

**Submission by the
Canadian Labour Congress**

to the

**House of Commons Finance Committee
2007 Pre-Budget Consultations**

**Winning the Race to the Bottom:
A Critical Appraisal of Corporate Tax Cuts**

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Canadian Labour Congress

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Recommendations

The Government of Canada should not implement the corporate income tax (CIT) cuts proposed for 2008-2011. Instead, it should consider slightly increasing the federal CIT rate and introducing stronger targeted measures to promote new investment in the Canadian economy. Corporate surtaxes should be applied to highly profitable sectors that are insulated from international competition, such as nonrenewable-resource extraction and financial services.

Introduction

On behalf of the three million members of the Canadian Labour Congress (CLC), we want to thank you for affording us the opportunity to present our views. The CLC brings together Canada's national and international unions along with the provincial and territorial federations of labour and 137 district labour councils whose members work in virtually all sectors of the Canadian economy, in all occupations, in all parts of Canada.

Have Recent Corporate Tax Cuts Been Worth the Cost ?

Since 2000, the federal government has greatly reduced its CIT rates with the stated purpose of making Canada more competitive in attracting internationally mobile capital. While these cuts have been very expensive in terms of forgone revenue, they do not appear to have increased corporate investment in Canada.

Budget 2000 reduced the general CIT rate from 28% to 21% by 2004. Ironically, this huge tax cut provided no savings for manufacturing, the economic sector most exposed to international competition. While manufacturers already had a 21% rate, small businesses pay only 12% and were also unaffected by the general-rate reduction.

Budgets 2005, 2006 and 2007 propose to reduce the general CIT rate to 18.5% by 2011, lower the small-business rate to 11% by 2009 and eliminate the corporate surtax by 2008, which effectively drops both rates by a further 1.1%. Although these rate cuts are less dramatic than those of Budget 2000, they will cost almost as much because they apply to all corporations.

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The Cost of Federal Corporate Tax Cuts, 2001 - 2008 (\$ billions)

	2001	2002	2003	2004	2005	2006	2007	2008	2011 Regime In 2008
Budget 2000	\$0.6	\$1.3	\$3.1	\$5.4	\$5.9	\$6.8	\$7.3	\$7.4	\$7.4
Budgets 2005-2007								\$3.0	\$6.0
Totals	\$0.6	\$1.3	\$3.1	\$5.4	\$5.9	\$6.8	\$7.3	\$10.5	\$13.4

Note: Calculated from Finance Canada, *Tax Expenditures and Evaluations 2006*. The 2008 figures do not sum exactly due to rounding.

The above estimates are quite conservative. First, they assume that manufacturing profits - which received no tax cut from Budget 2000 - accounted for a constant share of corporate profits after 2004. Second, to the extent that Finance Canada understates its future revenues, these estimates understate forgone revenues. Third, they do not include the cost of eliminating the federal capital tax in 2006.

If corporate profits continue to increase after 2008, the cost of CIT cuts implemented through 2011 will far exceed \$13 billion *annually*. By comparison, each of the Martin government's major expenditure initiatives - the childcare deals, the Canada-Ontario Agreement, the offshore arrangements, the Kelowna Accord - were projected to cost \$5 billion *over five years* or longer.

Corporate Taxes, Profits and Investment, 1961 - Present

	Corporate Tax/ Corporate Profit	<u>Percentages of Gross Domestic Product:</u>			
		Pre-Tax Profits	After-Tax Profits	Net Fixed Investment	Total Investment
1961-69	35.5%	10.7%	6.9%	3.3%	9.5%
1970-79	33.8%	11.0%	7.3%	3.8%	9.2%
1980-89	32.4%	9.7%	6.6%	3.8%	9.3%
1990-99	36.4%	8.0%	5.2%	2.3%	9.0%
2000	35.3%	12.6%	8.2%	3.4%	11.6%
2001	28.3%	11.5%	8.2%	2.8%	9.9%
2002	26.1%	11.7%	8.7%	1.9%	9.3%
2003	27.4%	11.9%	8.6%	1.8%	9.4%
2004	26.9%	13.1%	9.6%	2.3%	9.7%
2005	25.8%	13.8%	10.2%	3.0%	10.4%
2006	25.6%	13.7%	10.2%	3.5%	10.8%
2007Q1	25.1%	13.9%	10.4%	3.7%	10.3%

Note: Calculated from Statistics Canada's System of National Accounts. These figures exclude government business enterprises, which are normally included in the corporate-sector account.

