

## **CANADA'S 2010 TAX COMPETITIVENESS RANKING: Moving to the Average but Biased Against Services**

by Duanjie Chen and Jack Mintz

### **SUMMARY**

For the first time since 1975 (the year Canada's marginal effective tax rates were first measured), Canada has become the most tax-competitive country among G-7 states with respect to taxation of capital investment. Even more remarkably, Canada accomplished this feat within a mere six years, having previously been the least tax-competitive G-7 member. Even in comparison to strongly growing emerging economies, Canada's 2010 marginal effective tax rate on capital is still above average.

The planned reductions in federal and provincial corporate taxes by 2013 will reduce Canada's effective tax rate on new investments to 18.4 percent, below the Organization for Economic Co-operation and Development (OECD) 2010 average and close to the average of the 50 non-OECD countries studied. This remarkable change in Canada's tax competitiveness must be maintained in the coming years, as countries are continually reducing their business taxation despite the recent fiscal pressures arising from the 2008-9 downturn in the world economy. Many countries have forged ahead with significant reforms designed to increase tax competitiveness and improve tax neutrality including Greece, Israel, Japan, New Zealand, Taiwan and the United Kingdom.

The continuing bias in Canada's corporate income tax structure favouring manufacturing and processing business warrants close scrutiny. Measured by the difference between the marginal effective tax rate on capital between manufacturing and the broad range of service sectors, Canada has the greatest gap in tax burdens between manufacturing and services among OECD countries. Surprisingly, preferential tax treatment (such as fast write-off and investment tax credits) favouring only manufacturing and processing activities has become the norm in Canada, although it does not exist in most developed economies.

## INTRODUCTION

In 2010, Canada stood out on the global stage for the “good policies and regulations it has undertaken over the past two decades.”<sup>1</sup> Among these policies, a decade-long tax reform bore the most measurable fruit in 2010; for the first time since 1975 (the year Canada’s marginal effective tax rates were first measured<sup>2</sup>), Canada became the most tax-competitive country among G-7 states with respect to taxation of capital investment. Even more remarkably, Canada accomplished this feat within a mere six years, having previously been the least competitive G-7 country in taxing capital investment. More specifically, Canada’s marginal effective tax rate on capital investment almost halved, coming down to 20.5 percent in 2010 from 39 percent in 2005. The corresponding G-7 average is 28.2 percent in 2010 (versus 33.6 percent in 2005) while those of the OECD and the 83 countries covered in our study are 18.6 percent and 17.7 percent respectively (versus 22 percent and 20.4 percent in 2005). Accordingly, Canada’s ranking in business tax competitiveness has moved up 12 ranks among the 33 OECD member countries and 24 among all 83 nations we examined.

As we reported earlier<sup>3</sup>, the planned reductions in federal and provincial corporate taxes by 2013 will reduce Canada’s effective tax rate on new investments to 18.4 percent, which will move below the 2010 OECD average and close to the average of all 83 studied countries. This remarkable change in Canada’s tax competitiveness from one of the worst to a near-average position must be maintained in the coming years as countries are continually reducing their business taxation despite the recent fiscal pressures arising from the 2008-9 downturn in the world economy.

For instance, the Japanese government announced a five-point reduction in corporate income tax for April 1 along with a major reform of its corporate tax on foreign earnings of Japanese companies. Should Japan proceed, the United States will have the highest corporate income tax rate among OECD countries. The United Kingdom announced it will reduce its corporate income tax rate by a further four points to 24 percent by 2014 (tax revenues losses have been booked in the Exchequer’s budget), even below the 25.6 percent rate that is legislated by Canada by 2012. Australia is also reducing its corporate tax rate by one point from 30 to 29 percent. Other countries – the Czech Republic, Ecuador, Indonesia, Israel, Singapore and Slovenia – are also continuing to reduce their corporate income tax rates.

On the other hand, as the economic recovery remains weak and government budget deficits explode, tax competitiveness has become a lesser concern in some countries. Several (i.e., Mexico and Portugal) even raised their company income tax rates in 2010 as a result of concerns about revenues. By and large however, increases in personal income and consumption taxes, rather than corporate taxes, have been preferred by most countries to address revenue concerns.

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<sup>1</sup> Wendy Dobson and Diana Kuzmanovic, 2010, “Differentiating Canada: The Future of the Canada-US Relationship,” SPP Research Papers, Vol 3, Issue 7, November 2010.

<sup>2</sup> McKenzie, Kenneth J., and Jack M. Mintz, 1992, “Tax Effects on the Cost of Capital,” in Canada-U.S. Tax Comparisons, NBER, The University of Chicago Press.

<sup>3</sup> Duanjie Chen and Jack Mintz, “Federal-Provincial Business Tax Reforms: A Growth Agenda with Competitive Rates and Neutral Treatment of Business Activities,” SPP Research Papers, Volume 4, Issue 1, School of Public Policy, University of Calgary, January 2011.

Some countries have forged ahead with significant reforms designed to increase tax competitiveness. For example, New Zealand brought out its most comprehensive tax reform in 25 years, including rate-reduction and base-broadening measures that improve neutrality (although the effective tax rate does increase)<sup>4</sup>. Taiwan cut its corporate income tax rate twice in 2010 from the previous 25 percent to the current 17 percent, joining ranks with the most tax-competitive economies in Asia (i.e., Hong Kong and Singapore). Greece, under unprecedented fiscal pressure, will stick to the previously planned reduction in its corporate income tax rate from 25 percent to 20 percent by 2014. France also reformed its local business tax and slightly reduced the maximum rate for this tax. All these reforms have set the bar higher in tax competitiveness for capital investment, leaving Canada no reason to be complacent about its accomplishments in business tax reform.

