Table of Contents

The Chamber

Building the Best Business Climate in Canada

Submission to:	**Government of Saskatchewan, Department of Finance**
Re:	**Saskatchewan Corporate Income Taxation Policy**

1.0 Introduction

1.1 *Responding to Other Jurisdictions: "Playing Defense"*

The following outlines the major findings, including alternative policy considerations and recommendations of the Saskatoon and District Chamber of Commerce to the Right Honorable Eric Cline and the Finance Department of the Government of Saskatchewan.

In September of 2000, Alberta released the "Alberta Business Tax Review." This report gave recommendations with respect to improving the province's economic and business climate. Since then, the Government of Alberta has committed to building a stronger competitive position in Canada and around the world. Alberta has plans to adopt many of the recommendations that were proposed in the Business Tax Review document.

Saskatchewan has been forced yet again to play defense

As a result, Saskatchewan has been forced yet again to play defense as our neighboring province once again applies pressure. However, Alberta is not adopting policies as a direct method of attack against Saskatchewan. Rather, the province of Alberta has come to grips with the reality that in the new economy, the risk of wealth and talent exodus is greater than ever before.

In the past, Alberta has maintained an overall tax advantage compared with other provinces and Alberta continues to lead our country with respect to economic growth and job creation. As a result, other provinces and indeed jurisdictions around the world are moving to lower corporate income tax rates in order to attract investment. Germany, for example, has cut corporate taxes by more than 25%.

In 1999, the Saskatchewan Government appointed a committee to review personal income taxes in the province. This committee gave recommendations on ways to make Saskatchewan's Personal Income Tax structure simpler, fairer, more competitive and more responsive to the needs of Saskatchewan people and business. Since this time, the government of Saskatchewan has announced reduced personal income taxes. Nevertheless, the Government of Saskatchewan cannot afford to remain passive and only act in response to the initiatives of other jurisdictions. Saskatchewan policy makers must act quickly on the strategy unveiled by our nearest competitor. The Government of Saskatchewan must announce their commitment to improving the province's business climate and the methodology they plan to employ.

The Government of Saskatchewan cannot afford to remain passive and only act in response to the initiatives of other jurisdictions.

The Saskatoon and District Chamber of Commerce believes the Saskatchewan Government must bring to an end the wealth and talent exodus from our province. To this end, the Saskatoon and District Chamber of Commerce asserts that the first priority of our government should be to alleviate the taxes levied on businesses in the province. This strategy will send a clear signal to the marketplace and has the potential to change expectations.

The Government of Saskatchewan must eliminate the expectation within our business community that our tax structure will be non-competitive on all fronts and reactive. This negative expectation within the Saskatchewan business community is negatively influencing investment. Much was said to the issue of negative attitudes both in the provincial governments *Partnership for Prosperity* and the Saskatchewan Chamber of Commerce *Action Saskatchewan*. Attitudes are based on perceptions and perceptions for people will only change when there are clear signals shown by government.

1.2 *Measuring the Cost of Exodus*

$113 million in foregone personal and sales tax revenue due to the exodus

$27,213,600[1]. The estimated amount of personal income tax revenue lost because of the exodus of 5,916 people in 1999. The net present value of this future perpetual cash stream is calculated at $113 million in personal and sales tax revenues using a discount rate of eight percent (Appendix A). This lost revenue could have been used for improved health care, highway maintenance, or any number of other programs.

[1] Does not take into account the savings including healthcare and other government services that are no longer being used nor does it account for property taxes paid. It also does not measure the loss of economic activity attached to a lower population base, investment attributed or the taxes derived therefrom.

2.0 Saskatchewan and the Other Canadian Provinces

Saskatchewan must have a competitive taxation policy if there is any desire to attract businesses

Is Saskatchewan's taxation policy competitive with the rest of Canada as well as the rest of the world? It would seem that the answer has to be yes if there is any desire to attract businesses and retain the ones currently established here. In many instances the answer is no, Saskatchewan is not competitive when compared to other provincial jurisdictions.

