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CANADA'S TAX COMPETITIVENESS AFTER A DECADE OF REFORMS: STILL AN UNFINISHED PLAN

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SUMMARY

In the past decade, Canada has undertaken extensive business tax reform, with sharply lower corporate income tax rates, better capital cost allowances, sales tax harmonization, and the virtual elimination of capital tax on non-financial businesses. Further changes are in store by 2012 that will put Canada in the middle of the pack of a broad group of 80 countries.

Over the past several years, however, Canada has lost some standing. In 2005, it was the fourth-highest-taxed country, and by 2007 it had improved to thirteenth highest; by 2009, though, it had worsened to tenth highest. Still, in that year, taking into account the reforms that had taken place, Canada's business tax structure was better than that of the United States. Canada's tax competitiveness among the Group-of-7 major industrialized countries has also improved, but still lags that of most other members of the Organisation for Economic Co-operation and Development (OECD).

Additional reductions of business taxes by 2013 — particularly sales tax harmonization in Ontario and British Columbia and planned federal and provincial corporate tax rate reductions — will further improve Canada's business tax competitiveness, crucially with respect to the emerging economies of Brazil, Russia, India, and China.

Yet federal opposition parties are urging an end to further planned reductions of federal and provincial corporate income tax rates. Such a move would be seriously misguided. Not only would it put Canada's tax competitiveness at a disadvantage among OECD countries, impairing productivity; it would also harm government revenues as businesses shifted their profits out of high-tax jurisdictions and into lower-tax one abroad.

INTRODUCTION

In the past decade, reforms to Canada's business tax structure have improved the country's tax competitiveness remarkably. The combined federal and provincial corporate income tax rate fell sharply, from 42.6% in 2000 to 31.3% in 2009, and a further reduction to 25.7% is planned by 2013. Capital cost allowance rates are now better matched to economic depreciation, and most capital taxes have been or are being phased out entirely. After 1 July 2010, when British Columbia and Ontario harmonize their sales taxes with the federal goods and services tax, provincial sales taxes will no longer be a substantial burden on business capital purchases.

Already, these tax reform measures have contributed to reducing Canada's marginal effective tax rate (METR) on capital investment by large and medium-sized firms by more than 17 percentage points, from 45% in 2000 to 28% in 2009. Further tax changes in the pipeline, particularly British Columbia's and Ontario's sales tax harmonization, will reduce Canada's METR to 18.9% by 2013, which would compare well with the current 19.5% average for member countries of the Organisation for Economic Co-operation and Development (OECD), and would approach the 18% average of a broader group of 80 countries that we have examined. For Canada, this would be a great accomplishment given that it was the fourth-highest taxed-jurisdiction among the 80 countries only five years ago.

Yet, the federal opposition parties are calling for a halt to a further reduction in federal corporate income tax rates on the grounds that the revenues are needed to fund federal public services. Not only would this abandonment of Canada's tax competitiveness strategy leave the country with a corporate income tax rate of 29%, considerably higher than the average of the OECD and many emerging economies; it would give up the economic gains from which Canada would benefit by reducing distortions and increasing capital investment. Indeed, Canada would have been better off if, rather than forgoing its current tax-reduction plans, the federal government had accelerated the corporate rate reduction as part of the fiscal stimulus package it introduced in the January 2009 budget, since it would have provided more immediate tax relief to many companies during times of distress. Furthermore, the revenue losses that are forecast from corporate income tax reductions are exaggerated, since businesses can easily shift profits from high- to low-tax jurisdictions. The revenue-maximizing corporate income tax rate has been recently estimated as between 25% and 27%, a decline from earlier years.[1] The economic cost of giving up the three-point reduction in the federal corporate income tax rate planned by 2013 would be a long-run loss of $47 billion in capital investment and 233,000 jobs.

[1] See, for example, Kimberly Clausing, "Corporate Tax Revenues in OECD Countries," *International Tax and Public Finance* 14 (2, 2007): 115-134; Jack Mintz, "2007 Tax Competitiveness Report: A Call for Comprehensive Tax Reform," *C.D. Howe Institute Commentary* 254 (Toronto: C.D. Howe Institute, September 2007); and Alex Brill, "Corporate Tax Rates: Receipts and Distortions," *Tax Notes*, 22 December, 2008.

WHY BUSINESS TAX REFORM IS NECESSARY

Governments have succeeded in making Canada's business tax system much more competitive than it used to be, but the job is not finished, particularly given the fiscal pressures many governments face in wake of last year's Great Recession.

Some tax economists, including these authors, have been criticized for their relentless promotion of the goal of enhancing a nation's tax competitiveness. The main criticism is that, in international comparisons, we and other tax economists use an ever-moving standard that makes tax reduction a seemingly endless task. Critics complain that we first suggest Canada should aim for the METR in the United States as the target for competitiveness, then that Canada should match the METRs of the other Group-of-7 (G-7) major industrialized countries and the average of the OECD. Now we are eyeing a larger group of developed and developing economies, to take into account fast-growing emerging economies such as those of China and India. Will there never be an end?

Criticisms of the general approach to enhancing tax competitiveness by focusing on comparisons of METRs seem to be based on three main concerns. First, why is it appropriate to focus on corporate tax costs? Second, why shoot at a moving target? Third, does the focus on tax competitiveness not neglect the need to meet revenue goals and to address the issue of tax equity? Our response to these criticisms is as follows.