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In recent years, federal and provincial CIT has dropped from one-third to one-quarter of corporate profits, implying a combined annual revenue loss of at least \$15 billion in 2006. Pre-tax profits have soared to record heights and after-tax profits have grown even faster. There has been no comparable increase in corporate investment. Simply adding \$15 billion to the 2000 investment level would have increased total investment to nearly 13% of GDP in 2006.

Astonishingly, after-tax profits (which exclude depreciation) now equal gross investment (which includes depreciation). Corporate Canada's internally-generated funds (retained profits plus depreciation) far exceed gross non-financial investment. Business leaders are using this huge surplus to become net lenders to households, stockpile liquid assets, acquire other enterprises, and buy back stock.¹ While these actions may be viable business strategies, it is not clear why the public should subsidize them through further corporate-tax cuts.

Are Canada's Corporate Taxes High?

Echoing other commentators, Diane Francis wrote in a recent *Financial Post* column that "Canada has the highest corporate taxes in the world."² In fact, Canada's combined federal-provincial CIT rate of 36% is the third-lowest among the Group of Seven major, western, industrialized countries.

Of course, different countries maintain different definitions of taxable income, different tax credits, etc. KPMG takes account of these differences by calculating the average effective tax rates of twelve "standard businesses" in several cities in each country. These calculations suggest that Canada is tied for the second-lowest CIT in the G-7. Therefore, Canada could raise the CIT somewhat without becoming "uncompetitive".

Canada and the G-7, 2000 – 2007

	<u>Statutory Corporate Tax Rates</u>			<u>Range of Effective Tax Rates</u>
	<i>2000</i>	<i>2007</i>	<i>Reduction</i>	<i>2006</i>
Japan	42%	41%	1%	N.A.
United States	40%	40%	0%	30%-38%
Germany	52%	38%	14%	47%
Italy	41%	37%	4%	46%-53%
Canada	45%	36%	9%	27%-32%
France	37%	33%	4%	29%-31%
United Kingdom	30%	30%	0%	24%-28%

Note: Statutory rates are from KPMG's *Corporate and Indirect Tax Rate Survey 2007*. Effective rates are from KPMG, *Competitive Alternatives: Volume II Report - 2006 Edition*. The range for Canada excludes St. John's, which had an effective rate of only 19%.

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The notion that Canada has a high CIT is based on comparisons with the wider world. Canada's 36% rate exceeds the Organization for Economic Co-operation and Development average of 28% and the global average of 27%. These averages are calculated by summing many rates, including tiny tax havens, and dividing by the number of countries. In other words, such comparisons give the same weight to Slovakian CIT as to American CIT.

Canada and the World, 2000 - 2007

	<u>Statutory Corporate Tax Rates</u>		
	<i>2000</i>	<i>2007</i>	<i>Reduction</i>
Canada	45%	36%	9%
OECD:			
Unweighted Average	34%	28%	6%
Weighted Average	39%	35%	4%
WORLD:			
Unweighted Average	32%	27%	5%
Weighted Average	38%	34%	4%

Note: Statutory rates are from the same source as above. Weighted averages are weighted according to the International Monetary Fund's GDP figures.

However, there are obviously many more potential investors comparing Canada and the U.S. than comparing Canada and the Slovak Republic. A sensible approach is to weight countries by economic size. Canada's 36% rate barely exceeds the GDP-weighted averages of 35% for the OECD and 34% for the whole world. Presumably, Canada's abundant natural resources, modern infrastructure, educated workforce, and rule of law outweigh these slight tax differentials in the eyes of prospective investors. By any measure, Canada has cut its CIT significantly more than most other countries.

