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Saskatchewan Notes

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Lowering taxes comes at a cost: What the business lobby isn't telling you about taxes

- by Adam Shevell

Taxes are the price we pay for a civilized society – Oliver W. Holmes

Introduction

Taxes are an integral part of our society. They pay for the infrastructure we rely on, provide for public services such as health care, help redistribute wealth to facilitate a more just society, and fund essentials such as education.

The Saskatchewan government announced in its 2005 spring budget the creation of the Business Tax Review Committee (BTRC). The BTRC's mandate is to "assess the tax system's competitiveness and effectiveness in encouraging job creation and investment in Saskatchewan"[1]. From May until June 2005, the BTRC held public hearings in cities across Saskatchewan. The commission is scheduled to release its report in November, and will include recommendations to the government on how best to reform the business tax system in Saskatchewan.

It is important that Saskatchewan citizens understand that any changes to the business tax regime in the province will have a direct impact on all people of Saskatchewan, not just the business community. Tax cuts to business will affect the relative burden we each must bear in support of government services and other tax-funded benefits.

Types of Taxes paid by Corporations

Businesses pay different types of taxes on their operations depending on what type of business it is. Corporate income tax is a tax paid on the profits of a corporation, after all costs and other expenditures are taken into consideration. The rate at which a corporation's income is taxed may vary. Small businesses pay a reduced tax rate on their income up to a certain level of their profits. After the small business threshold they pay the regular corporate income tax rate. Corporations in the manufacturing and processing sectors in Saskatchewan pay a reduced tax rate on their income, a policy instituted in the mid-1990s to promote the industries operating in the province.

Some large corporations also pay a Corporate Capital tax, which taxes capital stock above a certain threshold. Typically, companies that pay the corporation capital tax are in capital-intensive industries, such as forestry or mining. Financial service providers also pay the corporate capital tax.

Like everyone else in the province, corporations pay a variety of other taxes in their daily operations. The most significant for business is the provincial sales tax, of which approximately 60 percent is paid for by business[2]. Property taxes, fuel taxes, and other local levies are also paid by companies that carry out their operations in Saskatchewan. Resource extraction companies pay resource royalties that attempt to capture the value of the publicly owned natural resource that the companies exploit.

Corporations in Saskatchewan do not pay payroll taxes at the provincial level, such as the federal Employment Insurance plan or Canadian Pension Plan. In other provinces, companies are increasingly subject to payroll taxes, in such forms as paying for employees' health insurance premiums.

Though the BTRC's mandate is to assess the tax system's competitiveness in encouraging job creation and investment in Saskatchewan, the Calvert government explicitly excluded local taxes, such as property tax, or resource royalties in the review. Given the fact that all taxes paid by businesses affect economic decision-making and thus the business environment in the province, it is questionable whether a limited review will be useful in guiding the government's intended reform of Saskatchewan's tax policy. Resource industries[3] comprise a large proportion of Saskatchewan's business activity, with royalties in 2004 accounting for 17% of government revenue, compared to 51.8% for all other taxes combined[4]. A review lacking the comprehensiveness required may not only fail to improve Saskatchewan's tax regime, but may actually make the province worse off.

Saskatchewan's Business Tax Regime

In 2004, the government of Saskatchewan collected $3.4 billion in taxes[5]. Approximately 1.5 billion dollars or just over 20 per cent of the revenue side of the provincial budget is accounted for by business taxes. That means that four-fifths of revenue taken in by the provincial government comes from sources and people other than business.

The rates corporations are taxed in Saskatchewan are roughly in line with other Canadian provinces, the lone exception being Alberta. While some business pay higher rates on income than businesses in neighbouring provinces, others pay a lower rate. Like all policies, the tax mix in each province reflects the individualized priorities of the government and the people.

The corporate income tax rate in Saskatchewan is 17%. Companies in the manufacturing and processing (M&P) sectors pay a reduced corporate income tax rate of 10%. This compares to corporate income tax rates of 13.5% in British Columbia, 11.5% in Alberta, 15% in Manitoba, and 14% in Ontario. Of the other provinces, only Ontario has a reduced income tax rate for M&P, which is 12%. The small business income tax rate in Saskatchewan, which applies to the $300,000 of profitable income, is 5.0%. The same rate in British Columbia is 4.5%, in Alberta 3%, in Manitoba 5%, and in Ontario 5.5%.

