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CORPORATE INCOME TAX: GETTING THE ECONOMICS RIGHT

The past decade has seen a remarkable transformation in Canada's business tax landscape. Starting in the late 1990s, both the federal and most provincial governments began to reduce corporate income taxes – the taxes levied on business income or profits. At the national level, the general federal corporate income tax (CIT) rate stood at 28% in 1999; today it is 18%, and the current government intends to bring it to 15% by 2012.[1] Moreover, in recent years Ottawa has eliminated the income surtaxes and capital taxes that it previously imposed on large and medium-sized businesses.

A similar pattern has been evident in the provinces – all of which maintain their own corporate taxes, in addition to the federal CIT. Alberta has a 10% business income tax, in place of the higher rates it charged in the 1990s. British Columbia has gradually trimmed its basic CIT rate from 16.5% in 2000 to 10.5% in 2010, on the way to a planned 10% rate by 2011. As a result, in both BC and Alberta, the *combined general federal-provincial CIT rate* will be down to 25% by 2012; this represents a very substantial drop in the overall corporate tax burden compared to the 1980s and 1990s. A number of provinces, including BC and Alberta, have also abolished the capital taxes they once levied on enterprises.

Income Tax Rates for Income Earned by a General Corporation

	2008	2009	2010	2011	2012
Basic federal rate	19.5%	19.0%	18.0%	16.5%	15.0%
Provinces:					
BC	11.5%	11.0%	10.5%	10.0%	10.0%
Alberta	10.0%	10.0%	10.0%	10.0%	10.0%
Ontario	14.0%	14.0%	13.0%	11.75%	11.25%

Source: KPMG

[1] A lower income rate is applied to small business, federally and in most of the provinces. Some jurisdictions maintain lower rates for manufacturing and processing business income. This paper focuses on the income taxes charged to the broad category of medium-sized and larger businesses.

With governments across the country slipping back into deficits as a result of the Great Recession of 2008-09, policy-makers will soon be under mounting pressure to address yawning public sector fiscal shortfalls. In this environment, business taxes could easily become targets for legislators and Finance Ministers in search of additional revenues. Already the Canadian Labour Congress and the federal NDP, among others, have called on the federal government to jettison plans to further reduce corporate taxes and to consider hiking taxes on business.

Reversing the trend to lower business taxes would be a backward step with negative implications for Canada's long-term economic performance. In this month's Policy Perspectives we take a closer look at the subject of corporate income tax.

Public Finance Theory

Most jurisdictions have tax systems that feature a myriad of different revenue sources, including some which fall on the business sector. According to PricewaterhouseCoopers, globally corporate income taxes account for 12% of all tax payments made to governments.[2] Of course, businesses pay many other types of taxes besides CIT – e.g., property taxes, sales taxes, payroll taxes, workers' compensation premiums, and a plethora of levies and fees imposed by various levels of government. These other types of tax clearly impact the cost of doing business and the competitive position of different jurisdictions.

That said, the taxes that apply to business income have significant consequences for the economy. To see why, recall that in a market economy, firms' investment decisions are heavily conditioned by the cost of and projected returns to investment projects. By reducing expected after-tax returns, corporate income taxes dampen private sector investment. And, this is especially true for small open economies like Canada (and BC), which must compete globally for increasingly mobile investment dollars. This is not to say that taxes are the only factor shaping investment decisions; but it is clear that they do have some influence. At a broader level, through their effects on investment, corporate income taxes impact the rate of capital accumulation, productivity, real wages, and the growth of GDP per capita.[3]

The above comments reflect a general consensus among public finance economists and international economic organizations that have studied business taxation. To take just one recent example, in 2008 the Organization for Economic Cooperation and Development (OECD) published two detailed studies of business taxes in a large number of industrial (mainly European) economies. The studies confirm that corporate income taxes reduce investment at both the firm and the industry levels, through their role in raising the user

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[2] PricewaterhouseCoopers, Paying Taxes 2010: The Global Picture (www.pwc.com). Accessed January 30, 2010.

[3] OECD, "Fundamental Reform of Corporate Income Tax," OECD Tax Policy Studies, Number 16, 2007.

cost of capital.[4] They also find that lowering corporate taxes leads to increased productivity at the firm and industry levels.

Corporate income taxes and employee compensation

Economists have long recognized that enterprises don't actually bear the income taxes imposed on them by government. Ultimately, the economic burden of business taxes, including corporate income tax, falls on individuals – business owners who receive lower after-tax returns, customers who face higher prices, and workers who receive lower wages. Many politicians and media commentators implicitly assume that businesses and their owners alone bear the burden of corporate income taxes, in the form of smaller dividends and reduced profits. However, economic analysis reveals that this is not the case; the owners of capital are not the only group whose economic well-being is affected by business taxes.

