# The corporate capital tax—Canada's most damaging tax

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## Introduction

The corporate capital tax is a business tax little known outside the circles of academia, tax-planning, and corporate boardrooms. However, the corporate capital tax is one of, if not the most, damaging tax currently imposed by governments in Canada. Because of its cost and complexity and because Canada must compete with other industrialized countries, few of which use such a tax, it should be eliminated by all Canadian governments.

This chapter provides a brief overview of the detailed analysis contained in *The Corporate Capital Tax: Canada's Most Damaging Tax*[1] and gives two of the four sections in the main study: (1) a description and critical evaluation of corporate capital taxes (hereafter "capital taxes"); and (2) the measurement of capital tax usage in Canada. The two sections not presented examine trends over time and present a more developed analysis of the use of capital taxes in various Canadian jurisdictions.

## 1 Description and evaluation of capital taxes

### *What is a capital tax?*

The capital tax generates revenue for governments by assessing a levy on corporations based on the amount of capital (essentially debt and equity) employed. There are two major categories of corporate capital taxes in Canada: those levied on financial institutions and those levied on non-financial companies.[2] The applicable rates vary from 0.0% in Alberta for both financial and non-financial corporations (i.e. there is no capital tax) to 0.64% in Quebec for non-financials and 4.0% in Newfoundland for financial institutions.

Like all business taxes, the burden of the capital tax, both the general and that specific to financial institutions, is borne by ordinary citizens through higher prices for goods and services, lower wages, and reduced rates of return on savings and investments.

### *Evaluating the capital tax*

There are three traditional measures of tax effectiveness: efficiency, fairness (also referred to as equity), and simplicity.

#### 1 Efficiency

Efficiency, as applied to taxation, requires that tax revenues be raised in the least distortionary manner, thus maximizing economic growth. The marginal efficiency cost (MEC) of taxation measures the cost of raising an additional dollar of tax revenue from an existing tax. Tables 1 and 2 give the results of two studies of MEC—*OECD Economic Surveys, 1996–1997* (Organisation for Economic Co-operation and Development 1997); The Excess Burden of Taxation in the United States (Jorgenson and Yun 1991)—that demonstrate the relatively high cost of raising tax revenues via capital-based taxes compared with the use of consumption and labour-based taxes.

The common finding in both studies of the MEC of different taxes is that business taxes are much less efficient than those with a labour income or consumption base. That is, payroll and sales (consumption) taxes are much more efficient than business taxes such as the corporate income tax.

Both studies found that using business taxes, specifically corporate income taxes, imposed a substantially higher cost to the economy than the use of either sales or payroll taxes. Thus, considerable

***Table 1: Estimates of marginal efficiency cost (MEC) for selected Canadian taxes***

| Tax | MEC ($) |
|---|---|
| **Corporate Income Tax** | $1.55 |
| **Personal Income Tax** | $0.56 |
| **Payroll Tax** | $0.27 |
| **Sales Tax** | $0.17 |

Source: Organisation for Economic Cooperation and Development 1997.

***Table 2: Estimates of marginal efficiency cost (MEC) for various taxes***

| Tax | MEC ($) |
|---|---|
| **Capital Income Taxes (Individual & Corporate)** | $0.924 |
| **Corporate Income Tax** | $0.838 |
| **Individual Income Tax** | $0.598 |
| **Labour Income Tax** | $0.482 |
| **Sales Tax** | $0.256 |
| **Property Taxes** | $0.174 |

Source: Jorgenson and Yun 1991.

efficiency gains can be achieved by simply reconfiguring the current tax mix to move away from corporate income and capital bases and toward labour income and consumption bases.

## 2 Fairness (equity)

The main concern for a capital tax in terms of fairness is whether or not it achieves horizontal fairness: firms with similar amounts of capital face similar corporate capital tax bills.

