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Corporate Income Taxes—Who Pays?

by Philip Cross

Main Conclusions

- **Corporate taxes ultimately are paid by people; calls to increase corporate taxes will lead to higher taxes for investors, lower wages for workers, or higher prices for consumers.**
- **Most countries have moved to lower corporate tax rates over the past decade, including Canada. The effective tax rate paid by firms in Canada is very close to the statutory rates.**
- **Governments should reduce their reliance on corporate income taxes for several reasons. Increases in corporate tax rates leads to a concurrent erosion of the tax base. Also, keeping corporate income taxes as low as possible minimizes the distorting impact they have on economic behaviour, a rationale that applies to all taxes.**

About the author

Philip Cross spent 36 years at Statistics Canada, the last few as its Chief Economic Analyst. He wrote Statistics Canada's monthly assessment of the economy for years, as well as many feature articles for the *Canadian Economic Observer*. After leaving Statistics Canada, he worked for the Macdonald-Laurier Institute. He is a member of the Business Cycle Dating Committee at the CD Howe Institute. He has been widely quoted over the years, and now writes a bi-weekly column for the *National Post* and other papers

Introduction

Whenever governments are strapped for cash—which is most of them, most of the time, given their voracious appetite for spending—eyes quickly turn to corporate income taxes as an expedient and presumed painless way to help balance their books. In Canada, two provinces raised corporate tax rates in 2013. Opposition leader Thomas Mulcair proposes to raise the federal corporate income tax from 15% to 22% while freezing personal income-tax rates, an implicit recognition that Canadians have reached the limits of the tax burden they are willing to tolerate. The erroneous thinking behind raising corporate income taxes, however, is that corporations and not people bear their burden.

The debate

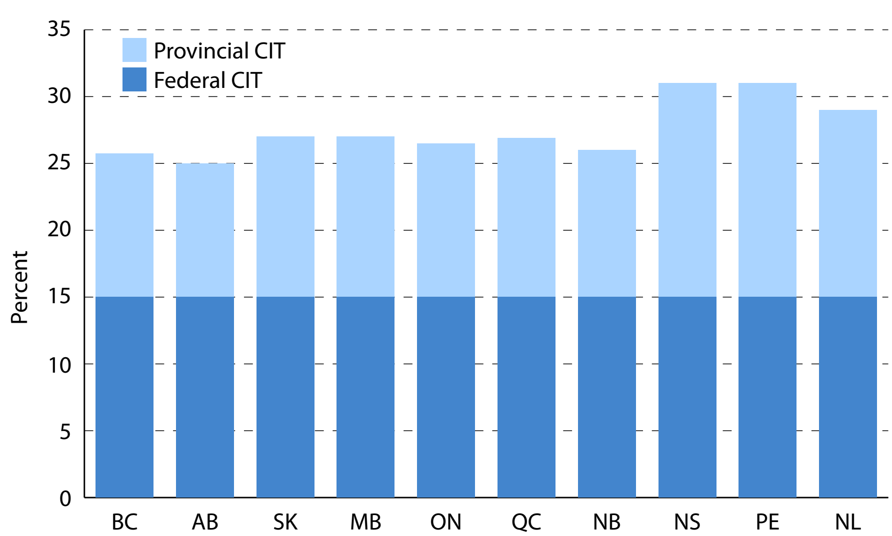
Economic theory and common sense—the two sometimes agree—argue that corporate taxes are actually paid by consumers, workers, and/or investors. When it comes to corporate income taxes, the tax buck does not stop at the corporation because only people can pay taxes. In the words of a leading expert on tax policy, "Taxing corporations ultimately results in the taxation of people" (Chen, and Mintz, 2013: 1). Even without a corporate income tax, the wealth from profits would be taxed when the profits are reaped by their owners, either through dividend pay-outs or through higher share prices if the profits are retained in the corporation and re-invested.[1] This is why economists have long argued that corporate income taxes represent "double taxation" of income already subject to taxes. Levying a corporate income tax also comes partly at the expense of workers, since firms will look to offset the cost of higher taxes by lowering labour costs. This takes the form of restraining wages or even shifting operations to jurisdictions with lower tax rates, resulting in lost jobs. Alternatively, firms could pass on income taxes in the form of higher prices, which costs all consumers. The unavoidable fact that people pay all taxes is one reason the Fraser Institute allocates corporate income taxes to people in its calculation of Tax Freedom Day, a decision that has been wrongly criticized by the Canadian Centre for Policy Alternatives (Brooks, June 2005).

