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ViewPoint

The negative effects of corporate taxes on investment and on workers

by Vincent Geloso and Jasmin Guénette | December 2010

Governments have made considerable efforts in recent years to reduce the tax burden of business. The federal government has promised to reduce the corporate income tax rate even further, toward a rate of 15% in 2012. The Quebec government's last budget highlighted the complete elimination of the capital tax, which will take effect on January 1st, 2011.[1] This is very good news, because corporate income taxes and other taxes paid by businesses have an impact not only or even primarily on shareholders, but also on workers, especially in an open economy.

THE EFFECT OF CORPORATE TAXES ON INVESTMENT

Corporate income taxes reduce the profitability of investments. In other words, raising these taxes drives investors to look elsewhere when they decide where to place their funds. Indeed, an economy like ours, in a globalized context, must deal with tax competition from other countries. The mobility of capital, which has been accelerating since the 1990s,[2] is such that an increase in corporate taxes can scare off potential foreign investors and local investors as well.

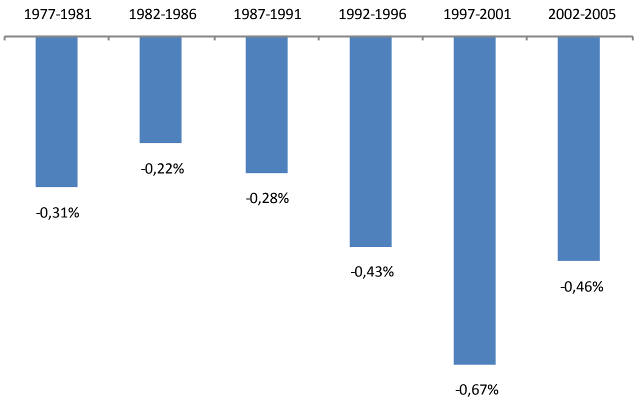
The authors of a recent study by the International Monetary Fund (IMF) examined some 40 countries in Latin America, the Caribbean and Africa and concluded that a reduction in the corporate income tax rate attracts foreign direct investment.[3] In another study of 69 countries, the same effect was observed: low effective tax rates on investment attract foreign direct investment.[4] The literature on the effect of taxes on foreign direct investment shows that the effective corporate tax rate has a statistically significant effect on investment, although the exact size of its impact remains uncertain.[5]

The heavy taxation of business also drives individuals to be less enterprising. A 2010 study published in the *American Economic Journal* reconfirmed the conclusions mentioned above, and also found that an increase in corporate taxes reduces the investment levels of businesses already in the market, as well as reducing entrepreneur-ship.[6] By examining 85 countries, the authors observed that a 10-percentage-point increase in the effective tax rate reduces the rate of investment as a percentage of GDP by 2.2 percentage points and foreign direct investment as a percentage of GDP by 2.3 percentage points. They also observed that this same increase in the tax rate reduces the number of businesses per 100 inhabitants by 1.9 (compared to an average of 5) and reduces the entry of new businesses into the market by 1.4 percentage points (compared to an average of 8%).

A study published by Canada's Department of Finance in 2008 looked into the benefits of federal corporate income tax reductions (from 2001 to 2004) and concluded that those reductions led to an increase in investment in the affected sectors.[7] This phenomenon is recognized by Quebec's Department of Finance, which states that a $1-billion increase in corporate income taxes reduces real GDP by $0.89 billion in the long run.[8]

Despite recent efforts to reduce corporate taxes, at both the provincial and federal levels, more can and should be done. The effective

Figure 1
Impact on wages of a one-percentage-point increase in the top marginal corporate income tax rate in U.S. states (1977-2005)



Source: R. Alison Felix, "Do State Corporate Income Taxes Reduce Wages?," *Federal Reserve Bank of Kansas City – Economic Review*, 2nd quarter 2009, p. 88.
Note: relationship is statistically significant at the 99% level.