Moreover, the stubborn bias in Canada's corporate income tax structure favouring manufacturing and processing business warrants close scrutiny. Measured by the difference between the marginal effective tax rate on capital (METR) between manufacturing and the broad range of service sectors, Canada has the greatest tax gap between manufacturing and services among OECD countries. Our preliminary analysis suggests that METRs, among other economic variables, do significantly impact foreign direct investment flows and therefore are meaningful to economies like Canada.<sup>5</sup> Surprisingly, preferential tax treatment (such as fast write-off and investment tax credit) favouring only manufacturing and processing activities has become the norm in Canada, although it does not exist in most developed economies.

Equally alarming is the renewed debate on the merit of reducing the corporate income tax in light of the current wave of financial crises and government deficits. In Canada, the opposition parties have objected to the corporate income tax rate reductions, arguing that revenues from higher corporate tax rates should be used for other priorities. However, the Irish government successfully struggled, in its bailout negotiations with the European Union and International Monetary Fund (IMF), to preserve its famously low corporate income tax rate of 12.5 percent and we believe that, even during an economic downturn, a sound and sustainable tax policy is superior to any short-term stimulus produced through temporary tax subsidies that simply borrow from future planned investments.

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<sup>4</sup> Tax Notes International, "New Zealand: 2010 Budget Brings Biggest Tax Changes in 25 Years," June 7, 2010.

<sup>5</sup> Using statistical analysis, we have examined whether our measured effective tax rates have an effect on foreign direct investment flows among countries during 2005-2008. Taking into account other factors that influence investment (inflation, political risk, GDP per capita, trade protection, human development and the exchange rate), we have found that a one percentage point increase in the effective tax rate on new investment causes foreign direct investment flows as a share of GDP to decline between 0.05 to 0.08 percentage points. Given that the mean average of foreign direct investment to GDP is about 5.2 percent, this reduction is substantial. A preliminary analysis is provided in M. Krzepkowski, J. Mintz and J-F Wen, mimeograph, University of Calgary, 2010.

## WHY IS REDUCING THE CORPORATE INCOME TAX RATE PREFERABLE TO KEEPING IT HIGH?

A decade-long business tax reform in Canada reduced our combined federal and provincial corporate income tax rate from 43 percent in 2000 to 29 percent in 2010. After the latest 1.5-percentage point rate reduction, the federal government's plan is to further reduce the federal corporate income tax rate by another 1.5 percentage points which, combined with provincial cuts, is expected to bring down the combined corporate income tax rate to close to 25 percent by 2012. Since this tax rate reduction for large and medium-sized corporations was initiated and implemented by the previous Liberal government and advanced by the current Conservative government, there has clearly been a strong political consensus that reducing the corporate income tax rate is good for the economy and public finances. However, a recession-induced government deficit has unfortunately become a rationale for arguments in favour of shelving the unfinished income tax rate reduction for business.

Such a break from the previous consensus goes against not only established economic wisdom but also recent findings, both of which support taxing corporate income as lightly as possible (albeit on a tax base as broad as possible, which is a strategy we shall discuss subsequently). It also creates political uncertainty, hurting prospects for economic growth and Canada's well-earned reputation as a country that welcomes investment and jobs.

Taxing corporate income is justified essentially as an administrative means of reinforcing the personal income tax system, taxing business income accruing to non-residents on Canadian operations and serving as a quasi-user fee for public services of direct benefit to businesses<sup>6</sup>. That is, corporate income taxation serves mainly as an administrative tool to reinforce revenue collection from the various stakeholders in corporations.

Considering the efficiency characteristics of all taxes, income (and capital-based) taxes on corporations have the greatest negative effects on the allocation of capital investment and business operations which directly link to job creation, economic growth and revenue collection by government. In other words, among the major tax categories (including income-based, consumption-based and property-based taxes), corporate income taxes are the most distortive and hence the most harmful type of tax for economic growth<sup>7</sup>. Furthermore, when viewing tax incidence in a small open economy like Canada, "the much greater mobility of capital than labour means that a significant part of corporate income tax is borne by domestic workers."<sup>8</sup> Therefore, taxing corporate income at a rate higher than the international norm (i.e., around 25 percent) will ultimately harm overall revenue collection by driving away mobile capital investment from Canada, negatively impacting employment.

<sup>6</sup> Report of the Technical Committee on Business Taxation, December 1997, available at [http://www.fin.gc.ca/toc/1998/brie\\_-eng.asp](http://www.fin.gc.ca/toc/1998/brie_-eng.asp) page 2.8.

<sup>7</sup> OECD (03 Nov 2010), *Tax Policy Reform and Economic Growth*, "Executive Summary," page 10. <http://www.oecd.org/dataoecd/34/49/46617652.pdf>.

<sup>8</sup> OECD (December 2010), *Tax Policy Brief: Tax Policy Reform and Fiscal Consolidation*, page 2. <http://www.oecd.org/dataoecd/28/12/46600079.pdf>. Also see Institute for Fiscal Studies, 2010, *Tax by Design: The Mirrlees Review* ([www.ifs.org.uk/mirrleesReview](http://www.ifs.org.uk/mirrleesReview)) for more detailed analysis.

Given the direct revenue impact of the corporate income tax rate, it has been proven that a tax rate higher than the international norm, which is around 25 percent, tends to reduce the domestic tax base through income-shifting means such as transfer pricing within multinational companies. Such income shifting prevents tax revenue from growing in tandem with the tax rate. Since Canada's 2010 corporate income tax rate is still higher than the international norm, we should not expect that keeping our corporate income tax rate at 29 percent in 2010 (28 percent after the latest federal rate reduction in 2011) would necessarily bring in more revenue<sup>9</sup>.

In light of the above arguments, we believe that sticking to the existing government plan to lower our corporate tax rate to close to 25 percent is crucial to growing our economy and balancing our budget. When there is an apparent conflict between gaining tax competitiveness and balancing the budget, it is helpful to focus on the effects of taxes on long-term economic growth and to think globally. Thus, lowering the corporate income tax rate to boost capital investment is good for long-term economic growth, which in turn provides assurance for revenue collection that helps balance the budget.

