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Money for Nothing: The Vicq Committee's Corporate-Tax Cuts

- by Erin Weir

Introduction

The Saskatchewan Business Tax Review Committee (BTRC) has proposed dramatically reducing provincial corporate taxes and harmonizing the Provincial Sales Tax with the federal Goods and Services Tax. Recognizing that the provincial government cannot afford both initiatives, the Committee recommends implementing a schedule of corporate-tax cuts through the 2006 budget and deferring sales-tax changes for future consideration. The BTRC argues that lowering corporate taxes will significantly increase investment and employment in Saskatchewan.

Two of the three BTRC members are from the 1999 Personal Income Tax Review Committee (PITRC), which successfully advocated the largest income-tax cuts in Saskatchewan history. Jack Vicq chaired, and Charlie Baldock served on, both Committees. The BTRC's call for sales-tax harmonization essentially repeats the PITRC's call to apply a slightly lower sales-tax rate to a broader range of consumer products. Therefore, the BTRC's proposals to eliminate the Corporate Capital Tax (CCT) for all private businesses except financial institutions and to cut the Corporate Income Tax (CIT) rate from 17% to 12% constitute the newer and more pressing issue. (BTRC 2005)

The Committee's theoretical approach misleadingly emphasizes marginal, as opposed to average, tax rates. Its empirical evidence does not link business location and investment to business profits and taxes. Although productive investment is desirable, simply having more corporate capital and income reported in Saskatchewan may not be beneficial. A tax credit would stimulate more investment, at less cost, than the BTRC's proposed tax cuts.

Theory

The provincial government asked the BTRC to determine which business-tax system would make Saskatchewan most competitive with other jurisdictions, while being "sustainable within the Province's fiscal plan." In effect, the Committee was mandated to propose lowering business taxes as much as possible without running a budget deficit. (BTRC 2005: i; Shevell 2005: 3)

In arguing that Saskatchewan's taxes are too high, both the PITRC and BTRC focused on marginal tax rates, as opposed to average tax rates. (PITRC 1999; BTRC 2005) A marginal rate is the tax paid on the last dollar of a given tax base. An average rate is the total taxes collected from a base divided by that total base. If a business with a $20-million profit pays a 20% tax on profits in excess of $10 million, then its profits are taxed at a marginal rate of 20% (i.e. 20 cents from the final dollar), but at an average rate of 10% (i.e. $2 million/$20 million).

Since marginal rates almost always exceed corresponding average rates, proponents of tax cuts prefer to discuss marginal rates. However, this focus is not appropriate to competition between jurisdictions. To quote Robin Boadway, Canada's leading public-finance economist, "mobile factors should respond to *average* tax rates rather than marginal ones." (Boadway 1999: 384)

This point is especially relevant to the CCT, a major focus of the BTRC's terms of reference and *Final Report*. The Committee emphasizes that Saskatchewan's

marginal CCT rate of 0.6% exceeds the marginal CCT rates of most other provinces. For example, Ontario, Quebec (by 2009), and New Brunswick have marginal CCT rates of 0.3%. However, the BTRC's *Final Report* barely mentions Saskatchewan's $20-million CCT exemption, which far exceeds the exemptions of about $5 million provided by other provinces (Gendron 2005: 8) and makes Saskatchewan's average CCT rates reasonably competitive.

A business with $35 million of capital would pay $90,000 of CCT, whether based in Saskatchewan (i.e. 0.6% of $15 million) or in a typical province (i.e. 0.3% of $30 million). Although Saskatchewan has a higher marginal CCT rate (i.e. 0.6% versus 0.3%), it remains competitive because it has the same average CCT rate (i.e. $90,000/$35 million = 0.26%). Smaller businesses pay less CCT in Saskatchewan than in a typical province.

Saskatchewan's taxes may be uncompetitive for large, capital-intensive businesses. But these firms are located in Saskatchewan for specific reasons, such as the presence of natural-resource deposits, and cannot necessarily relocate in pursuit of lower tax rates. Relatively few Saskatchewan businesses have more than $35 million of capital. It would be prudent to study these firms and their relative mobility before abolishing the CCT for the sake of competitiveness.

