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"Picking Winners": The Distorting Effects of Federal Corporate Tax Cuts

By Jim Stanford

The federal government has announced a plan to reduce corporate income tax rates over the coming four years by almost one-third. The statutory rate will fall by over 7 percentage points, from 22.12% in 2007 (including the federal corporate surtax) to 15% by 2012. Finance Canada estimates these rate cuts will reduce federal revenues by just under $15 billion per year (or about $450 per year per Canadian) once fully phased-in. The corporate tax cuts will therefore reduce the federal government's total revenue base by about 6%—at a time when the risk of federal deficits has once again become quite imminent.

Finance Minister Jim Flaherty has made these corporate tax cuts the centerpiece of his government's strategy to create a supposedly more efficient, competitive, and successful national economy. He has argued that the tax cuts will insulate Canada's economy against coming economic uncertainty (such as that arising from the current U.S. economic slowdown). More unusually, he has launched a pointed attack on provincial governments—including, most explicitly, his home province of Ontario—to push them to deeply reduce their corporate tax rates as well. Flaherty has argued that current economic problems affecting Ontario (linked largely to the decline in manufacturing) are the result of the province's failure to cut corporate taxes faster.[1]

On this latter point, Flaherty and his colleagues have emphasized their philosophical opposition to so-called "picking winners." Instead of providing targeted, pro-active assistance to specific industries or regions, Flaherty argues that his corporate tax cuts are economically neutral. His government will not judge which sectors or regions are more important. His government just establishes a neutral, competitive playing field, and then allows market forces to determine the most productive directions for investment, employment, and production.

However, every government decision has differential effects on different segments of Canada's society and economy. In reality no government decision is "neutral." And in setting priorities, and deciding to expend its fiscal and other resources in one direction rather than another, governments are inherently "picking winners"—regardless of whatever *laissez faire* rhetoric may be invoked to justify their deliberate, discretionary choice. Corporate tax cuts are no more or less "neutral" in this regard than any other government policy decision—such as choosing to spend additional monies or provide incremental public services.

And it turns out that corporate tax cuts are in fact an especially *uneven* policy tool. Different companies, industries, and regions have extremely different exposures to corporate taxation, and hence to corporate tax cuts. The amount of corporate income tax that a company, industry, or region pays varies dramatically on the basis of several underlying economic factors, including:

- the capital intensity of production,
- the profit margin earned on production,

Table 1: Value of Corporate Profits by Province (2006)

	Before-Tax Corporate Profits as Share Provincial GDP	Before-Tax Corporate Profits per Capita
Nfld.	31.7%	$15,925
Alberta	22.2%	$15,781
Sask.	22.2%	$10,334
Manitoba	12.7%	$4,838
B.C.	11.8%	$4,935
Ontario	11.5%	$5,069
N.B.	10.8%	$3,648
Quebec	10.1%	$3,739
PEI	9.9%	$3,080
N.S.	9.2%	$3,143
Canada Average	**13.7%**	**$6,091**
Oil-Producing Provinces	**23.0%**	**$14,369**
Non-Oil-Producing Provinces	**11.2%**	**$4,548**

Source: Author's calculations from Statistics Canada catalogue 13-016 and CANSIM table 051-0001.

• the ability to claim tax deductions (for depreciation and other expenses),

• the sensitivity of producers to international or inter-regional competition.