## THE MOVING AVERAGE OF TAX COMPETITIVENESS: AN UPDATE FOR 2010

In our previous report, we assembled a table<sup>10</sup> showing the moving average of tax competitiveness among various groups of countries around the world and Canada's corresponding rankings for the consecutive years from 2005 to 2009. We updated this table to 2010, as Table 1 in the current report. In addition to incorporating tax changes made by some countries for 2010, we also updated some non-tax data including real interest rates, capital weights by industry and asset type and country-specific inflation rates. As a result, not only are the data for 2010 different from 2009, but some numbers for pre-2010 years have changed slightly from those in our previous report. The OECD expansion from 30 countries to 34<sup>11</sup> and the expansion of our complete list of countries studied from 80 to 83 also affect the group averages for the pre-2010 years.

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<sup>9</sup> See, for example, Kimberly Clausing, "Corporate Tax Revenues in OECD Countries," *International Tax and Public Finance* 14 (2, 2007): 115-134; Jack Mintz, "2007 Tax Competitiveness Report: A Call for Comprehensive Tax Reform," *C.D. Howe Institute Commentary* 254 (Toronto: C.D. Howe Institute, September 2007); and Alex Brill, "Corporate Tax Rates: Receipts and Distortions," *Tax Notes*, 22 December, 2008.

<sup>10</sup> Chen, Duanjie and Jack Mintz, 2010, "Canada's Tax Competitiveness After a Decade of Reforms: Still an Unfinished Plan," *SPP Briefing Papers*, Volume 3, Issue 5, May 2010, Table 2.

<sup>11</sup> The latest addition is Estonia, which will be included in our future study of tax competitiveness.

**TABLE 1: Marginal Effective Tax Rate on Capital Investment, Various Country Groups, 2005 - 2010<sup>a</sup>**

	Marginal Effective Tax Rate						Statutory Company Income Tax Rate			
	2010	2009	2008	2007	2006	2005	2010	2005	Change in % points <sup>b</sup>	# of countries that cut general corporate tax rates
Canada	20.5	28.0	28.9	31.6	36.2	39.0	29.3	34.3	- 5.0	n/a
G-7	28.2	29.5	29.6	32.3	33.1	33.6	32.4	36.3	- 3.9	5
OECD (33)	18.6	18.9	19.1	20.1	20.6	22.0	25.7	28.4	- 2.7	21
BRIC	29.3	29.3	36.9	36.9	36.8	38.1	28.2	29.4	-1.2	2
Non-OECD (50)	17.0	17.3	18.2	18.5	18.8	19.3	25.5	27.8	-2.3	20
<b>ALL 83 COUNTRIES</b>	<b>17.7</b>	<b>17.9</b>	<b>18.6</b>	<b>19.2</b>	<b>19.5</b>	<b>20.4</b>	25.6	28.1	-2.5	43
<b>Canada's ranking by METR within various groups of countries, in descending order</b>										
G7	7	4	4	5	1	1				
OECD	13	5	5	7	1	1				
<b>ALL 83 COUNTRIES</b>	<b>28</b>	<b>10</b>	<b>12</b>	<b>13</b>	<b>4</b>	<b>4</b>				

NOTES: Canada's marginal effective tax rate on capital in 2013 will be 18.4 percent.

- a. The pre-2010 numbers may differ from our previous report mainly because of our expansion of OECD countries (from 30 to 33 countries) and our total country coverage (from 80 to 83 countries). Our switch from other sources to the OECD tax database for the statutory company income tax rates and updating non-tax parameters also made a difference to the calculations.
- b. Numbers may not add up due to rounding.

As summarized in Table 1 and detailed in Tables 2 and 3, Canada has had the third-fastest pace in advancing its ranking in tax competitiveness among the various groups of countries reviewed in this report<sup>12</sup>. Within the period 2005-10, Canada's overall METR dropped by nearly half from 39 to 20.5 percent, which was mainly attributable to corporate income tax reduction, provincial sales tax harmonization with the GST in Ontario and British Columbia and the almost complete elimination of capital taxes<sup>13</sup>.

<sup>12</sup> The largest change in ranking is Belgium followed by China. However, the speedy METR drop in these two countries is not related to any statutory tax rate reduction but to the notional interest deduction introduced in Belgium for equity financing and the sales tax reform instituted in China that eliminated VAT on machinery purchases.

<sup>13</sup> Duanjie Chen and Jack Mintz, "Federal-Provincial Business Tax Reforms: A Growth Agenda with Competitive Rates and Neutral Treatment of Business Activities," SPP Research Papers, Volume 4, Issue 1, School of Public Policy, University of Calgary, January 2011.

