

Business Tax Incentives for Economic Development: Do They Work?

Centre for the Study of Living Standards Seminar

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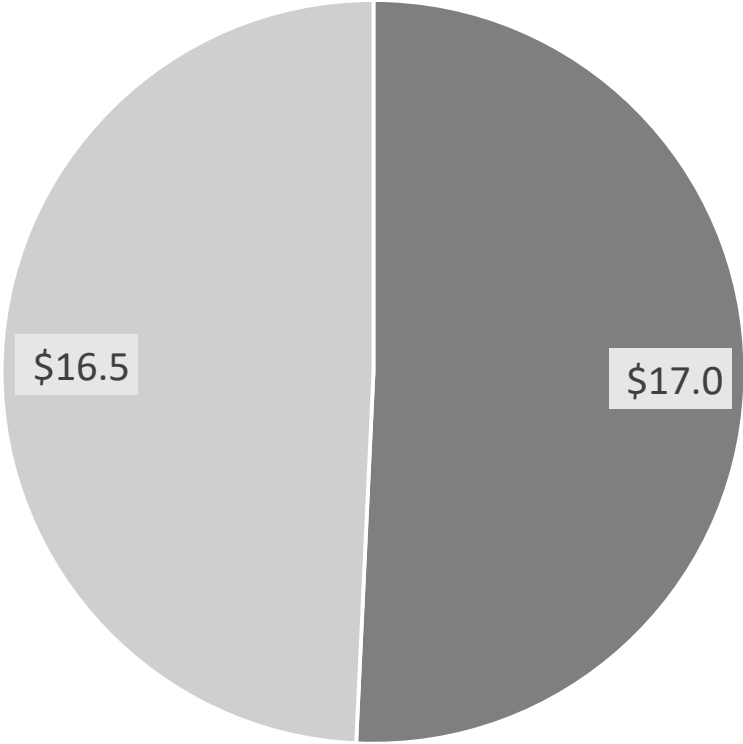
John Lester

(John.lester@sympatico.ca)



