Corporate-tax cuts are no solution to Canada's competitiveness problem

By Andrew Jackson
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The federal government is widely expected to announce a new competitiveness strategy as part of its Fall Economic Statement. Corporate Canada has been lobbying hard for a new round of corporate-tax cuts in response to recent tax "reform" under President Donald Trump in the United States.

It is true that Canada's once-large corporate-tax rate advantage has essentially been eliminated, with the statutory federal/state and provincial corporate rate now being almost the same (26 per cent) in the two countries. The United States has also temporarily allowed an immediate write-off of new capital expenditures for tax purposes in the hope that corporations will invest much more at home.

Business-sponsored studies such as that recently conducted by PwC for the Business Council of Canada forecast significant reductions to Canadian GDP and jobs as a result of a major shift of new investment from Canada to the United States.

However, there is a clear danger of government overreaction if Canada opts for a round of major new corporate-tax cuts as opposed to less costly and better targeted measures.

While marginal effective corporate-tax rates are clearly a factor in business investment decisions, they are by no means the only or most decisive factor.

Non-tax factors such as access to natural resources, skills, energy costs, house prices, urban amenities and other locational advantages play a major role in investment decisions, especially in the knowledge-intensive sectors. And investment will be limited if demand is sluggish, even if the after-tax cost of capital is relatively low.

Further, cuts to the corporate-tax rate are costly since most of the benefit goes to existing firms making profits from past investments, rather than to new firms or those thinking about expansion. A cut in the tax rate is also irrelevant to companies earning so-called rents or above-average profits compared to the international norm. For example, during the resource-boom companies would have invested in the oil sands even if the corporate-tax rate had been much higher, since expected profits were very high.

Canadian banks, utilities, airlines, railways, retailers and cultural industries among others all have to operate mainly in Canada to serve the Canadian market, so they are not very responsive to changes in tax rates compared to other countries.

It is striking that the level of business investment in Canada as a share of GDP remained almost unchanged in recent years as the Harper government cut the federal corporate-income-tax rate to 15 per cent today from 22.1 per cent in 2006, at a cost of about $12-billion in annual tax revenue.

Deep corporate-tax cuts came at the price of foregone public investments in areas such as infrastructure, research, education and skills that could have contributed more to productivity growth. Introduced at a time of deficits, these tax cuts also increased the public debt.

While the Trump tax cuts will have some negative competitive impacts at the margin, these will be offset and even outweighed by the rapid deficit-fuelled growth of the United States market for goods and services exported from Canada, especially now that the Canadian dollar is low relative to the greenback. The most recent data show a sharp increase in our

exports to the United States and a modestly rising rate of business investment in manufacturing through 2018.

Sluggish business investment is indeed widely recognized to be one of Canada's key economic problems, but across the board, corporate-tax cuts have been shown to be a costly and relatively ineffective solution.

Targeted measures such as investment-tax credits for spending on capital and equipment and research and development have a bigger bang for the buck in terms of increased investment. Department of Finance research shows that an increase in capital cost allowances for new investment boosts the economy by $1.35 per $1 spent, almost four times the $0.37 gain for a $1 reduction in the corporate-tax rate.

The received wisdom among economists used to be that governments should just set broad "framework" policies such as low taxes to raise investment. Anything smacking of hands-on "industrial policy" was to be avoided.

Rejecting this dogma, the influential British economist Mariana Mazzucato argues that government leadership and public investments are critical to building innovative economies. She has shown that publicly funded research well in advance of immediate commercial opportunities as well as direct support for strategic corporate investments have been central to the growth of innovative capacity.

Canada has recently made some modest moves in this direction. Funding has been increased to directly support the auto, aerospace and clean-tech sectors, to expand venture capital pools and to support basic and applied research in areas such as artificial intelligence and health technologies.

The Trump tax cuts do underline the need to support new business investment. But Finance Minister Bill Morneau should resist pressure for a major new round of corporate-tax cuts, and add to existing, better targeted measures to boost investment in the new economy.

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