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The False Promise of Tax Cuts

The current mayoral race in this city has not exactly sprung to life. There is little coverage of the issues in the local papers and none of the candidates challenging Sam Katz seem to have developed much of a profile. This is unfortunate since any election needs to be a contest of ideas and policy alternatives. It is, therefore, profoundly distressing that Katz' most dramatic policy proposal, the elimination of the business tax, is not being challenged by any candidates, or by the media for that matter.

The City's Business Tax

Firms located in the City of Winnipeg pay a business tax in addition to their property taxes. The tax is levied on the Annual Rental Value (ARV) of a business premise. Winnipeg currently has two rates: the standard rate of 9.75 and a lower rate of 7.75, so far only applied to the downtown. Business tax regimes vary across western Canada. Calgary (8.77%) and Edmonton (7.7%) continue to raise revenue through a business tax while Vancouver and Regina do not.

The Mayor's proposal is to gradually phase out the business tax. He has already implemented a 2% point reduction to downtown businesses and promises that it will be extended to the whole city. The long term plan is to phase out the business tax entirely. Since the tax differential between the downtown and the rest of the city is only temporary, it would seem unlikely that businesses in the city would make any long term location decisions on this basis, making it quite doubtful that the tax will act as a catalyst for downtown redevelopment. So, the real question is what are the costs and benefits of, first, extending the 2% cut to the rest of the city and, then, completely eliminating the tax.

Costs

The most obvious cost of the elimination of the business tax would be on the City's ability to deliver services. At the 2004 tax rate of 9.75%, the City collected over $60 million in business taxes, making up around 9% of total municipal tax revenue. If the tax base remained the same (an assumption to which we will return) then a 7.75% tax rate would generate $49.8 million dollars, a decrease of $12.9 million. This cut is especially problematic due to the slow growth in city revenue. Between 1999 and 2004 total revenue only grew only $36 million (5%), so it would take a considerable amount of time to replace this loss.

Business tax cuts are not costless. They represent a transfer from the government of the City of Winnipeg, and the programs that it funds, to firms in the city. Even the seemingly modest $12.9 million that the 2% point tax reduction would cost represents one third of the subsidy paid to Winnipeg Transit ($35.5 million) and would pay the entire street lighting budget ($9.6 million). It also represents the entire amount paid out by the city for grants to different organizations, which in 2004 amounted to $11 million. If this were to be the budget line sacrificed, funding would be eliminated to organizations like the Manitoba Children's Museum, Main Street Project, Rossbrook House and Winnipeg Harvest as well as the more affluent beneficiaries, like the Winnipeg Goldeyes and MTS Centre.

The $60 million price tag of an elimination of the business tax would exceed the entire subsidy to Transit, the whole budget of the Water and Waste department ($33 million), and make up 75% of the Community Services budget, which pays for libraries and recreation services. It is certainly interesting that the Mayor has been pleading poverty, lamenting the lack of money for infrastructure and arguing that the city needs larger transfers from other levels of governments, while at the same time he is voluntarily giving up a sizeable source of revenue.

Benefits

Of course, a transfer of money from the government to the private sector does not only hurt the government and the people who use its programs. It also benefits those who were paying the tax. If we take the $12.9 million loss in revenue from the 2% point reduction, this does not create much of a windfall for the firms of the city. According to Statistics Canada, there were 38,694 businesses in the city in 2002 (Market Research Handbook, 2004). Therefore, on average each business can expect to save $336 each year.

The complete elimination of the $60 million dollar tax would yield a quite modest average tax saving of $1,550 per business. However, this average hides the fact that many firms, especially those with large, expensive properties or rental locations can benefit substantially.

Tax Cuts and Economic Growth

Advocates of tax reductions argue that there is an important dynamic gain from increased economic activity as firms have more incentive to expand their operations in, and relocate to, a low tax region. The current tax structure in the City does not make it an unattractive location to invest. In ***Competitive Alternatives***, a comparison of the relative attractiveness of different municipalities by consulting firm KPMG, Winnipeg actually scores quite well compared to other cities. In the Midwest region, Winnipeg ranks third out of seventeen cities, only slightly behind Edmonton and Saskatoon, and higher than Calgary. Further, taxes only make up between 5% and 11% of manufacturing and 3% to 8% of non-manufacturing costs. If firms are genuinely interested in decreasing costs, they are much more likely to compare other costs, which contribute more substantially to their bottom line.

The ideologically loaded question of whether taxes are a drag on economic growth has been the subject of considerable empirical investigation. Although there is still some controversy, something approaching a consensus is starting to emerge. Studies seem to agree that a one percent reduction in taxes, will result in an increase in economic activity (measured either in terms of investment, firm births, or employment growth) within the region in which the tax cut took place of somewhere between 0.1% and 0.6%. Given that most of the studies fall on the lower end of this spectrum and the fact that most of the studies are on manufacturing firms, which are more mobile than services, it seems quite likely that the percentage is 0.3 or lower. In addition, the business tax makes up a small percentage of the total tax paid by firms (which in turn makes up a small percentage of the overall costs). The 2% point reduction in the business tax would only reduce the total average tax rate of businesses in the city by 1.4%. Eliminating the tax would only generate an 8% decrease. The reduction, or even elimination, of the business tax will not decrease the overall tax rate sufficiently to have a large impact on business investment or economic growth.

It is further worth noting that increases in economic activity from the tax reduction could be offset by decreases in economic activity caused by decreases in municipal spending. Public spending, especially in areas such as infrastructure and education often increases private investment. In addition, virtually all of the spending by the City of Winnipeg is done in the local economy, while a portion of the tax money returned to Winnipeg businesses will be spent outside the region.

It is alarming that implementing a policy in which the benefits do not clearly outweigh the costs has ceased to be a matter of debate in this city.

- Ian Hudson and Andrew Buchel

Ian Hudson is a CCPA Research Associate and teaches Economics at the University of Manitoba. Andrew Buchel is a PhD student at the University of Manitoba. A more detailed discussion of business taxes can be found at our web: www.policyalternatives.ca This is a revised Fast Facts first released in July 2005. This piece first appeared in the Winnipeg Free Press ***on September 12, 2006.***

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