

ECONOMIC SURVEY OF CANADA 2006:

BUSINESS TAXATION

*This is an excerpt of the OECD Economic Survey of Canada, 2006,
from the section on business taxation in chapter 2.*

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High taxes on business tend to discourage companies from expanding by investing in new capital. This matters because capital deepening is an important source of labour productivity growth, and a substantial share of innovation is diffused through the economy *via* the technology embodied in new machinery and equipment. Although they often attract considerable attention, statutory corporate tax rates are not generally a good indicator of the overall tax environment faced by businesses. Marginal effective tax rates (METRs) on capital provide a more useful comparative measure of the incentive structure that the taxation system produces (Box 2.1).

Most countries have recognised the harmful effects of high corporate taxation and have reduced effective average and marginal tax rates over the years (Devereux and Sørensen, 2005). Canada has made considerable progress towards reducing corporate taxes since 2000 when the combined average METR for medium and large firms was estimated at almost 45% (Finance Canada, 2005a). Even so, Canada still had the highest estimated METR in the OECD in 2005 (Figure 2.1). Some cuts¹ already announced have long phase-in periods, and the projected METR in 2010 will still be almost 32%, only very slightly lower than the average estimated METR in 2010 for the United States (Finance Canada, 2006). But this would still leave Canada with a higher rate in 2010 higher than the rate applying in most other OECD countries today.

Both federal and provincial governments impose taxes on business, and there are significant differences across the country (Figure 2.2). These reflect both the federal Atlantic Investment Tax Credit² and provincial tax variation. Where provinces levy sales taxes on business inputs, these add significantly to METRs. One key advantage of imposing value added taxes such as GST instead is that they do not apply to capital equipment, thus avoiding this anti-investment bias. Indeed, the five provinces concerned could cut their METRs on business investment by between 7 and 12 percentage points by eliminating such sales taxes (Finance Canada, 2005a). They could do this in a revenue-neutral fashion by following the example of the other provinces and switching from sales taxes to provincial value added tax.

Box 2.1. Marginal effective tax rates on capital

A marginal effective tax rate (METR) on capital is a summary measure of the tax that would be paid on a new investment. It is not a measure of the tax wedge that is paid on a company's total activities *i.e.* the difference between *before-tax* and *after-tax* profits. Instead, it is a forward-looking indicator that measures the extra return that an investment would need to earn to pay taxes, over and above the rate of return needed to make the investment worthwhile if there were no taxes to be paid.

Only investments that pay a sufficiently high rate of return *before tax* to meet the supplier of capital's minimum required rate of return *after tax* will go ahead. This means that if any taxes are levied on investment, some of the projects that would have passed the investor's threshold rate of return before tax will become uneconomic. Those projects will not be undertaken because of taxation. A higher average METR means that more projects will be foregone than if the average METR were lower, all else equal, and the lower will be the economy-wide rate of investment.

METRs on capital are typically calculated taking into account the following features of the tax system:

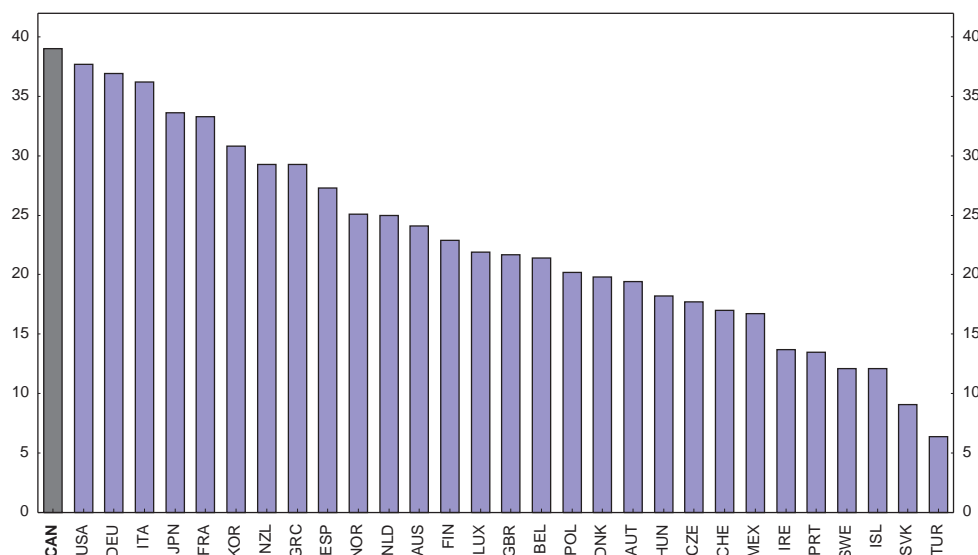
- Statutory corporate income tax rates
- Interest deductibility
- Capital cost allowances
- Inventory accounting methods
- Research and development tax incentives
- Investment tax credits
- Capital taxes
- Retail sales taxes on capital goods

