Institut du Québec

Taxation and Government Assistance to Companies

Literature Review and Analysis

At a Glance

- The tax burden on companies in Quebec is among the highest in North America. Reducing tax breaks for companies would only make the burden heavier and threaten Quebec's competitiveness.
- The Commission d'examen sur la fiscalité québécoise should look at ways to limit the impact that an increased tax burden on companies would have on economic growth and to encourage research and development.
- Measures to be considered include periodically reviewing preferential tax treatment, better targeting of government assistance, prioritizing productivity over job creation, and reducing the imbalance of R&D incentives between small and medium-sized enterprises and large companies.
- Other possible measures include focusing the R&D tax credit on technology-intensive sectors and reducing the tax rate on income earned from patented inventions.

A full French version of this publication follows this English executive summary.

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EXECUTIVE SUMMARY

Mandate and Structure

In conjunction with the work of the Commission d'examen sur la fiscalité québécoise, the Institut du Québec was mandated to review the literature on corporate tax incentives and reforms in Quebec, Canada, and the world, as well as to analyze these reforms and the models linking investment to taxation. The goal was to determine those that would best help Quebec improve its economic and fiscal situation.

Concepts and Definitions

In Quebec and most other industrialized societies, inflows from income and other taxes form the majority of the governments' revenues. In addition to financing government activities, taxation is also a tool that governments can use to influence certain economic behaviours—for example, by making some activities more costly and others more profitable.

Given that government revenues—as well as the job market and the standard of living—depend on the strength of economic activity, governments must avoid as much as possible introducing or maintaining policies that hinder the growth and health of their economies. In practice, the eagerness of governments to attract companies and encourage economic growth within their national or regional borders has led to the adoption of a great many proactive measures aimed at supporting companies. These government interventions can be found in nearly all industrialized countries, and they take many forms.

In terms of corporate taxation, the main challenge governments face is to find and adopt policies that allow them to finance their activities without hurting their economies. But not all forms of taxation are equal; their impact on economic growth varies widely.

Overall, the evidence shows that it is preferable to tax consumption rather than investment. The literature in Quebec and the rest of Canada echoes the international literature on this point—taxes on capital do the most harm in terms of hurting economic growth, while taxes on consumption are the least damaging. The literature also shows that a reduction in the income tax rate is three times more effective in encouraging economic growth than is a reduction in a tax on consumption.

Tax Competitiveness and the Determinants of Investment

Expected demand is the main determinant in the decision to invest. While income and other taxes generally represent less than 14 per cent of the costs of starting or expanding a business, corporate taxation still plays a determining role in a business's choice of location, particularly when the choice is between jurisdictions with similar characteristics.

Tax costs vary greatly, depending on the activity or sector. The decline in the video game industry in the United Kingdom is a good example of the importance the tax structure plays in a company's decision to invest and of the danger it faces if placed in a non-competitive position. Against the backdrop of economic globalization and increased mobility of capital and talent, governments have every reason to adopt tax policies that are competitive, particularly with those of neighbouring or competing jurisdictions.

International Context of Corporate Taxation

Tax reforms are at the heart of many discussions in industrialized countries today, given the difficult recovery from the 2008–09 recession and the pressure that aging populations are placing on public finances.

Four major global trends can be identified:

- To stabilize debt-service ratios and reduce deficits, many governments have raised value-added taxes, personal income tax rates, and social security contributions in recent years. Governments have also reduced the corporate tax rate in the hope of stimulating investment and economic growth. These changes are in line with Organisation for Economic Co-operation and Development (OECD) analyses that conclude that corporate income taxes are the most damaging to economic growth, whereas taxes on immovable property (such as property taxes) have the least negative impact. The OECD advocates replacing a portion of corporate income taxes with taxes that are less harmful to growth, thereby maintaining the level of budgetary revenues.
- Several countries have tried to expand the tax base by reducing or eliminating certain tax relief measures. These actions were generally limited to those tax relief measures linked to personal income taxes, which makes them easily accessible and revocable. Some countries also adopted budget measures to reduce tax expenditures. Germany and the Netherlands, in particular, have adopted review schedules to periodically assess their tax expenditures.
- The sluggish economic conditions that we have seen in recent years have prompted governments to implement measures to stimulate investment, such as accelerated depreciation, deductions for investment, and measures to promote R&D. For example, the U.K.'s 2010 budget introduced tax reforms intended to create the most competitive corporate income tax regime in the G20.
- The financial crisis also led to renewed interest in rent-based corporate tax regimes, which reverse the trend of debt financing. The International Monetary Fund and several European expert committees recommend setting up an equity deduction regime. In Canada, Robin Boadway and Jean-François Tremblay have also proposed this type of regime, which would eliminate some of the current barriers to investment, innovation, and productivity.[1]

1 Robin Boadway and Jean-François Tremblay, *Corporate Tax Reform* (Toronto: Mowat Centre, 2014).

The literature reviewed also suggests that even the most needed and appropriate tax reforms may be difficult to implement because of the resistance from some interest groups. The experiences of governments in the United States, Canada, Sweden, and Germany over the last 10 years, however, suggests that tax reforms that are introduced following periods of severe economic difficulties and are in line with global tax reforms are often more easily accepted from a political perspective.