The BTRC's overarching contention that lower business taxes would benefit the people of Saskatchewan cannot be proved or disproved with theory alone. The notion that lower corporate taxes, and higher corporate profits, would substantially increase investment and employment in Saskatchewan must be evaluated with empirical data.

Evidence

A key piece of evidence that confounds the BTRC's argument is *The Competitive Alternatives Report*, a KPMG study showing Saskatchewan's business costs, including taxes, to be among the lowest in North America. To minimize the revelation that businesses that can locate in Saskatchewan already have ample incentive to do so, the Committee had Doug Elliott of *Sask Trends Monitor* critique the KPMG study. Elliot correctly concludes that factors not covered by KPMG must explain the extent to which Saskatchewan is not, in fact, a magnet for business investment. Essentially, he alludes to more factors, other than business taxes, that influence business-location decisions. (BTRC 2005: 37-38, 121-123) The broader literature confirms "that fiscally-induced mobility is of second-order importance." (Boadway 1999: 385)

As Elliot points out, business investment is not correlated with business profits or taxes in Saskatchewan. To many, the fact that business profits are rising but business investment is falling would "imply that businesses are using these profits to improve their balance sheets or to distribute them to their shareholders." (BTRC 2005, 42, 131)

The BTRC sidesteps this sensible conclusion by suggesting, "it could also mean that these profits are being relocated to a more friendly tax jurisdiction for investment." (BTRC 2005, 42) This interpretation would have merit if investment were buoyant in other provinces. However, rising profits and declining investment are nationwide trends (Stanford 2005), rather than results of Saskatchewan's corporate taxes.

If business investment were correlated with business profits, as it was historically, tax cuts for business would reliably increase investment. Since this correlation no longer exists, it is doubtful that lower taxes would produce more investment. The combination in Canada of higher business profits than ever before, huge federal corporate-tax cuts in recent years, and disturbingly low business investment discredits the BTRC's recommended approach.

The link between tax cuts and job creation is even weaker. One of the Committee's main pieces of evidence that tax cuts are beneficial is a Canadian Federation of Independent Business survey of its members. It is not surprising that business owners, who have a direct material interest in business-tax cuts, claim that they would use tax savings for socially good purposes. It is significant that, even in this context, fewer than half of Federation respondents indicated an intention to use business-tax savings to hire more employees. In the first three pages of the *Final Report*'s executive summary, the BTRC asserts three times that tax cuts create jobs. Later, the Committee uses General Equilibrium analysis to forecast the benefits of its recommendations. Although there are projections for Gross Domestic Product and other variables, a projection for employment is conspicuously absent. (BTRC 2005: 86, 93)

Implications

While the BTRC believes that lower corporate-tax rates will attract investment and jobs to Saskatchewan, it also argues that lower rates would induce businesses to report more of their capital and income in Saskatchewan for tax purposes. The C. D. Howe Institute estimates that, largely due to such tax shifting, the provincial government "will recover about one-half of the revenue loss associated with the reduction in the statutory CIT rate." (BTRC 2005: 91) The notion that tax cuts will largely pay for themselves is appealing.

One objection to this analysis is that it treats tax avoidance as an acceptable activity, around which public

policy should be formulated. Society can, and arguably should, respond to misconduct by enforcing sanctions against it rather than by accommodating it. As the BTRC notes, the Canada Revenue Agency is implementing new measures to fairly distribute taxable corporate income between provinces. (BTRC 2005: 47)

Furthermore, Saskatchewan may not benefit from having more corporate capital and income reported in its jurisdiction. A larger corporate-tax base would increase the Province's revenues, but would also reduce its Equalization entitlement. Saskatchewan would gain from increased reporting only when it is already a "have" province with no Equalization entitlement. Although the BTRC neglects to discuss Equalization consequences in its 143-page *Final Report*, it is because of them that the C. D. Howe Institute's optimistic estimate "assumes that Saskatchewan continues to be a 'have' province under the Equalization program." (BTRC 2005: 91)

This assumption is dubious given Saskatchewan's economic reliance on volatile commodity prices, and its history of teetering between have and have-not status. The Committee itself calls for "a satisfactory arrangement on the treatment of natural resource revenue under the federal Equalization Program." (BTRC 2005: 7) If similar to the Atlantic Accords, such an arrangement would allow the Province to maintain its Equalization entitlement, and have-not status, despite Saskatchewan's natural-resource base. Thus, if the BTRC's call is heeded, the assumption underlying its chosen estimates will prove false.

