

Canada's Path to Strong Economic Growth and International Competitiveness

The federal government has and continues to make steady progress towards reducing Canada's marginal effective tax rate on capital (ETRC) which includes corporate income tax, sales tax on capital purchases and other capital related charges. Although steady, progress needs to move at a faster pace if Canada is to succeed in maintaining strong economic growth and in enhancing its international competitiveness.

The ETRC applicable to the services sector should be reduced to more closely approximate the ETRC applicable to the manufacturing sector, and consideration should be given to shifting a greater proportion of the tax burden to activities that, when taxed, will not adversely affect productivity.

Background

Canadian business capital investment is \$1600 less per worker than the United States and \$700 less than OECD countries. Although Canada's foreign direct investment inflow (FDI) potential was ranked 3rd in 2006, Canada only ranked 97th in the world for FDI inflow performance. (Source: UN Conference on Trade and Development, 2006). One of the key reasons cited for Canada's poor showing in capital investment and FDI inflow performance is its high ETRC.

Canada's ETRC continues to be one of the highest among OECD countries. Among 80 countries surveyed, Canada ranked as having the 11th highest average ETRC as of 2007 (30.9%). The ETRC applicable to the services sector – which includes construction, transportation, communications, public utilities, trade, business and household services – stood at 36.4%; the 6th highest. (Source: C.D. Howe Institute, Commentary No. 254, September 2007).

Measures announced in the October 2007 *Economic Statement* will further reduce Canada's ETRC to 25.3% by 2012. The government is seeking the collaboration of the provinces and territories to reach an ETRC of 23.7% by 2012. This is a step in the right direction; however, more needs to be done.

Globalization has given way to greater capital and labour mobility and a country's tax competitiveness is one of the more important factors taken into consideration by corporations in determining where to allocate capital and labour. Many countries that compete with Canada for labour and capital already have, or will by the end of 2008, a lower corporate income tax rate than the combined federal and provincial/territorial corporate income tax rate of 27.6% that Canada expects to achieve by 2012.

Switzerland, Sweden, the Netherlands, the United Kingdom, Norway, Austria, Finland, Italy, Australia, Spain, Denmark and Ireland, just to name a few, have a lower ETRC than Canada. Of these countries, only the service sectors in the UK and Italy are subject to an ETRC that is higher than the ETRC applicable to their respective manufacturing sectors and only by 5% and 2% respectively. Like Canada, the services sector in each of these countries makes up close to 70% of their respective GDP. Unlike all these countries, Canada imposes a much higher ETRC on this sector - 13% higher ETRC than that imposed on the manufacturing sector. Such high taxes on the services sector are hampering Canada's competitiveness. The costs of the services sector impact on the competitiveness of other sectors, such as the manufacturing sector. Many business services are traded internationally and although the export share of trade in services in the OECD of many industrialized countries has been on the rise, Canada's

export market share of trade in services in the OECD has dropped significantly from 6.2% in the 1970s to 3.4% in 2006.

According to the CD Howe Institute, a reduction of 1% to the ETRC would have the effect of increasing FDI by 3.3%. (Source: 2007 Tax Competitiveness Report: A Call for Comprehensive Tax Reform).

The federal government should revisit its current tax mix and further reduce its dependency on economically damaging taxes.

Recommendations

That the federal government work with the provinces\territories to reduce effective tax rates on capital in the service industry to be better aligned with the manufacturing sector.