# General Corporate — Commentary — Articles — English — Vern Krishna —, 2011-05-01 -- Tax Rates Must Remain Competitive

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-- Vern Krishna ... -- As we head into the federal budget season, the red menace is no longer about the spread of communism, but about government profligacy in democratic countries and their inability to stem red ink in their budgets. ... -- Should we increase taxes and spend more or decrease taxes and stimulate the private sector economy? The obvious answer would appear to be to increase taxes and raise government revenues. In fact, the obvious answer is wrong. Higher taxes do not necessarily generate more revenue. They merely increase legitimate tax avoidance and cause capital to fly to lower tax jurisdictions. ... -- Debates about tax rates are as predictable as leap years. We are in high season with the federal and Ontario elections

**Tax Rates Must Remain Competitive**
Date: May 2011
*Vern Krishna*

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Should we increase taxes and spend more or decrease taxes and stimulate the private sector economy? The obvious answer would appear to be to increase taxes and raise government revenues. In fact, the obvious answer is wrong. Higher taxes do not necessarily generate more revenue. They merely increase legitimate tax avoidance and cause capital to fly to lower tax jurisdictions.

Debates about tax rates are as predictable as leap years. We are in high season with the federal and *Ontario elections looming. Tax* debates divide people into two distinct groups: those who want to pay lower taxes and those who would like to increase taxes paid by others. This is the conventional left versus right political division. The issue, however, is more complex than mere spectrum positioning and plays out differently for individuals and corporations.

Individuals, particularly employees, are trapped in the tax net and, with the exception of the highly skilled and mobile, have no avenues for escape. In contrast, multinational enterprises (MNEs) must compete in a competitive global economy in highly fluid capital markets. A business must maximize its rate of return on equity and employ capital efficiently. After-tax increase in return on equity is the only measure of success in an international economy.

The political debate on international corporate tax rates usually focuses on nominal rates of tax and where we stand within the OECD (Organisation for Economic Co-operation and Development). However, nominal rates camouflage the issue. Greece and India, for example, have high nominal rates of tax, which few actually pay. Multinational enterprises function on the amount of *tax that they actually pay*—the effective rate of tax—to governments and not on nominal or theoretical rates. Google, for example, paid tax at an effective tax rate of only 2.4 percent on its global profits last year. That is a far cry from the nominal corporate tax of 35 percent rate in the United States.

Ireland is a good example of how low corporate taxes stimulated the economy. Ireland has nominal and effective corporate tax rate of about 12.5 percent, which makes it an attractive jurisdiction in which to do business—particularly technology and service businesses that are highly mobile. The low rate of corporate tax attracted MNEs such as Microsoft and Intel.

To be sure, Ireland now has difficult economic problems that it must resolve. The problems, however, stem from reckless banking and government policies in connection with the property market and not from its low tax rate.

Canada's corporate tax rates are becoming increasingly competitive. Depending upon who wins the next federal election, our rates should continue to be internationally attractive. However, it is even more attractive for mobile businesses to locate in low tax countries—such as Ireland and Barbados—than to set up shop in Canada.

A foreign subsidiary of a Canadian company that conducts its business in Ireland, for example, will pay corporate tax of only 12.5 percent and no tax in Canada when it remits its after-tax income back to its parent corporation. Similar considerations apply for businesses in Barbados, which has a tax rate of 2.5 percent on international business corporations. It is not an accident that former prime minister Paul Martin's shipping business was organized (quite cleverly and legitimately) through Barbados.

We see the adverse impact of high tax rates on the American economy. A subsidiary of an American MNE first pays tax on its foreign income and pays tax (with credits) again—a toll gate tax—when it repatriates its subsidiary's profits back into the United States. Thus, American MNEs will park their offshore profits in low tax jurisdictions and utilize their capital for the benefit of foreign countries. Recent estimates put the amount of American money parked offshore at $2 trillion.

For example, Microsoft recently borrowed $2.25 billion in unsecured debt to fund its operations even though it has $40 billion of cash reserves, a substantial portion of which is parked offshore. The company would have to pay substantial toll gate taxes if it repatriated the cash to the United States. Thus, the tax rules create an incentive (or bias) for American companies to invest abroad even if the rate of return on the investment is not as efficient as it might be in the United States. The saving of the domestic tax penalty more than offsets the drag on the return on equity.

Ultimately, all rules are behavioural. Contrary to popular opinion, lower effective tax rates will stimulate the economy, create jobs, and actually increase government revenues. The choice in tax debates should not be about the left and the right, but about up and down.

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