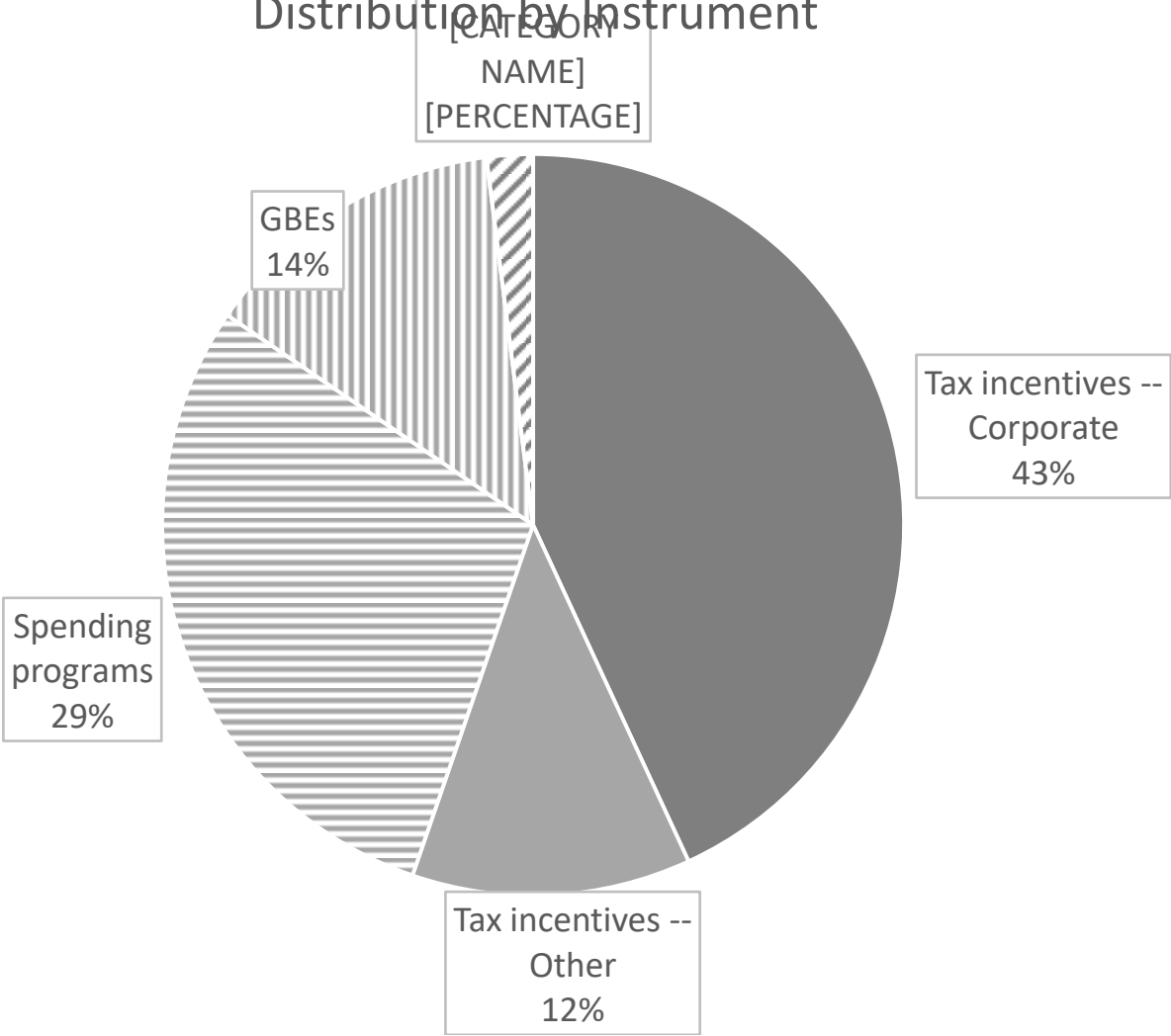
Business Subsidies in Canada 2014-15

Total Business Subsidies: \$33.5 Billion



■ Federal ■ Provincial

Distribution by Instrument



**Federal and Provincial Business Tax Incentives
for Economic Development**

	2015 Cost (\$ million)		
	Federal	Provincial	Total
Low tax rate for small businesses	3,250	5,500	8,750
Non-refundable SR&ED investment tax credit	1,360	335	1,695
Apprenticeship Job Creation Tax Credit	95	-	95
Atlantic Investment Tax Credit	230		230
Deductibility of cross border interest expense	2,500	1,880	4,380
Accelerated depreciation for M&E used in manufacturing	320	250	570
Accelerated deductibility of some exploration expenses	n.a.	n.a.	n.a.
Accelerated depreciation for vessels	n.a.	n.a.	n.a.
Low rate for M&P -- SK, ON, QC (SMEs only), NL.		268	268
Investment Tax Credits for M&P -- SK, MB, QC, PEI, NS.		183	183
Tax Holidays -- QC, PEI, NL.		27	27
Tax credit for international financial centres - QC, BC		24	24
Additional CCA for vessels - QC		n.a.	n.a.
Total	7,755	8,466	16,221



Rationales for business subsidies

- ◆ Mitigate market failures
- ◆ Industrial policy
- ◆ Optimal tax policy

Framework for Benefit-Cost Analysis

National Measures

Impacts of a targeted tax reduction

Benefit: Additional investment $+ \text{MEB}_{\text{CIT}}$

Spillovers $0 / +$

Resource allocation effects $- / +$

Sectoral variation in UC elasticity $0 / +$

Tax base shifting $0 / -$

Relative cost-effectiveness $0 / +$

Impact of a general tax rate increase

Cost: Less investment $- \text{MEB}_{\text{CIT}}$

Benefit-Cost Analysis of the Small Business Deduction (cents per \$ of tax revenue forgone)	
Efficiency cost of taxation -- All firms	41.0
Adjustment for tax base shifting	-5.4
Adjustment for lower productivity	-2.7
Efficiency cost of taxation -- small business	32.8
<i>Social Benefits</i>	
Mitigate capital market failure	0.6
Tax reduction for small business	32.8
Subtotal -- Benefits	33.4
<i>Social Costs</i>	
Tax increase for large businesses	-42.2
<i>Net social benefit</i>	<i>-8.8</i>
<i>Other costs not quantified</i>	
Increased tax evasion	-
Higher administration and compliance	-
Threshold effects on investment	-

