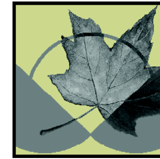
BEHIND THE NUMBERS
economic facts, figures and analysis



CCPA
CANADIAN CENTRE for POLICY ALTERNATIVES
CENTRE CANADIEN de POLITIQUES ALTERNATIVES

Volume 7, Number 3 • April 29, 2005

The Case Against More Corporate Tax Cuts

By Andrew Jackson

Introduction

In truly Pavlovian fashion, the words "corporate tax cut" seem to immediately trigger the words "investment" and "jobs" in corporate and media circles. It is taken as absolutely axiomatic that lower business taxes lead to more investment and more jobs.

The demand of the federal NDP to rescind a new round of corporate tax cuts was widely seen as nothing short of economic lunacy. *The Globe and Mail*, for example, sternly editorialized about killing the geese that lay the golden eggs ("Martin should resist NDP Tax Overture." April 25, 2005) and gave full coverage to apoplectic reactions from business lobby groups.

What was completely lost in this coverage was any sense of the rather tenuous links between business taxation and the process of real investment and job creation. Over the past few years, corporate profits have soared to a record high as a share of national income, and the bottom line has been further boosted by deep cuts in the corporate tax rate.

Meanwhile, job-creating corporate investments in buildings and machinery and equipment have lagged. Corporate Canada is awash with cash, but soaring profits are being invested outside the country in record amounts, stashed in offshore tax shelters, or paid out to corporate insiders and shareholders.

Corporate taxes are only one small element in the investment decision, and recent reports by KPMG, the *Economist* and others actually rank Canada very highly in terms of both tax competitiveness and overall cost competitiveness. Our key economic weaknesses as a country are in the building blocks of a knowledge-based economy, in areas like innovation and skills.

Social investments in areas like early childhood education, expanded access to post-secondary education and new environmental infrastructure should, as argued in the CCPA Alternative Federal Budget, be seen as policies which address our lagging productivity and create good jobs.

The key question is whether surpluses should be spent on further corporate tax cuts or on new public investments. This paper argues that the case for the former is far from proven.

A Decade of Costly Corporate Tax Cuts

The relentless corporate lobby for lower business taxes scored yet another win in the 2005 federal Budget. The federal corporate tax rate is to be cut, from 21% in 2005 to 19% by 2010, building on the large rate reduction from 28% to 21% which took place over the last five years, between 2000 and 2005.

The icing on the cake for business is that the corporate surtax will be eliminated by 2008, on top of the phase-out of the federal capital tax on corporations which will be completed by 2008.

Corporate income tax revenues in 2005-06 – when the tax rate will be 21% – are estimated to be $29.2 billion, or about $1.4 billion for each percentage point of the corporate income tax rate.

This implies that the annual cut to federal revenues from corporate income tax rate cuts in the 2005 Budget will be some $2.8 Billion when the new measures are fully implemented. (This includes elimination of the surtax.)

The full corporate tax rate cut of nine percentage points implemented between 2000 and 2010, plus the elimination of the surtax and capital tax, will reduce

annual (repeat, *annual*) federal government revenues by $12.6 billion in 2010 and future years, assuming corporate pre-tax profits remain at current levels. That is about $400 for every Canadian.

Why Cut Corporate Taxes?

The case that has been put forward for these deep corporate tax cuts is that Canada will lose out on new business investment if our corporate tax system is not "competitive" with that of the US and other major economies.

The 2005 Budget is quite explicit on this point. "In today's global economy, capital is highly mobile internationally, and a competitive tax system is critical to fostering business investment in Canada. Investment in new capital improves productivity, leading to economic growth, and higher wages and living standards." (P. 152.)

In short, the payoff from a more "competitive" tax system is supposed to be more business investment and better jobs. And, to get more investment, Canada needs a "corporate tax advantage."

Does Canada Have a Corporate Tax Competitiveness Problem?

The international business consulting firm, KPMG, produces a major annual report on 27 location-specific business costs in North America, Europe and the Asia-Pacific region for a wide range of industries. ("The Competitive Alternatives Report"). It is produced for CEOs considering alternative locations for new investments.

The most recent report, for 2004, found that effective corporate income tax rates in Canada are lower than in the US.