Saskatchewan's general tax rate for corporations of 17% is tied with Manitoba and New Brunswick for the highest rate in Canada. While Saskatchewan is at 17%, Ontario has plans to reduce their corporate tax rate from 14.5% to 8% by 2006.

On the small business side, as of January 1, 2001, British Colombia sits at 4.5% down from 4.75% in 2000 and 5.5% in 1999. Alberta released plans in September 2000 to reduce small business tax to 5% in 2001, 4% for 2002, and 3% for 2003. The small business threshold will also increase to $300,000 for 2001 and to $400,000 for 2002.

While Saskatchewan has announced a move from 8% to 6% in 2001 as well as an increase in the income threshold from $200,000 to $300,000, the efforts do not reflect the reality of the competitive situation Saskatchewan now faces. These changes are, once again, reactionary. An opportunity was missed to take a proactive role and force other districts to "play defense". A move to 0% for small businesses with an income level of $400,000 would certainly send a stronger statement to business rather than business owners seeing Saskatchewan falling short of Alberta and British Colombia's lead.

3.0 Rational Expectations and Market Signals

3.1 *The Economic Impact of Government Policy*

It is the goal of every government to grow the economy and improve the quality of life for the people they represent through enriched opportunities to build a career in their field. Government policy is intended to develop a climate that promotes a stronger and more diversified economy, thus creating jobs and meaningful employment opportunities. The policy decisions made by government have the potential to directly influence the behavior of investors, employers and employees.

3.2 *The Theory of Rational Expectations*

The behavior of taxpayers can be explained using the theory of "rational expectations." This economic concept assumes that people take into account all available information that influences the outcome of their decisions, that they utilize this information intelligently, and therefore that they do not systematically make mistakes.[2] The term "systematically" means that since people will learn from past mistakes and experience, on average they cannot be consistently fooled. Taxpayers will not consistently pay a premium to a given government. Taxpayers observe the products and services made available to them by government. The tax collected by government is the price paid for these products and services. If taxpayers are rational, they will make price comparisons. If other jurisdictions are selling the same products and services, taxpayers will expect prices to be identical, all else being equal. If there are price discrepancies, taxpayers will shop elsewhere and relocation will take place.

Wealth exodus occurs because individuals are making economically intelligent decisions

Wealth exodus occurs because individuals are making economically intelligent decisions. The risk of wealth exodus becomes dangerously high when other jurisdictions start offering “more” for “less”.

[2] “Rational Expectations”

4.0 The Tools Available to Government

The two primary tools used by federal government include monetary and fiscal policy. At the provincial level, government makes fiscal decisions. Given this constitutional framework, the provincial government is required to make decisions with respect to taxation and spending. Every year the Government of Saskatchewan determines who will pay the tax. After defining the taxpayer, the government must estimate the amount of revenue that the taxes will raise. Finally, fiscal responsibility requires the government to ensure that this revenue is greater than or equal to the amount required to support government programs and services. This process is inherently inefficient due to the frictional loss impact and distortions associated with the collection of taxes.[3] Studies, which examine the costs of delivering social programs, indicate that spending one tax dollar may in fact bear a cost to society of 20% to 50%.[4] In other words, frictional loss suggests that for each dollar spent, less than a dollar actually benefits the targeted stakeholder. The converse observation is if government needs $100M to fund social programs, they must raise between $120Million and $150Million in tax revenues to offset frictional losses.

For each untaxed dollar left in the hands of the taxpayer, more than a dollar will be returned to the economy as a result of the multiplier effect.

Tax cuts on the other hand, as a measure of pure stimulus, are too often ignored as a policy instrument available to public administrators. For each untaxed dollar left in the hands of the taxpayer, more than a dollar will be returned to the economy as a result of the multiplier effect. The decision to cut tax levels will fuel the economy and generate more wealth. Tax cuts offer greater disposable income and increased opportunities for investment.

[3] Harberger, Arnold C. "On the Use if Distributional Weights in Social Cost-Benefit Analysis." Journal of Political Econ. 86(1978): S87-S120.

[4] Alston, J.M. and Hurd B.H. "Some Neglected Social Costs of Government Spending in Farm Program." Amer. Journal of Agric. Econ. Feb. (1990): 149-155.

