Seriously, Let’s Cut All Corporate Taxes

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With just two weeks remaining in the federal election campaign, the Liberals and Conservatives have been working hard to differentiate their economic platforms. Stéphane Dion’s Liberals have focused on their “Green Shift”, the idea to raise taxes on carbon-based energy while reducing personal and corporate income taxes. Aside from this one big idea, which they’re not even explaining very well, the Liberals have thrown out a few silly ideas, the worst being the return of the tax loopholes for income trusts.

The incumbent Conservatives under Stephen Harper like to see themselves as all-round tax cutters, so they are emphasizing the unpleasant half of the Liberal Green Shift and hoping to convince us that they are better managers for these volatile economic times. So far, they are offering no new big ideas, but there is no shortage of small, silly ones – from a cut in diesel taxes to tax credits for kids in “artistic” programs.

I would like to add a new, big idea to the economic debate, in the hope that the economic part of this election doesn’t come down to a choice between which party has the silliest gimmicks. If either the Liberals or the Conservatives embraced it, they could legitimately claim to be adopting sensible actions to stimulate the current moribund economy and also to increase Canadian productivity, real wages and average living standards in the long run. To top it all off, they could even convince Canadians that it makes sense – if they explained it carefully.

The idea is to eliminate the federal corporate income tax. Let me explain.

Though we could easily debate the appropriate amount and kinds of government spending – from defence to foreign aid and from corporate subsidies to employment-insurance benefits – it is clear to all reasonably enlightened people that the government needs to do *some* spending. Taxes are therefore a necessary part of the fiscal picture. The view that “all taxes are bad” is simply silly.

The challenge for the government is then to decide which taxes to use and which ones to avoid. When economists and tax-policy wonks evaluate the various taxes at their disposal, they think not just about how much money will be raised, but also about how much economic damage is created by the tax – damage caused by changes in firm or consumer behaviour. Such changes may be sensible responses for the individuals involved, but for the economy as a whole they are inefficient and costly.

So let's think about Canada's main federal taxes. Despite the fact that the GST is the most hated tax in Canada, it is actually a very good one because it doesn't cause consumers or firms to favour some products over others (as it applies at the same rate to all goods and services). Personal income taxes are also quite good in this sense as long as marginal tax rates are not too high because most people do not alter their amount of work effort in response to small changes in the income-tax rate.

Whereas both the GST and personal income taxes deserve to be retained in the government's tax portfolio, corporate taxes are a different story altogether. Since these taxes apply to profits, they reduce any firm's incentive to become more profitable. As a result, corporate taxes tend to reduce firms' investment in new and productivity-enhancing capital equipment. In the absence of these increases in productivity, fewer new products get developed, fewer new markets are penetrated, and fewer new workers are hired. It is no surprise that economists routinely assess corporate income taxes as among the very worst kind of tax for the economy.

If the federal government after October 14th were to eliminate its corporate income tax, there would be a much greater incentive for Canadian firms to expand their investment plans, thus creating a short-run stimulus for the slumping economy. Over time, the greater stock of productive capital would drive greater productivity for Canadian workers, and these productivity gains would lead to increases in both employment and real wages.

A shrill complaint would be heard instantly from the leader of the NDP who would argue that corporate income taxes are socially just because firms must "pay their fair share". But the NDP position misses some essential facts. All firms in Canada, big or small, are ultimately owned by individuals. When profits get remitted to shareholders as dividends, they are fully taxable as personal income, and thus the "fair share" is being paid. And any profits that are retained by the firm are used to finance investment projects – leading to greater productivity, more business, and higher wages for more Canadian workers. Many Canadians may feel better knowing that Canadian firms are paying taxes, but the truth is that corporate income taxes ultimately lead to lower average living standards.

So there you have it. A new idea for this year's federal election campaign that, if implemented, promises genuine economic benefits for average Canadians now and in the future. Any takers in Ottawa?

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