

**Ensuring Economic Prosperity  
and a Sustainable Future**

**A Submission  
to the House of Commons  
Standing Committee on Finance by  
The Canadian Institute  
of Chartered Accountants**

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## Executive Summary

Canada's Chartered Accountants are pleased to put forward again this year advice to the House of Commons Standing Committee on Finance for its pre-budget deliberations.

In this submission, we offer our views on the federal tax and program spending measures needed to ensure prosperity and a sustainable future for Canadians.

With the country facing significant challenges, it is essential that the next budget support measures aimed at creating wealth, boosting job creation and facilitating capital mobility, and that strong controls be placed on ongoing program spending to guard against the creation of structural deficits.

As such, we believe the following initiatives should be pursued:

- **The government must stay the course in reducing the corporate income tax rate to 15 per cent by 2012 – a commitment that is made all the more essential in the current economic climate. As finances permit, the government should further reduce the corporate rate so that it reaches the small business level. Ongoing adjustments to capital cost allowances, along with strengthening incentives for research and development, should occur at the same time.**
- **The government should aggressively pursue sales tax harmonization by providing carefully limited financial incentives to the three remaining provinces with retail sales taxes.**
- **A framework should be established under which overall program spending does not rise at a rate faster than the rate of inflation (adjusted for population growth). At the same time, Canadians need to see a detailed plan put in place for eliminating the deficit at the earliest possible juncture.**

Now more than ever, Canada needs the right tax and fiscal framework to set the stage for sustainable recovery and economic growth.

The Canadian Institute of Chartered Accountants (CICA), together with the provincial, territorial and Bermuda Institutes/Ordre of Chartered Accountants, represents a membership of approximately 75,000 CAs and 12,000 students in Canada and Bermuda.

The CICA conducts research into current business issues and supports the setting of accounting, auditing and assurance standards for business, not-for-profit organizations and government. It issues guidance on control and governance, publishes professional literature, develops continuing education programs and represents the CA profession nationally and internationally.

## Introduction

The last year has seen a dramatic deterioration in Canada's fiscal situation, with the effects of the global economic downturn reflected in daily headlines, as well as in the federal government's finances.

Weaker than expected economic performance saw real GDP fall 3.7 per cent in the fourth quarter of 2008 and decline by a further 5.4 per cent in the first quarter of this year (expressed on an annualized basis). The most recent quarterly economic forecast issued by TD Economics<sup>1</sup> indicates that GDP growth is expected to contract by 2.4 per cent this year, followed by a modest rebound of 1.4 per cent growth in 2010.

The government is now projecting a deficit for 2008/2009 of \$3.9 billion, and \$50.2 billion for the current fiscal year – numbers that are significantly larger than those projected only a few months ago. While this is in part due to one-time measures taken to stabilize the auto sector, the higher figures also highlight the impact the downturn is expected to have on the government's finances in terms of lower tax revenues and higher Employment Insurance payments.

Looking further out, TD Economics<sup>2</sup> recently issued a forecast which indicates significant deficits will be a reality for another four years hence: \$45.3 billion in 2010/2011, \$28.3 billion in 2011/2012, \$23.1 billion in 2012/2013 and \$19.4 billion in 2013/2014. The report suggests that balancing the budget will be an elusive goal unless policy changes are effected.

The second progress report issued by the government highlights how a quickly changing fiscal situation is impacting Canada's open economy<sup>3</sup>:

In late January, when the Economic Action Plan was tabled, it was very difficult to foresee how the global financial crisis would be resolved and to what extent the global recession would affect the economy and reduce jobs in Canada. With the benefit of hindsight, it is now clear that in late 2008 and in the first quarter of 2009, economic conditions globally were significantly weaker than virtually all governments and private sector economists expected.

Despite this worrisome scenario, the government's progress report suggests there are reasons to be optimistic about what the future holds. Many private sector forecasters expect a return to growth in the second half of this year, with momentum gaining in 2010.

The International Monetary Fund believes Canada will have the smallest contraction among G7 countries this year and the strongest recovery going into next year. The government notes that Canada is well positioned to weather the economic storm with a debt burden that is the lowest within the G7, and with deficits, although large, that are expected to be the smallest among member countries.

While encouraging, the government also cautions that there continues to be a large degree of uncertainty with respect to fiscal projections, and that significant risks to the government's finances remain. The government's commitment to return to a surplus in future years and pay back the series of deficits that will be accumulated over the next few years is therefore essential to a sustainable future.

With myriad challenges ahead, it is of the utmost importance that the next budget support measures aimed at creating wealth, boosting job creation and facilitating capital mobility, and that strong controls be placed on ongoing program spending to guard against the creation of structural deficits.

## Ensuring Economic Prosperity and a Sustainable Future

Now more than ever, Canada needs the right tax and fiscal framework to set the stage for sustainable recovery and economic growth. The federal government's role is to facilitate such growth by putting the right policies in place that ensure Canada's competitiveness and economic viability.