5.0 How Can We Create Jobs for Saskatchewan People?

If our province is to prosper in the 'new' economy, government must be business and investment friendly.

By enabling investors and employers to make more money, the Government of Saskatchewan can help create jobs. Entrepreneurs will hire more employees and invest in productive assets in order to increase productivity. Tax relief for investors and employers will send a positive signal to the people of Saskatchewan. If our province is to prosper in the "new" economy, government must be business and investment friendly. As knowledge and vocational options become more readily available in the knowledge based economy of the future, government policy must be more than just partially reactive to change the rational expectation of business investors toward Saskatchewan.

At the same time, the government of Saskatchewan needs revenues to fund an array of publicly funded services. The Saskatoon and District Chamber of Commerce submits, that the most cost-effective method of growing our economy requires the elimination of small business income taxes in Saskatchewan. Eliminating the small business income tax will send a strong signal that the Government of Saskatchewan supports small business growth. Other jurisdictions, including British Columbia, understand the importance of retaining and growing the number of small businesses and are already proposing inducements that are superior to our current tax structure. The findings of the Government of British Columbia are published in the Small Business Profile[5].

[5] http://www.bcstats.gov.bc.ca/data/bus%5Fstat/sm%5Fbus/sbp2000.pdf

6.0 Eliminating Small Business Income Tax

6.1 *Background on Corporate Income Tax in Canada*

In 1950, corporate income tax accounted for 21.4% of total government revenue, nationally. In 1995, it made up only 5.9%. At first glance, these figures might suggest that businesses have received their fair share of tax breaks over the past fifty years. However, one should consider that in 1995, Canadian businesses paid taxes to the three levels of government, municipal, provincial, and federal. Each level taxes the corporation and, while the revenue generated at the federal level may make up only 5.9%, the corporation also has tax going to the provincial and municipal governments.

In Saskatchewan in 1976, corporate income tax accounted for 5.15% of total government revenue. In 2000, corporate income tax accounted for 4.73% of total Saskatchewan government revenues while it was budgeted to make up only 3.46%.

6.2 *Corporate Income Taxes: An Unstable Source of Revenue*

When taxes are levied against a corporation, the burden falls on the shoulders of the shareholders, the employees and customers.

A corporation means a body corporate incorporated or continued under the Canada Business Corporations Act and not discontinued under this Act. By definition, a corporation is a separate and distinct entity that shall have the right to sue and shall be subject to be sued, in all courts, in like cases as natural persons. However, a corporation is not a person. With respect to taxes, reference to a corporation is in fact a reference to the owners and employees. When taxes are levied against a corporation, the burden falls on the shoulders of the shareholders, the employees and customers. These individuals are taxed at the federal, provincial and municipal levels and pay tax on earned income (i.e. wages, pensions, dividends, or interest from businesses) and on spending (i.e. consumption taxes on goods produced by businesses).

Approximately 22% of the taxes paid by Canadian businesses are profit sensitive with the remaining 78% comprised of capital taxes, property taxes, sales taxes, and other fees, which must be paid regardless of profit[6]. In various instances, corporations enjoy the same public services as individuals. Therefore, corporations should pay a certain level of profit insensitive taxes, as a rental cost for these benefits, such as roads, utilities, and protective services. However, in respect to income taxes, the same logic does not apply. As illustrated previously, a business must have cash flow and earnings if it is to remain a going concern. Businesses must have cash flow to pay employees, pay suppliers, repay bank loans and replace capital assets. Cash is also required to declare dividends and to finance

[6] "In Support of a Zero Corporate Tax Rate" by Rick Martinson, BCom, CA www.hillandpartners.com

growth. Governments collect taxes on services and on business profits. Government also levies payroll taxes, personal income taxes, sales taxes, and capital taxes on the remainder.

The Saskatchewan Government would benefit from increased personal income taxes, and increased sales tax revenue.

