Mish-mash tax plans: A House committee call for tax breaks for manufacturers will only benefit accountants and lawyers. It should be relegated to the dustbin

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Financial Post

Wednesday, February 14, 2007

Put a bunch of politicians together with manufacturing industry representatives and what do you get? A mish-mash of flawed policy recommendations with a plethora of unwanted tax credits and complicated tax provisions.

Such is the fate of the House of Commons industry, science and technology committee report entitled, "Manufacturing: Moving Forward Rising to the Challenge." The only thing this report will move, besides some supposedly downtrodden manufacturing companies, are the accounting and legal professions, which will now be playing around with accelerated capital cost allowances and fattened R&D tax credits. Finance Minister Jim Flaherty should relegate this report to the dustbin and enact with his provincial cousins some smarter tax policies.

The manufacturing industry is feeling stiff competition from Asia, higher energy prices, and the effects on exports of a stronger Canadian dollar. The industry's employment has declined in the past two years after surging since 1996, joining other G7 countries that have had a secular decline in manufacturing employment since 1990.

The case for special treatment of the manufacturing industry is poorly made, going back to an outdated view that jobs only depend on this sector, which now accounts for less than a fifth of the Canadian economy. Sure, the U.S. is slowing down, but that affects all Canadian industries, does it not? Asian competition also affects services. Despite our environmental ramblings, Canadian power prices remain on average 50? (per kilowatt hour) below those in the United States.

Global growth, however, is creating some advantages for the Canadian economy. Our resource and service sectors have been booming, imports have become cheaper and our Canadian businesses are feverishly buying up assets abroad. Our productivity record in the past five years, including manufacturing, is still pretty abysmal, lagging behind not just Asia but the United States. However, the solutions are not to create tax shelters but instead look for meaningful reform that unleashes the Canadian entrepreneurial spirit.

Indeed, one problem with the existing business tax system is that it is nonneutral, favouring forestry, manufacturing and transportation activities compared with other industries. Structures and inventory assets are taxed more highly than other assets, especially research and development. Because of differential effective tax rates on capital, tax reduction, rather than economically profitable investments, drives business decisions in allocating financing.

So what does the report recommend? More non-neutrality! The committee recommends a two-year write-off for manufacturing and processing equipment as well as other equipment used in energy , environment and information technology. This write-off would last for a five-year period with a possible renewal (the renewal will come -- it took 15 years to get rid of the last two-year write-off for manufacturing assets). The report also recommends more than doubling depreciation for certain railway assets to match the United States, even though U.S. corporate income tax rates are far higher than in Canada. The effect of these policies is to drive down effective tax rates on forest, manufacturing and transportation (as well as communication if it qualifies as information technology) by up to six points, while leaving other business investments open to the vagaries of international competition.

To improve productivity, the report recommends broadening the tax deduction for research and development expenses and improving refundability for those companies unable to use the credit due to low profits. While improving refundability makes some tax policy sense, Canada already has the richest tax treatment for R&D in the world, giving us continuing mediocre results. Broadening an already rich credit is the wrong approach. The aim should be to look for more effective policies, such as removing high taxes on businesses finding good innovations.

If we really want to improve investment and productivity, we should follow the successful jurisdictions of recent years by making the tax system neutral and less interventionist in business decisions. Canada has the eighth-highest effective tax rate on capital among 82 countries in 2006 -- but this disadvantage affects most industries, not just forestry and manufacturing. We should be looking for tax policies that achieve both greater neutrality and international competitiveness. Since 2000, federal and most provincial governments have been generally following this path by cutting corporate income tax rates by nine points and reducing capital taxes.

For example, the committee could have recommended the acceleration and a further cut to the corporate income tax rate. The average federal-provincial corporate income tax rate, roughly 34% in 2007, moving down to 30.5% by 2011, remains high by international standards, which is roughly 28% in 2006 and still falling. (Germany, for example, is considering a reduction in its corporate rate by 10 points.) Cuts to the corporate income tax rate will not only attract highly profitable investments, but also counter business trends to shifting taxable profits out of high-tax Canada to the rest of the world.

Some room to improve capital cost allowances is needed to match economic depreciation and achieve greater neutrality. For manufacturing, a doubling of tax depreciation rates for structures to reflect better economic depreciation would be far better than introducing a highly distortionary two-year write-off for manufacturing equipment.

What the "new" Conservative government should also do is entice provinces to reform their business tax structures through a new deal on fiscal imbalance. The provinces need to eliminate capital taxes on non-financial and financial institutions, they need to eliminate insurance premium taxes and, in British Columbia, Manitoba, Ontario, Prince Edward Island and Saskatchewan, they need to reform retail sales taxes on business intermediate and capital inputs. Such actions would do a world of good, not only for forestry, manufacturing and railway, but also other industries.

Rather than back-slapping the four-party politicians for supporting manufacturing in Canada, Canadians should send a message that government interventionist policies to pick "winning" industries is no longer the path to improve productivity.

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