**TABLE 2: Marginal Effective Tax Rate on Capital Investment, OECD Countries, 2005 - 2010**

	Marginal Effective Tax Rate						Reference: Statutory Company Income Tax Rate		
	2010	2009	2008	2007	2006	2005	2010	2005	Change in % points
US	34.6	35.0	35.0	35.0	35.3	35.3	38.2	39.0	-0.8
France	34.0	35.1	35.1	35.1	35.1	35.4	34.4	34.9	-0.5
Japan	29.5	29.5	29.5	29.5	29.5	29.5	39.5	39.5	0.0
Korea	29.5	29.5	32.2	32.2	32.2	32.2	24.2	27.5	-3.3
UK	27.9	27.9	27.9	29.4	29.4	29.4	28.0	30.0	-2.0
Italy	26.9	26.9	26.9	32.1	32.1	32.1	27.5	37.3	-9.8
Australia	26.0	26.0	26.0	26.0	26.0	26.0	30.0	30.0	0.0
Spain	25.4	25.4	25.4	27.5	29.6	29.6	30.0	35.0	-5.0
Austria	25.3	25.3	25.3	25.3	25.3	25.3	25.0	25.0	0.0
Norway	24.7	24.7	24.7	24.7	24.7	24.7	28.0	28.0	0.0
Germany	23.8	23.8	23.8	33.1	33.1	33.1	30.2	38.9	-8.7
Portugal	20.8	18.8	18.8	18.8	19.6	19.6	29.0	27.5	1.5
Canada	20.5	28.0	28.9	31.6	36.2	39.0	29.3	34.3	-5.0
Sweden	18.9	18.9	20.3	20.3	20.3	20.3	26.3	28.0	-1.7
Denmark	18.5	18.5	18.5	18.5	21.0	21.0	25.0	30.0	-5.0
Finland	18.3	18.3	18.3	18.3	18.3	18.3	26.0	26.0	0.0
Switzerland	17.6	17.6	17.6	18.1	18.1	18.1	21.2	21.3	-0.1
New Zealand	17.6	17.6	17.6	19.8	19.8	19.8	30.0	33.0	-3.0
Mexico	17.5	16.1	16.1	16.1	16.8	17.5	30.0	30.0	0.0
Netherlands	16.8	16.8	16.8	16.8	19.9	21.4	25.5	31.5	-6.0
Luxembourg	16.8	16.8	18.4	19.3	19.3	19.8	28.6	30.4	-1.8
Hungary	15.9	16.4	16.4	16.4	15.1	14.5	19.0	16.0	3.0
Israel	14.6	15.3	16.0	17.4	18.9	18.9	25.0	31.0	-6.0
Poland	14.3	14.3	14.3	14.3	14.3	14.3	19.0	19.0	0.0
Greece	13.0	13.5	13.5	13.5	15.6	17.4	24.0	32.0	-8.0
Czech Rep	12.0	12.7	13.5	15.6	15.6	17.1	19.0	26.0	-7.0
Slovenia	11.6	12.3	13.0	13.7	14.4	15.1	20.0	25.0	-5.0
Slovak Republic	11.2	11.2	11.2	11.2	11.2	11.2	19.0	19.0	0.0
Ireland	10.9	10.9	10.9	10.9	10.9	10.9	12.5	12.5	0.0
Iceland	8.9	8.9	8.9	10.8	10.8	16.9	15.0	18.0	-3.0
Chile	6.7	6.7	6.9	7.2	7.3	7.3	17.0	17.0	0.0
Turkey	5.6	5.6	5.6	5.6	5.6	10.7	20.0	30.0	-10.0
Belgium	-1.7	-1.7	-1.7	-1.7	-1.7	23.0	34.0	34.0	0.0
<b>SIMPLE AVERAGE</b>	<b>18.6</b>	<b>18.6</b>	<b>18.9</b>	<b>20.1</b>	<b>20.6</b>	<b>22.0</b>	25.7	28.4	-2.6

\* By 2013, Canada's METR will decline to 18.4 percent, placing it below Denmark.