If the Saskatchewan Government eliminated income tax on small business profits, these enterprises would have more cash to invest in productive activities. The Saskatchewan Government would benefit from increased personal income taxes, and increased sales tax revenue. The overall increase in tax revenue will, we submit, exceed the foregone business income tax revenue over time. Furthermore, tax loss provisions outlined in the Income Tax Act, allow corporations to carry losses forward for a seven-year period or backward for a three-year period. This results in a contingent liability and leaves government responsible to return tax revenue previously collected. In the face of an economic downturn, many businesses may utilize the carry back rules and will therefore be entitled to a tax refund. This contingent liability can ultimately cause government to run a deficit.

What if corporations save instead of spend their income tax savings?

7.0 Working Capital: Fostering Employment Growth

7.1 *What is Working Capital?*

Every small business needs cash to finance their day-to-day activities. These businesses have to pay bills, pay for raw materials, pay wages, and so on. This money available to the small business is referred to as the working capital of the business. The cash adequacy of a business, to meet obligations as they come due is the central concern when analyzing liquidity. Other short-term assets (current assets) are used to generate cash and/or can be quickly converted into cash, thus increasing liquidity. However, because the business is likely to have short-term obligations (current liabilities) outstanding, the actual working capital available is the net of the short-term assets and liabilities (net current assets).

7.2 *Working Capital: The Lifeblood of Small Business*

> Working capital is vital to a small business and therefore it must be managed carefully.

Working capital is vital to a small business and therefore it must be managed carefully.

Between each stage of the cycle, there is a time delay. As cash decreases during the production stage, it is expected to increase as the product is sold. For some businesses this time delay will be very long as it takes a long time to make and sell the product. The implication of this can be summarized as follows, the longer this time delay, the more working capital required.

> A decrease in the ability to fund marketing, research, and training costs results in a decrease in the growth rate of the business

The concept of working capital is linked to job creation and this relationship can be pinpointed in stage (ii) of the cycle (Appendix C). In stage (ii), cash payments are made to workers, suppliers, and creditors. It is important to become conscious of the actual parties involved in these transactions. Specifically, when government acts as a creditor through the levying and collecting of small business income tax, this erodes the working capital available to that business. As a result, the pressure on working capital caused by an increase in creditor obligations from the corporate income taxes forces employers to reduce their input costs or investments by slowing their investment in the business. This affects the business' capacity to increase its investment in inventory, equipment, marketing activities, research and development, or staff training. A decrease in the ability to fund these previous activities results in a decrease in the growth rate of the business.

Discounting this argument suggests a lack of understanding with respect to the working capital cycle. The demand for positive working capital is very real. Many businesses have gone under, not because they were unprofitable but because they suffered from working capital shortages. In addition, cash allocated to labour, supplies, and capital is expected to generate a return on investment. This investment may or may not stimulate positive returns for the business. However, this investment is made in an effort to successfully profit through providing customers with goods and/or services demanded that will in turn fuel additional growth and profits. In contrast, cash to be paid in taxes does not yield any return on investment to the business. Corporate income taxes are negatively linked to job creation as they restrict the working capital of the business. This is most particularly aggravated in the case of small businesses where their only source of additional equity to finance growth is their annual profits net of taxes. The limited equity resources of a small business mean that income taxes on their business more adversely affect the growth capacity as contrasted to larger businesses with a wider array of equity and debt instruments available.

7.3 More Working Capital Means More Working People

Cash used to pay taxes has a negative relationship to job creation

In 1999, small business income tax revenue generated by the Government of Saskatchewan was approximately valued at $70 million. This tax revenue is a direct drain of cash flow that could be allocated toward assets that generate positive return and increased sales. With job creation as a function of increased sales, this tax relief has the potential to immediately create real jobs for Saskatchewan people. Cash used to pay taxes has a negative relationship to job creation and no direct or immediate return to businesses that are responsible for paying such taxes.

7.4 *Incremental Jobs and a Younger Demographic Profile for Saskatchewan*

The province will attract a younger sector of the population with more young people staying at home in Saskatchewan

Eliminating the small business income tax rate would increase Saskatchewan's competitiveness. Saskatchewan people would benefit through increased jobs, higher wages, increased economic activity, and greater incentive to in start-up and emerging industries. In addition, with increased activity in this sector of the economy the demographic profile of Saskatchewan is likely to change significantly. The province will attract a younger sector of the population with more young people staying at home in Saskatchewan. Growth in this segment of the population would result in greater consumption (increased sales tax revenue), more vehicles (increased fuel tax revenue), and greater investment in housing (increased property tax revenue). As well, a growing population base would further stimulate more economic activity and in turn grow short-term tax revenues through consumption taxes and incremental personal income taxes paid by an expanding workforce.