1. Ministère des Finances du Québec, *Budget Speech 2010-2011*, p. 28.
2. Sebastian Edwards, *Capital Mobility and Economic Performance: Are Emerging Economies Different?,* National Bureau of Economic Research, Working Paper 8076, January 2001, p. 1-2.
3. Alexander Klemm and Stefan Van Parys, *Empirical Evidence on the Effects of Tax Incentives*, International Monetary Fund, Working Paper WP/09/136, July 2009, p. 11.
4. Jack M. Mintz, *2007 Tax Competitiveness Report: A Call for Comprehensive Tax Reform*, C.D. Howe Institute, Commentary No. 254, September 2007, p. 11.
5. Simeon Djankov, Tim Ganser, Caralee McLiesh, Rita Ramalho and Andrei Shleifer, "The Effect of Corporate Taxes on Investment and Entrepreneurship," *American Economic Journal: Macroeconomics*, Vol. 2 (2010), No. 3, p. 32.
6. *Id.*, p. 47-48.
7. Mark Parsons, *The Effect of Corporate Taxes on Canadian Investment: An Empirical Investigation*, Department of Finance Canada, Working Paper 2008-01, May 2008.
8. Ministère des Finances du Québec, *Budget Plan 2010-2011*, p. A39.

marginal tax rate—which includes all taxes paid by businesses—for investment in Canada was 28.0% in 2009, which is the 10th highest rate in a comparison of 80 countries.[9] As for Quebec (20.9%), while it beats out Ontario (33.6%) and British Columbia (29.5%),[10] it still has not followed the recommendation of the Fortin Report to reduce the corporate income tax rate to 10%.[11] Indeed, Quebec has a lot to gain by outdistancing the pack since it would benefit from an influx of capital that would expand the fiscal pie and therefore compensate in part for its lost revenues, all while accelerating economic growth.[12]

THE EFFECT OF CORPORATE TAXES ON WORKERS

The negative effects of corporate taxes on investment and entrepreneurship, described above, are in practice mostly felt by workers. This happens in a number of ways.

First of all, the reduction in investment reduces productivity growth, which translates into smaller wage increases or even a wage freeze. Moreover, businesses react by reducing their production as well as their demand for labour. Corporate income taxes also contribute to a long-term reduction in the ability of businesses to pay higher prices to their suppliers, which in turn has an effect on those suppliers' employees. Researchers at Oxford University studied 23,000 companies in 10 European countries. In the short term, 54% of all effective corporate tax rate increases resulted in reduced overall compensation. In the long term, each $1 increase in effective corporate tax rates led to a reduction in overall compensation of more than $1.[13] A study of the 50 U.S. states obtained similar results.[14] From 1977 to 1991, a one-percentage-point increase in the top marginal corporate income tax rate reduced salaries by an average of 0.27%. From 1992 to 2005, thanks to increased capital mobility and tax competition, the same rate increase led to salary reductions of 0.52%.

In addition, fewer new businesses created translates into fewer jobs created, which means workers must compete more aggressively for the positions that are available. This situation puts downward pressure on salaries.

Finally, workers—who are also investors—want the best possible returns for their retirements. However, the heavy taxation of businesses reduces the dividends businesses can pay to investors. Among those investors are workers' pension plans that must therefore settle for lower returns and therefore less comfortable retirements for their members.

CONCLUSION

The actual effects of corporate taxes on workers must be taken into account in debates on tax rates, which too often portray the interests of companies and workers as being at odds with each other. On the contrary, economic analysis demonstrates that corporate taxes have negative consequences for the entire population.

9. Duanjie Chen and Jack Mintz, "Canada's Tax Competitiveness After a Decade of Reform: Still An Unfinished Plan," *University of Calgary School of Public Policy Briefing Papers*, Vol. 3, No. 5, May 2010, p. 5.
10. Duanjie Chen and Jack Mintz, *The Path to Prosperity: Internationally Competitive Rates and a Level Playing Field*, C.D. Howe Institute, Commentary No. 295, September 2009, p. 5.
11. *Id.*, p. 162.
12. Michael P. Devereux, Rachel Griffith and Alexander Klemm, "Corporate Income Tax Reforms and Tax Competition," *Economic Policy*, Vol. 17 (2002), No. 35, p. 493.
13. Wiji Arulampalam, Michael P. Devereux and Giorgia Maffini, *The Direct Incidence of Corporate Income Tax on Wages*, Oxford University Centre for Business Taxation, Working Paper 09/17, August 2009.
14. R. Alison Felix, "Do State Corporate Income Taxes Reduce Wages?," *Federal Reserve Bank of Kansas City – Economic Review*, Second Quarter 2009, p. 88.

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