First, it is appropriate to focus on the cost of taxes to companies because these taxes directly affect capital allocation and, hence, economic growth and living standards. In a small, open economy such as Canada's, capital investment can move in and out of the country freely, so that multinational companies might well decide whether or not to invest in Canada simply by gauging the cost to them of paying tax in this country relative to what they would have to pay in other countries (assuming non-tax investment conditions are similar to those in Canada). Besides, in the end, it is not companies that bear the cost of the taxes they pay but less mobile consumers, in the form of higher prices on goods, and workers, in the form of lower real wages. A competitive business tax system, therefore, means both lower prices for consumer goods and higher compensation for workers, which contribute directly to higher living standards. Moreover, compared to other major tax instruments — such as personal income taxes, consumption taxes, and property taxes — corporate income taxes are the most distortionary in terms of reducing long-run gross domestic product (GDP) per capita.[2]

Second, it is appropriate to shoot at a moving target in evaluating tax competitiveness because the world is changing in two key ways (see Table 1). First, Canada is not the only player pursuing tax reform, so it must continually re-evaluate where it stands relative to other countries in terms of its tax competitiveness. Second, globalization is changing the relative strengths of Canada's economic partners.

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[2] See Asa Johansson et al., "Tax and Economic Growth," Economics Department Working Paper 620. Paris: Organisation for Economic Co-operation and Development, 11 July 2008); available online at http://www.olis.oecd.org/olis/2008doc.nsf/LinkTo/NT00003502/$FILE/JT03248896.PDF.

China is a good example on both counts. Before 2009, its 17% value-added tax (VAT) on machinery and equipment, which was not refundable to business taxpayers, made China the second most highly taxed of the countries in our comparative list. As well, although aggregate foreign direct investment (FDI) in China is large, as a share of that country's GDP it is relatively moderate, so that, in the past, China gave foreign companies tax breaks to help attract FDI. When, in 2009, China belatedly introduced an input tax credit for its VAT on capital goods, its METR on capital investment dropped immediately from 41.5% to 16%, moving it from the second highest to the thirty-fifth lowest of the 80 countries in our tax comparison (see Table 1), which negatively affected Canada's tax competitiveness ranking. In addition, China, the world's fastest-growing economy, became Canada's second-largest trading partner in 2004, while the US share of Canada's overall bilateral trade dropped from 73% in 2004 to 63% in 2009.[3] China's direct capital investment in Canada has also increased more than tenfold over the past decade, although its share of Canada's overall FDI inflow is still small.[4] With China's huge foreign exchange reserves and its new taste for economic expansion abroad, it would be short-sighted for Canada to ignore tax competitiveness as a means to attract Chinese capital investment.

Moreover, despite suggestions that taxes do not affect business investment, our work and that of other scholars shows that, in fact, reductions in METRs do encourage capital investment and FDI.[5] Studies find that, on average, a tax rate increase of one percentage point results in a 3.3% decrease in FDI inflows and that, while statutory tax rates have a statistically significant effect on investment, both average effective tax rates and METRs affect investment even more.[6]

Finally, critics of a focus on comparisons of METRs are concerned that a reduced corporate tax rate might hurt Canada's tax revenue collection goals and be of greater benefit to the wealthy. Are these concerns justified?

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[3] Foreign Affairs and International Trade Canada, Office of the Chief Economist, "Canada's Bilateral Merchandise Trade" (Ottawa, April 2010); available online at http://www.international.gc.ca/economist-economiste/index.aspx.

[4] Statistics Canada, International Investment Position, Canadian Direct Investment Abroad and Foreign Direct Investment in Canada, by Country, Annual, CANSIM Table 376-0051 (Ottawa); available online at http://cansim2.statcan.gc.ca/cgi-win/cnsmcgi.exe?Lang=E&RootDir=CII/&ResultTemplate=CII/CII___&Array_Pick=1&ArrayId=3760051.

[5] See, for example, Department of Finance, "Corporate Income Taxes and Investment: Evidence from the 2001-04 Rate Reductions," in *Tax Expenditures and Evaluation* (Ottawa: Department of Finance, 2007); Duanjie Chen and Jack Mintz, "Taxing Business Investments: A New Ranking of Effective Tax Rates on Capital" (Washington DC: World Bank, Foreign Investment Advisory Service, 2008); and P. Egger, S. Loretz, M. Pfaffermayr, and H. Winner, "Bilateral Effective Tax Rates and Foreign Direct Investment," *International Tax and Public Finance* 16 (6, 2009): 822-849.

[6] R. de Mooij and S. Ederveen, "Taxation and Foreign Direct Investment: A Synthesis of Empirical Research," *International Tax and Public Finance* 10 (6, 2003): 673-693.

TABLE 1: The Marginal Effective Tax Rate on Capital Investment, 80 Selected Countries, 2005-2009

