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Justifying lower corporate taxes

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When the political debate over the final phase of corporate tax cuts got heated on Parliament Hill earlier this year, the minority Conservative government would point to studies that showed the cuts could create long-term job gains of up to 100,000 and a boost to business investment of $30-billion.

But with Canada's 41st election campaign set to get underway Saturday, Prime Minister Stephen Harper will be under the gun from the Opposition parties and Canadians to justify on a near daily basis the policy measure, which took corporate tax rates from 22.12% in 2007 to 16.5% this year and 15% in 2012. Beyond talking about what experts believe the tax cuts might do, the Prime Minister may be forced to tell Canadians what the tax cuts have done for them lately.

That will be a tough task. Tax experts who endorse the continued drop in business levies say it is difficult to measure tangible benefits. Still, it may be Canada is just beginning to reap the rewards from lower business taxes just as the political rhetoric about their effectiveness begins to ramp up on the hustings.

"I would hate to think where the economy would be coming out of the recession if tax rates hadn't been coming down," says Saul Plener, national tax leader at PwC Canada.

If Mr. Harper was hoping he could point to discernible benefits from the corporate tax cuts in the election campaign, the combination of a rapid surge in the Canadian dollar and the deepest global recession in the post-war era put paid to that. Companies were caught off guard when the loonie began its ascent and later scrambled to adjust to the reality. Then along came the credit crisis that sideswiped the global economy, compelling businesses to slash payrolls and delay investment plans as demand for Canadian-made goods dropped off a cliff.

A recovery, though, is underway with data indicating companies are indeed deploying some of the extra cash available from tax relief to invest in productivity-enhancing machinery and equipment. Business investment in this key category — expected to be a major driver of real GDP growth that will offset an expected decline in consumer spending — advanced 11.2% in 2010 and is expected to keep up a similar pace in 2011 and 2012, economists say.

"The last four quarters we have seen strong growth in business investment in Canada and investment intentions seem to be quite strong. There is no way of proving that's directly related to the reduction in corporate taxes. But my suspicion it is," said Don Drummond, former chief economist at Toronto-Dominion Bank.

Still, there's reason to be skeptical. Mr. Drummond said corporate Canada failed to take advantage of the first round of business tax cuts in 2000, which brought the rate down from 29.12% to 22.12% by mid-decade. Along with the tax cuts, corporate profits were booming – especially from 2003 to 2006, through double-digit growth in operating earnings — and the U.S. dollar weakening. But data from Statistics Canada indicate annual private-sector investment in machinery and equipment in the 2001-to-2010 period averaged 3.1%.

"I was perplexed that business didn't drive investment through the roof during that period," added Mr. Drummond, who was a senior official at the Department of Finance and played a big role in persuading the Chrétien government to cut them.

This helps explain Canada's abysmal productivity record, with growth last decade averaging a meagre 0.7% a year, lagging well behind its industrialized peers.

Years later, he said Canadian corporate executives confided to him they were anticipating the Canadian dollar would fall back like it did in the early 2000s. Once company executives realized a strong dollar was here to stay, they tried to move quickly and invest – but the financial crisis got in the way.

"I hate to admit this but I don't think much of the growth of the past decade could be attributed to lower corporate tax rate," Mr. Drummond said, "but it was still right policy move. I think it created the only chance to have a competitive corporate sector – but the corporate sector still has to take advantage of it."

This time around, Canadian companies might be getting the message. Business investment is up, and productivity advanced 1.4% in 2010, a big improvement over the 0.4% gain in 2009 and the largest advance since 2005.

In addition, the Conservative effort to drive the corporate rate to 15% — and establish a combined federal-provincial rate of 25%, down from 29.3% — is attracting attention. Taxand, a London-based organization of tax advisors to multinational corporations, singled out Canada as one of the few countries in the post-crisis era pursuing the type of tax policies that best stoke real GDP growth and attract business investment.

Len Farber, a former senior tax official at Finance, said the benefits from business relief tend to take time to work into the economy.

"If firms are looking five years out and they want to expand, they look at what tax rates are going to be," said Mr. Farber, who is now a senior advisor at law firm Ogilvy Renault.

"They want certainty about the returns they can generate. They have to know that, and if people see tax rates are going up and there's going to be less after-tax money, that could prove detrimental."

Yet there’s a school of thought that inherent flaws in the tax regime are preventing Canada from reaping the gains of lower corporate taxes.

Michael Smart, economics professor at the University of Toronto, said there is “a raft of policies” that offset the benefits of lower corporate tax rates. Chief among them, in his opinion, is the move to reduce tax rates for small businesses alongside cuts to the main statutory rate that applies to larger companies. Small firms, he said, tend to be less productive than larger corporations, and reducing their rates below the statutory level provides no incentive for them to expand and invest.

Mr. Smart, though, does see progress, most notably the introduction of a harmonized sales tax in Ontario and British Columbia – which eliminates a retail levy from business inputs such as equipment, software and fuel.

“Taxes are what policy makers can control so it’s essential to get that right,” he said. “Overall rate reductions are a move in the right direction. But it is not a silver bullet, and you have to remove other obstacles in the tax system.”

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