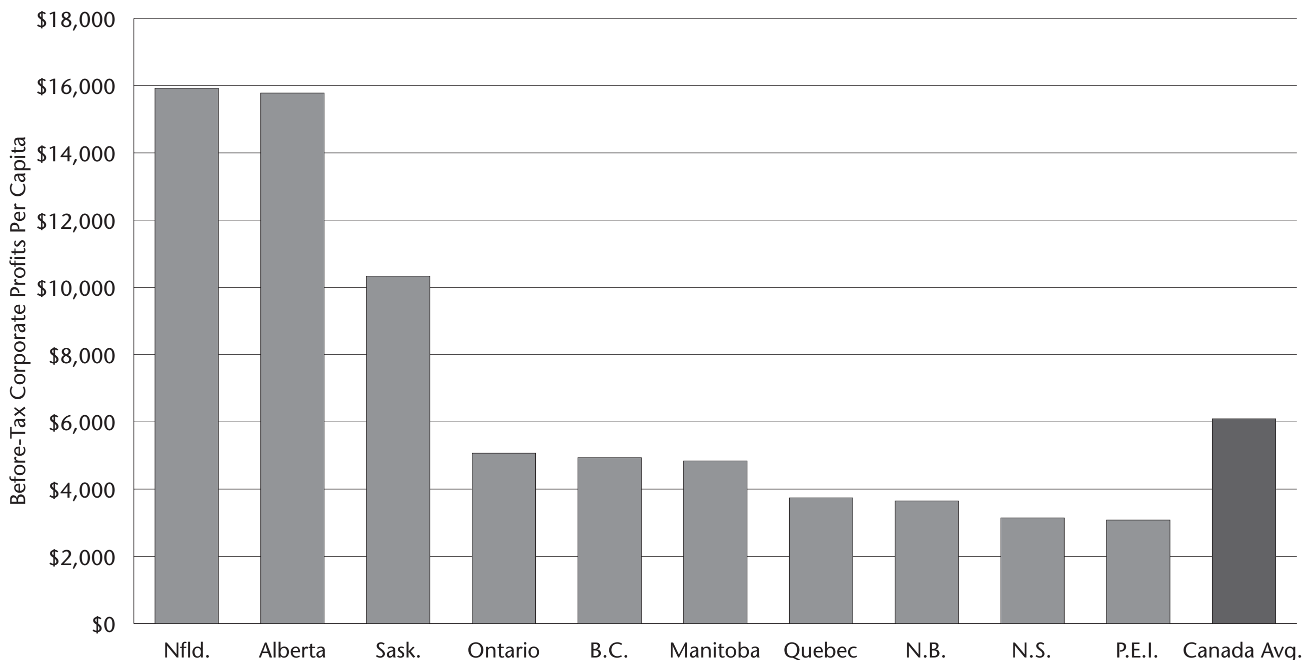
There is no reason to expect that corporate tax cuts should have an even-handed impact on different industries and regions in Canada, given large differences in these and other factors that determine corporate profitability and hence corporate taxes. This paper undertakes an analysis of the distribution of corporate profits across Canada's provinces, and across 16 major industries.

Statistical data (obtained from published Statistics Canada sources) indicate large differences in the economic importance of corporate profits in the different regions of Canada. Table 1 summarizes the share of pre-tax corporate profits in each province's GDP in 2006 (most recent data available). This profit share will be crucial in determining the relative importance of a reduction in corporate taxes in each province.[2] Newfoundland and Labrador, Alberta, and Saskatchewan are the three provinces with uniquely high profit shares (equal to 32% of GDP in Newfoundland's case, and 22% for Alberta and Saskatchewan). This obviously reflects the unique profitability of the petroleum industry, which plays a central role in each of those three provinces. Across the three oil-producing provinces, before-tax corporate profits average 23% of GDP.

For Canada as a whole, before-tax corporate profits accounted for 13.7% of GDP in 2006 (which was, incidentally, a record high share). In all non-oil-producing provinces, however, the profit share is lower than the national average (ranging from 9.2% in Nova Scotia, the lowest, to 12.7% in Manitoba). For the non-oil-producing provinces as a whole, before-tax profits equal 11.2% of GDP—less than half the profit share in the oil-producing economies. Since these non-oil-producing provinces account for a disproportionately small share of corporate profits, they will naturally receive a disproportionately small share of the value from a corporate tax cut. Similarly, the three oil-producing provinces will receive a larger share. Ironically, those are the three provinces which enjoy the most expansive economic conditions already, as a virtue of the surge in global oil prices and hence oil industry profits and investment activity. In fact, those three provinces (which together account for just 15% of Canada's population) accounted for 36% of total before-tax corporate profits in 2006 (more than twice its proportional share).