Within a country, METRs vary considerably depending on the type of capital investment, how it is financed and, in Canada, the sector and location of the business. Variation in METRs across different types of projects will favour certain investments over others. This means that investors will choose among projects according to their *after-tax* returns rather than on their *pre-tax* underlying economic merits. As a result, for any given average METR, the higher the variation in METRs, the greater will be the misallocation of capital across the economy as a whole.

Eliminating remaining capital taxes would also provide a sizable reduction in METRs. Taxes on the total capital assets of firms above a threshold are still a feature in Canada, although federal capital taxes³ have been abolished from 1 January 2006. Six provinces also impose capital taxes, although New Brunswick, Nova Scotia, and Saskatchewan have announced their phase-out between now and 2010. Ontario's capital tax is scheduled to be phased out by 2012 but its elimination will be accelerated to 2010 if the fiscal position of the province permits. Quebec is reducing its capital tax and Manitoba has announced that it plans to reduce its capital tax if balanced budget requirements are met. These taxes were originally motivated by a desire to ensure that all corporations do pay tax, even those managing their finances so as to shift profits to another jurisdiction. But they bear no relationship to the profitability of the business and discourage expansion. Few, if any, other countries apply such a tax to corporations, and their damage is significant: estimated welfare gains from cutting capital taxes are more than twice as large as those that would arise from cutting statutory corporate tax rates (see previous *Survey*).

Figure 2.1. **Marginal effective tax rates on capital in OECD countries**

Medium and large companies, percentages, 2005

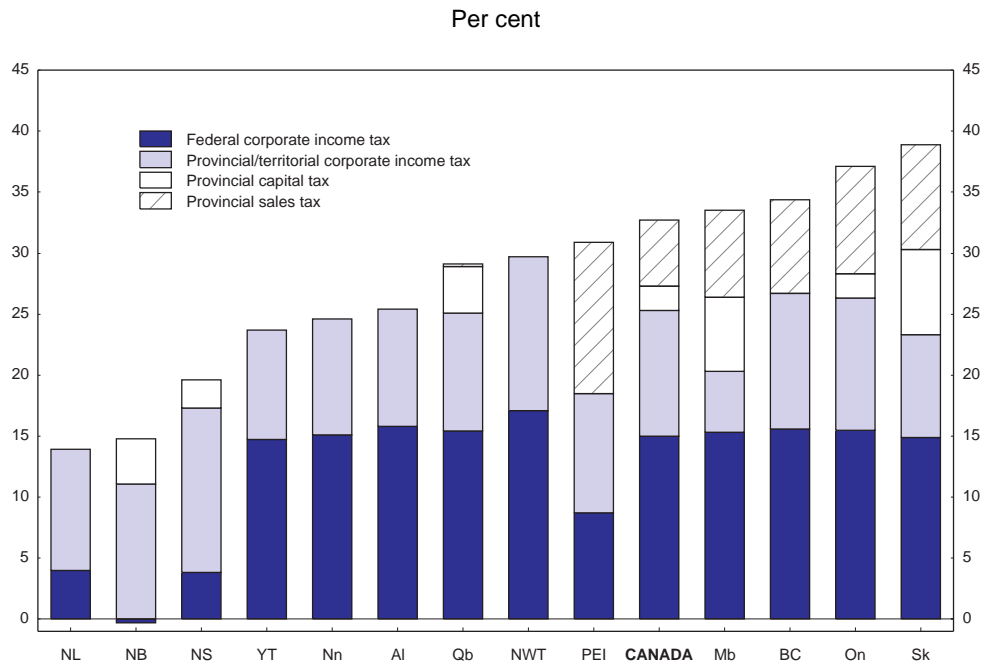


Source: Mintz, J., *et al.* (2005), "The 2005 Tax Competitiveness Report: Unleashing the Canadian Tiger", Commentary, No. 216, C. D. Howe Institute, Toronto.