**TABLE 3: Marginal Effective Tax Rate on Capital Investment in 83 Countries, 2010 vs. 2005**

	Marginal Effective Tax Rate								METR Ranking In Descending Order		Statutory Company Income Tax Rate		
	2010				2005				2010	2005	2010	2005	+-% point
	Overall	Manuf.	Services	Sectoral gap**	Overall	Manuf.	Services	Sectoral gap**					
Argentina	43.1	48.7	41.8	6.9	43.1	48.7	41.8	6.9	1	2	35.0	35.0	
Chad	36.3	40.1	35.3	4.8	40.0	44.0	38.9	5.1	2	3	40.0	45.0	-5.0
Brazil	35.1	33.7	35.2	-1.5	35.1	33.7	35.2	-1.5	3	11	34.0	34.0	
Uzbekistan	34.9	38.9	33.5	5.4	35.4	39.7	33.9	5.8	4	7	17.2	19.0	-1.8
US	34.6	32.7	36.2	-3.5	35.3	34.5	36.3	-1.8	5	9	38.2	39.0	-0.8
France	34.0	35.6	33.6	2.0	35.4	37.0	35.1	1.9	6	8	34.4	34.9	-0.5
India	33.6	28.8	35.4	-6.6	36.3	31.4	38.1	-6.7	7	6	34.0	36.6	-2.6
Russia	31.9	33.3	31.4	1.9	37.2	38.9	36.7	2.2	8	5	20.0	22.0	-2.0
Japan	29.5	29.4	29.6	-0.2	29.5	29.4	29.6	-0.2	9	16	39.5	39.5	
Korea	29.5	31.9	28.6	3.3	32.2	34.7	31.2	3.5	10	13	24.2	27.5	-3.3
UK	27.9	27.7	27.9	-0.2	29.4	26.7	30.0	-3.3	11	17	28.0	30.0	-2.0
Italy	26.9	25.1	27.4	-2.3	32.1	30.1	32.6	-2.5	12	14	27.5	37.3	-9.8
Australia	26.0	27.6	25.7	1.9	26.0	27.6	25.7	1.9	13	19	30.0	30.0	
Spain	25.4	24.3	25.6	-1.3	29.6	28.4	29.8	-1.4	14	15	30.0	35.0	-5.0
Lesotho	25.3	13.7	28.6	-14.9	35.1	20.1	39.4	-19.3	15	10	25.0	35.0	-10.0
Austria	25.3	25.1	25.3	-0.2	25.3	25.1	25.3	-0.2	16	21	25.0	25.0	
Costa Rica	25.2	35.3	25.0	10.3	25.2	35.3	25.0	10.3	17	22	30.0	30.0	
Norway	24.7	23.7	24.9	-1.2	24.7	23.7	24.9	-1.2	18	24	28.0	28.0	
Pakistan	24.1	28.1	22.8	5.3	24.0	28.1	22.8	5.3	19	25	35.0	35.0	
Germany	23.8	25.8	23.2	2.6	33.1	35.3	32.4	2.9	20	12	30.2	38.9	-8.7
Peru	23.0	29.8	21.4	8.4	23.0	29.8	21.4	8.4	21	27	30.0	30.0	
Bolivia	22.9	30.3	20.5	9.8	22.9	30.3	20.5	9.8	22	29	25.0	25.0	
Tunisia	21.9	24.0	21.2	2.8	25.6	28.0	24.8	3.2	23	20	30.0	35.0	-5.0
Portugal	20.8	18.9	21.2	-2.3	19.6	17.7	20.0	-2.3	24	39	29.0	27.5	1.5
Iran	20.6	27.6	18.5	9.1	20.6	27.6	18.5	9.1	25	33	25.0	25.0	
Fiji	20.6	25.1	19.4	5.7	23.1	28.0	21.9	6.1	26	26	29.0	31.0	-2.0
Indonesia	20.5	23.9	18.5	5.4	25.0	28.9	22.8	6.1	27	23	25.0	30.0	-5.0
Canada	20.5	11.7	24.0	-12.3	39.0	35.6	41.2	-5.6	28	4	29.3	34.3	-5.0
Kazakhstan	19.9	22.6	19.2	3.4	28.9	32.2	28.2	4.0	29	18	17.5	30.0	-12.5
Tanzania	19.3	15.2	20.1	-4.9	19.3	15.2	20.1	-4.9	30	40	30.0	30.0	
Sierra Leone	19.0	14.4	19.8	-5.4	19.0	14.4	19.8	-5.4	31	41	35.0	35.0	
Sweden	18.9	17.5	19.3	-1.8	20.3	18.8	20.7	-1.9	32	35	26.3	28.0	-1.7
Georgia	18.9	21.1	18.4	2.7	22.4	25.1	21.8	3.3	33	30	15.0	20.0	-5.0
Denmark	18.5	20.3	18.2	2.1	21.0	22.9	20.6	2.3	34	32	25.0	30.0	-5.0
Finland	18.3	20.2	17.7	2.5	18.3	20.2	17.7	2.5	35	43	26.0	26.0	
Malaysia	18.0	19.7	16.9	2.8	20.4	22.3	19.3	3.0	36	34	25.0	28.0	-3.0
Jamaica	17.9	15.9	18.2	-2.3	17.9	15.9	18.2	-2.3	37	45	33.3	33.3	
Ecuador	17.9	22.6	16.4	6.2	16.2	20.3	15.0	5.3	38	58	25.0	25.0	
Jordan	17.6	13.7	19.0	-5.3	17.6	13.7	19.0	-5.3	39	46	23.2	23.2	
Switzerland	17.6	16.8	17.8	-1.0	18.1	17.3	18.3	-1.0	40	44	21.2	21.3	-0.1
New Zealand	17.6	15.5	18.0	-2.5	19.8	17.5	20.3	-2.8	41	38	30.0	33.0	-3.0
Mexico	17.5	19.0	17.1	1.9	17.5	19.0	17.1	1.9	42	47	30.0	30.0	