On a per capita basis, the regional inequality in profitability (and hence the regional inequality of the effects of the planned tax cuts) is even more stark. In Newfoundland and Alberta, before-tax

Figure 1: Provincial Distribution of Corporate Profits, 2006



Source: Author's calculations from Statistics Canada catalogue 13-016 and CANSIM table 051-0001.

corporate profits equal almost $16,000 per resident. Saskatchewan generates over $10,000 per resident. In the non-oil-producing provinces, on the other hand, before-tax corporate profits average $4500 per capita, less than one-third the levels in oil-producing provinces. As a rule of thumb, therefore, ***a reduction in corporate tax rates will deliver approximately three times as much value per resident to the profit-intensive oil-producing provinces as to the rest of Canada.***

In essence, therefore, by disproportionately rewarding regions which are already experiencing the strongest economic growth (based on the oil industry), CIT cuts will clearly exacerbate regional differences in Canada's economy. The same three oil-producing provinces are now the only provinces which enjoy per-capita GDP higher than Canada's national average; by this measure, those three provinces are the only "have" provinces.[3] All other provinces (including Ontario and B.C.) have GDP per capita levels below the national average. Yet Mr. Flaherty's remarkably expensive corporate tax cuts will deliver a vastly disproportionate share of total benefits (likely over one third) to the three oil-producing provinces which already enjoy higher-than-average GDP.

An even more dramatic inequality is readily evident in empirical data regarding the varying profitability of different industries in Canada—and hence the differing extent to which industries will benefit from the planned tax cuts. Table 2 provides a similar set of data for 16 major sector groupings in Canada's economy: profitability is measured as a share of industry sales, and per worker employed in that industry. Again, differences in the relative intensity of profits across these industries can be interpreted as an indicator of the differential benefits resulting from corporate tax cuts.

Once again the oil and gas sector dominates the analysis. Before-tax profits equal almost 20% of the petroleum industry's total sales. In 2006 (when this data was assembled) this equaled over $300,000 for every employee in the industry—and this incredible number has grown even further since 2006, as a result of the subsequent expansion in oil prices and oil profits. Profits per worker in the oil and gas industry are 17 times higher than in the Canadian economy as a whole (just over $18,000 per worker).

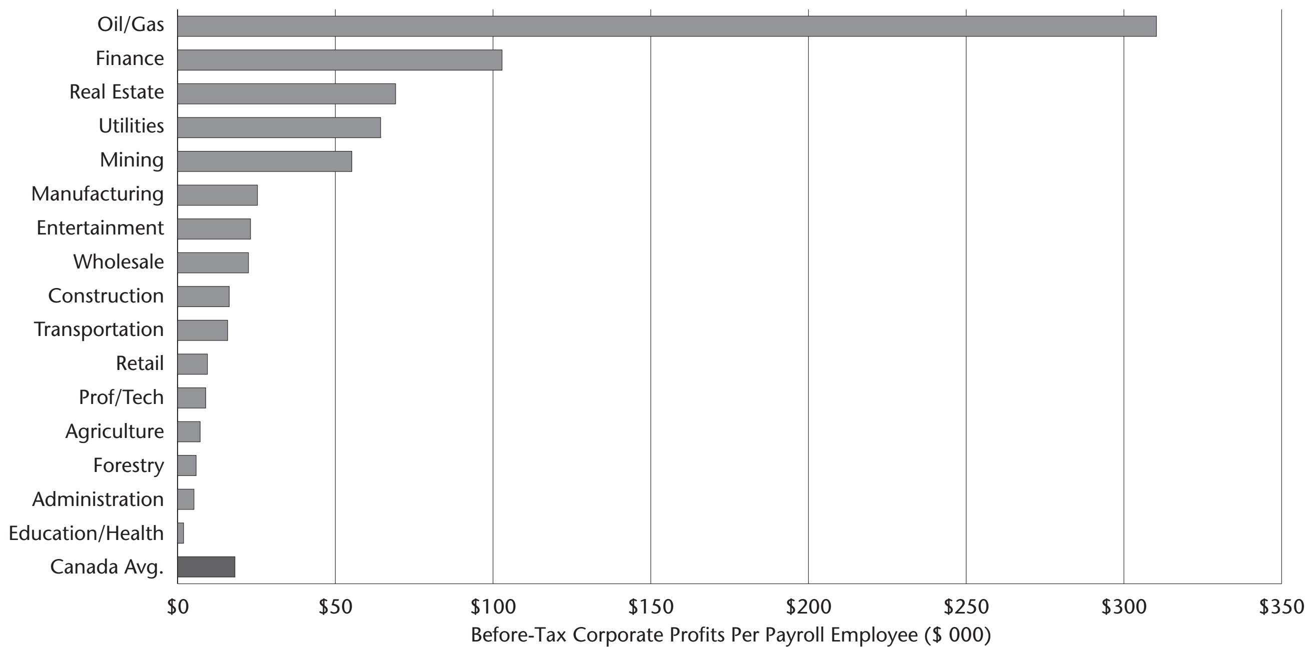
The finance sector is the second most profitable industry in Canada. Before-tax profits in finance exceed 20% of operating revenues, which works out to over

