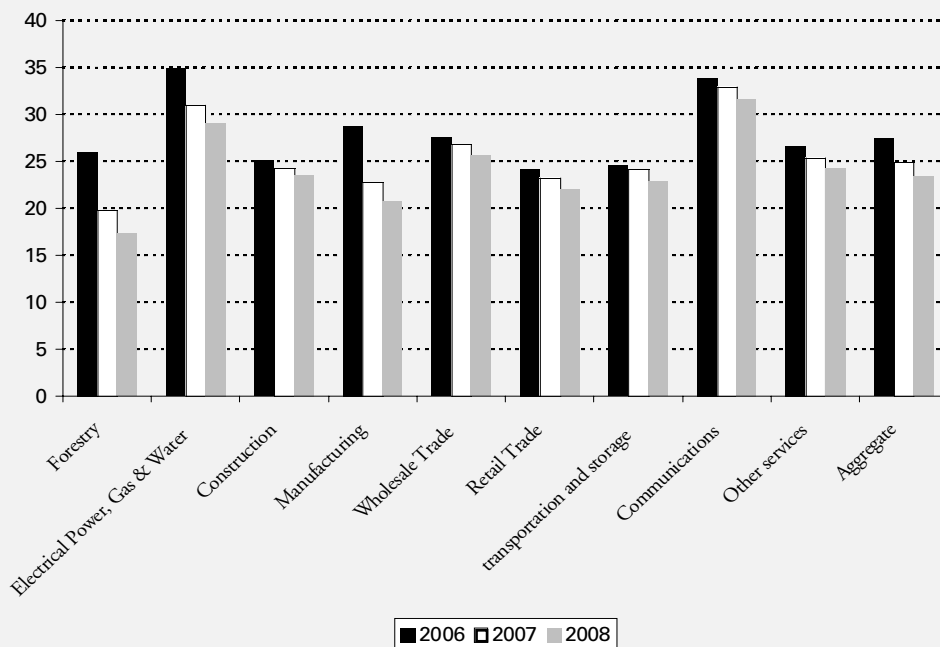
Applying differential corporate income tax rates on industries is not very sensible policy.

Figure 3a: Marginal Effective Tax Rate on Cost by Province:
A Comparison between 2006, 2007 and 2008



Sources: C.D. Howe Institute and School of Policy Studies, University of Calgary.

Figure 3b: Marginal Effective Tax Rate on Cost by Industry:
A Comparison between 2006, 2007 and 2008



Sources: C.D. Howe Institute and School of Policy Studies, University of Calgary.

Table 3: Policy Simulations for 2012

	Overall METR	Dispersion Index
	<i>Percent</i>	
A. Marginal Effective Tax Rate on Capital		
(1) The current projection	25.8	39.0
(2) With PST harmonization	18.9	38.9
(3) With a 10% provincial CIT rate and no investment tax credits	25.8	30.8
(4) = (2) + (3)	19.0	22.1
B. Marginal Effective Tax Rate on Labour		
(5) The current projection	45.3	
(6) With a 10% flat provincial PIT rate	42.3	
C. Marginal Effective Tax Rate on Cost of Doing Business		
(7) The current projection	23.4	
(8) = (4) + (6)	18.4	

Sources: C.D. Howe Institute and School of Policy Studies, University of Calgary.

provinces looking to make their corporate tax systems more competitive.

Sales tax harmonization in British Columbia, Manitoba, Ontario, Prince Edward Island and Saskatchewan would also be important in improving prospects for economic growth. It can be especially important at this time for those businesses with poor profitability that are nevertheless paying substantial tax on capital and intermediate business inputs. Sales tax reforms would be more sensible than providing grants and tax preferences to industries facing challenges arising from the US slowdown.

While many governments have undertaken reforms in the past several years, they need to do more on the personal income tax front. Federal and provincial governments have been enhancing incentives for retirement savings by expanding RRSP limits to shelter investment income from tax. The recent proposal for Tax Free Savings Accounts provides many Canadians, especially low-income families, an opportunity to accumulate wealth at yields free of tax. However, marginal tax rates on work effort seem exceptionally high. The federal government could devote more of its future surpluses to reduce personal income tax rates.

Provinces could, like New Brunswick, consider bold policies as well. As some economic studies

have suggested, provincial governments' redistribution policies are not as successful as federal policies since businesses and individuals move between provinces in a process that equalizes wage costs. Even though a province may wish to levy higher taxes on the rich and less on the poor, individuals move to jurisdictions with higher wages. Meanwhile, in the province they leave, wages are bid up in response to labour shortages. In the end, the high-income residents in the high-tax provinces receive higher pretax incomes, but the same after-tax income as they would earn in the low-tax province. Low-income residents receive lower pretax wages in jurisdictions with low taxes, but take home about as much as they would in a province with higher incomes and taxes. If redistribution policies are not effective at the provincial level due to migration (and should be left at the federal level to achieve), flat taxes could help simplify the tax system and encourage greater work effort if overall marginal tax rates are reduced.

Table 3 shows that a sales tax harmonization with the GST in provinces with existing retail sales taxes would reduce the marginal effective tax rate on capital by 6.9 percentage points for 2012. Although the standard deviation in effective tax rates declines, relative to the mean effective tax rate it remains the same.

On the other hand, a 10 percent provincial corporate income tax (CIT) rate with a complete removal of selected investment tax credits across provinces would have little effect on the aggregate marginal effective tax rate. But it would sharply reduce the overall dispersion in effective tax rates by 8 percentage points in 2012.

Provinces are important to business tax reform. A combination of sales tax harmonization and corporate tax reform in the provinces would reduce both the dispersion in effective tax rates on capital and the average marginal effective tax rate on capital. The combined federal-provincial marginal effective tax rate on capital would decline from 25.8 percent to 19.0 percent and the dispersion in rates by 16.9 percentage points. Further, provincial personal tax reforms that result in a flat rate would also reduce the marginal tax rate on labour. With a 10 percent flat provincial personal income tax (PIT) rate, the marginal tax rate on labour declines by 3 percentage points. Overall, with both reforms, the marginal tax rate on costs declines from 23.4 to 18.4 percent, which is a significant change in costs.

Conclusions

This *Commentary* finds that Canada continues to reduce taxes on capital investments, although it

has made little progress with respect to labour taxes, except in the case of Newfoundland and Labrador this past year. While several policies have been commendable – such as the significant reduction in corporate rates and the elimination of capital taxes planned for the provinces – some policies have provided relief to specific business activities, including some that face structurally declining markets. The dispersion in marginal effective tax rates across assets and industries will undermine growth in Canada.

Much can be done to reform taxes without resorting to special preferences. In some provinces, corporate income tax rates should be dramatically reduced instead of further complicated by special credits and deductions. Sales tax harmonization with the federal GST in those provinces with retail sales taxes would relieve many businesses from high taxes on business inputs. Canadians are waiting for more action on personal income tax rates, which continue to put high tax burdens on work effort.

Governments should continue the course of smart tax reform and make every effort to eliminate ill-conceived incentives for specific sectors that make it more difficult for the Canadian economy to adapt to the broader horizons of a changing global environment.

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