The Macdonald-Laurier Institute

COMMENTARY/COMMENTAIRE

Corporate Income Tax: Stay the Course

By Jason Clemens

Executive Summary/Sommaire

In a time of serious budgetary difficulties it is tempting to suggest that we "raise taxes" on corporations or, at least, do not cut them. But to evaluate this suggestion properly it is critical to understand the difference between raising tax rates and raising tax revenues.

Like most taxes in Canada, the corporate income tax or CIT has two components. First, there is the "base," the types of economic activity that are defined by law as corporate income subject to the CIT. Second, there is the "rate," how much of the base the tax takes. These two components combine to form the "take," the amount of money the government gets, the result of multiplying the rate by the base. When people suggest raising taxes they usually have in mind that we should increase the take. And they usually also assume that there is a straightforward relationship between raising the rate and raising the take. But Canada's recent history shows that the matter is not that simple.

Raising rates will only raise the take, especially over time, if higher rates do not tend to reduce the base. But if raising the rate causes people to rearrange their affairs so that they have less income that legally qualifies as part of the base (either because of clever technical adjustments in the way they earn a living, or because high taxes discourage productive effort), raising rates may leave the take more or less unchanged or even reduce it.

The history of corporate income taxes in Canada in recent decades reveals that there is no simple "linear" relationship between corporate income tax rates and the take from the CIT. Some periods saw a constant rate and a growing take; in others cuts in the tax rate were accompanied by fluctuating revenues, rising in some years and falling in others.

In short, changes in the tax rate do not lead to predictable changes in revenue in the long run. What does affect revenue most directly is changes in corporate profits. So if raising rates has a negative impact on business earnings in the long run, it will be ineffective in the short run and harmful over time.

The strongest rule to emerge from the data is that a lucid discussion about taxes is impossible unless we draw a clear and fundamental distinction between rates and revenues.

En cette période de difficultés budgétaires, on peut être tentés de suggérer « d'augmenter les impôts » des entreprises ou, à tout le moins, de ne pas les réduire. Pour évaluer cette proposition, il est absolument crucial de comprendre la différence entre augmenter le taux d'imposition et augmenter les recettes fiscales.

L'impôt sur les sociétés comporte deux parties: l'« assiette », c'est-à-dire les types d'activités économiques définis dans la loi comme étant des bénéfices auxquels s'applique l'impôt; et le « taux » qui détermine quelle proportion de l'assiette sera payée en impôt. Ces deux parties forment les « rentrées », soit le montant d'argent que le gouvernement reçoit, qui résulte d'une multiplication du taux par l'assiette. Lorsque les gens suggèrent d'augmenter les impôts, ils ont généralement à l'esprit qu'on devrait augmenter les rentrées, et présument aussi généralement qu'il existe une relation directe entre une augmentation du taux et des rentrées. L'histoire récente du Canada démontre toutefois que la question n'est pas si simple.

Si un taux plus élevé fait en sorte que les gens réorganisent leurs affaires de telle manière qu'ils ont moins de revenus qui correspondent légalement à l'assiette d'imposition (soit à cause d'ajustements techniques astucieux, soit parce que des impôts plus lourds découragent l'effort productif), il se peut bien qu'une augmentation du taux entraîne des rentrées plus ou moins équivalentes ou même réduites.

L'histoire récente de l'impôt sur les sociétés au Canada révèle qu'il n'existe aucune relation « linéaire » directe entre les taux et les rentrées. On a pu constater pendant certaines périodes un taux constant couplé à des rentrées croissantes ; à d'autres, des réductions dans le taux qui s'accompagnaient de rentrées fluctuantes, à la hausse certaines années et à la baisse d'autres années. C'est l'évolution des profits des entreprises qui semble influencer les recettes le plus directement. Si une augmentation des taux d'imposition a un impact négatif sur les bénéfices des entreprises à long terme, elle sera donc inefficace à court terme et aura des effets néfastes à plus long terme.

