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The economic costs of the capital tax

Canada is one of the few countries in the world where corporate capital is subject to a tax. At the federal level, this capital tax hits all large corporations, with big financial institutions paying higher rates. All provincial governments, with the exception of Alberta, levy a tax on the capital of financial institutions, and six of them also tax the capital of other medium to large companies.

Tax rates and exemptions, as well as exact definitions of taxable capital, vary from one government to another (see Table 1 and the appendix on the MEI website). Taxable capital is generally based on a company's equity plus long-term debt. In Quebec, the 2005 rates apply to companies with more than $1 million in capital; at the federal level, the exemption is $50 million.

In the 2003-04 fiscal year, the federal capital tax brought in $1.5 billion, or 0.7% of the federal administration's total receipts. In Quebec during the same period, receipts from the capital tax came to $1.4 billion, or 2.5% of total receipts.

History

In 1947, Quebec introduced Canada's first capital tax. At the federal level, the capital tax was established in 1985 as a temporary measure to fight the deficit, applying only to large financial institutions. It also aimed to resolve a problem connected with defining the profits of financial institutions. In 1988 it became permanent, and in 1989 it was extended to all large corporations.

In November 2001, Quebec's then minister of Finance, Pauline Marois, unveiled a plan to reduce the province's capital tax. "The general tax rate will be gradually cut to less than half its current rate by 2007, that is, from 0.64% to 0.30%,"[1] she announced. In March 2003, a document from the Quebec Liberal Party went further: "A Quebec Liberal Party government will eliminate the tax on capital of SMEs [small and medium enterprises] during its first term in office."[2]

In its first budget in June 2003, however, the new Liberal government stated that "the current situation … obliges us to defer the planned rate reduction."[3] It did, though, raise the exemption to $600,000 in 2004 and to $1 million in 2005, in order to fulfill its promise to exempt SMEs, whereas the previous government had planned to increase the exemption to $500,000 only in 2004 and to $1 million in 2006. At the federal level, the 2003-04 budget announced a gradual rate reduction for large corporations leading up to the disappearance of the tax in 2008. This promise still holds.

1. Gouvernement du Québec. *Budget Speech*, presented to the National Assembly by Pauline Marois. November 1, 2001, available at http://www.budget.finances.gouv.qc.ca/budget/2002-2003/en/pdf/BudgetSpeech.pdf.
2. Quebec Liberal Party. *Raising Quebecers' Standard of Living*. Working document, March 2003, available at http://www.plq.org/doc/platform/pmea.pdf.
3. Gouvernement du Québec. *Budget Speech*, presented to the National Assembly by Yves Séguin. June 12, 2003, available at http://www.budget.finances.gouv.qc.ca/budget/2003-2004a/en/pdf/BudgetSpeech.pdf.

This Economic Note was written by Norma Kozhaya, an MEI economist and University of Montreal lecturer.

Table 1

Capital tax rates in Canada as of January 1, 2005 (in percentages)

	Non-financial corporations	Financial institutions
Federal	0.175	1.0 - 1.25
Newfoundland and Labrador	n.a.	4.0
Prince Edward Island	n.a.	5.0
Nova Scotia	0.30 - 0.60	4.0
New Brunswick	0.30	3.0
Quebec	0.60	1.20
Ontario	0.30	0.60 - 0.90
Manitoba	0.30 - 0.50	3.00
Saskatchewan	0.60	0.70 - 3.25
Alberta	n.a.	n.a.
British Columbia	n.a.	1.0 - 3.0

n.a. : not applicable
Sources: Deloitte, available at http://www.deloitte.com/dtt/cda/doc/content/ca_tax_QTF2004-E.pdf; Statistics Canada, *Public sector statistics: Supplement*.

A high economic cost

The main disadvantage of the capital tax is that it discourages investment by raising the cost of capital, thereby reducing the amounts invested. It differs from income tax in that it strikes at capital even when the yield on this capital is nil or negative, in other words even when a company is losing money. Since the yield on capital varies with the economic cycle, a capital tax is equivalent to an income tax with rates that are higher during slowdowns.

In fact, this tax acts as a fixed cost on investment, resulting in businesses requiring a higher yield on capital to absorb the extra cost. This eliminates investments that might have been made if such an expense did not exist. A reduced level of investment means less innovation, less economic growth, and lower income and consumption. It also leads over time to lower labour productivity and thus to lower real wages and a lower standard of living for workers.