cont'd



TABLE 3: cont'd

	Marginal Effective Tax Rate								METR Ranking In Descending Order		Statutory Company Income Tax Rate		
	2010				2005				2010	2005	2010	2005	+-% point
	Overall	Manuf.	Services	Sectoral gap**	Overall	Manuf.	Services	Sectoral gap**					
Zambia	17.2	24.1	16.0	8.1	17.2	24.1	16.0	8.1	43	50	35.0	35.0	
Thailand	17.0	20.4	14.3	6.1	17.0	20.4	14.3	6.1	44	52	30.0	30.0	
Rwanda	16.9	26.8	15.2	11.6	16.9	26.8	15.2	11.6	45	54	30.0	30.0	
Netherlands	16.8	15.6	17.0	-1.4	21.4	20.0	21.6	-1.6	46	31	25.5	31.5	-6.0
Luxembourg	16.8	17.9	16.7	1.2	19.8	21.0	19.7	1.3	47	37	28.6	30.4	-1.8
China	16.6	21.1	15.7	5.4	43.7	47.0	43.0	4.0	48	1	25.0	25.0	
Hungary	15.9	17.2	15.6	1.6	14.5	15.6	14.2	1.4	49	64	19.0	16.0	3.0
Uganda	15.4	11.0	16.2	-5.2	15.4	11.0	16.2	-5.2	50	61	30.0	30.0	
Nigeria	15.1	20.7	14.2	6.5	14.7	20.2	13.8	6.4	51	63	33.0	32.0	1.0
Madagascar	14.6	19.4	13.2	6.2	20.1	26.1	18.5	7.6	52	36	23.0	30.0	-7.0
Israel	14.6	13.1	15.3	-2.2	18.9	17.2	19.7	-2.5	53	42	0.3	0.3	-0.1
South Africa	14.5	15.6	14.3	1.3	15.9	17.0	15.6	1.4	54	59	28.0	30.0	-2.0
Bangladesh	14.5	12.7	14.9	-2.2	16.3	14.5	16.8	-2.3	55	57	27.5	30.0	-2.5
Poland	14.3	13.4	14.5	-1.1	14.3	13.4	14.5	-1.1	56	66	19.0	19.0	
Morocco	13.9	18.7	12.5	6.2	17.2	22.6	15.7	6.9	57	49	30.0	35.0	-5.0
Botswana	13.6	7.9	14.0	-6.1	13.6	7.9	14.0	-6.1	58	68	25.0	25.0	
Trinidad	13.1	3.8	16.8	-13.0	16.6	5.9	20.9	-15.0	59	55	25.0	30.0	-5.0
Greece	13.0	12.3	13.1	-0.8	17.4	16.5	17.5	-1.0	60	48	24.0	32.0	-8.0
Ghana	12.9	13.4	12.7	0.7	12.9	13.4	12.7	0.7	61	69	25.0	25.0	
Czech Rep	12.0	12.0	12.0	0.0	17.1	17.1	17.1	0.0	62	51	19.0	26.0	-7.0
Vietnam	11.7	19.4	8.9	10.5	13.7	22.2	10.6	11.6	63	67	25.0	28.0	-3.0
Slovenia	11.6	11.7	11.6	0.1	15.1	15.1	15.0	0.1	64	62	20.0	25.0	-5.0
Slovak Republic	11.2	14.2	10.4	3.8	11.2	14.2	10.4	3.8	65	70	19.0	19.0	
Ireland	10.9	10.3	11.2	-0.9	10.9	10.3	11.2	-0.9	66	71	12.5	12.5	
Taiwan	10.9	13.0	9.9	3.1	16.6	19.5	15.2	4.3	67	56	17.0	25.0	-8.0
Ethiopia	9.8	24.3	6.4	17.9	9.8	24.3	6.4	17.9	68	74	30.0	30.0	
Croatia	9.5	11.9	8.4	3.5	9.5	11.9	8.4	3.5	69	75	22.0	22.0	
Iceland	8.9	5.9	9.4	-3.5	16.9	14.1	17.5	-3.4	70	53	15.0	18.0	-3.0
Romania	8.6	10.9	7.6	3.3	8.6	10.9	7.6	3.3	71	76	16.0	16.0	
Singapore	8.5	6.8	9.9	-3.1	10.3	8.3	11.9	-3.6	72	73	17.0	20.0	-3.0
Mauritius	7.8	8.7	7.5	1.2	14.4	15.9	14.0	1.9	73	65	15.0	25.0	-10.0
Egypt	7.0	9.4	6.2	3.2	15.8	19.9	14.5	5.4	74	60	20.0	34.0	-14.0
Chile	6.7	7.3	6.6	0.7	7.3	7.9	7.2	0.7	75	78	17.0	17.0	
Turkey	5.6	4.9	5.8	-0.9	10.7	9.9	11.0	-1.1	76	72	20.0	30.0	-10.0
Latvia	5.6	7.2	5.3	1.9	5.6	7.2	5.3	1.9	77	79	15.0	15.0	
Bulgaria	4.6	5.1	4.5	0.6	7.4	8.1	7.2	0.9	78	77	10.0	15.0	-5.0
Kenya	4.5	-35.2	11.7	-46.9	4.5	-35.2	11.7	-46.9	79	80	30.0	30.0	
Hong Kong	4.0	3.6	4.1	-0.5	4.3	3.9	4.4	-0.5	80	81	16.5	17.5	-1.0
Ukraine	3.1	11.8	0.1	11.7	3.1	11.8	0.1	11.7	81	82	25.0	25.0	
Belgium	-1.7	-0.2	-2.0	1.8	23.0	22.0	23.2	-1.2	82	28	34.0	34.0	
Serbia	-5.1	-11.4	-2.5	-8.9	-5.1	-11.4	-2.5	-8.9	83	83	10.0	10.0	
<b>AVERAGE</b>	<b>17.7</b>	<b>18.2</b>	<b>17.5</b>	<b>0.7</b>	<b>20.4</b>	<b>21.0</b>	<b>20.2</b>	<b>0.8</b>			25.3	27.7	-2.4

\* By 2013, Canada's METR will decline to 18.4 percent, placing it below Denmark.

\*\* Sectoral gap is the manufacturing METR minus the services METR.

As a result, Canada's tax competitiveness ranking has significantly improved by various measures. Canada has gone from the highest taxed to the lowest among the G-7 countries, from the highest taxed to the 13th highest within OECD countries and from the fourth highest taxed to the 28th highest among all 83 countries studied.

Largely as a result of Canada's accomplishment in advancing its tax competitiveness, the average METR for the G-7 countries has dropped more than five percentage points from 34 percent in 2005 to 28 percent in 2010. Other G-7 members that also improved their tax competitiveness in this period include Germany (with a METR reduction of nine percentage points), Italy (five percentage points), the United Kingdom (1.5 percentage points) and France (one percentage point).

The US has made little progress with its slightly lowered company income tax rate only for domestic productive activities and a temporary 50 percent bonus depreciation allowance providing for the expensing of machinery capital in 2011<sup>14</sup>. Temporary measures, however, do not result in a sustained increase in capital stock held by businesses. Rather, temporary accelerated depreciation primarily pushes investment from the future to the period when the incentive is available. Our METR evaluation excludes such temporary measures because potential investors view the predictable long-term tax provisions critical for long-term investment planning.

Other countries that advanced their tax competitiveness at a pace comparable to Canada's (i.e., lowered their METR by nearly half or more over the past five years) include China, Egypt, Mauritius and Turkey. Many developed countries that have always been more tax-competitive than Canada have continued to reduce corporate taxes, including Hong Kong (China), Singapore, Taiwan, Israel, the Czech Republic, the Netherlands, Luxembourg, Slovenia and New Zealand, to name a few. It is obvious that tax competitiveness is a moving target, making reform an ongoing task for all nations.

## **INTER-INDUSTRY TAX BURDENS: AN IMPORTANT DIMENSION OF TAX COMPETITIVENESS**

We believe tax competitiveness must be improved for all industries in Canada, rather than only for a few selected by the government such as manufacturing. Our ranking for both the manufacturing and service sectors shows that, despite the recent advance in its overall tax competitiveness, Canada does not fair well in the tax competitiveness of its service sectors. Ranked by the METR for the services sector, Canada is the 19th highest country among all 83 countries studied despite the fact that Canadian manufacturing industry is only the 66th highest taxed among the 83 countries. In other words, Canada has the second-highest METR ranking gap between manufacturing and services among all 83 countries (Table 4).