Il est impossible d'avoir une discussion lucide sur le sujet des impôts à moins de comprendre clairement la distinction fondamentale entre les taux d'imposition et les rentrées fiscales.

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As federal and provincial governments grapple with the weight of deficits and increasing debt,[1] there are prominent Canadians calling for a reversal of tax cuts implemented over the last decade. In particular there are calls to undo the critically important reductions in Canada's corporate income taxes.[2] This would be an enormous mistake, which would both fail to improve the country's finances and imperil future economic growth. For the sake of the economy and the government's finances, it is critical that Canada remain on the path established by Jean Chrétien, Paul Martin and the Liberals beginning in the 2000 budget.

Canada's 2000 federal budget[3] is most remembered as the tax cutting budget. Its 5-year, $100-billion tax relief measures reduced most major taxes. Included amongst the many tax cuts[4] was the first step to dramatically improve Canada's business tax competitiveness and strengthen the incentives for investment and business development.

A key change in the 2000 federal budget was its plan to reduce the general corporate income tax rate from 28 percent to 21 percent by 2004, which would bring it in line with the preferential corporate income tax rate available to manufacturers and processors. This measure improved economic efficiency by ending preferential corporate income tax rates for particular sectors of the economy, a key recommendation of the Mintz[5] Committee.[6] Moreover this first heroic[7] foray into reducing business taxes led to a number of subsequent reforms and additional reductions.

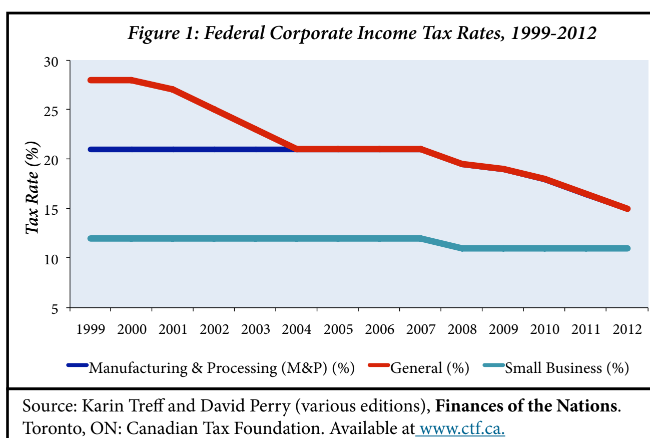

Figure 1: Federal Corporate Income Tax Rates, 1999-2012

Source: Karin Treff and David Perry (various editions), **Finances of the Nations**. Toronto, ON: Canadian Tax Foundation. Available at www.ctf.ca.

The general corporate income tax rate, which stood at 28 percent in 2000[8], was reduced to 18 percent on January 1, 2010 (figure 1) for all corporations except those eligible for the small business tax rate,[9] to 16.5 percent on January 1, 2011 and is scheduled to decline to 15 percent in 2012.[10]

There are some Canadians[11] now calling for either a freeze in the plan to further reduce business taxes or an outright reversal of the reductions already achieved. At least some of the impetus to freeze or undo the corporate tax reforms is based on a misunderstanding of corporate tax revenues. Such revenues, like all taxes, are a function of two factors: (1) the "base" a tax is applied to and (2) the "rate", or how much of that base the government takes. In the case of corporate income tax, the base is corporate profits and the rate is the corporate income tax expressed as a percent. And it might seem that if you simply apply a higher rate to the tax base you get more revenue.

The idea that raising tax rates increases revenue depends upon the assumption that the tax rate has no meaningful effect on the base to which it is applied. In other words, some Canadians are arguing that changes in tax rates do not affect the way people and businesses behave. That is, that we do not respond to incentives. But of course we do.

Businesses are composed of individual workers, managers and owners who all respond to incentives.[12] Increasing corporate income tax rates influences corporate behavior. International companies can respond to increases in tax rates by shifting some of their costs into higher tax jurisdictions. For instance, firms can borrow in the higher tax jurisdiction in order to reduce their profits there and thus shift income to other lower tax jurisdictions.

