Chapter 8

Corporate Tax Reform Since 2000 and its Aftermath

By Jack Mintz[*]

After the 1995 spending-restraint federal budget, the minister of finance, Paul Martin, looked to address the revenue side once the federal deficit was eliminated. He struck a Technical Committee on Business Taxation in January 1996 to provide recommendations to reform the business tax structure to encourage growth and job creation, keeping in mind that the budget was not yet in surplus. Recommendations therefore had to be revenue neutral.

What was the problem?

Historically, Canada had been reliant on capital inflows and the development of export markets to grow its economy. Its labour productivity record in the 1990s was fourth lowest among OECD countries (Fortin, 1999). Although free trade in North America provided access to the large US market for Canadian businesses, it was unclear whether Canada would be in a position to attract businesses to serve the North American market. Despite the federal government's having replaced the manufacturers' sales tax with the GST in 1991 (which relieved capital inputs from federal sales tax), businesses faced one of the highest tax burdens on capital investment among OECD countries, impairing both adoption of innovation and export competitiveness.[1]

By the late 1990s, Canada had the highest federal-provincial corporate income tax rate in the world (43 percent), plus federal-provincial capital taxes, plus provincial retail sales taxes on capital purchases in most

* Endnotes, references and the author biography can be found at the end of this document.

provinces. Thus, the tax system impaired both competitiveness and investment. It also worked against federal and provincial public finances because Canada's high corporate income tax resulted in substantial tax avoidance as companies shifted the corporate tax base out of Canada through financial and transfer pricing arrangements.

The tax system also favoured primary and manufacturing investments over service businesses that were increasingly being exposed to trade. Only 12 percent of tax-favoured small businesses grew into larger firms. Employment Insurance supported many resource and manufacturing businesses with EI benefits in excess of contributions while service companies paid more premiums than they received in benefits. The federal fuel excise tax narrowly applied to one type of energy source as the federal government was becoming increasingly focused on environmental issues, especially the December 1997 Kyoto agreement on climate change.

What the report recommended

Paul Martin's technical committee argued that the best business tax structure to address growth and competitiveness would be to impose similar tax burdens on all business activities—i.e., create tax neutrality—by levying internationally competitive tax rates. The committee recommended that the federal general corporate income tax rate be reduced from 29.12 percent to 21.0 percent, the differential rate between manufacturing and other sectors be eliminated, and the small business tax rate left unchanged (thus reducing the differential between large and small business tax rates). Further, the committee recommended that the tax rate on resource profits should remain the same although the resource allowance in lieu of royalty deductibility would bring the statutory rate down to 21.0 percent. It made a number of recommendations to scale back various tax incentives.

The committee supported the integration of corporate and personal taxes but recommended a minimum tax on dividends paid by companies to ensure that the dividend tax credit was equal to corporate tax payments in the year. The committee frowned upon income trusts as a corporate structure because they not only enabled companies to avoid paying corporate taxes but also distorted capital market efficiency. It also noted that capital taxes placed a burden on a cyclically-based economy like Canada's. It called for a review of capital cost allowances so that they better reflected economic asset depreciation. It made various recommendations regarding international taxes so as to encourage capital exports and imports and to tighten up deductions to protect the corporate tax base, especially with respect to withholding taxes and interest limitation rules.

The committee recommended experience-rating for Employment Insurance to better relate premiums to employer layoffs. While it could not talk about carbon taxes (which were not government policy at the time), the committee recommended broadening the federal fuel excise tax by lowering motor fuel tax rates and expanding the tax to include natural gas and coal to account for sulphur and other pollutants.

What happened?

The report was released in April 1998. In 2000 the government announced a package of corporate and personal income reforms that enabled tax reductions in the presence of fiscal surpluses. The general corporate income tax rate was reduced to 21.0 percent over four years. The differential between manufacturing and non-manufacturing federal tax rates was eliminated. Federal Finance Minister John Manley introduced reductions to capital taxes in 2003, keeping the capital tax on financial institutions as a minimum tax. He also eliminated the resource allowance and introduced deductibility of resource taxes, which I personally supported (Mintz, 2001). The Harper government also reduced the federal corporate income tax to 15.0 percent by 2012 although it re-introduced accelerated depreciation for manufacturing equipment in 2006, contrary to the report's recommendations.

