Patrick Grady
David Husband
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Taxing Canada's Ability to Compete in the Market

CORPORATE TAX rates in Canada and the United States affect the competitive position of industry, particularly, the manufacturing sector, since the' market is essentially North American and investment is highly mobile between the two countries.

Tax reform in both' countries has dramatically changed corporate tax rates, a fact that has gained more importance with the apparent go-ahead for the free-trade agreement.

Unfortunately, the net effect of corporate tax reform has been to significantly reduce the competitive edge of Canada's – manufacturing sector, at least relative to what used to be the case before the reforms , introduced by the Reagan and Mulroney governments.

While in each case the objective of corporate tax reform has been to lower the tax rate . through the curtailment or elimination of exemptions and incentives (e.g., 'the investment tax credit), the result has been to lower the average tax rate but to increase the marginal tax rate.

Canada's real effective tax. rate for investment in machinery and equipment has increased 22 per cent (from 11 per cent before tax reform to 33 after). In the U.S. case, the marginal rate for the same class of investment has increased only 14 per cent (from 19 to 33). Canada's marginal tax rate . concerning non-residential construction has also increased, but only fractionally so. In contrast, in the United States the marginal tax rate for this category has jumped - in parallel with the rate for machinery and equipment -by 12 per cent.

All. this has eliminated an 8-per-cent advantage Canada used to enjoy on investment in machinery and equipment. On the other hand, with the two tax reforms, Canada's 5.5-per-cent disadvantage on investment in non-residential construction has become a 6-per-cent advantage .

Combining the two classes of investment according to their respective significance .. (machinery and equipment outlays account on average for 84 percent of total fixed investment, and non-residential construction for 16 percent) yields a marginal corporate tax rate on returns from fixed investment. In terms of this more general measure, the marginal tax rate on investment has narrowed from almost 6 per cent in Canada's favor before tax reform (14:6 per cent versus 20.3) to less than 1 per cent after (33.4 per cent versus 34.1).

There is a deliberate policy in both countries to make the tax system more neutral. Thus, the choice between alterna tive forms of investment (such as machinery, and equipment versus non-residential construction) is now less biased by the tax system. Also, the choice between "old" investment and "new" investment is more neutral since the difference between statutory and

marginal tax rates has been substantially narrowed.

What may seem paradoxical to some is that corporate tax reform has all but eliminated the advantage Canadian manufacturers used to enjoy, even though the statutory rates remain strongly in Canada's favor. The national average statutory rate in Canada is 34.8 per cent (including an 11.8 per cent provincial rate), compared with 39 per cent in the United States (including an average 7.5 percent state tax).

Real effective rates in Canada, however, approximate those in the United States as a result of Canada's greater tightening of the treatment of capital cost allowances. Substitution in Canada of the 25-per-cent declining-balance capital cost allowance rate for the former three-year write-off has considerably increased the effective tax rates facing Canadian manufacturers. Substitution in the United States of the five-year 150 per cent declining write-off with a seven-year double declining balance has had a much smaller effect on tax rates facing U.S. manufacturers. ,

Provinces· such as Ontario with corporate tax rates in the 15-to-17 per-cent range are particularly affected by Canada's tighter treatment of capital cost allowances. Except for Quebec and Alberta, which have corporate tax rates of 5.5 per cent and 9 per cent, respectively, most provinces now are at a corporate tax dis advantage in competing with the United States for manufacturing investment. Outside manufacturing, Canada's real effective tax rates were already higher than in the United States and remain so.

The key question with respect to the competitiveness of the Canadian corporate tax is whether it is prudent to raise the tax burden on Canadian manufacturing at a time when Canada is entering into a free trade agreement with the United States and when the manufacturing sector will be called upon to bear the brunt of any indus trial restructuring required. Corporate tax reform has significantly reduced the incentive to invest in Canada rather than in the United States, particularly in manufacturing.

It is terribly important that Canadian industry be competitive and able to take full advantage of the opportunities created by improved access to the much larger U.S. market. Free trade represents both a window of opportunity and a challenge. Canadian Industry will have to invest heavily in restructuring over the next few 'years to succeed. If not, there may be no second chance.

To raise questions about tax reform is not to deny that, in the longer, run, the economy, will benefit from an improved allocation of investment as the tax differt ential between the manufacturing and, non- manufacturing sectors is reduced. Rather, it is to question how corporate tax reform can be made more complementary to the government's major policy initiative – the free-trade agreement.

One way to cushion the shock to the manufacturing sector from tax reform and free trade is to quickly move to replace the outdated and distortive 'manufacturers' sales tax with a multi-stage sales tax, as has been proposed by the government. Indeed, the reform of corporate

taxation and sales tax were designed to go hand in hand, and it is unfortunate that one has been implemented before the other.

Another way would be to include an investment tax credit in the package of adjustment measures being designed to aid the industrial restructuring that will be made necessary by free trade. The investment tax credit, which ,could be applied more generally to all industries likely to be seriously affected by free trade, should be made explicitly temporary so as not to build permanent additional distortions into the corporate tax system.