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<sup>14</sup> Internal Revenue Service website, <http://www.irs.gov/newsroom/article/0,,id=233907,00.html>

**TABLE 4: Canada's Ranking: Inter-Industry Tax Differences 2010\***

	Overall	Manufacturing	Services
<b>A. Canada's ranking by METR, by sector, in descending order</b>			
G7	7	7	6
OECD	13	28	11
<b>ALL 83 COUNTRIES</b>	<b>28</b>	<b>66</b>	<b>19</b>
<b>B. METR ranking gap between manufacturing and services: The top ten countries in descending order</b>			
Ethiopia	51		
Canada	47		
Lesotho	45		
Trinidad	36		
Rwanda	33		
Vietnam	32		
Tanzania	25		
Sierra Leone	25		
Nigeria	23		
Jordan	23		

\* Refer to Table 3 for METR by sector. The ranking gap is the difference between the rank for services minus the rank for manufacturing.

Tax preferences or targeted tax reliefs are not uncommon in many tax regimes around the globe. For business taxation, the most-used tax reliefs include – but are not limited to – accelerated depreciation allowances and investment tax credits. For example, New Zealand in the past provided a 20 percent investment allowance for new plant and equipment (this allowance was eliminated in its 2010 budget). The US government also introduced a temporary 50 percent bonus depreciation allowance in 2008 and 2009 for fixed capital assets with certain lengths of useful lives (with 100 percent investment allowance available in 2011). But these tax reliefs were provided across all business sectors in both countries.

What is unusual about the use of tax reliefs in Canada is that they are almost always narrowly targeted at the manufacturing and processing sectors as well as resource sectors such as agriculture, fishing, forestry and extractive industries.<sup>15</sup> Such tax relief directed only at the resource and manufacturing sectors includes the federal Atlantic Investment Tax Credit, repeatedly extended temporary fast write-offs for machinery and equipment, several provincial investment tax credits and the reduced corporate income tax rate for manufacturing income in a few provinces.

For the manufacturing and service industries, the combined result of all these targeted tax reliefs is a sectoral METR ranking gap that is the widest among OECD countries, indicating that Canada is the most active user of tax measures in support of so-called industrial policy among the developed countries.

<sup>15</sup> Our international comparisons do not include agriculture, fishing and extractive industries.

Only Ethiopia has a wider METR ranking gap between manufacturing and services sectors than Canada. Other countries occupying the top ten spots with the widest METR ranking gap between sectors are Lesotho, Trinidad, Rwanda, Vietnam, Tanzania, Sierra Leone, Nigeria and Jordan. Among these nine countries, five have a tax structure favouring manufacturing industry.

For example, Lesotho and Jordan have a reduced tax rate for manufacturing (ten and 15 percent respectively versus 25 percent for non-manufacturing sectors) while Tanzania and Trinidad provide substantial initial allowances for manufacturing investment (40 and 60 percent respectively). Sierra Leone also favours manufacturing industry with a very generous depreciation allowance. Among the other four countries in the top ten, all seem to favour the service sector more than manufacturing. However, the METR ranking gaps in these four countries are more attributable to their high inflation rates (e.g., 20 percent in Ethiopia, 11 percent in Rwanda and Vietnam, and nine percent in Nigeria)<sup>16</sup>.

An obvious question arising from the above cross-border comparison of the sectoral METR dispersion is whether Canada's use of business tax relief justifies tax policy as a tool of industrial policy. Regardless of the answer, we have an urgent need to catch up with the international trend in tax design that favours broad bases and low rates for all taxpayers.

As discussed above, low rates encourage investment but also help reduce tax avoidance, generating revenues for governments. Reducing inter-sector differences in tax burdens improves the allocation of resources in the economy, maximizes output and reduces both administrative costs for governments and compliance costs for taxpayers. To accomplish this, the first step might be to evaluate whether our sector-oriented tax relief package, including various investment tax credits and fast write-offs, has accomplished anything on a cost-benefit basis<sup>17</sup>.

## LOOKING BEYOND 2013

Assuming all the tax changes announced in government budgets materialize, Canada's overall METR will drop to 18.4 percent in 2013 and the METRs for manufacturing and a broad range of service sectors will be 13.8 percent and 20.5 percent respectively.<sup>18</sup> As a result, Canada's inter-sector METR gap will drop. Despite such a significant improvement, however, Canada's business tax system will still have the greatest gap between manufacturing and services sectors among OECD countries.

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<sup>16</sup> Capital assets with longer useful lives (e.g., buildings) are usually given a lower tax depreciation allowance than those with shorter useful lives (e.g., machinery and equipment). Inflation discounts the value of tax benefits generated from tax depreciation allowances. For a given high inflation rate, the higher the tax depreciation allowance, the greater the loss of tax benefit due to the discounting effect of inflation. Since, compared to service sectors (which use more buildings and structures), manufacturing industry generally uses capital assets with a shorter lifespan that are hence entitled to a higher tax depreciation allowance, a high inflation rate harms manufacturing industry more than it does service sectors. Other things being equal, a high inflation rate may cause a METR for manufacturing to be higher than that for service sectors.

<sup>17</sup> OECD, "Executive Summary", in OECD, *Choosing a Broad Base - Low Rate Approach to Taxation*, 28 Oct 2010.

<sup>18</sup> Duanjie Chen and Jack Mintz, "Federal-Provincial Business Tax Reforms: A Growth Agenda with Competitive Rates and Neutral Treatment of Business Activities," SPP Research Papers, Volume 4, Issue 1, School of Public Policy, University of Calgary, January 2011.