Such behaviourial responses are not limited to international companies. Domestic firms can, for example, alter their financing to rely more heavily on debt, which is tax deductible, rather than retained earnings or equity in order to reduce their taxable income. These are just two examples among many

ways firms can respond when corporate income taxes change.

Figure 2 illustrates the general corporate income tax rate between 1990 and 2009 as well as federal corporate income tax revenues over the same period.[13] It's pretty clear that *there is no simple linear relationship between the statutory tax rate and the revenues collected by government*. Recall that many of those people advocating for a reversal or freezing of the corporate income tax rate assume that there is a simple linear relationship between the tax rate applied and the revenues collected. In other words, they assume that when you increase the tax rate, no one changes their behaviour, so revenues necessarily increase in accordance with the higher tax rate.

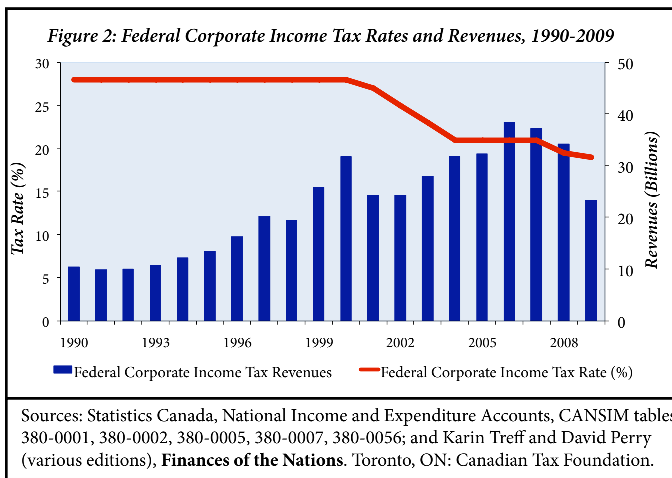

Figure 2: Federal Corporate Income Tax Rates and Revenues, 1990-2009

Sources: Statistics Canada, National Income and Expenditure Accounts, CANSIM tables 380-0001, 380-0002, 380-0005, 380-0007, 380-0056; and Karin Treff and David Perry (various editions), **Finances of the Nations**. Toronto, ON: Canadian Tax Foundation.

Figure 2 clearly illustrates the faulty nature of that assumption. For example, between 1994 and 2000, nominal federal corporate income tax revenues increased, on average, by almost 18 percent annually even though the corporate income tax rate remained constant at 28 percent. Federal nominal (non-inflation-adjusted) corporate income tax revenues increased, on average, by almost 10 percent between 2001 and 2006 even though the corporate income tax rate declined from 27 percent (2001) to 21 percent (2006).

In some years the tax rate decreased while revenues increased. In other years, the rates and revenues both fell, and in still others the tax rate was stable with revenues fluctuating up and down. In other words, there is no simple linear relationship between the tax rate and the resultant tax revenues.

This is not to suggest, however, that the corporate income tax rate or other tax rates for that matter don't influence economic performance. Tax rates, particularly marginal tax rates, have enormous economic influences because they affect our decision-making with respect to work effort, savings, investment, and entrepreneurship. In other words, tax rates affect economic performance because they influence the incentives for productive behaviour. Too high tax rates, or ones that are not competitive, result in lower work effort, savings, investment, and entrepreneurship, which are the foundation of a prosperous society.

The issue at hand, however, is not whether increasing corporate income tax rates influences behaviour, which it clearly does by reducing the returns (rewards) to investment and risk-taking but whether they result in higher revenues for government. Figure 2 illustrates that the relationship between corporate income tax rates and the revenues collected by government are more complicated than the advocates for higher rates suggest.

