BOOSTING CANADA'S COMPETITIVENESS BY REFORMING BUSINESS TAXATION

BY TREVOR TOMBE

Canada's economic performance is faltering. By June of 2024, real GDP per capita had declined for five straight quarters. Over the previous year, per capita GDP fell by 2.2%, and compared to 2022, it is down 3.6%.

Meanwhile, the US continues to pull ahead. Real GDP per capita there rose by 0.6% last quarter, up 2.6% from last year and 4.5% from 2022. In fact, the US has returned to its pre-COVID economic trajectory while Canada lags far behind its own.

This has real implications for the economic wellbeing and standard of living of Canadians. Had Canada simply matched US growth, for example, our economy would be 8.5% larger today. That is roughly equivalent to $6,200 more annual income per Canadian. This growing gap is now the widest it has been in nearly a century, which should prompt serious concern.

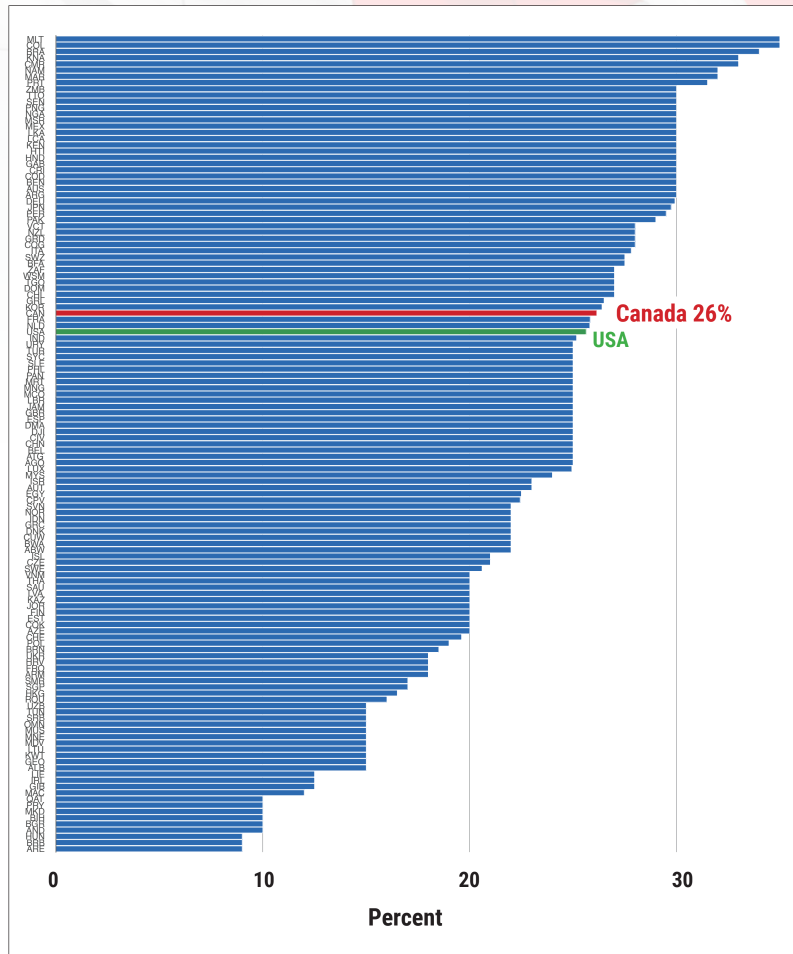
If Canada is to close this prosperity gap, business tax reform must be a top priority. Without bold action, this trend will continue, and Canadians will be left further behind.

Reforming Canada's approach to business taxation is a critical part of the solution.

There has been recent progress, to be clear. Canada's federal corporate income taxes have plummeted—from over 41% fifty years ago to 29% in 2000 to just 15% today (Finances of the Nation, n.d.).

Strategic tax reforms have also helped. One such reform was the harmonization of Ontario's sales tax with the federal GST.[1] This move, although seemingly technical, had significant implications for businesses. The previous provincial sales tax applied to business inputs, not just consumer goods and services. The effect was to distort decisions, discourage investment, and lower productivity. The GST, meanwhile, avoids these negative effects by taxing only final consumption. University of Calgary economist Jack Mintz and co-author Philip Bazel estimated that this move was equivalent to a reduction in the tax on investment returns by nearly 13 percentage points.[2]

Figure 1: Combined Corporate Income Tax Rates, 2024



Despite these positive changes, there is still much work to be done to boost Canada's lagging economy. Canada's federal business tax competitiveness has notable shortcomings. This article explores these challenges and potential solutions.

Canada's International Tax Competitiveness

Currently, Canada's corporate tax rates are higher than the global average. In figure 1, the combined federal and provincial average corporate rate is ranked relative to all countries for which the Organisation for Economic Co-operation and Development (OECD) reports data. While not among the highest, there are many countries with more attractive rates. It is lower in the United States and considerably lower in many European countries. And among the G7 economies, Canada is in the middle of the pack.

But the corporate rate is not the only aspect of business tax competitiveness that matters. Various credits, deductions, and so on have a crucial impact on investment decisions.

Evaluating Tax Efficiency

This is where the concept of the *marginal effective tax rate* (METR) comes in. The METR estimates the proportion of investment returns lost to taxation. For example, if a project yields an 8% return after taxes but would have delivered 10% without taxes, the METR is 20%. The corporate tax rate significantly impacts the METR, but there are ways to reduce its effect without eliminating corporate taxes entirely.

