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CAPITAL TAXES IN CANADA: THE BEGINNING OF THE END OF AN ERA?

HIGHLIGHTS

- **Capital taxes are the most inefficient form of taxation**
- **Non-financial corporations to be capital tax free across Canada by 2013**
- **Elimination of capital taxes for all businesses must be part of general shift to a smarter tax mix**

Once upon a time…

A capital tax assesses a levy on corporations based on the amount of capital. Although there are variations in the rules of different jurisdictions, taxable capital is generally defined as capital – mostly equity & debt – less an investment allowance and a stated deduction or threshold. Canada employs a multi-tiered system that imposes different capital tax rates according to the sector of activity. Broadly speaking, rates for financial institutions and insurance companies differ from that of all other businesses. In 2006, capital tax rates were on average[1] six times higher for financial institutions than for non-financial institutions (see accompanying tables).

Capital taxes have been part of the provincial corporate tax landscape for 60 years. Québec first imposed capital taxes in 1947, with Ontario following suit ten years later. The first federal capital tax was introduced in 1985 as a 'temporary' capital tax on financial institutions, at a time when federal deficits were surging. The federal 'Large Corporations Tax', which followed in 1989, made the capital tax permanent and broadened it to include virtually all corporations. By 1996, five provinces[2] had a capital tax levy on non-financial corporations ranging from 0.3% to 0.64%, while every province had a capital tax on financial institutions, with rates ranging from 1.12% in Ontario to 4% in Newfoundland.

CAPITAL TAX RATES ON NON-FINANCIAL INSTITUTIONS

Per cent

	Actual			Scheduled					
(As at Jan.)	2005	2006	2007	2008	2009	2010	2011	2012	2013
Canada (Federal)	0.175	--	--	--	--	--	--	--	--
Newfoundland & Labrador	--	--	--	--	--	--	--	--	--
Prince-Edward Island	--	--	--	--	--	--	--	--	--
Nova Scotia	0.600	0.600	0.250	0.250	0.225	0.200	0.150	0.100	--
New Brunswick	0.300	0.250	0.200	0.100	--	--	--	--	--
Québec	0.600	0.525	0.490	0.360	0.240	0.120	--	--	--
Ontario	0.300	0.300	0.285	0.285	0.225	0.150	--	--	--
Manitoba	0.500	0.500	0.500	0.500	0.400	0.400	--	--	--
Saskatchewan	0.600	0.600	0.300	0.150	--	--	--	--	--
Alberta	--	--	--	--	--	--	--	--	--
British Columbia	--	--	--	--	--	--	--	--	--

'--' Indicates no tax or tax eliminated; Source: Federal and Provincial Governments' Ministry of Finance, Canadian Tax Foundation

Today, very few other industrialized countries use such a tax. Canada is one of only six out of thirty OECD countries to levy such a tax at some level. Historically, one finds that the federal government, the Maritime Provinces, and Alberta have been relatively low users of this form of taxation.[3] Meanwhile, Saskatchewan and Québec have been the most reliant on capital taxes, where they have accounted for as much as 5.5% and 3.5% of their respective own-source revenues. To a lesser degree, Manitoba, British Columbia, and Ontario also relied on capital taxes as an important source of revenue.

Why are capital taxes so damaging?

It should come as no surprise that this form of taxation is rarely used abroad given what we know about their negative impact on capital investment, productivity, and economic growth, especially given the existence of less damaging forms of taxation that governments have at their disposal to raise revenue. The evaluation of tax instruments has three main dimensions: efficiency, fairness (equity), and simplicity.

Modern economic studies[4] which rank tax instruments consistently show that capital taxes are more inefficient than corporate income taxes, labour income taxes, and consumption taxes. Furthermore, the tax burden does not fall solely on corporations. Indeed, that burden is also shouldered by individuals through higher prices for goods and services, lower wages, and reduced rates of return on savings and investments.

As for equity considerations, horizontal fairness is concerned with whether or not firms with similar amounts of capital face similar corporate tax bills. Capital taxes, as applied in Canada, fail this test by treating different types of corporations asymmetrically, both across sectors of activity and across provinces.