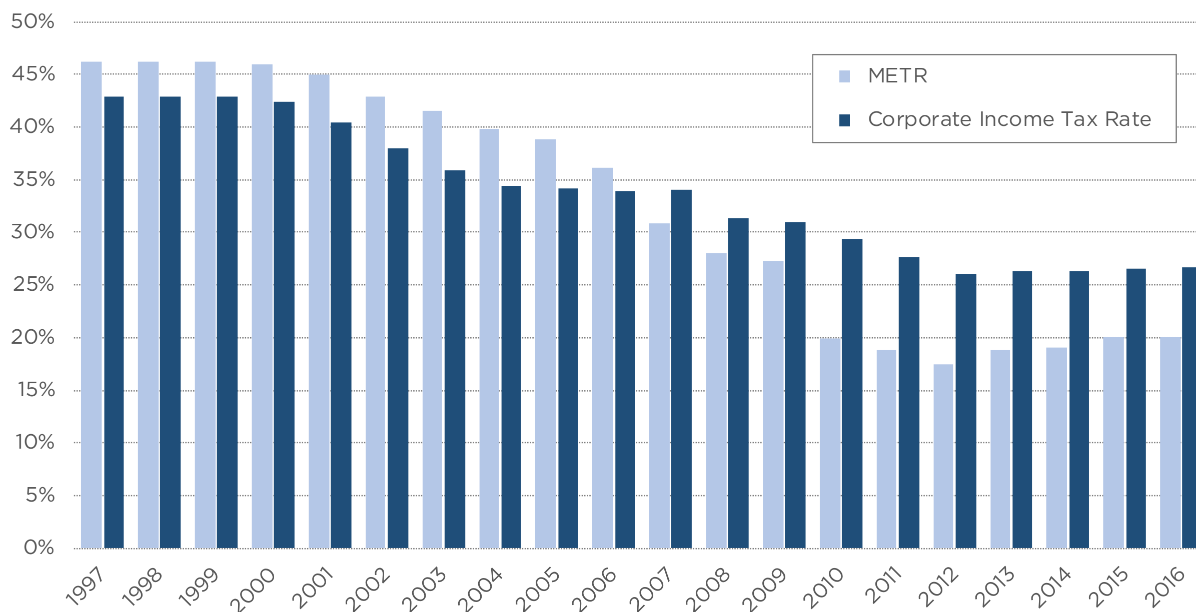
The federal report also influenced the provinces. Alberta was first to reduce its general corporate income tax rate from 15.5 percent to 10.0 percent and broaden its tax base. Other provinces followed suit with reform packages, including NDP governments in Manitoba and Saskatchewan. Most provinces also eliminated capital taxes though a few retained a financial institution tax.

As for other reforms, capital cost allowances were reviewed by 2004. It took time but the federal government phased out most income trusts beginning in 2006. Withholding taxes on interest payments were eliminated in 2007 and various measures were adopted to protect the international tax base. On the other hand, the minimum dividend tax, EI experience-rating, and the federal fuel excise tax reforms were not adopted.

Economic impact

The effect of corporate tax reform together with provincial sales tax harmonization in Ontario and Prince Edward Island after 2010, resulted in a dramatic reduction in the corporate marginal effective tax rate on capital

Figure 1: Marginal Effective Tax Rates and Corporate Income Tax Rates for Large and Medium-Sized Corporations, 1997 to 2016



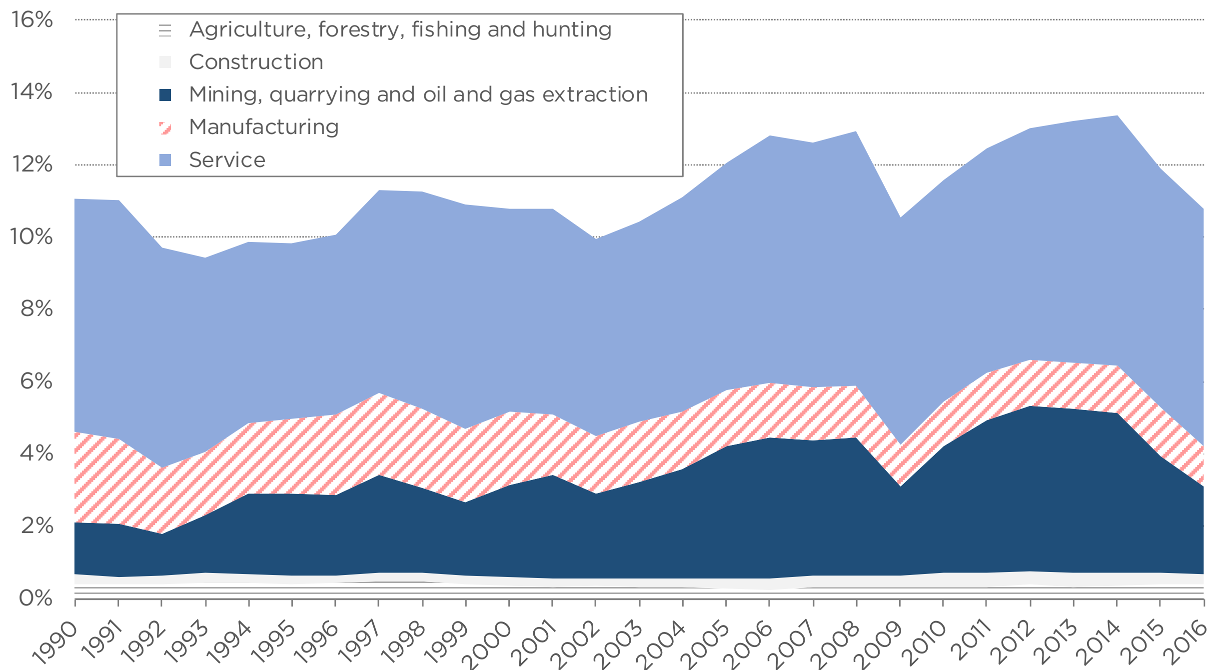
Source: Bazel and Mintz, 2016.