### The Case for Corporate Income Tax Reductions

Canada's Chartered Accountants continue to believe that in order to ensure prosperity for all Canadians, our tax system should create wealth, and enable individuals to maintain a relatively high standard of living. Central to this is the need to further reduce corporate income taxes.

There are solid reasons for reducing corporate taxes. For example, there is growing evidence that businesses don't pay tax, people do. According to a C.D. Howe report<sup>4</sup>, recent studies show that an increase in the tax burden placed on capital investment substantially reduces the income paid to workers when business productivity is impaired.

<sup>1</sup> TD Economics, TD Quarterly Economic Forecast, June 16, 2009.

<sup>2</sup> TD Economics, 5-Year Federal Fiscal Forecast, June 2009.

<sup>3</sup> *Canada's Economic Action Plan: A Second Report to Canadians*, June 2009, Government of Canada.

<sup>4</sup> *Limited Horizons: The 2008 Report on Federal and Provincial Budgetary Tax Policies*, C.D. Howe Institute.

Moreover, a recent report by Finance Canada acknowledges that lower corporate income taxes result in increased business investment, since taxes affect the rate of return on investment<sup>5</sup>. Research by the Department<sup>6</sup> also suggests that a 10 per cent reduction in the cost of capital can increase investment in machinery and equipment by 10 per cent in Canada. Finance Canada also examined the impact of corporate tax reductions between 2001 and 2004 and found that a one per cent reduction in the cost of capital raised investment by 0.7 per cent<sup>7</sup>.

Canada has made important progress in reducing corporate taxes. The government has committed to reducing the general corporate income tax rate from 22.12 per cent (including the corporate surtax) in 2007 to 15 per cent by 2012, and has set a goal of establishing the lowest marginal effective tax rate (METR) on new business investment in the G7 by 2010.

While this goal is indeed encouraging, it assumes that other countries within the G7 will resist further reductions, while ignoring the potential for continued progress by other key competitors outside the G7.

To this end, a recent report by the Institute for Competitiveness and Prosperity<sup>8</sup> notes that taxes on new business investment in Canada are among the highest in developed economies, urging the government to continue to pursue tax reform. According to the Institute, Canada's METR in 2008 was 29.1 per cent, a level which compares unfavourably with most other developed countries. The Institute notes that the median rate among OECD countries in 2008 was 19.6 per cent, while at the same time acknowledging that further planned reductions in federal corporate income taxes as well as reductions announced by governments in Ontario and New Brunswick will reduce Canada's METR to below the OECD median by 2012.

The Advisory Panel on Canada's System of International Taxation<sup>9</sup> reports that while Canada's statutory tax rate is expected to be six percentage points lower than other G7 countries by 2012, it will still be higher than the rates in many other countries. Similarly, research by the C.D. Howe Institute indicates that Canada is still one of the higher tax jurisdictions among developed countries<sup>10</sup>.

Looking at yet another measure, a World Economic Forum report on global competitiveness<sup>11</sup> shows that although Canada's rank has risen to tenth on the global index, the country's aggregate score has essentially remained the same – at 5.4 out of 7, versus 5.3 last year. The report also cites a series of factors seen by Canadian business executives as the most problematic for doing business in their economy: the top two factors are Canada's tax rates, and its tax regulations.

These reports make clear that Canada's business tax regime continues to lag behind those in many countries and highlight the need to further reduce the corporate income tax rate.

## The Impact of Sales Tax Harmonization

There is a widely-held view that provincial sales taxes are levied mostly on retail purchases by consumers – but research shows that more than 40 per cent of sales tax revenue is estimated to come from purchases by businesses, including capital investments<sup>12</sup>.

Any discussion of high METRs must therefore examine the impact that sales tax harmonization would have on improving business competitiveness and enhancing the capital markets. A recent report by the Institute for Competitiveness and Prosperity<sup>13</sup> notes that one fifth of Canada's METR on new business investment is attributable to provincial retail sales taxes.

Last year, the C.D. Howe Institute noted that achieving sales tax harmonization in the remaining provinces with retail sales taxes would reduce the METR on capital by 6.9 percentage points for 2012<sup>14</sup>.

Sales tax harmonization delivers meaningful benefits to business, and helps make Canadian goods more competitive on the global stage. The recent announcements that the governments of Ontario and British Columbia will each adopt a harmonized sales tax on July 1, 2010 is welcome news, as is the provision of one-time federal government funding to these provinces to support the transition to the new value-added tax.

<sup>5</sup> *Tax Expenditures and Evaluations*, Department of Finance Canada, 2008.

<sup>6</sup> Aled ab Iowerth and Jeff Danforth, "Is Investment Not Sensitive to its User Cost? The Macro Evidence Revisited." Department of Finance, Working Paper 2004-05, Ottawa.