Table 2: Value of Corporate Profits by Industry (2006)

	Before-Tax Corporate Profits as Share Industry Revenues	Before-Tax Corporate Profits per Payroll Employee
Oil and Gas	18.34%	$310,324
Finance	20.20%	$102,858
Real Estate	25.48%	$69,123
Utilities	7.62%	$64,375
Mining	18.39%	$55,243
Manufacturing	6.59%	$25,321
Entertainment and Recreation	19.82%	$23,117
Wholesale Trade	3.65%	$22,468
Construction	6.08%	$16,370
Transportation	7.92%	$15,875
Retail Trade	3.81%	$9,461
Professional and Technical	6.43%	$8,914
Agriculture, Fishing, and Hunting	9.10%	$7,146
Forestry and Logging	3.48%	$5,873
Administrative	6.21%	$5,191
Education and Health	13.60%	$1,905
Total All Industries*	**8.46%**	**$18,176**
5 High-Profit Industries†	**18.02%**	**$107,175**
All Other Industries	**5.89%**	**$10,807**

Source: Author's calculations from Statistics Canada catalogue 61-219 and CANSIM table 281-0024.
* Total includes sectors not listed on the table (public administration and unclassified).
† Oil and Gas; Finance; Real Estate; Utilities; Mining.

Figure 2: Sectoral Distribution of Corporate Profits, 2006



Source: Author's calculations from Statistics Canada catalogue 61-219 and CANSIM table 281-0024.

Table 3: The Concentration of Corporate Profits by Region & Industry (2006)

Concentration by Province

	Before-Tax Corporate Profits ($b.)	Percent Canadian Total	Population (mil.)	Percent Canadian Total
3 Oil-Producing Provinces	$71.5	36.0%	5.0	15.1%
All Other Provinces	$127.3	64.0%	28.0	84.9%

Concentration by Industry

	Before-Tax Corporate Profits ($b.)	Percent Canadian Total	Payroll Employment (mil.)	Percent Canadian Total
5 High-Profit Industries	$115.0	45.1%	1.1	7.6%
All Other Industries	$140.1	54.9%	13.0	92.4%

Source: Author's calculations from Statistics Canada catalogues 13-016 & 61-219, and CANSIM tables 051-0001 & 281-0024.
Total profits by province ($198 billion) do not equal total profits by industry ($255 billion) because of different definitions used in the national income and corporate finance surveys utilized to construct each set of data.

$100,000 per employed worker, or five times higher than the national average. Three other industries also enjoy disproportionately high levels of profitability: mining, utilities, and real estate. Together these five sectors (concentrated in resources and finance) accounted for over 45% of all before-tax corporate profits in 2006, reporting average profits per worker of $107,000.

All other industries in Canada, on the other hand, reported profits per worker of just $10,800—or one-tenth as high as the super-profitable resource and finance sectors.