Canada's METRS in 2010 will still show a marked variation across industries, which may bias investment towards certain sectors at the expense of others. For example, the estimated METR on investment in agriculture, fishing and forestry is less than half that in some services. More generally, both federal and provincial governments show a distinct bias towards manufacturing, whether through special capital cost allowances for machinery and equipment in manufacturing, lower tax rates on manufacturing income and some industry-specific sales tax exemptions (Finance Canada, 2005a). At the margin, these differences may slow the process of developing more sophisticated services in Canada, especially those where technology can deliver significant productivity gains. A more consistent rate across sectors would lead to a more efficient allocation of factors of production across the economy as well as ensuring that new investment is oriented towards the most productive opportunities.

A significant shortcoming of the current business tax environment is that the various features combine together to discourage firms from growing. A dramatically smaller proportion of Canadian firms have more than 100 employees than US ones. Larger firms are better placed to exploit economies of scale, especially those that come from technology and from specialisation of skilled labour within the firm. But the Canadian tax system provides for lower federal and provincial statutory tax rates for small businesses.⁴ Medium and larger businesses face a statutory corporate tax rate that can be up to 21 percentage points higher (Table 2.1). Tax credits for R&D expenditure are also more generous for small firms (see Chapter 3). Furthermore, provincial capital taxes generally have low capital thresholds (*e.g.* CAD 12.5 million for Ontario in 2007) which add another source of bias against expansion. To some extent these measures reflect a deliberate attempt to provide a more favourable environment for small business by helping them retain more earnings for reinvestment and growth (Box 2.2). Other biases, such as sales taxes on capital goods also discourage firms from expanding capacity through capital investment.

Figure 2.2. METRS on capital by province or territory in 2010



Source: Finance Canada (2005a), *Tax Expenditures and Evaluations*, Ottawa.

Creating a more favourable business taxation regime would involve some loss of government revenue, at least in the short term, although it is reasonable to expect that dynamic gains over time would provide some offset through a larger tax base. There could be scope for some base-broadening measures within the overall corporate tax system, which would also reduce the complexity and compliance burden of the tax system. However, another approach would be to reconsider the overall tax mix. Canada's corporate tax receipts amounted to 3.4% of GDP in 2003, slightly higher than the OECD unweighted average. But total taxes on goods and services were only 8.8% of GDP, almost 3 percentage points below the OECD average (Figure 2.3). Thus, another option would be to raise a greater share of government revenue through value added taxes. While these taxes are currently unpopular in Canada, there is broad consensus, at least among tax experts and economists, that such taxes are more efficient than comprehensive income taxes, including corporate taxes (OECD, 2005a). Overall, taxing businesses less and taxing consumption more would seem to offer considerable scope for boosting Canada's growth potential.

Box 2.2. Reassessing the rationale for supporting SMEs

Most OECD countries provide some degree of support specifically targeted on its small business sector in part because such firms are often considered to play a key role as engines of job creation. The practice of providing assistance to small and medium-sized enterprises (SMEs) is not a recent innovation and has long been justified by citing a variety of specific disadvantages they face relative to larger firms.

Perhaps the most frequently cited argument is that SMEs face higher financing costs because of agency problems related to the inability to write complete contracts, asymmetric information about creditor risk and other market characteristics and policy settings that result in incomplete financial markets.

It could be argued that favourable tax treatment or other assistance measures would be justified as compensation for these handicaps. However, in many OECD countries, banks have generally seen SME finance as an attractive market opportunity and have developed tools and techniques, such as scoring models to overcome these obstacles.

As a result, in most OECD countries no generalised financing gap can be identified, as most SMEs are able to obtain sufficient credit from banks and other credit institutions, supplemented in some cases by a modest volume of official guarantees (OECD, 2006a). These results are confirmed for Canada, where the majority of SMEs are able to obtain financing when required and the difficulties faced by the others may reflect factors other than shortcomings of financial markets (Robertson and Belanger, 2006).

However, many OECD countries perceive that a lack of appropriate financing remains a hindrance to innovative SMEs and, especially, start-ups and very young firms. But the lack of comprehensive data, particularly covering private equity, hampers a definitive assessment that would validate these views. OECD work is underway to address these and other data gaps concerning entrepreneurship and financing for SMEs.