	MARGINAL EFFECTIVE TAX RATE					METR RANKING IN DESCENDING ORDER		REFERENCE: STATUTORY COMPANY INCOME TAX RATE		
	2009	**2008**	**2007**	**2006**	**2005**	2009	2005	2009	2005	+-% point
	(percent)							(percent)		
Argentina	41.7	41.7	41.7	41.7	41.7	1	1	35.0	35.0	0.0
Chad	40.8	40.8	40.8	40.8	40.8	2	3	45.0	45.0	0.0
Brazil	36.5	36.5	36.5	36.5	36.5	3	6	34.0	34.0	0.0
India	35.7	35.7	35.7	35.3	38.3	4	5	34.0	36.6	-2.6
Uzbekistan	35.5	35.5	35.5	36.1	36.1	5	8	17.2	19.0	-1.8
France	34.4	34.4	34.4	34.4	34.7	6	10	34.4	34.9	-0.5
Japan	33.3	33.3	33.3	33.3	33.3	9	13	40.3	40.3	0.0
South Korea	32.6	35.0	35.0	35.0	35.0	7	9	24.2	27.5	-3.3
Spain	30.9	30.9	32.8	34.7	34.7	8	11	30.0	35.0	-5.0
Canada*	**28.0**	**28.9**	**31.6**	**36.2**	**39.0**	**10**	**4**	**31.3**	**34.3**	**-3.1**
United Kingdom	27.5	27.5	29.1	29.1	29.1	11	17	28.0	30.0	-2.0
Italy	27.2	27.3	32.5	32.5	32.5	12	15	31.4	37.3	-5.9
United States**	27.2	27.2	35.0	35.3	35.3	13	7	38.6	39.0	-0.4
Russia	26.7	30.8	30.8	30.8	33.3	14	14	20.0	22.0	-2.0
Australia	25.9	25.9	25.9	25.9	25.9	15	18	30.0	30.0	0.0
Austria	25.2	25.2	25.2	25.2	25.2	16	20	25.0	25.0	0.0
Pakistan	25.0	25.0	25.0	24.9	24.9	17	21	35.0	35.0	0.0
Germany	24.4	24.4	30.3	31.7	31.7	18	16	31.0	37.0	-6.0
Lesotho	24.2	24.2	24.2	24.2	33.8	19	12	25.0	35.0	-10.0
Costa Rica	23.9	23.9	23.9	23.9	23.9	20	23	30.0	30.0	0.0
Norway	23.8	23.8	23.8	23.8	23.8	21	25	28.0	28.0	0.0
Bolivia	23.6	23.6	23.6	23.6	23.6	22	26	25.0	25.0	0.0
Indonesia	22.3	23.4	24.1	24.1	24.1	23	22	28.0	30.0	-2.0
Tunisia	22.0	22.0	22.0	25.8	25.8	24	19	30.0	35.0	-5.0
Sierra Leone	21.1	21.1	21.1	21.1	21.1	25	30	35.0	35.0	0.0
Fiji	20.8	22.5	22.5	22.5	22.5	26	28	29.0	31.0	-2.0
Tanzania	20.4	20.4	20.4	20.4	20.4	27	34	30.0	30.0	0.0
Zambia	20.3	20.3	20.3	20.3	20.3	28	35	35.0	35.0	0.0
Iran	19.9	19.9	19.9	19.9	19.9	29	38	25.0	25.0	0.0
Finland	19.6	19.6	19.6	19.6	19.6	30	39	26.0	26.0	0.0
Sweden	19.5	20.9	20.9	20.9	20.9	31	32	26.3	28.0	-1.7
Malaysia	18.6	18.6	19.4	20.2	20.2	32	36	26.0	28.0	-2.0
Portugal	18.6	18.6	18.6	19.4	19.4	33	41	26.5	27.5	-1.0
Luxembourg	18.4	19.1	19.1	19.1	19.6	34	40	28.6	30.4	-1.8
Thailand	18.4	18.4	18.4	18.4	18.4	35	45	30.0	30.0	0.0
Jordan	18.4	18.4	18.4	18.4	18.4	36	46	25.0	25.0	0.0
Denmark	18.2	18.2	18.2	20.6	22.3	37	29	25.0	30.0	-5.0
New Zealand	17.7	17.7	20.0	20.0	20.0	38	37	30.0	33.0	-3.0
Georgia	17.6	17.6	21.0	21.0	21.0	39	31	15.0	20.0	-5.0
Rwanda	17.4	17.4	17.4	17.4	17.4	40	49	30.0	30.0	0.0
Kazakhstan	17.2	17.2	17.2	17.2	17.2	41	50	30.0	30.0	0.0
Switzerland	16.8	16.8	16.9	16.9	16.9	42	52	21.2	21.3	-0.1
Botswana	16.6	16.6	16.6	16.6	16.6	43	55	25.0	15.0	10.0
Ecuador	16.4	16.4	13.0	13.0	13.0	44	65	25.0	25.0	0.0
Netherlands	16.3	16.3	16.3	19.3	20.8	45	33	25.5	31.5	-6.0
China	16.0	41.5	41.5	41.5	41.5	46	2	25.0	25.0	0.0
Uganda	15.9	15.9	15.9	15.9	15.9	47	58	30.0	30.0	0.0
Mexico	15.8	15.8	15.8	16.4	17.1	48	51	28.0	30.0	-2.0
Peru	15.2	23.9	23.9	23.9	23.9	49	24	30.0	30.0	0.0
Israel	15.1	15.8	17.2	18.7	18.7	50	44	26.0	31.0	-5.0