Figure 3 provides an explanation for why this is the case. This chart plots the same federal corporate income tax revenues over the same period as Figure 2 but this time compares them to the underlying base of corporate profits. Figure 3 demonstrates that there is a strong relationship between corporate profits and the revenues the government receives in corporate income taxes. Put simply, when corporate profits increase, revenues to the government in the form of corporate income taxes also increase, and vice versa.[14]

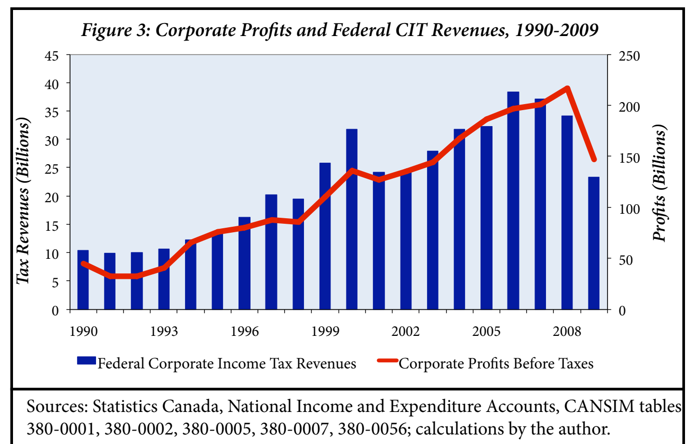

Figure 3: Corporate Profits and Federal CIT Revenues, 1990-2009

Sources: Statistics Canada, National Income and Expenditure Accounts, CANSIM tables 380-0001, 380-0002, 380-0005, 380-0007, 380-0056; calculations by the author.

In short, where corporate profits go, so goes federal corporate income tax revenues. Corporate profits are influenced by economic growth and the state of the economy. Tax policies that impede economic growth generally, discourage investment, entrepreneurship or business development will ultimately reduce corporate profits and thus corporate income tax revenues to the government. Increasing corporate income tax rates clearly discourages investment and business expansion by reducing the rewards to these activities. In addition, higher corporate income tax rates create incentives for firms to shift profits out of Canada and/or use mechanisms within Canada to reduce their taxable income (profits). Both of these responses mean less corporate profits in Canada and thus lower corporate tax revenues to government.

The sound economic and tax policy is to retain the current plan for corporate income tax reductions, which increase Canada's tax competitiveness and improve the incentives for investment and business development. Successive Liberal and Conservative governments have understood that cutting the corporate income tax rate has generally led to higher corporate income tax revenues as corporate profits increased. The corporate income tax rate reductions begun by the Liberals under the leadership of Jean Chrétien and Paul Martin and continued, indeed expanded, by the current Conservatives, have benefitted the country greatly. It's a major reason why Canada has emerged from the economic crisis amongst the strongest in the world.

There is never a good time to undo good tax policy. But one of the worst times would be when an economy is just emerging from recession. That's why the Conservatives should stay the course set for them by the Liberals and ignore well-meaning policy suggestions built on faulty assumptions.

Endnotes

1 For a summary of the current financial positions of the federal and provincial governments, please see the budget summary section of TD Bank Economics at www.td.com/economics/gov_finances.jsp.

2 Paul Vieira (2010). "Liberal corporate tax freeze 'unwise'", *National Post*, Tuesday, March 30, 2010.

3 Comprehensive information on Budget 2000 is available at www.fin.gc.ca/toc/2000/buddocs-eng.asp.

4 Information regarding the tax relief measures included in the 2000 budget are available at www.fin.gc.ca/budget00/tax/tax1-eng.asp#Five.

5 Professor Jack Mintz, formerly of the University of Toronto and currently the Palmer Chair of Public Policy at the School of Public Policy at the University of Calgary held the prestigious Clifford Clark Visiting Economist position at the Department of Finance in 1997 before assuming the chair position of the Technical Committee on Business Taxation.

6 Former finance minister Paul Martin appointed the Technical Committee on Business Taxation, commonly referred to as the Mintz Commission, on March 6, 1996. A little over two years later, on April 6, 1998 the Department of Finance released the Committee's report on Canada's business taxes. In February of 2000, the federal government delivered its annual budget, which included many of the recommendations made by the Mintz Commission. Information about the Technical Committee on Business Taxation, including working papers, a summary, and the full report are available at www.fin.gc.ca/toc/1998/brie_-eng.asp#Brief.