In fact, research on the incidence of taxes suggests that workers actually incur a sizable portion of the economic cost stemming from corporate income taxes. And, in a world where capital is becoming more mobile across jurisdictions, many economists believe that workers will bear a rising share of the cost of business taxes going forward.

One recent US study looked at unionized workplaces in American states with different state-level business tax rates. The authors discovered that union wage premiums decline in tandem with higher state-level corporate taxes. They also conclude that workers in unionized enterprises obtain up to half of the economic benefits that accrue to their firms when state corporate tax rates are reduced.[5] Another recent paper reviewed economy-wide evidence on how the burden of corporate taxation is allocated between the two principal factors of production, "labour" and "capital," across a number of advanced countries. The authors estimate that, depending on the country, the industry, and the tax structure, somewhere between one-half to three-quarters of the economic burden of corporate income tax ends up falling on the shoulders of employees.[6] Other studies confirm this result.[7]

This line of research highlights an important fact: multiple stakeholders, including employees, share in the benefits from profitable, growing enterprises. By the same token, increasing the income taxes charged to business will create burdens that extend beyond

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[4] C. Schwellnus and J. Arnold, "Do Corporate Income Taxes Reduce Productivity and Investment at the Firm Level? Cross-Country Evidence from the Amadeus Dataset," OECD Economics Department Working Paper No. 641, September 2008; and L. Vartia, "How Do Taxes Affect Investment and Productivity? Industry Level Analysis of OECD Countries," OECD Economics Department Working Paper No. 656, December 2008.

[5] Alison R. Felix and James R. Hines Jr., Corporate Taxes and Union Wages in the US, National Bureau of Economic Research, Working Paper 15623, August 2009.

[6] Mir A. Desai, C. F. Foley, and James R. Hines Jr., "Labor and Capital Shares of the Corporate Tax Burden: International Evidence," paper prepared for the International Tax Policy Forum and Urban-Brookings Tax Policy Conference on Who Pays the Corporate Tax in an Open Economy, December 18. 2007.

[7] See William Gentry, "A Review of the Evidence on the Incidence of the Corporate Income Tax," Department of the Treasury, Office of Tax Analysis, December 2007, and the literature cited therein.

shareholders/owners and impinge on the economic welfare of workers (among other groups).

Staying the Course

In part due to lower corporate income taxes, Canada's relative business tax competitiveness has improved over the past several years. The latest update from the C.D. Howe Institute projects that Canada's overall effective tax rate on capital – a measure that includes CIT rates but also encompasses various other tax provisions that affect the returns on new business investment – will be close to the average for 80 countries by 2013.[8] As recently as a few years ago, Canada had one the world's least competitive business tax regimes – so there has been significant progress in a short period of time. According to the OECD, today Canada has one of the lowest tax burdens on business investment among the major industrial nations.[9] This suggests that Canada is well-positioned to attract more business investment, including foreign direct investment, to support the goals of enhanced innovation, higher productivity and better quality jobs.

Marginal Effective Tax Rates on Capital, Industrial Countries
(averages across all business sectors)

	2005	2007	(Projected) 2012
US	36.7%	37.8%	36.9%
Canada	39.1%	30.9%	25.2%
Japan	30.4%	31.3%	31.3%
Germany	36.1%	35.7%	29.7%
France	33.0%	31.9%	31.9%
UK	28.5%	28.8%	26.9%
Australia	23.4%	26.7%	26.7%

Source: See text footnote 9. The marginal effective tax rate is the amount of corporate income and other, capital-related taxes paid by a business as a percentage of pre-tax profits for incremental ('marginal') investments. It takes into account not only the statutory tax rate, but also the definition of the tax base, sales tax on business inputs, capital taxes, and depreciation.

For British Columbia, the government's decision to replace the provincial sales tax with a Harmonized Sales Tax that is integrated with the federal Goods and Services Tax promises to build on the tax advantages created through previous federal and provincial tax reforms. This is because the HST will remove some $2 billion in sales tax that is currently paid by BC businesses on their inputs. The HST will deliver a further, substantial decline in both the overall business tax burden and the average effective tax rate on capital, thus making British Columbia an increasingly competitive location for investment, jobs and business innovation -- especially in industries producing tradable goods and services.

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[8] Duane Chen and Jack Mintz, "The Path to Prosperity," C.D. Howe Institute Commentary, September 2009.
[9] A. Bibbee, "Tax Reform for Efficiency and Fairness in Canada," OECD Economics Department Working Paper No. 631, August 2008.