Politically, however, it has proved impossible to convince large parts of the public of the futility of shifting the tax burden to corporations. Many people believe it is unfair for a corporation that earns billions in profits to pay no income tax (witness the recent outcry over Apple Inc. paying little income tax in the United States). Given the difficult optics of abolishing the corporate income tax, the next best alternative is to lower the rate as much as possible. This is what governments around the world have been doing since 2000, as globalization has intensified. A KPMG survey found that the world's average corporate tax rate has fallen in each of the past 11 years, from 29.02% in 2000 to 22.96% in 2011 (KPMG, 2011). Among the richest countries, the OECD average statutory corporate income-tax rate was 27.6% in 2007, down from 33.6% in 2000 (OECD, 2008: 3).

Canada's rate

Canada has a slightly lower corporate income-tax rate than the OECD average, although it varies by province. A standard federal rate of 15% applies across the country, while provincial rates in 2013 ranged from 10% in Alberta to 16% in Nova Scotia and Prince Edward Island, with rates just below 12% in the two

Figure 1: Corporate income tax by province, 2013



Source: EY, 2014.

largest provinces of Ontario and Quebec (figure 1) (OECD, 2008: 3).

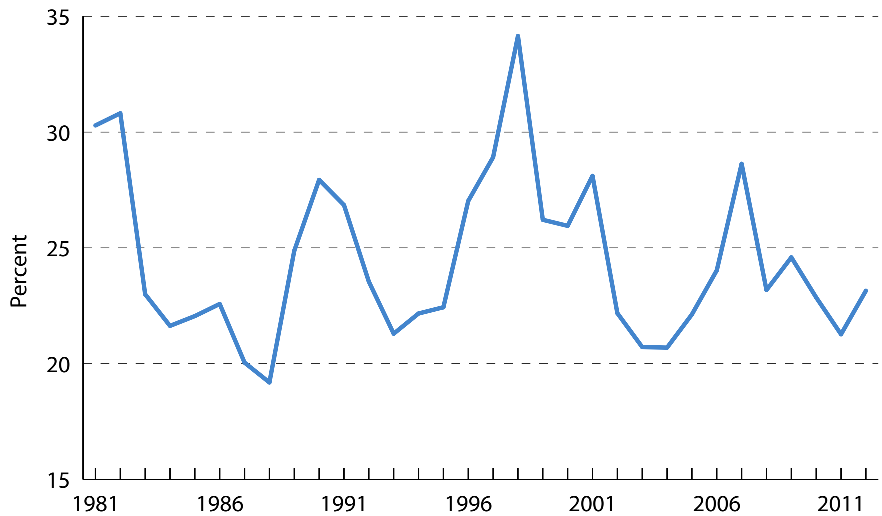
The average effective tax rate on corporate profits is calculated as total corporate transfers to government as a share of corporate profits. The National Accounts data from Statistics Canada captures all the revenues governments collect from corporations. So when a government like Ontario's uses the sleight of hand of calling a tax on firms an "Employer Health Tax" that ranges from 1% to 3% of payrolls, it is treated the same as income tax.

The effective tax rate in 2012 was quite close to the statutory rates listed above, which demonstrates that public concerns about corporations evading taxes through loopholes and creative accounting are unwarranted. Firms are paying what governments are asking them to pay, probably because the ultimate burden of these taxes is borne by workers, consumers, and/or investors.

Government's share of the profits

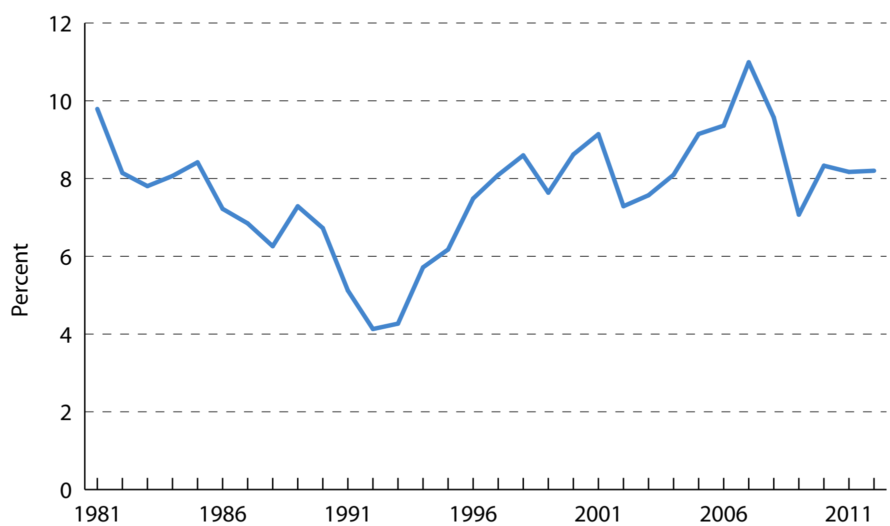
The share of profits paid to government has fluctuated between 20% and 30% over the past four decades, reflecting changes to the tax rate itself and the wide range of differential tax rates and deductions (such as depreciation) by industry and by province (figure 2). For example, the manufacturing and processing industry is taxed at a lower rate in several provinces. Small businesses that are incorporated pay a lower rate of tax than large firms. So it is easy to understand how shifts in profits by industry will lead to changes in the calculated effective tax rate.