7 I characterize the changes made in the 2000 budget as heroic because Canadians, like citizens in most countries, fundamentally misunderstand business taxes. There is a prevailing belief that businesses in and of themselves pay taxes when the reality is that a business is nothing more than a legal entity or mechanism used to bring people together to achieve a common economic goal. It is these people, the workers, the owners, and their customers that ultimately bear the burden of business taxes in the form of lower wages, lower returns, and/or higher prices. The Liberal government and in particular Finance Minister Paul Martin deserve enormous credit for taking on this challenge and a host of vested interests opposed to such tax relief.

8 The corporate income tax rate was actually 29.12 percent once the 4 percent surtax was taken into account; the surtax was completely eliminated as of January 1, 2008.

9 Canadian controlled public companies (CCPC) whose earnings are within the current $500,000 deduction limit face a lower corporate income tax rate of 11 percent.

10 Information on the October 2007 Economic Statement, which accelerated and deepened the previously announced corporate income tax rate reductions is available at www.budget.gc.ca/2008/plan/chap3b-eng.html#tax

11 Including federal Liberal leader Michael Ignatieff (see www.liberal.ca/newsroom/news-release/michael-ignatieff-sets-out-fiscally-responsible-approach-to-invest-in-canadas-priorities/) deputy federal Liberal leader and former Finance Minister Ralph Goodale (see www.liberal.ca/newsroom/news-release/in-advance-of-g8-liberals-tell-harper-to-fight-deficit-by-deferring-corporate-tax-cuts/), federal NDP leader Jack Layton (see www.youtube.com/watch?v=2F06xJKvqTs) and Canadian Centre for Policy Alternatives Senior Economist Marc Lee (see www.progressive-economics.ca/2010/05/29/dangerous-delusions-about-corporate-income-tax-cuts/). On Jan. 21, 2011 the federal Liberals released a video ad sharply critical of corporate tax cuts: www.liberal.ca/newsroom/photos-and-video/#media/video/zvvpu__6nMc

12 For a review of the research on how taxes influence behaviour and incentives please see Jason Clemens, Niels Veldhuis, and Milagros Palacios (2007). *Tax Efficiency: Not All Taxes Are Created Equal*. Vancouver, BC: The Fraser Institute. Available at http://www.fraserinstitute.org/researchandpublications/publications/3178.aspx

13 The corporate income tax revenues included in Figure 2 encompass revenues from the previously available preferential corporate income tax rate for manufacturers and processors as well as the preferential corporate income tax rate available to eligible small businesses.

14 The decline in corporate income tax revenues in 2001 owes much more to the economic slowdown that year and related decline in corporate profits than to the reduction in the corporate income tax rate of 1 percentage-point. Similarly, the increases in corporate income tax revenues between 2001 and 2006 are largely the result of a prosperous economy in which corporate profits were increasing.

The Macdonald-Laurier Institute

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Allan Gotlieb, former Deputy Minister of
External Affairs and Ambassador to Washington

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It is not often that Canadians talk about moving out of America's shadow— for far too long we have simply assumed that being in that shadow was the natural order of things. Crowley, Clemens and Veldhuis remind us that Sir Wilfrid Laurier thought that all things were possible for us, and they show, with an impressive array of facts to support their argument, that Laurier's plan for Canada can still carry us through to that Canadian century we have all been eagerly awaiting for over a hundred years. -**Allan Gotlieb**, from the foreword

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"This wonderful book is an urgent wake-up call for Canada's current leaders—of all political stripes—and raises crucial economic issues that should be top-of-mind in coming federal elections. Now is the time to reaffirm the power of Laurier's vision, to make some courageous policy decisions, and to thereby ensure that the 21st Century belongs to Canada in the way Sir Wilfred intended a hundred years ago. Will Canada's political leaders pay attention?" - Christopher Ragan, Clifford Clark Visiting Economist, Finance Canada