	MARGINAL EFFECTIVE TAX RATE					METR RANKING IN DESCENDING ORDER		REFERENCE: STATUTORY COMPANY INCOME TAX RATE		
	2009	2008	2007	2006	2005	2009	2005	2009	2005	+-% point
	(percent)							(percent)		
Jamaica	15.0	15.0	15.0	15.0	15.0	51	60	33.3	33.3	0.0
Morocco	14.9	14.9	18.3	18.3	18.3	52	47	30.0	35.0	-5.0
Bangladesh	14.6	16.5	16.5	16.5	16.5	53	56	27.5	30.0	-2.5
Madagascar	14.3	15.0	18.9	18.9	18.9	54	43	24.0	30.0	-6.0
South Africa	14.2	14.2	14.9	14.9	15.6	55	59	28.0	30.0	-2.0
Hungary	13.6	14.0	14.0	14.0	12.5	56	66	19.0	16.0	3.0
Poland	13.6	13.6	13.6	13.6	13.6	57	63	19.0	19.0	0.0
Czech Republic	13.4	14.1	16.4	16.4	18.0	58	48	20.0	26.0	-6.0
Chile	13.3	13.5	13.7	13.8	13.8	59	62	17.0	17.0	0.0
Trinidad & Tobago	13.3	13.3	13.3	16.8	16.8	60	54	25.0	30.0	-5.0
Nigeria	12.8	12.8	12.4	12.4	12.4	61	67	33.0	32.0	1.0
Ghana	12.4	12.4	12.4	12.4	12.4	62	68	25.0	25.0	0.0
Ireland	12.3	12.3	12.3	12.3	12.3	63	69	12.5	12.5	0.0
Slovak Republic	12.2	12.2	12.2	12.2	12.2	64	70	19.0	19.0	0.0
Vietnam	12.2	14.2	14.2	14.2	14.2	65	61	25.0	28.0	-3.0
Greece	12.0	12.0	12.0	14.1	15.9	66	57	25.0	32.0	-7.0
Croatia	9.8	9.8	9.8	9.8	9.8	67	72	22.0	22.0	0.0
Iceland	9.6	9.6	11.7	11.7	16.9	68	53	15.0	18.0	-3.0
Egypt	9.2	9.2	9.2	9.2	19.0	69	42	20.0	34.0	-14.0
Kenya	9.1	9.1	9.1	9.1	9.1	70	73	30.0	30.0	0.0
Romania	8.9	8.9	8.9	8.9	8.9	71	74	16.0	16.0	0.0
Singapore	8.8	8.8	8.8	10.0	10.0	72	71	18.0	20.0	-2.0
Ethiopia	8.0	8.0	8.0	8.0	8.0	73	76	30.0	30.0	0.0
Mauritius	7.0	7.0	11.5	13.1	13.1	74	64	15.0	25.0	-10.0
Turkey	4.1	4.1	4.1	4.1	8.6	75	75	20.0	30.0	-10.0
Bulgaria	4.1	4.1	4.1	6.6	6.6	76	77	10.0	15.0	-5.0
Latvia	3.8	3.8	3.8	3.8	3.8	77	78	15.0	15.0	0.0
Ukraine	3.7	3.7	3.7	3.7	3.7	78	79	25.0	25.0	0.0
Serbia	-5.4	-5.4	-5.4	-5.4	-5.4	79	80	10.0	10.0	0.0
Belgium	-6.5	-5.0	-0.5	2.2	23.0	80	27	34.0	34.0	0.0
Simple average	**18.2**	**18.8**	**19.5**	**19.9**	**20.8**			**26.3**	**28.1**	**-1.9**

* By 2013, Canada's METR will decline to 18.9%, placing it below Sweden's.

** The US METR, without the temporary bonus allowance, would be 35.0%, placing it sixth highest among the 80 countries.

On the tax revenue issue, the good news is that the steady reduction in the corporate income tax rate over the past decade has not been costly in terms of lost revenue: corporate tax revenue as a share of GDP stayed well above 2% except during the serious economic downturns in 2002 and 2008; in 2007, the share reached 2.6%, the highest level since 1977. In contrast, this share was below 2% for most of the 1980s and 1990s, when the statutory corporate tax rate was well over 40%.[7] Several recent studies reinforce these statistics by finding that businesses shift profits to

[7] Department of Finance, *Fiscal Reference Tables* (Ottawa, October 2009), table 4.

jurisdictions with lower corporate income tax rates, enabling those jurisdictions to collect more corporate tax revenues.[8] Another finding is that corporate tax revenue as a share of GDP has risen steadily in many OECD countries, a result that might be attributed in part to corporate tax reform that combined rate reduction and base broadening,[9] which, by eliminating special treatment for some, made overall rate reduction possible while maintaining revenue targets. The tax base broadening certainly also helped improve the neutrality of business taxation.

On the fairness of taxation, given the global integration of capital markets, reductions in corporate income taxes on medium and large corporations do not benefit shareholders. Rather, corporate taxes tend to be shifted onto labour, which is less internationally mobile. If anything, it is lower-income Canadians who bear the burden of corporate taxes, particularly when such taxes lead to higher consumer prices.[10]

Reductions in Canadian corporate income tax rates also have been criticized as a transfer of revenue to the US Treasury when Canadian corporate income taxes are credited against US tax liabilities owed by US multinationals. Given that only a small portion of corporate taxes is credited abroad, however, this concern seems unwarranted even at the still lower tax rates that are due to be implemented in 2012.[11] In fact, globalization is intertwining the designs of corporate income tax systems of open economies such as Canada's since they all face the challenge of how to be tax competitive for capital investment while keeping tax revenue collection intact. For this reason, international competition to cut corporate tax rates and coordinate the protection of jurisdictional tax bases might become the norm in future tax reform in these countries.[12]

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[8] See Clausing, "Corporate Tax Revenues in OECD Countries"; Mintz, "2007 Tax Competitiveness Report"; and Brill, "Corporate Tax Rates." See also Jack Mintz and Michael Smart, "Income-shifting, Investment and Tax Competition: Theory and Evidence from Provincial Taxation in Canada," *Journal of Public Economics* 88 (6, 2004): 1149–1168, which focuses on how provincial tax rate reductions affect income shifting from inside and outside Canada.