There are several reasons that capital taxes fail the test of horizontal fairness. First, because there are varying definitions of what constitutes an eligible large corporation and, thus, the exempted level of capital, firms with equivalent capital are not treated equally across jurisdictions. Second, financial institutions are taxed more heavily by the capital tax than non-financial institutions. Third, capital taxes fail the test of fairness because they place a higher burden on industries whose activities are more capital intensive than others. Growth-enhancing industries like software, biotechnology, and communications bear a heavier capital tax burden than other, less capital-dependent industries.

**3 Simplicity**

Simplicity refers to the cost to the government of collecting taxes as well as the costs incurred by businesses and individuals in complying with a tax system. The principle of simplicity requires that both sets of costs be minimized.

The Technical Committee on Business Taxation, one of the most important recent Canadian commissions to evaluate taxation concluded that "capital taxes are becoming increasing[ly] complex" (Technical Committee on Business Taxation 1997: 4.21). This is due to the inherent administrative complexity of taxing capital and to the lack of uniform interpretation of the capital tax legislation both in and across jurisdictions.

Corporations are required to calculate total capital tax payable by determining the taxable capital, investment allowance, and applicable exemptions, deductions, and credits. One study concluded that this requires accounting for 103 items simply to determine capital tax payable in a single jurisdiction.

Although the capital tax on its surface may appear to be relatively simple, in reality it is complex and becoming more so as additional credits and deductions are added.

### *Conclusion*

The capital tax is a poor way to raise revenues for government because it violates the principles of fairness, simplicity, and efficiency, and ultimately impedes economic growth.

## 2 Measuring the use of capital taxes

### *International comparison*

Canada is almost alone in its use of capital taxes, one of only three countries in the OECD that levies a direct tax on the capital of corporations at the federal level. The other two OECD countries, that impose capital taxes are Germany and Japan, but they do so to a much lesser extent. Several American states levy a minor tax equivalent to a capital tax but the amount and the effect are negligible. Canada's capital tax is levied at the highest rates, extracted from the broadest bases, and administered with the greatest degree of complexity compared with the few other jurisdictions using capital taxes.

### *Intra-Canadian comparisons*

Four measures were used to rank the use of capital taxes by Canadian federal and provincial governments over the last 12 years: capital tax as a percent of (1) own-source revenue, (2) business profits, (3) gross domestic product (GDP), and (4) corporate income tax. The results are summarized in table 3.

***Table 3: Use of capital taxes in Canada (2000/01)***

| | Capital tax as a percent of: | | | | Average Rank |
|---|---|---|---|---|---|
| | (1) Own-source revenue | (2) Business profits | (3) GDP | (4) Corporate income tax revenues | |
| **Canada** | 8 | 8 | 8 | 10 | 8.5 |
| **BC** | 5 | 4 | 4 | 3 | 4.0 |
| **AB** | 11 | 11 | 11 | 11 | 11.0 |
| **SK** | 1 | 2 | 1 | 1 | 1.3 |
| **MB** | 4 | 3 | 3 | 4 | 3.5 |
| **ON** | 3 | 5 | 5 | 7 | 5.0 |
| **QC** | 2 | 1 | 2 | 2 | 1.8 |
| **NB** | 7 | 7 | 7 | 6 | 6.8 |
| **NS** | 6 | 6 | 6 | 5 | 5.8 |
| **PEI** | 10 | 9 | 10 | 9 | 9.5 |
| **NF** | 9 | 10 | 9 | 8 | 9.0 |

Source: Clemens et al. 2002.
Note: updates using data for 2001/2002 are available in Clemens 2002.

The table shows that, in general, Saskatchewan and Quebec use the capital tax to the greatest extent. In fact, Saskatchewan's capital tax consistently generates more revenue than its corporate income tax. British Columbia is a relatively high user of capital taxes although it has announced it will eliminate its non-financial capital tax in 2002. Finally, Manitoba rounds out the group of Canadian jurisdictions that use capital taxes to a relatively high degree.