This tax also harms Canada's international competitiveness and its ability to attract investment in a context of globalization and business relocation. Its effects are all the more serious since Canada is among the countries where income from capital is most heavily taxed. Taking account of all factors affecting investment costs, in particular the capital tax and sales taxes on capital goods, Canada's capital charge is near the top.

A recent study shows that, despite lower statutory corporate income tax rates in Canada than in the United States, the effective rate of the tax on capital is higher in Canada.[4] In 2004, the effective rate was 31.3% in Canada compared to 23% in the United States, even though the combined statutory rate on corporate income was 34.9% in Canada and 39.5% in the U.S. Canada in fact has the third highest effective tax rate on capital among a group of 20 industrialized countries.[5]

A document from the federal Department of Finance concludes that the capital tax causes substantial losses in economic efficiency and well-being – 90 cents for every dollar collected in capital tax.[6] In other words, reducing the tax by a dollar would lead to a rise in well-being whose present value would be 90 cents. This represents the advantage to taxpayers and society of reducing economic distortions, which include the higher cost of investment caused by the capital tax. The only taxes with higher economic costs are other taxes on capital, such as the capital gains tax on individuals. In comparison, corporate income tax costs 40 cents for each dollar collected in terms of lost well-being, individual income tax costs 30 cents and consumption taxes cost 10 cents (see Figure 1).

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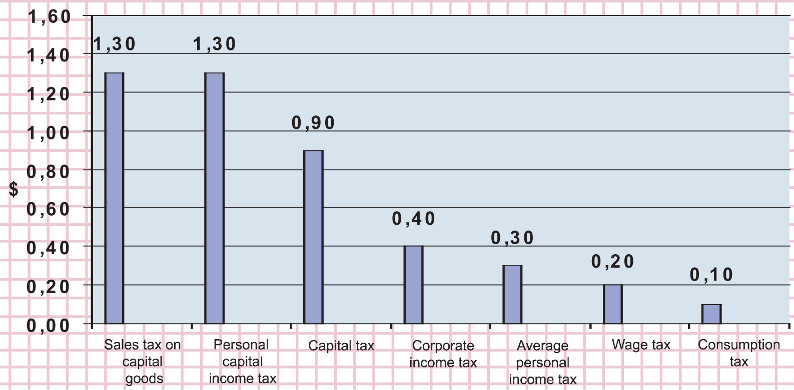
What's more, this 90-cent loss represents a conservative estimate. The model from the Department of Finance ignores added distortion caused by the risk of higher losses during difficult financial times. As we have seen, the capital tax is payable even if the yield on capital comes down, in an economic slowdown, for instance.

4. Chen, Duanje, and Jack Mintz. *How to become more seductive: Make Canada more investment-friendly*. C.D. Howe Institute, January 19, 2005, available at http://www.cdhowe.org/pdf/ebrief_11.pdf.
5. Other OECD studies find similar results, including: Carey, David, and Josette Rabesona. "Tax ratios on labour and capital income and on consumption." *OECD Economic Studies*, no. 35 (2002), available at http://www.oecd.org/dataoecd/42/37/22027720.pdf.
6. Department of Finance. *Tax Expenditures and Evaluations 2004*. Ottawa, 2004, available at http://www.fin.gc.ca/taxexp/2004/TaxExp04_e.pdf.

Figure 1

Gains in long-term economic well-being for each dollar in tax reductions*



* Without affecting tax receipts

SOURCE: Department of Finance, *Tax Expenditures and Evaluations 2004*, Ottawa, 2004, p. 71

For Quebec, it has been estimated that eliminating the provincial capital tax would lead to a rise in capital stock of at least $7 billion, based on conservative hypotheses (3% of the $215 billion recorded in 2003).[7] This would create a proportionate rise in production, employment and income generation possibilities.

There is a further cost: resources wasted in applying this tax. Since rates, definitions of taxable capital, deductions and possible exemptions differ across Canada, calculating taxable capital and the amounts due is complicated. In addition, tax planning by companies to minimize what they pay in tax is an unproductive use of resources.

Who pays the capital tax?

To understand the effects of the capital tax, we need to know who, in effect, is paying this tax. Two important points must be considered. The first point is that, when companies are taxed, whether through the capital tax, the corporate income tax or other levies, a tax is being imposed on the production process in the economy. A company is a legal entity that, by definition, suffers no loss of utility if it is taxed, unlike individuals. Taxing it simply makes the production of goods or services more expensive and thus less competitive, which is inefficient from an economic standpoint. Taxing individuals, while causing distortions in the allocation of resources, is less harmful to economic growth.