Vertical fairness is concerned with the distribution of the tax burden across the tax base criterion, in this case the level of capitalization. The capital tax places a heavier burden on industries whose activities are more capital intensive (e.g. biotech research, software development, telecommunications, energy), thereby introducing a bias across industries. Strictly speaking, this could be viewed as a criticism against the use of capital as a tax base criterion in the first place rather than a violation of vertical fairness. Regardless, the point is somewhat moot as the end result, which is to discourage capital-intensive investments, remains. The use of capital as a criterion for taxation is also questionable in that it disregards flows (earnings, profit) in favour of stock (capital), penalizing firms who could be suffering fiscal year losses regardless of capitalization, at a time when debt or equity financing would be most needed. This is in fact the most damaging aspect of any capital tax. Like all business taxes, capital taxes tend to reduce investment by raising the required rate of return on incremental investment. But whereas the investment risk is shared between firms and governments under a corporate income tax, capital taxes are due even when investments are not profitable, which makes them all that more damaging to investment.

In a study just recently released[5], Statistics Canada provided yet further evidence linking business investment to labour productivity, concluding that "investment in capital [...] was the most important factor in the growth in labour productivity in the business sector during the past four decades". The slowdown in the growth of labour productivity remains one of Canada's most pressing challenges.

Last but not least, as for any tax, one should ask: is it simple? This attempts to measure the costs of collection and compliance. It turns out that what could be a straightforward calculation has become increasingly complex due to different definitions of capital for financial, insurance, and non-financial corporations, layered on top of different provincial tax codes with different thresholds and deductions. Provincial governments are making headway in harmonizing with the federal tax base, which will alleviate compliance burden and costs for taxpayers while achieving administrative efficiencies, but such gains are marginal at best.

Just how costly are capital taxes? Estimates of their welfare costs vary in magnitude, but economic studies on this topic agree in ranking them as having the highest costs among tax instruments. In their Budget 2007-08, *Finances Québec* calculates that a revenue-neutral[6] $1 reduction in capital taxes would yield an additional $1.33 of real GDP for Québec. Their calculations also show that per dollar of tax reductions, every other tax has a real GDP impact ranging from only $0.51 dollars (QST) to $0.63 (PIT), i.e. considerably less than capital tax reductions. Similarly, Canada's *Department of Finance* calculates that the net long-term real GDP impact per dollar of revenue-neutral capital tax reduction is 90 cents, which, even at such a high value, they recognize as being an understatement.[7]

The economic costs can also be evaluated in terms of their impact on long-term real GDP growth. Two studies[8] conducted for the Canadian economy estimate that a revenue-neutral[9] 1%-of-GDP reduction in capital taxes would boost real GDP growth by about 0.05 percentage points. These figures might appear small, but recall that seemingly minor differences in average growth rates compound over time to become very significant. As an example, consider that an economy growing at an average rate of 2.95% doubles its income a full year later than one growing at 3%.

The overall picture

Of course, capital taxes are only part of the overall business tax burden, which is also comprised of corporate income taxes, sales tax on capital goods and other business inputs, depreciation and inventory cost allowances, as well as other taxes related to capital investment. A standard measure of the overall business-tax structure is given by the marginal effective tax rate (METR) for an investment. It represents the amount of corporate income and other capital-related taxes as a percentage of pre-tax corporate profits for marginal investments, i.e. investments that earn a rate of return on capital just high enough to attract international investments. Canada's METR ranking isn't flattering. As of 2006, Canada's business investment tax burden was third highest among industrialized countries and fifth highest in a sample of 36 industrialized and emerging market economies.[10] By province, the contribution of capital taxes to overall METR ranges from zero to more than 5 percentage points for Manitoba. According to calculations by *Department of Finance Canada*, as well as those from J. Mintz and D. Chen , the elimination of non-financial sector capital taxes would bring down Canada's METR by 1.3 to 2.4 percentage points. Generously assuming that other countries didn't modify their business taxes[11], this alone would help put Canada on a more competitive footing, placing it closer to the middle of the pack in terms of the aforementioned METR ranking.

The end of an era?

Thankfully, we have seen a lot of action in recent years and the general (non-financial) business capital tax should soon be a thing of the past. The latest round of federal and provincial budgets continued to move in the right direction, which will help Canada close the competitive gap. Note that Alberta, Newfoundland & Labrador and P.E.I. never had a capital tax on non-financial corporations. Of those governments in Canada that did, British Columbia was first to move on theirs, eliminating this tax in 2002. The federal government eliminated its non-financial business capital tax last year. However, six provinces[12] still levy capital taxes as of this year.

In its latest budget, the federal government has given provinces an incentive to eliminate their capital taxes. The incentive runs until the end of 2010 in order to accelerate the elimination of these capital taxes across the country.