Benefit-Cost Analysis of Cross-border Interest Deductibility (2015, cents per \$ of tax revenue forgone)	
<i>Efficiency cost of taxation</i>	
All firms	41.0
MNEs without tax base shifting	35.6
<i>Benefits</i>	
Induced effects on domestic investment ¹	15.1
Repatriated after-tax income	-0.1
Increased productivity of MNE's domestic assets	1.4
Productivity spillovers on non-MNEs	0.5
Higher productivity of MNEs	0.7
<i>Subtotal</i>	<i>17.6</i>
<i>Costs</i>	
Substitution between domestic & foreign assets	-1.7
Efficiency loss from a general rate increase	-41.0
<i>Net social benefit</i>	<i>-25.2</i>

Benefits and Costs of Accelerated CCA for Selected M&E Assets used in Manufacturing (Cents per \$ of Tax Revenue Forgone)	
Efficiency cost of taxation	41.0
Adjustment for international tax base shifting	-5.4
Adjustment for higher relative cost-effectiveness	24.4
<i>Efficiency gain from the selective tax reduction</i>	60.1
Resource allocation effects	
Inter-asset -- within M&E	-2.1
Inter-Asset -- M&E vs. other assets	-1.6
Inter-industry	-0.9
<i>Efficiency loss from a general tax rate increase</i>	<i>-41.0</i>
<i>Net social benefit</i>	<i>14.4</i>
Non-quantified impacts	
Higher administration and compliance costs	-
Premature retirement of capital	-
Spillovers	+

Benefit-Cost Analysis of Provincial Tax Incentives for Manufacturing and Processing in a Competitive Equilibrium -- Parameters

	Statutory Rate Reduction	Investment Tax Credit
Efficiency cost of taxation (cents per \$ raised)	41.0	41.0
Adjusted for international tax base shifting	--	35.6
Adjusted for relative cost effectiveness	0.0	60.1
Adjusted for higher prov. investment elasticities (25%)	51.2	74.1
Weighted rate change	1.7%	5.7%
Reduction in the user cost of capital	0.2%	5.7%
Provincial tax base semi-elasticity	2.2	
Input elasticity of substitution	2	2

Benefits and Costs of Provincial Tax Incentives for Manufacturing Evaluated from a Provincial and National Perspective

(Cents per dollar of tax revenue forgone)

	Rate Reduction		ITC	
	Provincial	National	Provincial	National
<i>Impact of selective tax reduction</i>				
Efficiency gain from increased investment	51.2	41.0	74.1	60.1
Resource allocation effects				
Provincial inter-industry	-0.0	-0.0	-1.6	-1.6
Inter-Provincial	-- ¹	-0.0	-- ¹	-1.8
Inter-asset (Short vs. Long-lived)	--	--	-1.7	-3.7
Tax base shifting within province	-3.0	-3.0	0.0	0.0
Tax base shifting -- interprovincial	3.4	0.0	0.0	0.0
<i>Subtotal</i>	<i>51.6</i>	<i>38.0</i>	<i>70.8</i>	<i>53.0</i>
<i>Impact of general rate increase</i>				
Efficiency cost of decline in investment	-51.2	-41.0	-51.2	-41.0
Interprovincial resource misallocation	-- ¹	-0.1	-- ¹	-3.3
Inter-provincial tax base shifting	-6.4	0.0	-6.4	0.0
<i>Subtotal</i>	<i>-57.6</i>	<i>-41.1</i>	<i>-57.6</i>	<i>-44.3</i>
Net social benefit	-6.0	-3.1	13.1	8.7
Non-quantified impacts				
Premature retirement of capital		NA		-
Additional admin and compliance costs		-		-
Higher TFP in manufacturing		+		+
Higher user cost sensitivity in manufacturing		+		+
1. Included in efficiency benefit/cost of taxation.				

Business Tax Incentives for Economic Development: Do They Work? Summary

- ◆ Small number of measures with a high fiscal cost.
- ◆ Intervention is successful only for the large firm SR&ED credit and other targeted investment tax credits. The social cost of cross-border interest deductibility is particularly high.
- ◆ The necessary conditions for a successful industrial policy appear to exist.
- ◆ Scope for applying optimal tax principles.
- ◆ The case against investment tax credits is weaker than I expected.