Another rationale for providing specific policies and programmes geared to SMEs is that administrative costs of complying with government regulation (e.g. tax, employment rules and environmental protection) fall disproportionately on smaller firms. One survey of SMEs across 11 OECD countries, found that costs per employee were around five times higher for firms with fewer than 20 employees than for those with a payroll of between 50 and 500 (OECD, 2001). However, providing financial support to SMEs to offset these higher costs would be a second-best response and lightening the regulatory burden as far as possible would be a better solution.

Indeed, in 2005 the Canadian authorities announced the Paperwork Burden Reduction Initiative (PBRI), a public-private sector partnership aimed at reducing the costs of paperwork and regulatory compliance for small businesses, making it easier for them to do business in Canada and around the world. This initiative also involves a triennial Survey of Regulatory Compliance Costs, conducted by Statistics Canada. Preliminary results of the initial survey, which was distributed to some 30 000 SMEs and 5 000 external service providers, are expected to become available in July 2006.

In any case, there is broad consensus among policymakers on the importance of the overall economic, legal, institutional and regulatory framework in providing an environment within which SMEs can flourish (OECD Brasilia Action Statement for SME and Entrepreneurship Financing, 2006). It is also recognised that policies and measures targeted to SMEs should be adopted only to the extent that there is a clear rationale for doing so, in terms of market, governmental or systemic failures (The Istanbul Ministerial Declaration on Fostering the Growth of Innovative and Internationally Competitive SMEs, 2004).

Table 2.1. Corporate tax rates for small and large businesses

As at 1 January 2006

	Small business tax rate			Large corporations tax rate			Percentage point differential
	Federal	Provincial	Total	Federal	Provincial	Total	
Newfoundland and Labrador	12.0	5.0	17.0	21.0	14.0	35.0	18.0
Nova Scotia	12.0	5.0	17.0	21.0	16.0	37.0	20.0
Prince Edward Island	12.0	6.5	18.5	21.0	16.0	37.0	18.5
New Brunswick	12.0	2.0	14.0	21.0	13.0	34.0	20.0
Quebec	12.0	8.5	20.5	21.0	9.9	30.9	10.4
Ontario	12.0	5.5	17.5	21.0	14.0	35.0	17.5
Manitoba	12.0	4.5	16.5	21.0	14.5	35.5	19.0
Saskatchewan	12.0	5.0	17.0	21.0	17.0	38.0	21.0
Alberta	12.0	3.0	15.0	21.0	11.5	32.5	17.5
British Columbia	12.0	4.5	16.5	21.0	12.0	33.0	16.5
Yukon	12.0	4.0	16.0	21.0	15.0	36.0	20.0
Northwest Territories	12.0	4.0	16.0	21.0	14.0	35.0	19.0
Nunavut	12.0	4.0	16.0	21.0	12.0	33.0	17.0

Source: Finance Canada.

Figure 2.3. Taxation of goods and services

Per cent of GDP, 2003



Source: OECD Revenue Statistics 1965-2004, OECD, Paris.

Notes

1. The contributions of each individual tax policy change have also been estimated. The largest contributions are -3.6 percentage points coming from lower federal general corporate income tax rates phased in from 2001 to 2004 and -2.3 percentage points from the elimination of federal capital taxes.
2. This federal tax credit applies only to qualified assets acquired for use in the Atlantic Provinces and the Gaspé region in Quebec. The credit is 10% of the capital cost of equipment and buildings in manufacturing, processing, mining, oil and gas, logging, farming, and fishing industries. Credits that exceed federal tax payable can be carried back to reduce federal tax in the three previous years or forward up to ten years. Budget 2006 proposes to increase this carry-forward period to 20 years.
3. The Minimum Tax on Financial Institutions remains and is levied at a rate of 1% on taxable capital employed in Canada between CAD 200 million and CAD 300 million and at a rate of 1.25% on capital in excess of CAD 300 million. The 2006 budget proposed to apply a single rate of 1.25% on taxable capital employed in Canada government in excess of CAD 1 billion from 1 July 2006. As a minimum tax, the financial institution can reduce the capital tax payable by the amount of federal income tax that it pays.
4. In 2006, the federal small business rate applies only to qualifying income up to CAD 300 000 of Canadian-controlled private corporations (CCPCs) with taxable capital employed in Canada of less than CAD 15 million. Access to the federal small business rate is phased out on a straight-line basis for CCPCs having between CAD 10 million and CAD 15 million of taxable capital employed in Canada. The 2006 budget proposed to increase the threshold from CAD 300 000 to CAD 400 000 from 1 January 2007 and lower the small business rate to 11.5% in 2008 and 11% in 2009.

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