Other OECD countries that have planned or proposed further reduction in company income tax rates include Israel (which plans to reduce the rate annually until it reaches 18 percent by 2016), Australia (reducing the tax rate by one percentage point in 2013-4), New Zealand (two points by 2011 with base-broadening measures), Greece (four points by 2014), Japan (by five points proposed to come into effect April 1, 2011) and the UK (decline to 24 percent by 2014)<sup>19</sup>. Incorporating all these tax cuts and the lower US federal company income tax rate of 26 percent (the mid-point of the corporate rates as proposed by the Presidential Deficit Commission), the average of effective tax rates will be 26 percent within the G-7, 18 percent for the OECD members and 17.4 percent for all 83 studied. Canada's METR in 2013 will still be somewhat above the OECD average.

More fundamentally, signs of sweeping tax reforms are gathering momentum in major industrial countries such as Australia, the UK and the US<sup>20</sup>. In fact, the UK government has already set out a timetable for corporate tax reform aimed at delivering a more competitive tax system<sup>21</sup>. If these well-designed or hotly debated reform proposals do materialize, they will certainly lead to a new international business taxation norm that embraces many seemingly radical tax ideas. Canada, despite having earned the top ranking in tax competitiveness among G-7 countries, may not have much time to wait before responding to these new challenges.

## APPENDIX

The estimates of effective tax rates on new investment in this report are based on a methodology summarized in Duanjie Chen and Jack Mintz, "Taxing Business Investments: A New Ranking of Effective Tax Rates on Capital," World Bank, 2008. Our model assumes a multinational company seeking to maximize value for its projects around the world, raising equity and debt financing from international markets. The company minimizes its cost of finance by choosing an optimal debt and dividend policy, taking into account tax and non-tax factors that influence financial decisions (independent of the investment decision). The cost of equity and debt is determined by international markets independent of the availability of domestic savings in a small open economy. Therefore, personal income taxes on dividends, interest and capital gains do not affect the multinational's cost of financing even though those personal taxes do effect personal savings decisions.

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<sup>19</sup> Tax Notes International, various issues, up to January 10, 2011.

<sup>20</sup> Contributing ideas for these possible tax reforms may be found in, but are not limited to, Australia's Future Tax System Review, also referred as The Henry Review, available at [http://www.taxreview.treasury.gov.au/content/Content.aspx?doc=html/pubs\\_reports.htm](http://www.taxreview.treasury.gov.au/content/Content.aspx?doc=html/pubs_reports.htm); Institute for Fiscal Studies, 2010, Tax by Design: The Mirrlees Review, available at [www.ifs.org.uk/mirrleesReview\(2010\)](http://www.ifs.org.uk/mirrleesReview(2010)); and The National Commission for Fiscal Responsibility and Reform, "The Moment of Truth," December 2010, [http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12\\_1\\_2010.pdf](http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf).

<sup>21</sup> HM Treasury and HM Revenue and Customs, 2010, "Corporate Tax Reform: Delivering a More Competitive System," November 29, available at [http://www.hm-treasury.gov.uk/d/corporate\\_tax\\_reform\\_complete\\_document.pdf](http://www.hm-treasury.gov.uk/d/corporate_tax_reform_complete_document.pdf).

To calculate the effective tax rate on new investments, similar investment projects in manufacturing and service industries are assumed in each country. The same capital structure for eight industries (manufacturing, construction, utilities, communications, transport, wholesale trade, retail trade and other services) is assumed across countries, using data for capital stock weights developed by Finance Canada. We also use Statistics Canada's recently estimated economic depreciation rates and apply them across all countries. We account for corporate income tax rates, tax depreciation, inventory cost deductions, sales taxes on capital inputs and capital-related taxes such as financial transaction taxes, equity contribution taxes and asset-based taxes. Due to lack of data or limited application, property taxes, export development zones and tax holidays are not included in the analysis.

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Jack M. Mintz was appointed the Palmer Chair in Public Policy at the University of Calgary in January 2008.

Widely published in the field of public economics, he was touted in a 2004 UK magazine publication as one of the world's most influential tax experts. He serves as an Associate Editor of *International Tax and Public Finance* and the *Canadian Tax Journal*, and is a research fellow of CESifo, Munich, Germany, and the Centre for Business Taxation Institute, Oxford University. He is a regular contributor to *Canadian Business* and the *National Post*, and has frequently published articles in other print media.

Dr. Mintz presently serves on several boards including Brookfield Asset Management, Imperial Oil Limited, Morneau Sobeco, and Royal Ontario Museum. He was also appointed by the Federal Minister of Finance to the Economic Advisory Council to advise on economic planning and served as research director for the Federal-Provincial Minister's Working Group on Retirement Income Research.

Dr. Mintz held the position of Professor of Business Economics at the Rotman School of Business from 1989-2007 and Department of Economics at Queen's University, Kingston, 1978-1989. He was a Visiting Professor, New York University Law School, 2007; President and CEO of the C.D. Howe Institute from 1999-2006; Clifford Clark Visiting Economist at the Department of Finance, Ottawa; Chair of the federal government's Technical Committee on Business Taxation in 1996 and 1997; and Associate Dean (Academic) of the Faculty of Management, University of Toronto, 1993-1995. He was founding Editor-in-Chief of *International Tax and Public Finance*, published by Kluwer Academic Publishers from 1994-2001, and recently chaired the Alberta Financial and Investment Policy Advisory Commission reporting to the Alberta Minister of Finance.

In 2002, Dr. Mintz's book, *Most Favored Nation: A Framework for Smart Economic Policy*, was winner of the Purvis Prize for best book in economic policy and runner-up for Donner Prize for best book in public policy.

Dr. Mintz has consulted widely with the World Bank, the International Monetary Fund, the Organization for Economic Co-operation and Development, the governments of Canada, Alberta, New Brunswick, Ontario, and Saskatchewan, and various businesses and nonprofit organizations.

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