(METR).[2] An increase in the METR squeezes out marginal projects and results in a loss of investment (the converse for a reduction in the METR).

As figure 1 shows, the METR fell dramatically, from about 46.0 percent in 1997 to 18.0 percent in 2012. (Since then, it rose to 20.9 percent by 2017, but dropped to 15.5 percent in 2019 with accelerated depreciation.[3]) The decline in the tax burden on capital was steeper than the corporate income tax rate because federal and provincial governments also reduced other taxes on investment.

Did the METR change result in better investment performance? As figure 2 shows, private investment picked up after 2000 after performing poorly in the 1990s. As a share of GDP, private investment rose from 10.5 percent in 2003 to 13.0 percent by 2012. The better performance was partly related to the commodity boom but also to the improved fiscal climate for investment as shown by various economic studies.[4] While mining and petroleum investment expanded as expected from the commodity price boom, services, which benefited the most from tax reform, rose from 5.5 percent in 2001 to 8.0 percent of GDP. The average growth rate for private investment in Canada rose from 2.1 percent in 1988 to 2000 to 4.5 percent in 2001 to 2011 (both periods had significant recessions: the former

Figure 2: Private Investment as a Share of GDP in Canada



Source: Statistics Canada, Table 36-10-0096-01. Excluded are educational services, health care, social assistance, and the government sector.

during 1990-92 and the latter from 2008-9). Investment rates improved in Canada relative to the United States, as well; US private investment fell behind Canada's after 2000 (the US annual growth rate for private investment declined from 4.4 percent during 1990–2000 to 0.1 percent during 2001–2011).

After 2014, private investment declined, no doubt reflecting the commodity downturn. However, it is also the case the METR started rising after 2012, with other business tax hikes and regulations affecting cost competitiveness.

Did corporate tax reductions lower revenues? Canadian corporate tax revenues hardly budged between 2001 and 2012 during the rate reduction, ranging between 3.0 percent and 3.5 percent of GDP (see Chen and Mintz, 2012). Corporate taxes have held up for at least two reasons. First, multinational companies were willing to keep more profits in Canada when its corporate rate was lower than in many other large countries, especially the United States.[5] Second, the lower rates also encouraged in-

dividuals to shift income into the corporate sector, although small business rates did not decline much during this period.

Conclusion

Corporate tax reform from 2000 to 2012 was a success in Canada. It led to more investment without a significant loss in revenues and it created a more neutral and competitive tax system.

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1. Much of the discussion in this and the following section is based on conclusions in the report of the Technical Committee on Business Taxation (1998).

2. The METR is measured as the ratio of corporate income taxes, sales taxes on capital purchases, land transfer taxes, and asset-based taxes as a share of profits earned by marginal projects. Provincial and municipal property taxes as well as the resource and finance sectors are not included due to lack of data.

3. These results will be forthcoming in a new paper.

4. Taking into account the various economic and political factors that affect investment, a general result is a 10 percent increase in the cost of capital (adjusted for the METR, which adds to the cost of capital) causes a decline of 7 to 10 percent in capital stock (see Parsons, 2008).

5. Mintz and Smart (2004) estimate that a 1-point reduction in the provincial statutory tax rate increases the corporate tax base by 4.9 percent for large corporations that do not allocate income across provinces and 2.3 percent for those that do allocate corporate income.

CHAPTER 9: Replacing a Vicious Fiscal Circle with a Virtuous One
by Don Drummond

1. Throughout this article federal debt refers to accumulated deficits. During the time of the 1990s fiscal correction the focus was on the net debt. Net debt is higher than the accumulated deficits, the difference being net non-financial assets, which are subtracted from net debt to produce accumulated deficits. The differences are $44.4 billion or eight per cent in 1995-96 and $86.6 billion or 12.6 per cent in 2018-19. Accumulated deficits are used here because due to an accounting change a consistent series for net debt is not available prior to 1983-84.

2. Notes: (i) The data shown are for “accumulated deficits” and are from Canada, Fiscal Reference Tables, various years; (ii) Due to a break in the series following the introduction of full accrual accounting, data from 1983/84 onward are not directly comparable with earlier years.

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Canada. *Hidden Agendas* was short-listed for the Donner Prize for the best book in public policy, 2003/04.

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He chaired the federal government's Technical Committee on Business Taxation in 1996 and 1997 that led to corporate tax reform in Canada since 2000. He has also served on numerous panels and boards at the federal and provincial levels including vice-president and chair of the Social Sciences and Humanities Research Council 2012-2018.

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