Corporate Taxation in Quebec and Canada

The tax rates in effect in OECD countries have followed a very clear downward trend over the last three decades, declining from an average tax rate of 47 per cent in 1981 to 25.5 per cent in 2013. The statutory tax rate on corporate profits in Quebec—which, at 26.9 percent, is currently higher than the OECD average—has followed a similar trend. And while Quebec's rate is higher than the rates in effect in Ontario and British Columbia (26 per cent) or Alberta (25 per cent), it is lower than the rates in Germany (30.2 per cent), France (34.4 per cent), and the U.S. (39.1 per cent).

If we look exclusively at corporate tax rates, Quebec is relatively competitive in comparison with other similar jurisdictions. However, the statutory tax rate on corporate profits does not provide a complete picture of the tax burden on businesses—in particular, because it does not take into account payroll taxes, the various social security taxes, government assistance, or the details of how the tax regime is applied.

If we consider the taxes actually paid by businesses, the literature reviewed shows that:

- despite the reduction in tax rates on corporate profits since 1981, the proportion of tax revenues collected through the taxes on corporate profits has continued to increase in Quebec and in OECD countries as a whole;
- the total tax burden on businesses in Quebec is higher than in neighbouring jurisdictions and is the highest among the OECD countries;

- the heavy tax burden on businesses in Quebec is largely attributable to payroll taxes;
- thanks to tax credits and other related measures, however, Quebec is able to bring its corporate taxation levels more into line with those of other provinces and the U.S., although the net tax costs to Quebec businesses remain the highest among the provinces and the United States.

Although the absolute level of tax incentives for corporations has stabilized over the last five years, tax incentives as a proportion of all taxes paid by corporations continue to increase. In absolute terms, tax incentives for businesses are 60 per cent higher in Quebec than in Ontario. Relative to the size of their respective economies, they are three times more important.

Quebec and the rest of Canada use tax incentives mainly as an incentive to businesses to invest in R&D. This reliance on tax incentives (rather than budgetary assistance) is much greater than in the main competing jurisdictions. In addition, in Quebec and elsewhere in Canada, tax incentives for R&D is aimed more at small and medium-sized enterprises (SMEs) than large companies, compared with the situation in a number of other industrialized countries.

However, an excessive gap between the incentives given to SMEs and those given to large companies could constitute a disincentive for smaller businesses to grow. Hence, lowering the refundable tax credit for SMEs could make it possible to attain two objectives: promote the growth of small businesses, and increase the net economic benefit of the R&D tax credit. The literature also indicates that when public funding exceeds the optimum point, it replaces private funding.

Government assistance has resulted in an increase in business spending on R&D and in the number of patent filings in Quebec and Canada. However, the results are more mixed when we consider the effectiveness of tax incentives for R&D, as measured by the number of patent filings relative to the level of R&D spending. From this perspective, Quebec is below the average of OECD countries.

Although frequently used, the ratio of patent filings to R&D spending constitutes an imperfect measurement of the effectiveness of tax incentives for R&D, as it does not take into account non-patented innovations or jobs and investments related to the R&D activities that lead to the granting of a patent.

The literature also shows an increase in the number of Canadian patents transferred to jurisdictions that have adopted advantageous tax policies (e.g., Patent Box, which reduces the tax rates on income earned from exploiting patented inventions and lower statutory tax rate) aimed at intellectual property.

Main Findings

Given Quebec's position relative to its neighbours and competitors, it is not in the province's interest to increase the tax burden on its businesses or to adopt policies that run counter to major global trends.

The literature—both national and international—is unanimous in concluding that, to minimize the negative impacts of tax policy on economic growth, it is preferable to tax consumption rather than income and investment. To reduce the economic distortions generated by tax incentives, several authors, including Jack Mintz, favour the "broad base, low rate" approach, which consists of reducing corporate tax rates in exchange for broadening the tax base.[2]

Despite the criticisms directed at tax expenditures, OECD analyses note that these measures continue to play an important role in the tax systems of many countries and that there are few serious proposals to eliminate them. Several governments have even recently adopted tax measures aimed at stimulating investment—measures such as accelerated depreciation, deductions for investment, and R&D incentives.

2 Duanjie Chen and Jack Mintz, "Canada's 2010 Tax Competitiveness Ranking: Moving to the Average but Biased Against Services," *SPP Research Papers* 4, no. 2 (February 2011).