[9] Johansson et al., "Tax and Economic Growth."

[10] For the United Kingdom, see W. Arulampalam, M.P. Devereux, and G. Maffini, "The Direct Incidence of Corporate Income Tax On Wages," Working Paper 07/08, 2nd version (Oxford: Oxford University, Centre for Business Taxation, 2008); for the United States, see K.A. Hassett and A. Mathur, "Taxes and Wages," Working paper (Washington, DC: American Enterprise Institute, 2006); and for Germany, see N. aus dem Moore, T. Kasten, and C. Schmidt, ."Do Wages Rise When Corporate Tax Rates Fall? Difference-in-Differences Analyses of the German Business Tax Reform 2000" (Berlin: Rheinisch-Westfäliches Institut für Wirtschaftsforschung, 2009).

[11] Most countries — including the United Kingdom and Japan, which are adopting exemption systems for dividends — now exempt foreign source profits from home tax. US-owned capital accounts for about 13% of total capital in Canada, but most profits are retained in Canada and, when remitted back to the United States, about two-thirds of US parents have tax credits in excess of US tax so that reductions in Canadian corporate tax would not lead to more US tax paid in this instance; see Rosanne Altshuler and Harry Grubert, "Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income," Departmental Working Paper 200626 (New Brunswick, NJ: Rutgers University, Department of Economics, 2007). Thus, less than 4% of Canadian corporate income tax is credited against US tax in any one year.

[12] See Johansson et al., "Tax and Economic Growth," box 1.

THE MOVING AVERAGE OF TAX COMPETITIVENESS: A SUMMARY PICTURE

With the above arguments in mind, we review Canada's current tax competitiveness compared with a broad group of 80 countries, with particular emphasis on comparisons with other G-7 and OECD countries and with the four leading emerging market economies, Brazil, Russia, India, and China — the so-called BRICs.

Over the past decade, there has been explosive economic growth in countries outside the G-7 and the 20 original member countries of the OECD. The BRICs have become an engine of world economic growth — their share of the total GDP of the 80 countries (including Canada) in our comparative survey rose from 8% in 2000 to 16% in 2008, while that of the G-7 countries dropped from 69% to 57% over the same period.[13] A number of more recent OECD members and non-OECD countries also have joined the ranks of fast-growing economies.

Table 2 provides, for various groups of countries, the unweighted average METR over the 2005-09 period, their statutory corporate income tax rates in 2005 and 2009, and Canada's changing rank over those five years. Several observations may be drawn from the table. First, the average METR among the 80 countries dropped annually over the period by 2.6 percentage points, mainly due to corporate tax rate reductions that occurred in 39 countries (19 OECD and 20 non-OECD countries).

TABLE 2: The Marginal Effective Tax Rate on Capital Investment, Various Country Groups, 2005-2009

	MARGINAL EFFECTIVE TAX RATE					REFERENCE: STATUTORY COMPANY INCOME TAX RATE			
	2009	**2008**	**2007**	**2006**	**2005**	2009	2005	Change in % Point	Number of Countries that Cut General Corporate Tax Rate
			(percent)			(percent)			
Canada	28.0	28.9	31.6	36.2	39.0	31.3	34.3	-3.0	n/a
G-7	28.8	28.9	32.5	33.4	33.8	34.0	35.9	-2.0	4
OECD	19.5	19.8	21.0	21.7	23.0	26.5	28.8	-2.3	19
BRICs	28.7	36.1	36.1	36.0	37.4	28.3	29.4	-1.2	2
Non-OECD	17.3	18.3	18.6	18.9	19.4	26.1	27.9	-1.8	20
All 80 countries	**18.2**	**18.8**	**19.5**	**19.9**	**20.8**	17.2	19.0	-1.8	39
Canada's ranking by METR within various groups of countries, in descending order									
G-7	3	3	5	2	1				
OECD	5	5	7	2	1				
All 80 countries	**10**	**12**	**13**	**6**	**4**				
REFERENCE 1: METR, including only company income taxes									
G-7	25.0	25.1	29.0	29.8	30.7				
OECD	17.2	17.5	18.9	19.5	20.8				
BRICs	22.2	23.8	23.8	23.7	25.4				
Non-OECD	15.7	16.1	16.4	16.8	17.3				
All 80 countries	**16.1**	**16.5**	**17.2**	**17.6**	**18.4**				
REFERENCE 2: METR, assuming inflation rate of 2% across all countries									
G-7	29.0	29.0	32.5	33.4	33.9				
OECD	19.3	19.5	20.8	21.4	22.8				
BRICs	28.4	35.3	35.3	35.3	36.3				
Non-OECD	17.9	18.8	19.1	19.4	19.8				
All 80 countries	**18.4**	**19.1**	**19.7**	**20.1**	**20.9**				

[13] International Monetary Fund, *World Economic Outlook* database (Washington, DC, April 2009).

Second, on average, the METR among non-OECD countries in 2009 was two percentage points below that of the OECD countries, but the average statutory corporate tax rate in the two groups was almost the same. This seeming paradox can be explained partially by the effect on METRs of both non-tax factors (such as a country's inflation rate and industrial structure) and tax factors. For example, OECD countries tend to make more use of capital-based taxes (such as capital transfer taxes) than do non-OECD countries. At the same time, however, OECD countries tend to offer more generous depreciation allowances than do non-OECD countries. Thus, if one considers only corporate income taxes, the gap between OECD and non-OECD countries narrows (Table 2, reference 1).