When a province eliminates a capital tax, it provides a windfall for the federal government since a corporation is no longer able to claim a federal deduction for having paid such a tax at the provincial level. The federal government will send these extra monies back to provincial governments that enact legislation to eliminate their capital tax before January 1, 2011. On average, this offsets about

CAPITAL TAX RATES ON FINANCIAL INSTITUTIONS
Per cent

	Actual			Scheduled				
(As at Jan.)	2005	2006	2007	2008	2009	2010	2011	2012
Canada (Federal)	1.40	1.40	--	--	--	--	--	--
Newfoundland & Labrador	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00
Prince-Edward Island	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00
Nova Scotia	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00
New Brunswick	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00
Québec	1.45	1.05	0.98	0.72	0.48	0.24	--	--
Ontario	0.90	0.90	0.86	0.86	0.68	0.45	--	--
Manitoba	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00
Saskatchewan	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25
Alberta	--	--	--	--	--	--	--	--
British Columbia	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00

'--' Indicates no tax or tax eliminated; Source: Federal and Provincial Governments' Ministry of Finance, Canadian Tax Foundation

15 cents per dollar of provincial revenue loss.

Québec and Ontario have announced accelerated plans to eliminate *all* of their capital taxes by January of 2011. If the scheduled reductions take hold as planned, all provinces – except Nova Scotia which will wait until January 2013 – will have eliminated their capital tax for non-financial institutions by then (see accompanying table). This would make Canada capital tax-free for non-financial corporations less than 6 years from now.

But if Canada and its provinces are to remain competitive, these taxes must be eliminated for *all* businesses, regardless of sector of activity. The federal capital tax on financial institutions is eliminated as of this fiscal year, but it is alone with Alberta[13] in not having such a capital tax. However, options for other, often competing, provincial jurisdictions look rather limited in this matter. Provinces should utilize every incentive opportunity extended by the federal government. The sooner they eliminate all capital taxes, the more attractive they will be to domestic and foreign investors, equipping themselves to face the productivity challenge to help grow their economies and standard of living. Given the current momentum, in an era of worldwide integrated and open capital markets, maintaining such barriers to investment will become untenable sooner than later.

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Endnotes

1 Across federal and provincial governments, for those that had a general (non-financial) business capital tax in 2006.

2 These were Québec, Ontario, Manitoba, Saskatchewan, and British Columbia. Source: Canadian Tax Foundation, *Finances of the Nation, 1996*.

3 Clemens, J. et al. 2002. *The Corporate Capital Tax – Canada's most damaging tax*. Public Policy Sources 56. Vancouver, B.C.: The Fraser Institute.

4 A good survey of studies on this issue is provided by Baylor, M. "Ranking Tax Distortions in Dynamic General Equilibrium Models: A Survey", *Department of Finance Canada Working Paper 2005-06*.

5 John R. Baldwin, J. R. and Gu, W. "Investment and Long-term Productivity Growth in the Canadian Business Sector, 1961 to 2002". *The Canadian Productivity Review, Statistics Canada, June 2007*.

6 Also called a 'deficit-neutral' reduction, compensated by lump-sum taxes.

7 This is because capital taxes are profit-insensitive and the model used to calculate the impact of different tax policy scenarios is one of perfect foresight. It therefore does not include the additional costs that capital taxes introduce given the inherent uncertainty attached to investment projects. See "Taxation and Economic Efficiency: Results from a General Equilibrium Analysis", from *Tax Expenditures and Evaluations 2004, Department of Finance Canada*.

8 Mérette, M. (1997). "Incomes Taxes, Life-Cycles, and Growth". *Department of Finance Canada Working Paper 97-06* and Xu, J. (1997) "The Dynamic Effect of Taxes and Government Spending in a Calibrated Canadian Endogenous Growth Model," *Department of Finance Canada Working Paper 97-02*.

9 See note 6.

10 Mintz, Jack M. *The 2006 Tax Competitiveness Report: Proposals for Pro-Growth Tax Reform*, C.D. Howe Institute Commentary No. 239, September 2006.

11 In fact, since 2000, many European countries have been moving aggressively to lower their corporate tax burden. See "Europe Competes for Investment With Lower Corporate Tax Rates", *Wall Street Journal April 17, 2007*.

12 These are Nova Scotia, New Brunswick, Québec, Ontario, Manitoba, and Saskatchewan.

13 Alberta eliminated its capital tax on financial corporations in 2001.

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