The second point is that, even if it applies in theory to corporations, this tax, like any other, ends up being paid by individuals whether as shareholders (in lower returns on capital), as consumers (in higher prices) or as employees (in lower wages). Even if the capital tax is aimed mostly at company owners (who own the assets), an analysis of the tax incidence on public finances shows that they are not necessarily the ones who really – or totally – bear the cost.

In fact, studies on this topic suggest that, in a small open economy, taxes formally levied on companies fall at least in part on workers since labour is the least mobile factor of production (because of the costs of emigration).[8] Investors, who have access to international capital markets, will not be satisfied with a less attractive return on capital within the country and would choose instead to invest elsewhere. With labour kept relatively less productive by this smaller capital contribution (in machines, technology, etc.), wages are lower than they would be otherwise. This is how wage earners end up paying, at least in part, the cost of the capital tax.

For Quebec, it has been estimated that eliminating the provincial capital tax would lead to a rise in capital stock of at least $7 billion.

7. Calculation for the MEI, based on the methodology presented by Jack M. Mintz and Thomas A. Wilson. "Assessing Expenditure and Tax Reform Measures: A Review." International Tax Program, Rotman School of Management, University of Toronto, ITP paper 0408, 2004, available at http://www.rotman.utoronto.ca/iib/ITP0408.pdf. See the appendix on the MEI website for further details.
8. Estimating the incidence of a tax is especially complex. See Kesselman, Jonathan R., and Ron Cheung. "Tax Incidence, Progressivity, and Inequality in Canada." *Canadian Tax Journal*, vol. 52, no. 3 (2004), pp. 709-789 and, on the particular topic of taxes on business, pp. 776-778.

A discriminatory tax

Besides these costs, the capital tax presents other negative effects due to its discriminatory character. First, it applies only to companies of a certain size, especially those that are more capital-intensive (such as manufacturing companies), and it is harder still on companies whose activities are more heavily cyclical.

Second, the capital tax is discriminatory because it hits certain sectors, notably the finance industry, more heavily than others. In effect, the rates that pertain to financial institutions are generally at least double those applying to other companies (see Table 1). This explains in part why, in 2004, the effective overall tax rate of the service sector (including the finance sector) was 33.8%, compared to 28.8% for the manufacturing sector. According to calculations by accounting firm Ernst & Young for 1998, the financial sector contributed 5.5% of GDP that year but paid 21.3% of the capital tax in Canada.[9]

The economic costs of the capital tax are so obvious that the federal government has promised to eliminate it and the Quebec government has promised to lower it substantially.

The tax puts Canadian financial institutions at a disadvantage compared to unregulated loan companies (such as companies involved in car loans or in industrial and commercial financing like GE Capital) and also compared to foreign banks (ING Bank, for instance) that pay the capital tax only on capital deployed in Canada. It harms Canada's competitiveness as an international financial centre.

Finally, the capital tax penalizes the accumulation of capital by banks, contradicting the regulatory goal of having higher capital ratios to ensure the stability of the financial system.[10]

Conclusion

In 2004, the level of capital investment per worker in Canada was $850 below the OECD average and $2,160 below the level in the United States. The Quebec level is 38% below the North American average.[11] Reducing the capital tax is one of the most obvious ways of helping improve this performance.

Imposing a direct tax on a factor of production such as capital is a way of taxing the very process of production and wealth creation instead of taxing individual income or consumption. This involves substantial costs in terms of economic efficiency, and it harms the competitiveness of Canada and Quebec.

The economic costs of the capital tax are so obvious that the federal government has promised to eliminate it and the Quebec government has promised to lower it substantially. What remains is for the federal government to maintain this course and for the Quebec government to get back on track.

9. Ernst & Young. "Who Pays the Capital Tax." *Tax Policy Bulletin*, May 2002, available at http://www.ey.com/global/download.nsf/Canada/Tax_Policy__Who_Pays_The_Capital_Tax/$file/CapitalTaxBulletin_2002.pdf.
10. The Basel agreements between the G-10 countries essentially require banks to have ratios of capital to lending of at least 8%.
11. Robson, William, and Danielle Goldfarb. *Tools for Workers: How Canada is faring on the competition for capital investment*. C.D. Howe Institute Backgrounder, no. 87, December 2004, available at http://www.cdhowe.org/pdf/backgrounder_87.pdf.

Montreal Economic Institute

Montreal Economic Institute
6708 Saint-Hubert Street
Montreal (Quebec)
Canada H2S 2M6
Telephone: (514) 273-0969
Fax: (514) 273-0967
e-mail: info@iedm.org
Web Site: www.iedm.org

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