Canada Has Much to Lose From TCJA, Study Shows

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By Amanda Athanasiou

The potential effects of the U.S. Tax Cuts and Jobs Act on the Canadian economy have been hotly debated, but a new report suggests that significant percentages of Canada’s GDP and employment are at risk.

According to a new PwC study commissioned by the Business Council of Canada (BCC) on the potential for the TCJA (P.L. 115-97) to affect the movement of Canadian investment and workers, the news isn’t good for Canada. “U.S. tax reform has eliminated one of Canada’s main competitive advantages,” and will have a sizable negative impact on capital-intensive sectors, according to the study, released by the BBC September 12. U.S. tax reform exacerbates a trend of lower investment growth in Canada and is expected to result in an increased emigration of highly skilled employees, the report says.

The study assessed the effect of the TCJA on nine sectors in Canada and concluded that capital-intensive sectors are likely to face a shift in investment away from Canada and toward the United States over the next 10 years, though the magnitude of the risk varies among sectors. The sectors expected to suffer the most in the long term are chemical, machinery, plastic and rubber, and transportation manufacturing.

Not only does the U.S. tax law threaten existing economic activity in Canada, it could also compromise Canada’s “ability to expand its industrial base through the opportunities that would be created by the digital revolution,” the report says. Greater digitalization will have a large effect in manufacturing industries, which have a high potential for digital transformation, it says. This is expected to lead to a return to North America of significant production that was lost to developing countries in recent decades, it says. But greater digitalization increases the TCJA’s threat to Canada because of the lost opportunity to onshore activity that has been outsourced, it adds.

Although some experts have suggested that the North American Free Trade Agreement negotiations and the prospect of termination are dominant concerns for Canada, the PwC report suggests that the TCJA will have a much greater effect on the Canadian economy. The Conference Board of Canada predicts a 0.5 percent decline in Canada’s GDP and a loss of 85,000 jobs if NAFTA is terminated, PwC said. But the TCJA puts 635,000 jobs at risk, or 3.4 percent of Canadian employment, according to the report.

Also at risk as a result of the TCJA are C $85 billion in GDP (4.9 percent of Canada’s GDP), C $47 billion in labor income, and C $20 billion in government revenue. Ontario, Alberta, and Quebec will experience the largest GDP effects because of their high concentrations of affected sectors, the report says.

The lowering of U.S. personal income tax rates and increased bracket thresholds could also
affect Canada’s ability to attract and retain highly skilled workers, the report says, adding that there is already a large gap in after-tax income between Canada and the United States in high-skilled occupations. The widening of that gap will increase incentives for Canadian workers to relocate to the United States, the report adds.

The report underscores the need for Canada’s government to respond to U.S. tax changes with a comprehensive plan to strengthen Canada’s economic competitiveness, John Manley, CEO of the BCC, said September 12. “Failing to respond to U.S. tax reform puts Canadian jobs and prosperity at risk at a time when Canada is already wrestling with rising protectionism,” he said.

Not everyone agrees. In July Canadians for Tax Fairness urged the government to help stop the corporate tax race to the bottom. The group argued that evidence of capital flight is anecdotal thus far and that net investment actually flowed north in the first quarter of 2018.

Diana Gibson, communications and research manager for Canadians for Tax Fairness, told Tax Notes that the methods used in the PwC report are questionable. “The report mapped general sectors of the economy for which competitive positions [are] slightly changed as a result of the U.S. tax change. That does not mean that we will lose 4.5 percent of our GDP — that is a very alarmist way of framing the issue,” she said. The report fails to examine the effect on GDP of tax revenue expenditures to stimulate jobs and investment, she added.

President Trump is opting to run a huge deficit, increase inequality, and undermine the long-term strength of his economy, and “Canada should not follow suit,” Gibson said. Competitiveness can be done by taking the high road, through higher taxes to build a diverse economy with great social and physical infrastructure, she said, adding that taxes are only a small part of corporate location decisions.

Kim Moody of Moodys Gartner Tax Law LLP said he found the conclusions of PwC’s report unsurprising. Canada’s senior business leaders and tax practitioners have been warning about the TCJA’s likely effects for the last nine months, he said. A real response with decisive action should include personal tax cuts, he said.

“A response is definitely necessary,” agreed Aaron Wudrick, federal director of the Canadian Taxpayers Federation. There was nothing in the spring budget to address the TCJA, but in recent months, Finance Minister Bill Morneau has suggested that the government will announce some measures in the fall economic update, he said.

“This is just another warning bell for the Trudeau government,” Wudrick said. “It is irresponsible to pretend that the TCJA has not changed the game,” and action needs to be taken to ensure that Canada remains competitive, he said.

Wudrick said he found the report’s NAFTA figures surprisingly low. “It’s possible that the effect of NAFTA is understated — it is so wide-ranging and could cause disruption in many ways that are difficult to quantify,” he said. He added that Canadian policymakers are probably underestimating the impact of the TCJA and that the PwC report seems to support that suspicion.

Roy Berg, also of Moodys Gartner, agreed that the figures highlighted in the report could understate the negative effect of NAFTA termination. “One of its benefits is the reduction of
administrative hurdles to the migration of skilled workers from the U.S. and vice versa,” he said. Overall, though, it isn’t surprising that the estimated effect of NAFTA termination would be smaller than the effect of U.S. tax reform, which affects a much larger percentage of the Canadian economy, Berg said.

While the report focuses on the brain drain from Canada that could result from lower U.S. personal income tax rates, Canada will likely benefit from the United States’ protectionist position on immigration, Berg said. Skilled workers who are denied work in the United States will likely find it easier to obtain the required status in Canada, he said.

“We’re hopeful that the report, as well as the BCC’s actions, will be catalytic to action in Canada,” Berg said. “We hope that the contentiousness of the NAFTA negotiations do not spill over into the tax context, resulting in the rejection of all things American.”