At the other end of the spectrum, Alberta no longer has a capital tax, having eliminated its captial tax on financial institutions on April 1, 2001. The federal government along with Newfoundland and Prince Edward Island are also relatively low users of capital taxes.

Below is a brief summary of the findings from four specific measures of the use of capital taxes by the federal and provincial grovernments in Canada.

**1 Corporate capital tax as a percent of own-source revenue**

This measures the proportion of revenues collected in a particular jurisdiction (i.e. own-source revenue) in the form of capital taxes (figure 1). Saskatchewan was the leader in capital tax revenue as a percentage of own-source revenues (5.40%). Quebec ranked second with 3.48%. Ontario, Manitoba, and British Columbia ranked third, fourth, and fifth, respectively. Alberta ranked last in the percentage of its own-source revenues provided by capital taxes: only 0.14 cents of every dollar collected in revenues were from capital taxes.

Saskatchewan and Quebec remained in first and second position throughout the period from 1989 to 2001. Alberta frequently ranked last, indicating the lowest reliance on capital taxes as a percent of own-source revenues over the twelve-year period. The federal government along with the Atlantic Provinces generally also ranked relatively low.

**2 Corporate capital tax as a percent of business profits**

This indicator measures the amount of capital tax collected compared to the profits generated by corporations (figure 2). Quebec's capital tax extracted the greatest amount of revenue as a percent of business profits (6.9%). Quebec was followed closely by Saskatchewan (6.1%). Manitoba (5.1%) and British Columbia (4.3%) followed in third and fourth positions. Alberta was again ranked last

***Figure 1: Corporate capital tax as a percent of own-source revenue, 2000/2001***

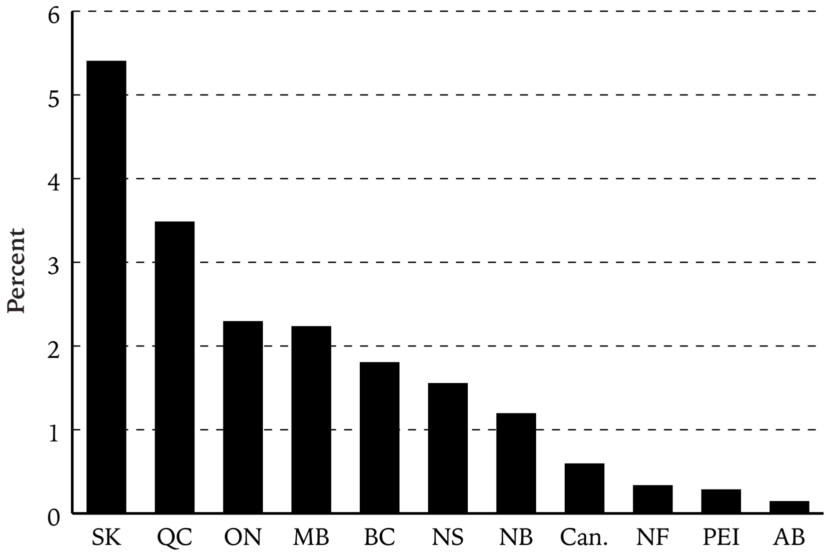
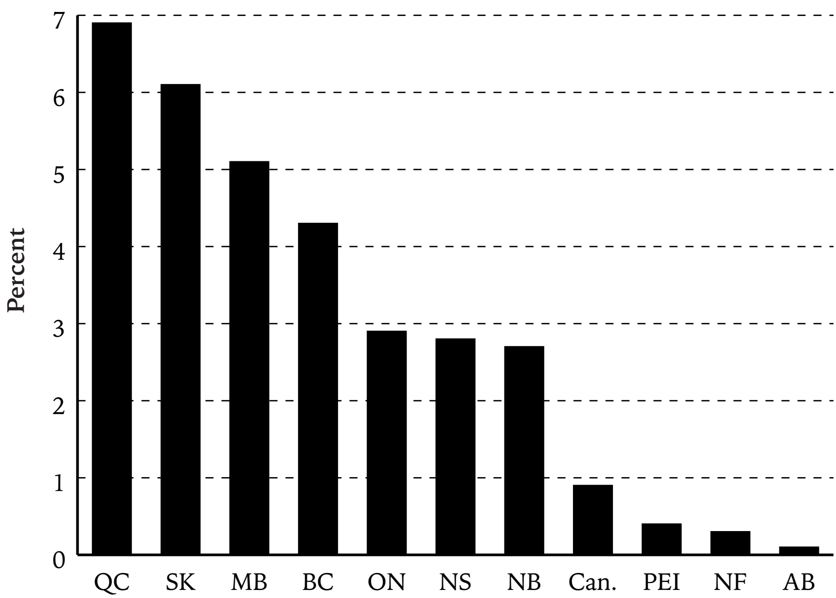