The C. D. Howe Institute, an organization committed to tax cuts, argues that Canada has comparatively high marginal effective tax rates (METRs) on capital. In calculating this measure, the Institute excludes local business taxes, which are particularly low in Canada, and research and development tax incentives, which are particularly generous here. It includes inventories, which Canadian tax-accounting rules subject to a particularly high METR. However, fixed capital such as machinery and equipment is what matters most for productivity and economic growth.

Marginal tax rates are not the appropriate measure of international competitiveness. An investor deciding where to locate a facility is concerned about the investment's total tax liability (i.e. the average tax rate), not the tax on the last dollar invested (i.e. the marginal rate).

Even if METRs were the appropriate measure, across-the-board CIT cuts are not a cost-effective way of reducing METRs. Finance Canada's *Budget Plan*

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2007 indicated that its permanent Capital Cost Allowance (CCA) changes, which are projected to cost \$145 million in 2008, will reduce Canada's METR almost as much as the Budget 2006 CIT cuts, which are projected to cost \$3 billion in 2008.

Budget 2007 also introduced a temporary accelerated CCA for manufacturers at a cost of \$1.3 billion over three years. The C. D. Howe Institute recently revealed that this measure, along with similarly targeted provincial incentives, dramatically reduced Canada's overall METR on capital from 37% in 2006 to 31% in 2007.³ Not surprisingly, measures tied to new investment have relatively more effect at the margin.

Are Canadian Tax Cuts Transferring Revenue to the US Treasury?

The U.S. government taxes American corporations on a worldwide basis. Profits from the Canadian subsidiaries of American corporations repatriated to the U.S. are subject to American tax minus credits for Canadian tax paid. Therefore, if effective tax rates are lower in Canada than in the U.S., American-controlled corporations pay the difference back to the U.S. government. Japan and the United Kingdom also tax their corporations on a worldwide basis. Further CIT rate reductions and/or targeted tax incentives could simply transfer revenues from the Canadian treasury to foreign treasuries.⁴

Canadian and American Effective Corporate Tax Rates, 2000 - 2007

(CIT Revenues as Percentages of Corporate Profits)

	2000	2001	2002	2003	2004	2005	2006	2007Q1
U.S. Total Rate	42%	38%	31%	33%	30%	29%	29%	30%
U.S. Federal Rate	35%	31%	25%	27%	25%	23%	24%	25%
Canadian Rate	35%	28%	26%	27%	27%	26%	26%	25%

Note: Calculated from Statistics Canada's System of National Accounts and the US Bureau of Economic Analysis' National Income and Product Accounts.

Canadian rates are well below American rates, but only the U.S. federal rate applies to profits repatriated from Canada. Clearly, the U.S. federal rate already exceeds the overall Canadian rate in lower-tax provinces. Any further CIT cuts could cause most Canadian subsidiaries of American corporations to pay U.S. tax.

Internal Revenue Service data suggests that falling Canadian taxes may be transferring revenue to the U.S. In 2001, American credits on taxable income from Canada almost equalled the statutory 35% American federal rate, implying further U.S. tax payments of only \$57 million. In 2002, credits fell to 32% of taxable income, implying U.S. payments of \$0.5 billion. In 2003, the most recent data available, credits fell again to 29%, which implied U.S. payments of \$1.4 billion on Canadian operations.⁵ Since credits can reflect taxes paid in previous years, the full effect of Canadian CIT cuts on American revenues may not be apparent for several years.

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Of course, there are many complications, including the fact that American multinationals may apply credits from one country against income from another. At a minimum, however, the potential redirection of tax payments to the U.S. and other foreign treasuries merits in-depth study prior to proceeding with more multi-billion-dollar CIT cuts.

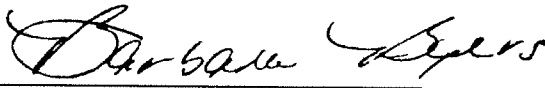
This document is respectfully submitted on behalf of the Canadian Labour Congress:



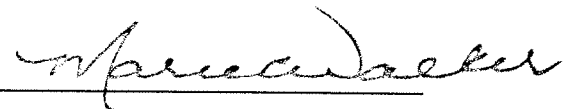
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