Figure 2: Corporate income tax as a share of corporate profits, 1981–2012



Source: Statistics Canada, 2013.

Figure 3: Corporate income as a share of all government revenue, 1981–2012



Source: Statistics Canada, 2013.

The unweighted average effective tax rate in the OECD was just under 24% in 2005, one-third less than its rate in 1982 (OECD, 2008: 3). The drop in the effective tax rate has not been as pronounced as cuts to the statutory rate, reflecting how governments have tried to recoup some revenue by broadening the tax base through less generous depreciation allowances and eliminating loopholes.

The effective tax rate is clearly cyclical, plunging during recessions and rising as the economy recovers. Attempts to target "excess" profits at the peak of an industry boom, such as high tech in 2000 or mining more recently, would make taxes even more cyclical.[2] However, the track record in Canada shows that, by the time governments identify a boom in profits and enact legislation to extract more revenue from a particular industry, the boom is already over and the increased fiscal burden only worsens the bust cycle of the industry. This is exactly what happened to Alberta's natural gas industry in 2007 and Quebec's mining industry after 2010.[3] Expecting governments to be smart and nimble enough to fine-tune taxes with industry booms shows a naïve faith in the efficacy of government.

Corporate income taxes account for a small share of total government revenues in Canada (figure 3). This share fluctuates between about 5% and 10% of government revenues, depending on the buoyancy of profits and the effective tax rate. Government revenues from corporate income taxes are highly cyclical. Apart from a decline below 6% during the recession of the early 1990s and a spike above 10% during the commodity price boom in 2007, corporate taxes usually contribute about 8% to all government revenue. The rising share of GDP going to corporate profits over the last three decades—a clear if poorly understood phenomenon throughout the western world—has buttressed corporate tax revenue despite lower tax rates.

The needed changes

There are several reasons that governments should reduce their reliance on corporate income taxes. First, every percentage-point increase in corporate tax rates leads to a significant erosion of the tax base. One estimate is that every increase of one point in corporate income tax rates results in a drop of 13.6% in the corporate tax base, compared with only 3.6% for personal income taxes and 3.2% for sales taxes (Dahlby and Ergete, 2012). This reflects the relative ease with which firms (unlike most persons) can shift their operations to jurisdictions in Canada or abroad with lower tax rates. As well, higher taxes lead to less investment, which reduces corporate profits and therefore corporate income taxes in the long-term.

Another reason to keep corporate income taxes as low as possible is to minimize the distorting impact they have on economic behaviour, a rationale that applies to all taxes. For example, since interest payments are deductible from corporate income and therefore taxes, the corporate income tax encourages firms to issue debt instead of equity (the return on which is taxed). Reducing corporate cash flow also inhibits firms from investing, which has a direct impact upon productivity. This reduces their ability to compete, and lowers wages, which in the long run are determined by productivity.

Ultimately, the major stumbling block to lowering or eliminating corporate income taxes comes down to the public's perception of equity—that it is unfair that an entity, even if it only exists on paper, should earn money and not pay taxes. This concern for "fair" treatment is misplaced. Corporate income taxes are ultimately paid by people. Moreover, the tax and transfer system for persons is the best way to address questions of equity, not raising corporate tax rates. This is because it is uncertain how corporate taxes are distributed among workers, consumers, and investors. The desire to insulate voters from higher taxes by raising corporate rates could well result in ordinary workers losing income or everyday consumers paying higher prices. The personal tax and transfer system does a better job of targeting who gains and who loses from tax changes than the blunt instrument of higher corporate income taxes.

Notes

1 The OECD also argues that corporate income taxes are a "backstop" to personal income tax, in case firms do not pay out dividends and indulge in strategies to keep share price low, thus helping shareholders shelter their income from taxation. It also reduces the incentive for individuals to incorporate and reduce their tax rate. Corporate income tax also acts as "a withholding tax on equity income earned by non-resident shareholders, which might otherwise escape taxation in the source country." If all profits of a firm were paid to foreign shareholders, conceivably it could avoid paying for any of the public services it consumes in Canada, such as infrastructure. See OECD (2008).

2 The OECD claims that because profits in booming industries are already high enough to attract invest, such taxes on excess rents do not entail efficiency losses, but notes they would drive investment to regions or

countries with lower taxes. See OECD (2008): 2.

3 Alberta raised royalties on oil and gas to 50%, but has since reversed some of that increase. Quebec raised its tax on mining from 4% to 16% since 2010, and also stopped firms from deducting losses from money-losing sites. As a result, Quebec fell from first place in the Fraser survey of most attractive jurisdictions for mining in 2010 to eleventh place last year. See Green and Wilson (2013).

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