***Figure 2: Corporate capital tax as a percent of business profits, 2000/2001***



with capital taxes representing only 0.1% of business profits. Newfoundland and Prince Edward Island tied for tenth position.

Throughout the period from 1989 to 2001, Quebec ranked first in every year but one. Saskatchewan ranked second in every year but one, in which it was ranked first. Manitoba was consistently ranked third. Alberta, Prince Edward Island, Newfoundland, and New Brunswick generally extracted the least amount of capital tax revenues relative to business profits.

### 3 Corporate capital tax as a percent of GDP

This indicator measures the use of capital taxes relative to the size of the economy (figure 3). Saskatchewan ranked first in this indicator with capital taxes representing 0.98% of GDP. Quebec followed in second position with capital taxes representing 0.73% of GDP. Manitoba (0.40%) ranked third and British Columbia (0.34%), fourth. Alberta was ranked last with capital taxes representing a mere 0.03% of GDP in 2000/2001. Prince Edward Island and Newfoundland followed closely, tying for tenth position.

Saskatchewan and Quebec consistently ranked first and second throughout the period from 1989 to 2001. Manitoba and British Columbia (after 1992/1993) consistently held third or fourth. Alberta ranked last for 10 of the 12 years. Prince Edward Island and Newfoundland also regularly ranked low.

### 4 Corporate capital tax as a percent of corporate income tax

The fourth indicator compares the amount of capital tax revenue with the amount of revenue collected by the corporate income tax (figure 4). Saskatchewan ranked the highest of all jurisdictions. Saskatchewan was the only jurisdiction in which more revenues were raised from capital taxes than from corporate income taxes: $1.05 in capital taxes for every $1 in corporate income tax. Quebec ranked second in the amount of capital taxes raised relative to corporate income taxes, British Columbia, third, and Manitoba, fourth. Alberta, Prince Edward Island, and the federal government ranked low in their use of capital taxes relative to corporate income taxes.

Throughout the period from 1989 to 2001, Saskatchewan, on average, collected $1.21 in capital tax revenues for every $1.00 raised in corporate income tax. Saskatchewan is the only province to collect more, consistently, through capital taxes than through corporate