Third, the average corporate income tax rate of non-OECD countries dropped by less than two percentage points between 2005 and 2009, while that of OECD countries declined by 2.3 percentage points. The reason for the difference is that about two-thirds of OECD countries cut their corporate tax rates over the period, while only two-fifths of non-OECD countries did so. As a result, as measured by the gap between the two groups' METRs, the overall tax competitiveness of non-OECD countries relative to OECD countries shrank from about four percentage points (19% versus 23%) in 2005 to two percentage points (18% vs. 20%) in 2009.

Fourth, both the G-7 and the BRICs appear to have had higher average METRs than their counterparts in the OECD and non-OECD countries, respectively. This finding suggests that countries with substantial non-tax advantages for capital investment (such as rich natural resources, a large domestic consumer market, and mature financial institutions) are often slow to initiate tax reform to enhance their international tax competitiveness, in part because of the rents they earn from locational and technological advantages. With the shift of economic activity to the emerging countries, however, some countries, such as United States, will lose some of the advantages they have held — indeed, the United States' loss of tax competitiveness has led to proposals for a substantial corporate tax rate reduction in that country.[14] In the meantime, even within the economic power houses, quick movers such as China, Germany, Russia, and the United Kingdom did not wait to gain tax competitiveness among their counterparts.

Finally, while Canada was the fourth-highest-taxed country in 2005 and improved to sixth-highest in 2006 and thirteenth-highest in 2007, it rose again to twelfth-highest in 2008 and to tenth-highest in 2009, despite the continuing decline in its METR on capital investment. Although year-by-year rankings are not as critical as simply achieving a better business tax structure, these changes in ranking indicate the extent of the shift in global trends over time. Further planned reductions in the METR are expected to move Canada to the mid-range of the tax competitiveness pack by 2013, but it is hard to predict how rankings will evolve over the next three years.

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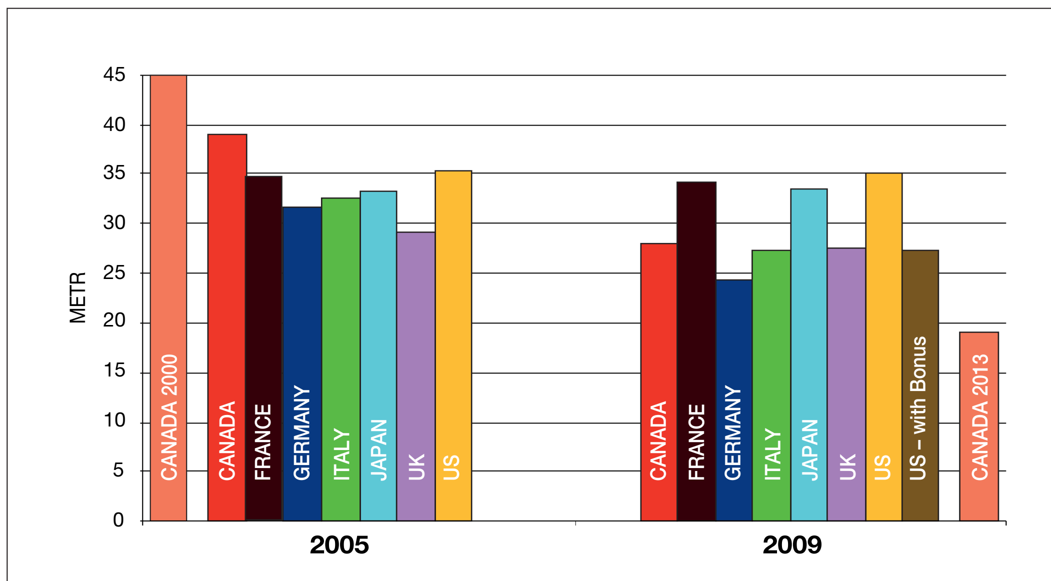
[14] See, for example, Scott A. Hodge and Andre Dammert, "U.S. Lags while Competitors Accelerate Corporate Income Tax Reform," *Fiscal Facts* 184 (Washington, DC: Tax Foundation, 5 August 2009); available online at http://www.taxfoundation.org/research/show/24973.html.

Reform-minded Competitors among the G-7 and OECD Countries

Figure 1 shows METRs on capital investment for the G-7 countries in 2005 and 2009, as well as Canada's METR in 2000 (45%) and the planned rate in 2013 (18.9%) — a stunning reduction of 26 percentage points in 13 years. The other G-7 countries can be grouped into those — Germany, Italy, and the United Kingdom — that have actively adopted tax reform and those — France and Japan — that have shown little enthusiasm for cutting down their tax cost for capital investment. The remaining G-7 country, the United States, appears to be an outlier in that, while its METR dropped by about nine percentage points from 2007 to 2008, this tax reduction came not from fundamental tax reform but from the introduction of a temporary bonus depreciation allowance that has no finite life span and that has further complicated the already complex US corporate tax system. Without it, the US METR would be 35.0%, one of the world's highest.

FIGURE 1: Marginal Effective Tax Rate on Capital Investment, G-7 Countries 2009 vs. 2005



For years, the United Kingdom has been a role model among G-7 countries for its relatively simple and efficient corporate income tax system. It has had the lowest general corporate income tax rate among the G-7 since at least 2000, with no multiple rates or preferential tax treatments by industry. Its corporate tax rate was further lowered from 30% to 28% in 2008. Its 2007 reform bill also introduced an annual 100% investment allowance of £50,000 for all corporations and a simplified system of capital allowances consisting of only two major categories based on how long assets last. To streamline the corporate income structure, the United Kingdom also raised the tax rate on small companies from 19% to 21% in 2009. These reforms gave the United Kingdom the lowest METR among the G-7 countries until 2008, when tax reform took shape in Germany and the aforementioned bonus depreciation allowance was introduced in the United States.