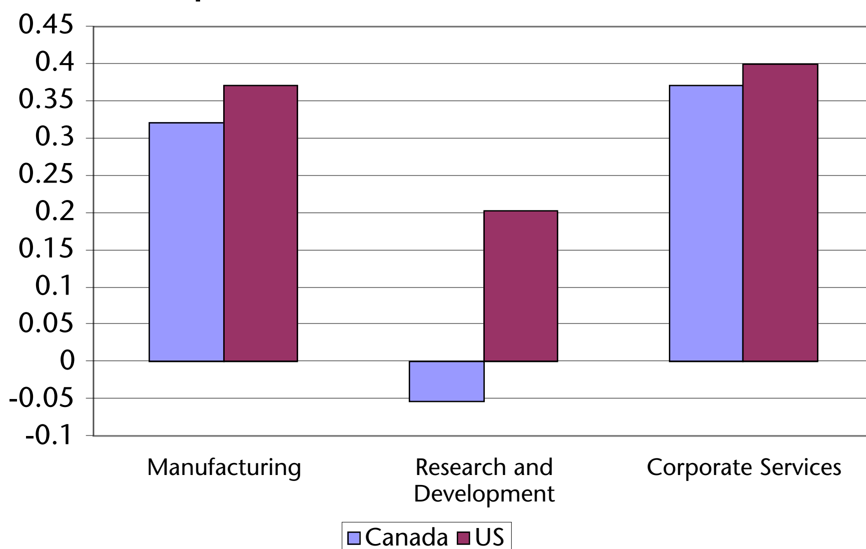
As shown in Table 1 and Chart 1, KPMG calculates that, in 2004, effective corporate income tax rates for

Table 1
Effective Combined Corporate Income Tax Rate
(as % of Net Profit Pre-Tax)

	Canada	**US**	**Canada's Rank** (out of 11 countries)
Manufacturing	32.0%	37.1%	4
Research and Development	-5.5%	20.1%	1
Corporate Services	37.0%	39.9%	7

Source: KPMG. Competitive Alternatives Report. 2004
Manufacturing is average for 7 operations.
Effective rate is for all levels of government.

Chart 1
Effective Corporate Income Tax Rates in 2004



manufacturing were more than five percentage points below the US level, and that tax rates on research and development intensive activities were actually negative, because of rich Research and Development tax credits. Canada ranked high among 11 countries, in terms of tax competitiveness.

In short, there was no real evidence of a tax-competitiveness problem before the 2005 Budget.

Moreover, the KPMG study calculates that business taxes account for only between 3 and ll per cent of location-specific business costs. And their study shows that Canada had the lowest location-specific costs of any of the eleven countries in the study, with total costs at just 91% of comparable US business costs (based upon a 75-cent exchange rate). The Canadian cost advantage was in the range of 8-9% in manufacturing, and even higher in research and development.

Canada had lower business costs compared to the US across most major categories, including lower utilities costs, generally lower transportation costs, low payroll taxes on employers, and low private employment benefits. The fact that most health care costs in Canada are paid for through public programs provides a major cost advantage compared to the US.

In short, Canada does not have a cost-competitiveness problem or a tax-competitiveness problem. The same conclusions have been reached by other business consulting groups, such as the Economist Intelligence Unit, which has just ranked Canada second only in the world to Denmark, and the widely-cited World Competitiveness Report.

Even the federal Budget noted that average corporate tax rates in Canada (combining federal and provincial rates) are today lower than average rates in the US (by 2.3 percentage points), and will remain that way even after planned corporate tax changes in the US. It is calculated that the new tax cuts in the 2005 Budget will significantly increase "Canada's corporate tax advantage," to 4.5 percentage points for the manufacturing sector.

Recent widely-publicized studies by the C.D. Howe Institute have put forward the case that Canada's marginal effective corporate tax rates (that is, the tax on a new capital investment at the margin of profitability) are sometimes higher than in the US. These studies seem to have been given a great deal of credibility by the House of Commons Finance Committee, and were prominently cited in its report before the 2005 Budget. However, these calculations look at many aspects of the business tax system (including depreciation rates for tax purposes, tax treatment of inventories, capital taxes, and, sometimes, sales taxes on capital goods as well as payroll taxes on employers). Therefore, they do not support the conclusion that the Canadian corporate tax rate as such is too high.