***Figure 3: Corporate capital tax as a percent of GDP, 2000/2001***

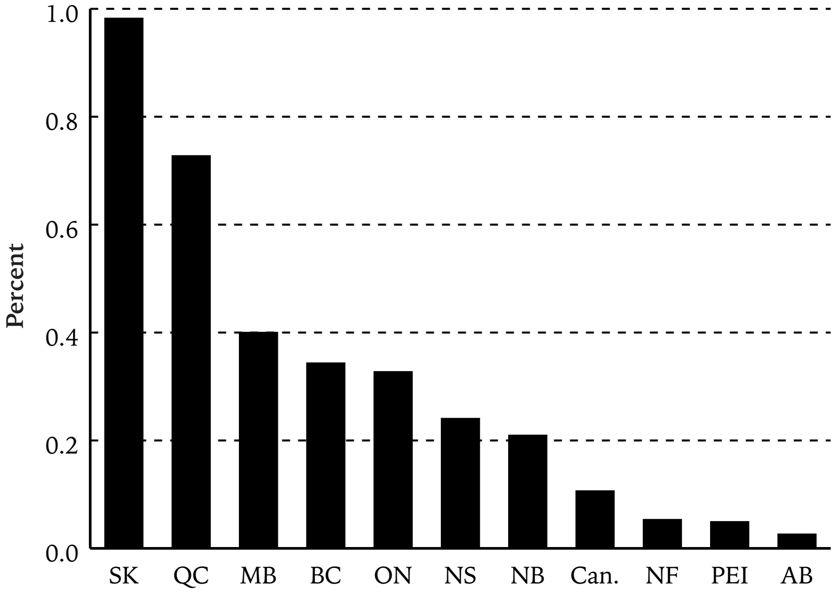
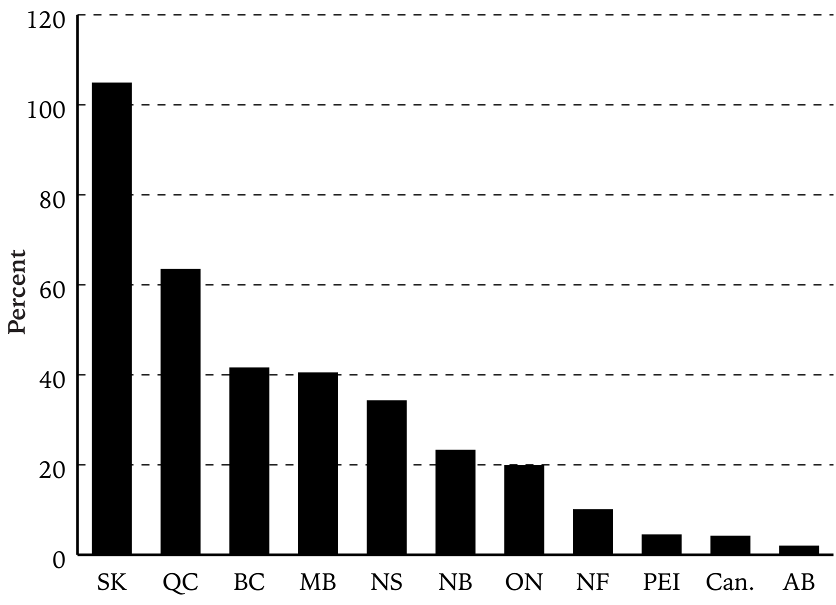



***Figure 4: Corporate capital tax as a percent of corporate income tax, 2000/2001***



income taxes. Quebec consistently ranked second but was far behind Saskatchewan. Manitoba and British Columbia commonly alternated between third and fourth places. Alberta collected relatively low amounts of capital tax revenues compared with corporate income taxes consistently over the period. The federal government also received low rankings over the period.[3]

### *Conclusion*

The combination of these four measures indicate quite strongly that Saskatchewan, Quebec, Manitoba, and British Columbia are the highest users of capital taxes in Canada. On the other end of the spectrum, Alberta, the federal government, and the maritime provinces tend to be relatively low users of capital taxes.

## Recommendation

Given that there are high and unnecessary costs associated with using capital taxes and that Canada is one of only three OECD coutries to use them, it is imperative for all Canadian jurisdictions to follow the lead of Alberta and eliminate them. At the very least, capital taxes should be replaced with more efficient taxes such as payroll or sales taxes. However, the first and best option for every jurisdiction in Canada is the straightforward elimination of capital taxes—a tax reduction, like that in Alberta, rather than a tax replacement.

## Notes

**1** Clemens, Emes, and Scott 2002. Also available as a digital document (PDF) from www.fraserinstitute.ca.

**2** Note that there is also a capital tax assessed on insurance companies that is not dealt with in this study.

**3** Section 4 of Clemens, Emes and Scott 2002 provides detailed profiles of the use of capital taxes by each jurisdiction.

## Reference

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