7.5 *Delayed But Not Forgone*

Eliminating small business income tax means tax revenue may be delayed but will not be forgone. The small business which chooses to retain all earnings to invest and grow the business will generate a later but larger tax revenue stream with the taxes accruing to the shareholders. This is particularly true of small closely held small businesses where taxes on dissolution will accrue to the local shareholders.

8.0 Recommendations:

8.1 *The Finance Department of the Government of Saskatchewan should investigate potential strategic responses to competing tax jurisdictions. The Saskatoon and District Chamber of Commerce proposes eliminating small business income taxes as just such a strategic response.*

8.2 *The Government of Saskatchewan must announce a business tax strategy that will be perceived in a positive manner by investors and business owners to deal with rational expectations and alter provincial attitudes. In the longer term, businesses that choose to payout dividends expose their shareholders to personal income taxes thereby ensuring that taxes are not foregone, but are only delayed by this strategy.*

8.3 The Government of Saskatchewan must eliminate expectational disinvestment. This can only be achieved if investors, employers and employees are clear as to the consistent approach to policy that will be engaged by the government. This requires a real commitment shown by government through reducing small business taxation to build a positive investment climate.

APPENDIX A

In 1999, the Government of Saskatchewan levied $2.1 billion in personal income taxes and provincial sales taxes[7]. For the same year, Statistics Canada reported Saskatchewan inter-provincial out migration of 5,916 people. Calculating the average personal income tax load and provincial sales tax load carried by the average Saskatchewan taxpayer, the Chamber estimates this figure to be $4,600, using a base of 457,600 taxpayers. This number of taxpayers is the actual number of individuals whom paid personal income tax in 1998 (most recent) out of 707,000 individuals filing, as reported by the Government of Saskatchewan, Finance Department. We use this figure as a proxy for the number of individuals likely to have paid tax in 1999.

If this average tax load figure of $4,600 is multiplied by the number of people that actually left Saskatchewan in 1999, the cost of exodus for 1999 is equal to $27,213,600. Assuming that every individual whom left Saskatchewan was in fact an average taxpayer. If just one-third of the individuals whom left Saskatchewan were taxpayers, which the Chamber believes is a conservative estimate, then the cost of exodus for 1999 is equal to $9,071,200 in annually foregone provincial personal income tax and sales tax revenue as a result of the exodus.

This annual cost of exodus can be expressed on a net present value basis using a discount rate of eight per cent. This figure is calculated at $113 million, which is today's valuation of the future perpetual cash stream on an annualized basis that would be generated in provincial personal income tax and sales tax revenues.

Nominally, (i.e. without discounting) this figure checks in at closer to $272 million over a thirty-year period. Regardless, of the variables used to arrive at a final figure, the point is that every year Saskatchewan loses people, the province's ability to fund social programs, now and in the future, is jeopardized.

The model representing the cost of exodus does not take into account property tax revenue forgone, assuming even one of the taxpayers owned taxable land, which would further increase the tax loss cost of losing each additional taxpayer and further erodes the addition of government services in the areas of education, roads, recreation, policing and fire protection. This figure is also based on tax base alone and ignores the negative economic multiplier from the economic activity that these former residents would have generated within the Saskatchewan economy.

[7] Includes $1,448,043,000 in personal income tax and $742,846,000 in provincial sales tax revenues.

APPENDIX B

How Does Saskatchewan Measure Up?

Is Saskatchewan's taxation policy competitive with the rest of Canada as well as recent trends around the world? In many instances, Saskatchewan is not competitive when compared to other provincial jurisdictions. The following information is drawn directly from the Alberta Business Tax review. While tax comparisons are sometimes difficult to make because of the variety of factors and detailed provisions involved, the next section illustrates a few key points about Saskatchewan's competitive readiness.