A study by the Caledon Institute notes that estimates of marginal taxes vary a great deal depending on the assumptions which are made, that inclusion of tax treatment of inventories changes the results considerably, and that Canadian corporate taxes on fixed investment alone are no higher than in the US. (Joe Ruggeri and Jennifer McMullin. "Canada's Fiscal Advantage." Caledon Institute. November 2004.)

What is the Link Between Corporate Taxes and Business Investment?

There is little doubt that transnational corporations will try to declare profits in countries and jurisdictions with lower tax rates. However, the accounting tricks used to do this, such as distorted transfer-pricing, can be countered by tax-compliance policies, proper auditing and the development of international rules on tax evasion. The OECD, for example, has been developing policies to counter the use of tax havens.

Economists would agree that high levels of business investment in new buildings, machinery and equipment, research and skills contribute to economic growth, higher productivity and better jobs. It is much less certain that corporate tax rates play a major role in the decisions made by business on how much to invest.

Most reputable and independent economic studies find that business investment is much more strongly related to the rate of growth of demand than to the cost of capital. According to a major literature review by the International Monetary Fund, "numerous studies . . . have attempted to measure the influence of the cost of capital on investment . . . [w]hile many of these studies find that investment is negatively related to the cost of capital, most find that the size of the effect is rather small." (Philip Gerson. "The Impact of Fiscal Policy Variables on Output Growth." International Monetary Fund Working Paper (WP/98/1) (www.imf.org, 1998). Studies for the 1980s by the OECD and those commissioned by the Mintz Committee on business taxation for Canada showed only a modest, if any, relation between the cost of capital and real business investment. (For a summary see: Andrew Jackson. "Tax Cuts: The Implications for Growth and

Productivty. CLC Research Paper #16. 2000 (Http://action.web.ca/home/clcpolcy/attach/taxcut-feb2k.pdf). Republished in Vol. 48, #2, Canadian Tax Journal, 2000). The cost of capital to business is much more strongly influenced by the level of interest rates than by corporate taxes.

Corporations, of course, will take tax rates into account when calculating if a particular investment is profitable, and where it should be made. But corporate tax rates are a small factor among many others at play. And it is far from clear that general, across-the- board tax cuts are the best way to lever new investment. General tax cuts may just provide windfalls to corporations for investments that would have taken place anyway.

Moreover, it must be noted that there is a wide range of businesses for which tax competitiveness is not much of a factor in where to invest. It is true that manufacturing investments are fairly mobile, and can be made anywhere in North America or even around the world. But this is not true for investments in much of the service sector, such as retail trade and many financial services, since investments must be made in Canada in order to serve the Canadian market.

Finally, it should be noted that corporate tax cuts erode the fiscal basis for public investments which can lower business costs and improve productivity.

Are Canadian Corporate Tax Cuts Raising the Rate of Business Investment?

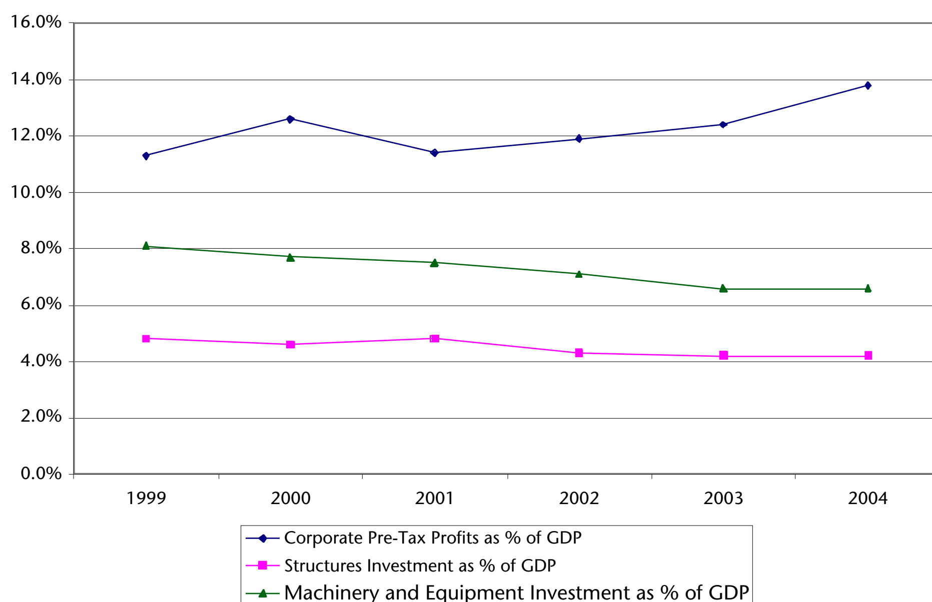
As noted, the federal corporate income tax rate has been cut from 28% in 2000 to 21% today. But there is, to date, no evidence of a significant impact on investment. On the contrary, corporate pre-tax profits have soared to a record-high as a percentage of national income, while real business investment in structures and in machinery and equipment has languished.