Germany once had a very complicated business tax system that imposed a heavy burden on capital investment, but no longer. In 2008, it lowered the federal corporate tax rate by 10 percentage points, from 25% to 15%.[15] This giant step, combined with a reduction in the local trade tax and some streamlining measures, reduced Germany's METR from more than 30% to just over 24%, the lowest in the G-7. Italy also reduced its METR in 2008 from 33% to 27%.

In contrast to these bold tax reforms, Canada's measured and persistent tax reductions over the past ten years have improved its tax competitiveness among G-7 countries only relative to the United States (without bonus depreciation), France, and Japan, which have undertaken no significant tax reform. Canadians thus have no reason to be complacent even though further tax reductions should improve the country's ranking considerably among the G-7 countries in the near future.

Table 3 compares METRs on capital investment among the OECD countries and shows that, other than the G-7, almost all those that did not already have a relatively low tax regime reduced their corporate tax rates between 2005 and 2009. The most noticeable reductions occurred in the Czech Republic, Denmark, Greece, the Netherlands, Spain, and Turkey, where tax rates dropped by five to ten percentage points. As a result, among the 23 countries that are not in the G-7, 20 have either an METR on capital investment that is near or below the OECD average of 19.5%, or a corporate income tax rate near or below 25%, or both. It is encouraging that Canada seems set to catch up to these countries in a few years, when its METR falls to 19%. But it would not be surprising if by then the OECD average METR will have declined still further, setting a still higher standard for Canada to meet. Even so, Canada is likely to be at least in the mid-range of OECD countries, which would be a major accomplishment compared to its tax competitiveness of a decade ago.

[15] If subnational tax rates are included, Germany's corporate income tax rate fell from 37% to 31%.

TABLE 3: The Marginal Effective Tax Rate on Capital Investment, OECD Countries, 2005-2009

	MARGINAL EFFECTIVE TAX RATE					REFERENCE: STATUTORY COMPANY INCOME TAX RATE		
	2009	**2008**	**2007**	**2006**	**2005**	2009	2005	Change in % Points
	(percent)					(percent)		
France	34.4	34.4	34.4	34.4	34.7	34.4	34.9	-0.5
Japan	33.3	33.3	33.3	33.3	33.3	40.3	40.3	
South Korea	32.6	35.0	35.0	35.0	35.0	24.2	27.5	-3.3
Spain	30.9	30.9	32.8	34.7	34.7	30.0	35.0	-5
Canada*	**28.0**	**28.9**	**31.6**	**36.2**	**39.0**	**31.3**	**34.3**	**-3**
United Kingdom	27.5	27.5	29.1	29.1	29.1	28.0	30.0	-2
Italy	27.2	27.3	32.5	32.5	32.5	31.4	37.3	-5.9
United States**	27.2	27.2	35.0	35.3	35.3	38.6	39.0	-0.4
Australia	25.9	25.9	25.9	25.9	25.9	30.0	30.0	
Austria	25.2	25.2	25.2	25.2	25.2	25.0	25.0	
Germany	24.4	24.4	30.3	31.7	31.7	31.0	37.0	- 6
Norway	23.8	23.8	23.8	23.8	23.8	28.0	28.0	
Finland	19.6	19.6	19.6	19.6	19.6	26.0	26.0	
Sweden	19.5	20.9	20.9	20.9	20.9	26.3	28.0	- 1.7
Portugal	18.6	18.6	18.6	19.4	19.4	26.5	27.5	- 1
Luxembourg	18.4	19.1	19.1	19.1	19.6	28.6	30.4	- 1.8
Denmark	18.2	18.2	18.2	20.6	22.3	25.0	30.0	- 5
New Zealand	18.0	18.0	20.3	20.3	20.3	30.0	33.0	- 3
Switzerland	16.8	16.8	16.9	16.9	16.9	21.2	21.3	- 0.1
Netherlands	16.3	16.3	16.3	19.3	20.8	25.5	31.5	- 6
Mexico	15.8	15.8	15.8	16.4	17.1	28.0	30.0	- 2
Hungary	13.6	14.0	14.0	14.0	12.5	19.0	16.0	+ 3
Poland	13.6	13.6	13.6	13.6	13.6	19.0	19.0	
Czech Republic	13.4	14.1	16.4	16.4	18.0	20.0	26.0	- 6
Ireland	12.3	12.3	12.3	12.3	12.3	12.5	12.5	
Slovak Republic	12.2	12.2	12.2	12.2	12.2	19.0	19.0	
Greece	12.0	12.0	12.0	14.1	15.9	25.0	32.0	- 7
Iceland	9.6	9.6	11.7	11.7	16.9	15.0	18.0	- 3
Turkey	4.1	4.1	4.1	4.1	8.6	20.0	30.0	- 10
Belgium	-6.5	-5.0	-0.5	2.2	23.0	34.0	34.0	
Simple average	**19.5**	**19.8**	**21.0**	**21.7**	**23.0**	**26.5**	**28.8**	**- 2.3**

* By 2013, Canada's METR will decline to 18.9%, placing it fifteenth highest.