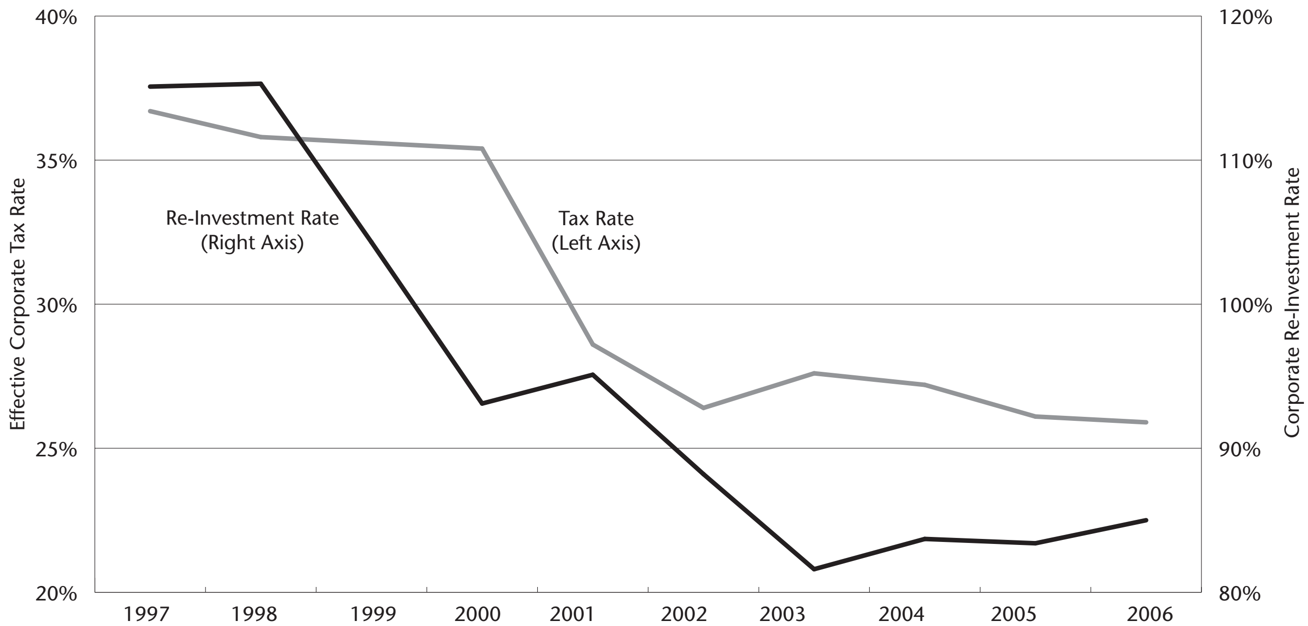
Measured as a share of industry revenues, profits in Canada's hard-hit manufacturing sector are disproportionately small: equal to 6.59% of revenues in 2006 (and this share has certainly declined since then, given the very challenging economic conditions facing Canadian manufacturing). Profits are even lower for a range of economically important service industries. Outside of the resource and financial sectors, therefore, these data suggest that the value of planned business tax cuts—whether measured as a share of total sector revenues, or on a per-worker basis—will range from modest to imperceptible.

In short, in both regional terms and sectoral terms, Mr. Flaherty and his government are clearly "picking winners" with this extremely expensive program of corporate tax reductions. The planned tax cuts will significantly undermine the federal government's revenue-generating capacity. The business tax cuts are more expensive, and proportionately far deeper, than reductions implemented in either personal income taxes or sales taxes. Effective federal corporate tax rates will have been cut almost in half since the turn of the century, once the planned reductions are fully implemented. In contrast, the federal GST rate was cut by just over one-quarter, and the average effective federal personal income tax rate has hardly declined at all, from 11% of personal income in 2000 to 10% today (since reductions in statutory rates were mostly offset by bracket creep and other tax factors).

The effect of the CIT reductions will be to clearly accentuate existing inequalities in Canada's economy—both between oil-producing and non-oil-producing regions, and across industries. Industries and regions that are already doing very well (especially those dependent on petroleum production and the financial sector) will receive substantial revenues from the tax cut program. Those that are struggling (including every non-oil-producing province, and hard-hit industries such as manufacturing and tourism) will receive virtually nothing. This historic reduction in corporate income taxes clearly reflects a decision by Mr. Flaherty's government to "pick winners." Surprisingly, the "winners" he is picking are the provinces and industries that are already doing very well indeed.