Table 2
Profits and Business Investment
as % of GDP

	1999	2000	2001	2002	2003	2004
Corporate Pre-Tax Profits as % of GDP	11.3%	12.6%	11.4%	11.9%	12.4%	13.8%
Structures Investment as % of GDP	4.8%	4.6%	4.8%	4.3%	4.2%	4.2%
Machinery and Equipment Investment as % of GDP	8.1%	7.7%	7.5%	7.1%	6.6%	6.6%

Source: Statistics Canada. National Accounts.

Chart 2
Corporate Pre-Tax Profits and Non-Residential Business Investment as % of Nominal GDP



As shown in Chart 2, corporate pre-tax profits have been on an upward trend since 2001, and are now at an all-time high as a share of national income. (14.0% in 2004.)

Meanwhile, business investment in structures (buildings) and in machinery and equipment has stagnated, even dipping slightly as a share of GDP.

Capital investment in machinery and equipment per worker in manufacturing is one-third lower than in the US, and Canadian businesses invest only half as much as US businesses in research and development. We fall well behind highly innovative countries like Sweden and Finland when it comes to corporate and public investment in innovation and in skills.

Clearly, tax cuts alone are not doing the job.

Where are the Profits Going?

Canadian corporations have boosted returns to shareholders, including through increased dividends and some purchases of their own shares to boost stock values. And, Statistics Canada reports that corporations are accumulating large cash surpluses as they use high profits to improve balance sheets rather than to invest. ("Corporations Build Surpluses During the Year." Canadian Economic Accounts Quarterly Review. Fourth Quarter, 2004.)

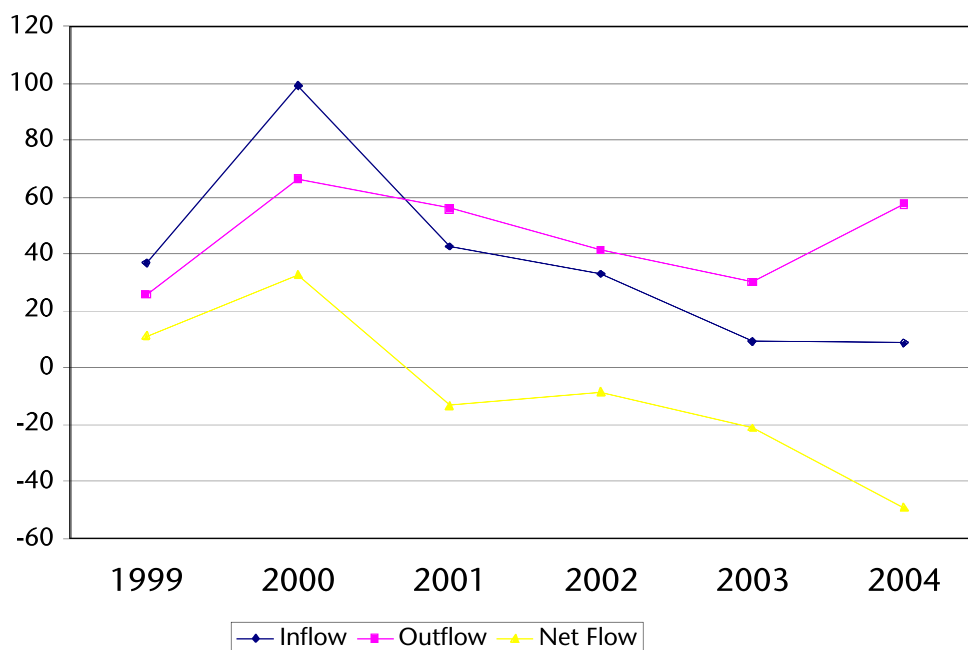
Corporations have also shipped profits out of Canada. Foreign direct investment flows are the result of corporate decisions on where to invest. Inflows represent decisions by foreign transnational corporations to invest in Canada, either directly in new plant and new businesses, or indirectly through takeovers and increased shareholdings. Outflows represent