Since changes in economic conditions and/or in the Equalization system could return Saskatchewan to have-not status, the Equalization consequences of the BTRC's recommendations must be examined. If Saskatchewan eliminated its CCT, businesses would eagerly report as much taxable capital as possible in Saskatchewan and pay nothing to the provincial government. However, the Province's Equalization entitlement would decline by the value of additional capital reported in Saskatchewan multiplied by the national-average CCT rate. As a province that sometimes receives Equalization, Saskatchewan would be extremely unwise to completely eliminate its CCT.

The Committee also recommends lowering the Province's CIT rate below the national average, which could prompt businesses to report more income in Saskatchewan. The Province would gain own-source revenue equal to the additional income multiplied by its reduced CIT rate. However, Saskatchewan would lose Equalization transfers equal to the same income multiplied by the higher national-average CIT rate. For every additional dollar reported in Saskatchewan, the Province would lose more than it would gain.

Although simply having more capital and income reported in Saskatchewan may be undesirable, investment is needed to create new jobs, make existing employees more productive, and increase labour's capacity to bargain for higher wages. (Stanford 2005) Therefore, Saskatchewan should focus on promoting real investment, rather than on becoming a tax haven.

Real investment, as opposed to tax shifting, might best be promoted through public expenditure, rather than through tax cuts. However, even if one accepts the BTRC's premise that tax abatement is needed to increase investment, its advocacy of tax cuts for existing capital is questionable. Exempting Saskatchewan's accumulated stock of private capital, except financial institutions, from taxation by eliminating the CCT is an exceedingly costly means of providing a very small additional incentive (worth 0.6% annually) for new capital investment.

Boadway notes that, "once in place, capital no longer is mobile," but opportunities "exist to compete for new capital." (Boadway 1999: 385) Raising taxes on existing capital might discourage prospective investors. However, lowering taxes on existing capital would provide a fiscal windfall to established businesses without greatly enhancing competitiveness. If the goal is to promote investment, why not focus tax-reductions on new capital?

The BTRC rejects targeted business-tax measures that 'pick winners' by favouring certain sectors. However, a corporate-tax credit for new investment need not discriminate between sectors. The federal government used to offer such a credit, equal to 7% of gross investment. Economic analysis indicates that the Mulroney government's decision to eliminate this credit in favour of lower corporate-tax rates slowed investment in Canada. Such a credit would subsidize the depreciation costs of maintaining existing capital and encourage the establishment of new capital. An equivalent tax credit for a greater percentage of investment net of depreciation would more strongly encourage the establishment of new capital. (Stanford 1999: 317, 436) The cost of administering such a credit provincially would pale in comparison to the amounts of provincial revenue and business investment at stake.

Rather than eliminating the CCT, the Government of Saskatchewan could create a tax credit for net investment deductible against CCT liabilities. To promote investment by businesses that do not have enough existing capital to pay CCT, this credit could be made refundable. This approach would reduce taxes not in proportion to a business's accumulated capital stock, but in proportion to its establishment of new capital in Saskatchewan. A tax credit would provide a greater incentive for investment at a lower cost than the BTRC's proposed tax cuts.

Conclusion

An evaluation of the theory, evidence, and implications employed by the BTRC reveals significant flaws in its case. The constructive case against the BTRC's recommendations is twofold. First, as argued above, different tax reforms would achieve superior results at less cost than the Committee's recommendations. Second, as others have argued (e.g., Shevell 2005), the public funds raised by business taxes are needed for economic-development initiatives and other important social priorities.

The tax cuts recommended by the PITRC severely disrupted provincial finances prior to the recent, fortuitous increase in provincial resource revenues. (Weir 2004) This experience should make the Government of Saskatchewan more cautious about the BTRC's recommendations.

Because Equalization could be important to Saskatchewan's business taxes, the provincial government should not commit to specific reforms in its March 2006 budget. Instead, the Government of Saskatchewan should wait for the spring 2006 report of the Expert Panel on Equalization and the Government of Canada's response to it. More fundamentally, the provincial government must question whether corporate-tax cuts, as opposed to tax credits or public programs, are the most cost-effective way to increase investment in Saskatchewan.

About the Author

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