** Without the temporary bonus allowance, the United States' METR would be 35.0%, highest among OECD countries.

More Competitors among the Fast-Growing Economies

Table 4 compares Canada's METR with some economies, mostly non-OECD members, that have had a record of "sustained rapid growth," which we define as those with an average annual growth rate of 7% or higher over the five years before 2008 when the recent recession set in. We also include Brazil and Mexico, which, although they do not meet our criterion, are worthy of attention because of their geographic proximity, economic scale, and growth potential.

TABLE 4: The Marginal Effective Tax Rate on Capital Investment, Fast-Growing Economies, 2005-2009

	ANNUAL GROWTH % (2003-07)*	MARGINAL EFFECTIVE TAX RATE					REFERENCE: STATUTORY COMPANY INCOME TAX RATE		
		2009	2008	2007	2006	2005	2009	2005	Change in % Points
		(percent)					(percent)		
Brazil	3.6	36.5	36.5	36.5	36.5	36.5	34	34	0
India	8.6	35.7	35.7	35.7	35.3	38.3	34	36.6	-2.6
Russia	7.3	26.7	30.8	30.8	30.8	33.3	20	22	-2
China**	11.0	16.0	41.5	41.5	41.5	41.5	25	25/33	-0/8
Mexico	3.3	15.8	15.8	15.8	16.4	17.1	28	30	-2
Vietnam	8.0	12.2	14.2	14.2	14.2	14.2	25	28	-3
Singapore	7.0	8.8	8.8	8.8	10.0	10.0	18	20	- 2
Turkey	6.7	4.1	4.1	4.1	4.1	8.6	20	30	-10
Simple average	**6.9**	**19.5**	**23.4**	**23.4**	**23.6**	**24.9**	**25.2**	**28.2**	**-2.7**
Canada	**2.9**	**28.0**	**28.9**	**31.6**	**36.2**	**39.0**	**31.3**	**34.3**	**-3**

* Source: International Monetary Fund, *World Economic Outlook* database (Washington, DC, April 2009).

** China had a general tax rate of 33% with numerous reduced special rates conditioned on industries, investment locations, and so on, until 2008, when the multiple-rate regime was replaced by a single rate of 25%. We used the 25% rate for our METR calculation, as it was available to foreign firms before the rate consolidation.

The countries in Table 4 may be divided into three groups in terms of their tax features. The first group consists of Brazil and India, whose outdated and cumbersome business tax systems resemble that of Canada's past: a rather high corporate tax rate combined with additional taxes that are not based on a company's profit. Both countries have a corporate tax rate of 34%, which is a combination of the basic tax rate and some surcharges. Brazil also collects a 3.5% municipal service tax based on gross receipts from the services sector. In India, the depreciation allowance for machinery and equipment is far below what is required to cover economic depreciation. India also collects a minor transfer tax on equity at a rate of 0.25%. If both Brazil and India were to follow the Canadian example and eliminate these non-profit-based taxes (particularly Brazil) and match their depreciation allowance with economic depreciation (particularly India), their METRs could quickly drop to below 30%.

The second group consists of China, Mexico, Turkey, Russia, and Vietnam. A principal feature of this group is a combination of a reasonable corporate tax rate (below 30%) and a generous, although distortionary, tax depreciation allowance scheme, which accounts for their much lower METRs than that in Canada. Like Canada's tax system, moreover, theirs are relatively simple and efficient. We should also add two special notes about Mexico and Russia. Mexico has a tax-accounting approach that recognizes the effect of inflation and ensures there is no inflation-induced tax distortion. Russia not only has an excessively generous depreciation allowance, but it also imposes a regional asset-based corporate tax at a maximum rate of 2.2%, without which its METR could drop from the current 27% to 11%.

In a category of its own is Singapore, which seems never to stop searching for any tax advantage it could offer to attract mobile investment sources. The persistent use of conditional tax incentives distorts the allocation of resources; in many cases, such incentives are ineffective anyway. However, Singapore does generate innovative tax ideas and abandons some wasteful ones. For example, unlike some of its neighbours, Singapore long ago abandoned its preferential tax treatment for manufacturing sectors and switched its attention to the high-value-added sectors, including information, financial, and transportation services. It also moved smartly to reduce its corporate tax rate by ten percentage points in the decade up to 2007.

Canada's planned reductions in federal and provincial taxes on capital investment over the next several years will reduce this country's METR to a level that should be competitive with these rapidly growing economies, enhancing Canada's ability to attract capital investment in a volatile global economy. For instance, the three-point reduction in the federal corporate income tax will reduce the METR from 21.4% to 18.9% by 2013. Based on typical empirical estimates, a 10% reduction in the tax-inclusive cost of capital would increase the demand for capital stock by 7% in the long run. This would imply that the planned federal corporate rate cut would increase Canada's capital stock by $49 billion and labour demand by 233,000 jobs in the long run.[16]

CONCLUSION

Canada has made remarkable progress toward reforming its business tax structure and improving its international tax competitiveness. The substantial reduction in the marginal effective tax rate on capital that has taken place over the past decade should improve conditions for the expansion of private sector investment in this country for years to come. Nevertheless, Canadians cannot afford to be complacent. Many countries are similarly engaged in efforts to improve their tax competitiveness, with the so-called emerging economies becoming particularly important as both sources and destinations of capital investment. Therefore, those who call for a reversal of further corporate tax rate reductions adopted in recent legislation should understand that such a move would put Canada offside with respect to trends elsewhere. Indeed, it would be in Canada's interest to consider even further reductions in business taxes in the future.

[16] This projection is obtained using the so-called Cobb-Douglas production function, with labour's share of net output being three-quarters.

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