Table 3
Net Flow of Foreign Direct Investment
(Inflow Minus Outflow)

	$ Billions					
	1999	2000	2001	2002	2003	2004
Inflow	36.8	99.2	42.6	33	9.2	8.5
Outflow	25.6	66.4	55.9	41.5	30.2	57.5
Net Flow	11.2	32.8	-13.3	-8.5	-21	-49

Source: Statistics Canada. Canada's Balance of International Payments

Chart 3
Net Flow of Foreign Direct Investment



decisions by Canadian corporations to invest outside the country.

As shown in Table 3 and Chart 3, there has been a serious deterioration in the net flow of foreign direct investment in recent years, especially in 2004 when the net outflow reached almost $50 Billion.

As reported recently by Statistics Canada (The Daily. March 14, 2005) there has been a large and growing outflow of Canadian Foreign Direct Investment to offshore financial centres (or tax havens), led by the financial sector which now has $72 billion invested in these centres, including $53 billion in banking services.

In any given year, between one-fifth and one-third of corporate income tax is paid by the finance sector which has led this financial exodus, meaning that they have reaped the same proportion of the value of corporate tax cuts.

Alternative Ways to Boost Investment

There are alternatives to general corporate tax cuts to improve Canadian business investment, productivity and job growth performance. We need measures which are directed toward resolving some of the underlying structural weaknesses of corporate Canada, notably a lack of innovative capacity compared to many other leading industrial economies.

Public investment can play a major role in increasing our productive capacities, but such investment has been sacrificed to tax cuts to at least some degree. Investments in education – from early childhood education to post-secondary education – have been found to produce high social rates of return and to have a major impact on business sector productivity. Workplace training is also crucially important. A major gap in our so-called, knowledge-based economy is the lack of lifetime-learning opportunities for non-managerial/professional workers. Investment in physical infrastructure, including highways, railways, port and water transport systems, and electronic infrastructure can all help promote higher business productivity and new business investment.

Our innovative capacities as a country have been considerably strengthened by academic research and by the research of other public sector bodies, notably the National Research Council and its Industrial Outreach (IRAP) Program, all of which could be greatly increased.

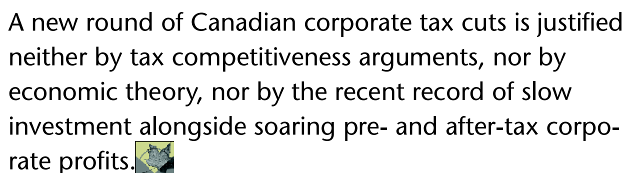
Targeted measures to support keystone investments can help create good, new jobs, especially by major firms in sectors like auto, aerospace, forest products and steel which create significant spin-off jobs in supplier firms. Support which is specifically targeted to additional research and development or training costs by corporations is much less costly than general corporate tax cuts, and can be used to build more high-value industries and better jobs. More public support of private investment in research and development and training is justified by the fact that the returns to the whole economy are greater than returns to the individual firms. The benefits of more Research and Development and more training are shared, so the market tends to lead to under investment. Moreover, large R&D investments can be very risky, and firms which invest in R&D and training may find that the benefits are captured by rival firms.

The Technology Partnerships Canada program has assisted in research and development costs of some of Canada's most successful and innovative enterprises, and merits more funding to allow it to play a larger role.

Finally, there may be an argument for specific corporate tax measures, as opposed to a new round of general corporate tax cuts. Companies should be allowed to write-off productive new investments for tax purposes at realistic depreciation rates, and complaints that the rules have not caught up with shorter working lives for some investments may be warranted. It may be that investment tax credits would have a greater impact on real investment at less cost than general tax cuts.

Conclusion

A new round of Canadian corporate tax cuts is justified neither by tax competitiveness arguments, nor by economic theory, nor by the recent record of slow investment alongside soaring pre- and after-tax corporate profits.



Andrew Jackson is National Director of Social and Economic Policy at the Candian Labour Congress and a CCPA Research Associate.