Corporate Income Tax

On the corporate income tax side, Saskatchewan's general tax rate of 17% is tied with Manitoba and New Brunswick for the highest rate in Canada. Ontario is leading the country with plans to reduce their corporate income tax rate from 14.5% to 8% by 2006.

Small Business Tax

Saskatchewan's small business tax rate of 8% is the second highest in Canada with Quebec having the only higher rate at 9.04%. However, Quebec's general rate is considerably lower as this same rate applies to all businesses, regardless of size. As of July 1, 2000, British Columbia had the lowest rate at 4.75%, followed by Nova Scotia, Newfoundland, and Manitoba at 5%. Most recently, Alberta has proposed that they will move to a 3% rate and will increase the income limit from $200,000 to $400,000. Pressure to move with respect to small business tax is coming from all neighboring jurisdictions.

Manufacturing and Processing

Saskatchewan's manufacturing and processing rate compares well with most other provinces. Saskatchewan has a rate of 17%, but reduces that rate to 10% as the share of a corporation's national manufacturing and processing income allocated to Saskatchewan increases. Additionally, one-half of Canadian provinces do not have a separate rate for manufacturing and processing. However, Alberta's rate is 14.5% with plans to move to an 8% rate. Ontario has also announced plans to move to an 8% rate, once again forcing Saskatchewan to play catch up.

Capital Taxation

Saskatchewan levies the second highest general capital tax rate in Canada. The general rate is 0.60% and the rate on financial institutions is 3.25%. Alberta does not administer a general capital tax, nor does Prince Edward Island and Newfoundland. Capital taxes are a disincentive for investment. Therefore, the Chamber does not support such a tax. Furthermore, given that Alberta is our most significant competitor, the fact that there is no such tax is alarming for Saskatchewan. To make matters worse, Alberta has plans to remove the deductibility of capital taxes payable in other provinces. This means that Alberta will no longer subsidize capital taxes payable in Saskatchewan, which ultimately will give any Alberta businesses with "out of province" operations, an incentive to return investment to the Alberta economy rather than investing elsewhere. Alberta also plans to eliminate the capital tax on financial institutions.

Provincial Sales Taxes
Saskatchewan's provincial sales tax is the second lowest in Canada at a rate of 6%. Alberta does not charge a provincial sales tax.

Province	GST / HST Rate	PST Rate	Combined Rate
Alberta	7%	0%	7%
British Colombia	7%	7%	14%
Saskatchewan	7%	6%	13%
Manitoba	7%	7%	14%
Ontario	7%	8%	15%
Quebec	7%	7.5%*	15.025%*
New Brunswick	15%	0%	15%
Newfoundland	15%	0%	15%
Northwest Territories	7%	0%	7%
Nova Scotia	15%	0%	15%
Nunavut	7%	0%	7%
Prince Edward Island	7%	10%*	17.7%*
Yukon	7%	0%	7%

* In Quebec and Prince Edward Island only, the GST is included in the provincial tax base.

APPENDIX C

The working capital cycle in its simplest form consists of the following four stages:

1. Cash; (injections and withdrawals)
2. Cash Payments; (to workers, suppliers, creditors)
3. Goods Produced – (negatively related to cash)
4. Goods Sold – (positively related to cash)

APPENDIX E

Supporting Documents

Supporting Documents

General Revenue Fund Financial Statements from 1999-2000 and 1975-76

KPMG Canadian Tax Letter, November 2000
http://www.kpmg.ca/english/services/docs/tax/ctl/ctl00113.pdf

British Columbia Small Business Profile 2000
http://www.bcstats.gov.bc.ca/data/bus%5Fstat/sm%5Fbus/sbp2000.pdf

Schedule of Revenue and Fiscal Stabilization Fund – March 2001

For additional information, or comments regarding this document, please contact:

Matt McMillan
Research and Policy Development
Saskatoon and District Chamber of Commerce
345 Third Avenue South
Saskatoon, SK S7K 1M6
Tel: (306) 244-2151
Fax: (306) 244-8366
Email: chamber@eboardoftrade.com