Any reduction in or elimination of tax incentives for businesses will increase their tax burden proportionately. Consequently, we should proceed with caution and avoid further undermining the tax competitiveness of Quebec. Considering the negative impacts of instability and uncertainty on investment, reforms should, insofar as possible, also promote stability and predictability.

The literature also identifies a few principles and avenues for action, which may be useful to the commission:

- Institute a process of regular reviews of preferential tax treatments in order to evaluate whether the benefits exceed the costs. (This is already done in several other countries.)
- Promote tax incentive measures that have targeted and measurable economic objectives, making it easier to assess their effectiveness.
- Provide government assistance to businesses in a specific and targeted manner, rather than try to help as many businesses as possible through across-the-board policies.
- Place the priority on productivity rather than job creation, so as to avoid artificially supporting jobs that are destined to disappear.
- Evaluate the advisability, advantages, and disadvantages of adopting a rent-based corporate tax regime, along the lines of the proposal made by Boadway and Tremblay.

More concretely, the commission could consider the advisability of applying the following findings and conclusions to the corporate tax regime in Quebec:

Scientific Research and Experimental Development Tax Credit

Direct government support is sometimes more effective than tax incentives in attaining targeted economic objectives and allowing for the measuring of results. For this reason, the commission could explore the possibility of reducing the general R&D tax credit in favour of better-targeted budgetary assistance. This reduction in tax incentives for R&D should take the following factors into account:

- The imbalance between the tax incentive regimes for R&D offered to small businesses (more favourable) and those available to larger companies (less favourable) could represent an obstacle to growth for small businesses. For this reason, the commission could consider changes aimed at reducing this imbalance, either by setting a minimum threshold (essentially an exemption) above which businesses would be eligible for the tax credit, or by reducing the discrepancy between the rates applicable to small and large companies (by reducing the rate of the tax credit for SMEs).
- To avoid large expenditures on support for less technology-intensive sectors, the commission could specifically identify the sectors that should benefit from the R&D tax credit rather than providing more general assistance.

Indeed, the lack of effectiveness of R&D in Canada could be explained in part by the fact that the tax treatment of intellectual property is less competitive in Quebec and in Canada as a whole than in other countries. In theory, adopting a more competitive tax policy with respect to intellectual property could increase the effectiveness of government investments in R&D. On this point, several countries have developed the Patent Box model. This is a model the commission might consider adopting.

Investment Tax Credit for Manufacturing and Processing Equipment

A 2008 report for the Quebec government entitled *L'investissement au Québec : on est pour* proposed replacing the investment tax credit with an across-the-board reduction in the general tax rate.**3** This recommendation is also in keeping with the broad-base, low-rate approach, and the reasons cited in 2008 are still valid today. As well, a 2014 report by the Centre for Productivity and Prosperity on the manufacturing sector concludes that the investment tax credit should

3 Jean Boivin, Andrée Corriveau, and Pierre Fortin, *L'investissement au Québec : On est pour* (Québec City: Government of Quebec, 2008).

be reviewed and that a budgetary approach should be favoured in order to make government support more effective.[4] That conclusion is based mainly on the fact that the tax credit is granted without any real distinction as to the industry mix of the manufacturing sector.

Overview

To carry out their mandates, governments need money. The level of funding required varies depending on the role that government plays in a given society; the more extensive the range of government intervention and responsibilities, the greater the funding requirements.

Governments can fund their activities in various ways: by imposing royalties on the exploitation of their natural resources, by charging fees for certain services, by operating state-owned enterprises, and by collecting taxes on the economic activities that fall under their authority. In Quebec and most other industrialized societies, income and other taxes account for the bulk of government revenues.

While taxes are the main source of funding for government operations, they are also an important tool that governments use to influence certain economic behaviours by, for example, making some activities more costly or more profitable. Whether intentional or not, the fiscal choices of governments—particularly with respect to taxation—can encourage or discourage certain behaviours on the part of individuals and businesses.

Beyond their economic impacts, tax policies are also subject to a certain number of principles and constraints. The following are a few relevant considerations:

- What is the ideal distribution of the tax burden?
- What behaviours and activities does the government encourage or discourage through its tax policies?

4 Robert Gagné, Jonathon Deslauriers, and Jonathon Paré, *Mieux outiller le secteur manufacturier : entre politique et adéquation des besoins* (Montréal: HEC Montréal, 2014).

- How do the tax policies in a given jurisdiction compare with those of neighbouring or competing jurisdictions?
- What are the global trends in corporate taxation?
- What measures are the fairest, most efficient, and transparent?
- Which are most likely to generate new revenue for the government, while minimizing any adverse impact on economic activity?
- What are the impacts of certain fiscal choices on wealth creation or distribution?
- Do the tax measures attain the stated objectives?

These questions form the foundation of any serious consideration of tax policies. They are also the central focus of this study—namely a critical analysis of corporate taxation and business incentive measures, as well as a comparison of relevant Quebec policies with best practices, both nationally and internationally.