The corporate capital tax rate in Saskatchewan is 0.6%, paid on capital assets above $20 million for Saskatchewan-based corporations and $10 million for corporations run from outside the province. Though British Columbia and Alberta no longer have a corporate capital tax, Manitoba and Ontario tax all capital assets above $5 million at 0.5% and 0.3% respectively. Financial companies (banks, trusts, and credit unions) pay capital taxes in all provinces, usually between 1 and 3% on net paid up capital.

The provincial sales tax rate in Saskatchewan is 7%, as it is in both British Columbia and Manitoba. Alberta has no sales tax and Ontario's sales tax rate is 8%. Saskatchewan has no forms of payroll taxes at the provincial level. On the contrary, Manitoba and Ontario apply labour-based payroll taxes on businesses and in British Columbia, Alberta and Ontario, health care premiums are more often than not paid by businesses on behalf of their employees. Saskatchewan continues to operate its health care system with no health insurance premiums.

Tax Expenditures and Average Effective Tax Rate

Understanding how the business tax regime influences the economic environment of the province requires more than looking at the tax rates for various activities. Just as important as the levels of tax rates are the tax expenditures and other fiscal incentive programs that provide targeted businesses with relief from paying taxes. These tax incentives vary from reduced tax rates to investment tax credits or exemptions from paying royalties on resources.

As we have seen, both small business and M&P corporations are taxed at reduced rates compared to other corporations in the province. Other important sectors of the Saskatchewan economy also receive incentives through investment tax credits, employment tax credits, sales and fuel tax exemptions, or reduced income tax rates. Such industries include research and development operations, agriculture, natural resource industries, and the film sector.

Though the statutory corporate income tax rate in Saskatchewan is 17%, the average effective tax rate (the actual taxes paid once tax expenditures and other deductions are taken into account), is much considerably lower. For example, if a corporation in Saskatchewan made $1 million in profit, they would be taxed at 17% and would pay $170,000 in corporate income taxes. However, if that same company claimed $500,000 in tax expenditures, they would be left with $500,000 of taxable income. At 17%, the company would pay $85,000 in corporate income tax. Though the rate at which the company is taxed in the second instance is still 17%, when we look at how much they are taxed relative to their profits of $1 million (85,000/1,000,000) we get an effective tax rate of 8.5%.

The Competitive Position of Saskatchewan

According to international accounting firm KPMG, taxes – in all their forms - represent only between 3 to 11% of location-specific business costs[6]. This means that anywhere between 89 to 97% of the cost of doing business is unrelated to taxation. In order to understand where Saskatchewan stands competitively with other provinces, one must consider the other costs of doing business *in addition* to taxes.

KPMG conducts an extensive and extremely thorough study of the cost of doing business in cities across the world.[7] The study compares the cost of doing business in different countries, as well as compares the cost of doing business between cities within the same country.

This report shows that of all cities in Midwest North America, Saskatoon is the second least costly city in which to operate a business. It is the cheapest place to do business of all urban areas in the Midwest with a population under 500,000. Saskatchewan boasts inexpensive utilities provided by our Crown Corporations, low labour wages, and inexpensive land and building costs. Businesses benefit greatly from tax-funded government services, from low-cost utilities to a health care system requiring employers to pay no insurance levies. Though businesses in some sectors do pay higher taxes than other jurisdictions in Canada, they also save a significant amount because of these inexpensive factors and tax-funded initiatives.

Indeed, the current business tax regime doesn't seem to be burdening the provincial economy like some make it out to be. For the first time in over 20 years, Saskatchewan is a "have" province, transferring more to the federal government than it receives in transfer payments. Saskatchewan's bond rating was recently increased by bond-rating agencies from 'A' to 'A high'.

CIBC World Markets recently ranked Saskatoon and Regina second and eighth respectively in economic growth among all Canadian urban centres. High global demand for natural resources has meant high commodity prices. Most notably, Statistics Canada predicts that in 2005, investment growth in Saskatchewan will be 12.6%, the highest rate of growth anywhere in Canada and twice the national average.

Do tax cuts lead to investment and economic growth?

Economists agree that high levels of business investment in new buildings, machinery and equipment, research and skills contribute to economic growth and high productivity. It is much less certain that corporate tax rates play a major role in the decisions made by business on how much to invest[8]. It is argued that reducing corporate income taxes and other taxes on business lead in turn to increased investment and likewise economic growth. The causal picture is not so certain. A critically important question that any inquiry into tax reform must explore is to what extent would a reduction of business taxes increase investment in the province.