The concentration of the likely benefits of corporate tax cuts in these already-successful provinces and industries is summarized in Table 3. The oil-producing provinces, which account for 15% of Canada's population,

Figure 3: Money Down the Drain? The Questionable Value of CIT Cuts, 1997-2006



Source: Author's calculations from Statistics Canada catalogue 380-0006 and Department of Finance Fiscal Reference Tables.

generate 36% of corporate profits—and can be expected to reap a similarly large share of the benefits of corporate tax reductions. Even more lopsided, five super-profitable resource and financial sectors, which employ just 7.6% of the Canadian workforce, account for almost half of all before-tax corporate profits—and will receive a similarly disproportionate boost as a result of the corporate tax cuts.

On a per capita basis, companies in oil-producing provinces are likely to receive over three times as much from the CIT cuts and those in non-oil-producing provinces. And on a per-employee basis, the five super-profitable resource and finance sectors are likely to receive ten times as much from the tax cuts as the rest of the economy.

If the prosperity of the petroleum and financial industries genuinely reflected economically rational work, investment, and innovation, then perhaps Mr. Flaherty could argue that his tax cuts will stimulate more of that essentially productive behaviour. In reality, of course, his tax cuts are rewarding something else: good fortune (in the case of the oil industry, benefiting from strong Canadian resource endowments and record-high global prices) and speculative behaviour (in the case of the financial sector, whose innovative but risky activity has ushered in the current intense uncertainty that is undermining economic progress in Canada and around the world).

In addition to questioning the regional and sectoral impact of these policies, a separate set of questions must also be asked about their economic impact. Despite the historic decline in corporate tax rates which has already been engineered in this decade (as indicated in Figure 3, the average effective rate, considering both federal and provincial corporate taxes, has declined by about one-third since the end of the last decade), business spending on capital equipment and R&D has been remarkably sluggish in Canada—even though Canadian companies are enjoying all-time record profits and a surplus of disposable cash flow.

Incredibly, business spending on machinery and equipment has declined as a share of Canada's GDP, and total business investment spending (which includes construction costs, like major oil sands projects) has declined as a share of available corporate cash flow. Figure 3 illustrates this decline: whereas in the late 1990s Canadian companies regularly re-invested well over 100% of disposable cash flow (counting both after-tax profits and depreciation allowances) into new projects, in recent years that re-investment rate has declined to the low 80% range. Corporate tax cuts,

as expensive as they have been (and will continue to be), have had no visible impact on the broad pattern of business investment at all. If anything, corporate investment performance has become *weaker*, even as corporate taxes have been deeply cut.

A more detailed consideration of the link (or lack of a link) between corporate tax cuts and business investment is beyond the scope of this paper. But, in addition to asking whether the regional and sectoral impacts of the Harper government's $15 billion annual corporate tax cuts are fair and acceptable to the majority of Canadians, we should also ask whether they will have any beneficial impact on Canada's economy at all.

(Jim Stanford is an economist with the Canadian Auto Workers and a CCPA Research Associate.)

Notes

1. For example, Mr. Flaherty recently linked Ontario's refusal to cut corporate income taxes to GM's decision to eliminate a shift at a truck plant in Oshawa that sells almost all its output to the hard-pressed U.S. economy; see "Another dark day for Oshawa," *Toronto Star*, April 29, 2008, p. A8.

2. The amount of corporate taxes paid in any region or industry obviously depends, first and foremost, on the amount of corporate profits generated in each region or industry. Other factors, however, are also important in determining ultimate corporate tax liability, including different values for tax deductions, carried-forward losses, etc. So the relative importance of before-tax profits in each region or industry is only a broad guide to the likely incidence of corporate income taxes (and hence the ultimate value of reductions in those taxes).

3. Saskatchewan and Newfoundland currently receive federal equalization payments despite enjoying higher-than-average GDP per capita. These payments are expected to cease, however, within the next couple of years as record oil prices push their provincial GDP per capita far above the Canadian average. Ontario, meanwhile, still pays into the equalization program despite having a per capita GDP that is now slightly below the national average. It should be reinforced that the connection between super-high corporate profits (and hence GDP) and broad prosperity in a particular region is not at all direct. Despite huge profits and higher-than-average GDP, personal incomes in both Saskatchewan and Newfoundland are below the national average. While corporate tax cuts will deliver a disproportionately large boost to companies operating in these provinces, there is no assurance at all that this will enhance the average incomes of the people who actually live there.

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