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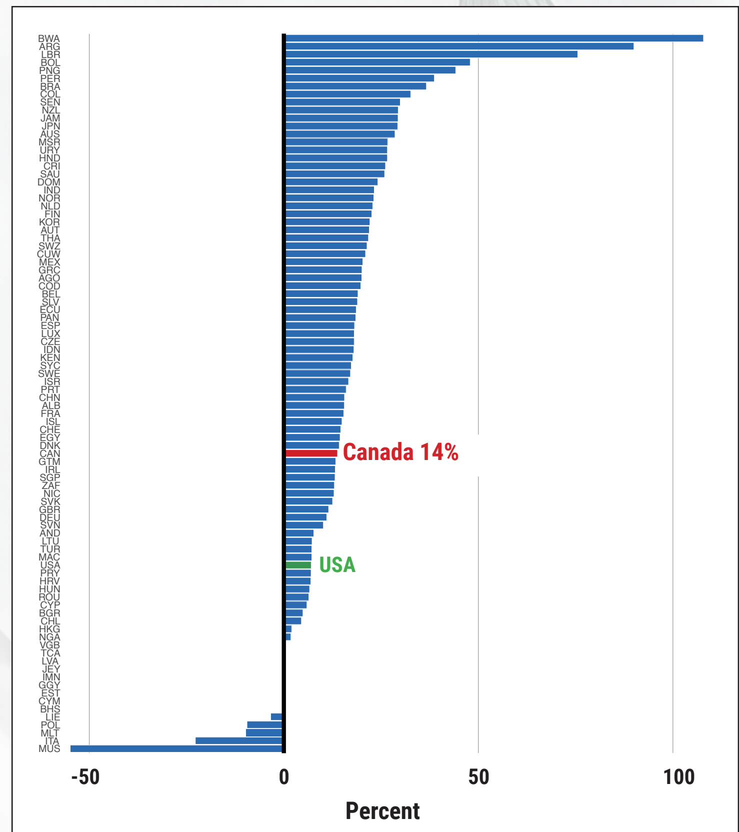
This can involve tax credits, accelerating depreciation allowances for capital investments, and more.

Governments often adjust the speed of capital expensing, to be clear, but this is rarely in a broad, full, and permanent way. Instead, they try to influence where investment dollars go. This approach can be problematic because it may misallocate capital across firms, sectors, or regions, ultimately lowering Canada's overall productivity.

When we look only at the marginal effective tax rate, for example, Canada looks a little better compared to others around the world. Although it remains above most peer countries and has the third highest rate in the G7.

Figure 2: Effective Marginal Tax Rates on New Investment, 2023



Canada is Moving in the Wrong Direction

Instead of exploring growth-enhancing reforms, the Canadian federal government is moving in the opposite direction. Starting in 2024, provisions that allow for modestly faster depreciation of capital investments will be phased out. As a result, the METR is projected to increase from 14% today to nearly 17% within four years. While this may not seem like a significant jump, evidence suggests each percentage point increase in the METR lowering investment by around 1% or more (McKenzie, 2016).

This matters. Research found that since 2000, about 90% of labour productivity increases came from increased capital investment (Sharpe and Sargent, 2023). Measures that lower the incentive to invest slow productivity growth, negatively impacting the purchasing power of our income.

Exploring More Innovative Reform Options

Another attractive option is to transform Canada's system of business taxes into something entirely different. Instead of taxing profits, we could tax disbursements. If the goal is to complement personal income taxes or serve as withholding of some payments to individuals abroad, then levying a tax only at the point of a dividend payment, share buyback, or other distributions may be better. Any profits withheld by the corporation to invest in operations, equipment, buildings, and so on would face no tax at all.

Jack Mintz explored a comprehensive proposal of this kind in a 2022 paper. While novel for Canada, this approach is already in use in other countries. Estonia taxes corporate distributions at 20% but does not tax earnings reinvested in the business. This model has placed Estonia consistently at the top of the Tax Foundation's international tax competitiveness rankings, while Canada was ranked 24th in 2023 (Mengden, 2023).

This approach does not undermine the government's ability to raise revenue. In fact, Estonia plans to increase its tax rate on income and VAT from 20% to 22% by 2025. The rate can be adjusted up or down, depending on the revenue needs that a government has. The efficient structure of Estonia's tax regime minimizes distortions and unnecessary economic costs for any given dollar raised.

There is also a role for the federal government in encouraging the three remaining provinces—British Columbia, Saskatchewan, and Manitoba—to harmonize their sales taxes with the GST. Such a move would significantly improve business tax competitiveness by removing sales taxes on input purchases, lowering compliance costs, and eliminating administration and enforcement expenses.

There are also important ways in which Canada's system of business taxation discourages firms from growing. For small businesses, the corporate rate is six percentage points lower (up to $500,000 in income) than the rate faced by larger businesses. This may create an incentive to remain small to take advantage of this favourable treatment. It may also create an incentive for more smaller and less productive firms to enter, which is a drag on growth (Dachis and Lester, 2015).

As a small, open economy in an increasingly uncertain world, ensuring Canadian economic and tax policy is as growth oriented as possible must be a priority. While we cannot control global developments, getting our business tax policies right is within our grasp. ❖

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