Business investment decisions depend much more on the growth of demand in an economy than on the cost of capital. Since the year 2000, the federal government has reduced its corporate income tax rate from 28% to 21% - a reduction of 25% of the statutory rate. If investment did indeed respond negatively to corporate tax rates, we would expect levels of investment in Canada to rise as corporate taxes have been substantially reduced. In fact, quite the opposite has occurred.

Since 1999, investment in structures, machinery and equipment as a percent of GDP has fallen from 12.9% to 10.8%. At the same time, corporate pre-tax profits have increased from 11.3% of GDP to 13.8%[9]. Tax cuts have not led to higher levels of business investment. Instead, they have been used to improve corporate performance and reward stockholders[10].

Public Investment: the Alternative to Tax Cuts

Instead of giving tax cuts to corporations and relying on them to spend the windfall on new investments, the provincial government should keep the tax proceeds and invest directly in the province. As has been evidenced at the federal level, tax cuts are not being reinvested at significant rates, but rather tend to go towards improving debt-to-equity ratios or providing higher dividends to stockholders. By relying on the private sector to distribute tax cuts, we risk having them leave the province or put to unproductive use.

The government has a responsibility to promote a dynamic economy with innovative capacity and sustainable economic growth. Public investment can play a major role in increasing productive and innovative capacity by investing in targeted programs instead of relying on the private sector to fill the gap. Public investment can create a positive business climate in which corporations benefit from publicly provided cost-reducing services.

Investment in education, at all levels from pre-school to post-secondary, is a proven means for producing high social rates of return and has a high impact on business sector productivity. Workplace training is another area of crucial potential for the economy at large and businesses in particular. As the Saskatchewan economy moves from one based on resource extraction and primary productivity to a knowledge-based economy, it is critical that we provide lifetime learning opportunities for non-managerial/professional workers in order to maintain a productive workforce. Business would benefit directly from this process of lifelong training. Investment in physical infrastructure, from roads and highways to water transport systems or electronic infrastructure, can promote better business productivity and its associated general benefits.

Public investment is critical in sectors of the economy that provide spillover benefits to society as a whole but which are not captured in private markets. A perfect example of this is the investment tax credit instituted in Saskatchewan for research and development operations. Though this is a positive step, more needs to be done to support research and development and training in order that the benefits disperse throughout the economy. Support programs such as these can be used to build more high-value industries and better jobs for the people of Saskatchewan.

Conclusion

Though some people have protested that corporations in Saskatchewan are unfairly taxed, the level of taxation in the province is not far off from the Canadian average. What's more, taxpayer-funded public services directly benefit the business community in the province, providing businesses with inexpensive factors of production that make Saskatchewan an incredibly competitive place to do business. The healthy economic growth and high levels of investment are testament to the success of both our tax and non-tax economic policies.

Across-the-board tax cuts may provide short-term windfalls to companies in the province, but it is questionable how well tax cuts will promote reinvestment in the Saskatchewan economy. The livelihoods of all the people of Saskatchewan are at stake when the government reforms the business tax regime; let's make sure the reform serves us all.

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[1] Business Tax Review Committee: http://www.gov.sk.ca/finance/btrc/mandate.html
[2] Business Tax Review Committee - http://www.gov.sk.ca/finance/btrc/taxes.html
[3] For a full account of resource royalties in Saskatchewan, see John Warnock (2005) *Natural Resources and Government Revenue: Recent Trends in Saskatchewan* (CCPA Saskatchewan)
[4] Form 18-K *Annual Report of the Province of Saskatchewan* as filed by the Saskatchewan Ministry of Finance with the Securities and Exchange Commission, Washington D.C.
[5] *Ibid.*
[6] *The Competitive Alternatives Report* (KPMG: http://www.competitivealternatives.com/)
[7] *Ibid.*
[8] Jackson, Andrew (2005) *The Dubious Case for More Corporate Tax Cuts* (Ottawa: Canadian Labour Congress)
[9] Statistics Canada, National Accounts
[10] "Corporations Build Surpluses During the Year" *Canadian Economic Accounts Quarterly Review.* Fourth Quarter 2004

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