<sup>7</sup> Department of Finance Canada, 2007.

<sup>8</sup> *Opportunity in the Turmoil; Institute for Competitiveness and Prosperity, Report on Canada 2009*.

<sup>9</sup> *Enhancing Canada's International Tax Advantage*, Final Report, Advisory Panel on Canada's System of International Taxation.

<sup>10</sup> *Limited Horizons: The 2008 Report on Federal and Provincial Budgetary Tax Policies*, C.D. Howe Institute.

<sup>11</sup> *Global Competitiveness Report 2008/2009*, World Economic Forum

<sup>12</sup> *Opportunity in the Turmoil; Institute for Competitiveness and Prosperity, Report on Canada 2009*.

<sup>13</sup> *Ibid.*

<sup>14</sup> *Limited Horizons: The 2008 Report on Federal and Provincial Budgetary Tax Policies*, C.D. Howe Institute.

## Personal Income Taxes

We applaud the personal income tax initiatives brought forward in the last federal budget to both increase the amount of income that can be earned before having to pay federal income tax, as well as adjust the thresholds at which the two lowest income tax brackets apply.

There is no doubt that very high marginal tax rates on employment income have a profound effect on Canadians, and that investment income which falls outside of sheltered savings faces quite high effective tax rates. Moreover, high marginal rates act as a disincentive to attracting talent to Canada.

A survey carried out by KPMG International<sup>15</sup> examines the highest rates of personal income tax applied in 87 countries between 2003 and 2008. At 29 per cent, Canada's top marginal federal rate kicks in at \$123,185 of taxable income. Among the countries examined, nearly a third have top marginal rates that are lower than Canada's – and there are 10 other countries whose top marginal rate is applied at a higher level of income.

Looking at combined federal/provincial marginal rates that apply is also instructive. For example, estimates show that an individual living in Ontario who earns between \$80,000 and \$150,000 would pay tax at a marginal federal/provincial tax rate of approximately 44.4 per cent in 2009<sup>16</sup>. Contrast this with a combined rate of 32.9 per cent that would be paid by someone in this same wage bracket living in New York<sup>17</sup>. This and other similar provincial/state examples illustrate the high personal income tax burden placed on Canadians relative to the U.S.

## What Must Be Done?

### Corporate Income Tax Reductions

We believe that economic prosperity and sustainability are best achieved through further corporate income tax measures that create wealth, boost job creation and facilitate both capital mobility and corporate liquidity, and through additional progress in sales tax harmonization. At the same time, strict control on program spending is essential to avoiding a structural deficit and allowing further corporate tax reductions.

Canada cannot afford to abandon the progress that has been made in reducing corporate taxes. We welcome the government's continued commitment to cut corporate taxes as a form of economic stimulus. This approach targets relief to successful corporations – those most likely to provide economic growth and create jobs. Corporate tax reductions will help restore some of the country's competitiveness in the global economy, and create a foundation from which it can take better advantage of the recovery.

As noted by the C.D. Howe Institute<sup>18</sup>, taxes on capital investments have the most profound effect on our productivity, compared to all other taxes. As such, we believe that further business tax reductions must be undertaken in order to truly drive wealth creation and increased prosperity in Canada.

The government must stay the course in reducing the rate to 15 per cent by 2012 – a commitment that is made all the more essential in the current economic climate. As finances permit, the government should further reduce the corporate rate to the small business level.

As a further comment, The Institute for Competitiveness and Prosperity notes that the Finance Department's own analysis shows that the greatest impact on the economic lives of ordinary Canadians would come from reductions in taxes paid by businesses on their investments<sup>19</sup>. That said, we know that individuals are increasingly mobile in a global economy. Canada must, therefore, stay attuned to the personal income tax burden placed on Canadians in order to stay competitive and both attract and retain human capital. In particular, we believe a closer look is needed at the level of personal income taxes paid by individuals earning between \$80,000 and \$150,000 and encourage the government to undertake this analysis.

There are two additional measures we believe should be considered to boost investment in Canada: ongoing adjustments to capital cost allowance (CCA) rates, and strengthening the Scientific Research and Experimental Development (SR&ED) Tax Credit Program. In order to ensure they act as incentives to investment, CCA rates should be continuously adjusted to line up with the true economic life of the asset. Adjusting CCA rates would enhance the overall efficiency and international competitiveness of Canada's businesses

<sup>15</sup> KPMG's *Individual Income Tax Rate Survey 2008*.

<sup>16</sup> Estimates prepared by KPMG LLP (Toronto), June 2009.

<sup>17</sup> Ibid.

<sup>18</sup> *The 2006 Tax Competitiveness Report: Proposals for Pro-Growth Tax Reform*, C.D. Howe Institute.

<sup>19</sup> *Taxing Smarter for Prosperity*, The Institute for Competitiveness and Prosperity, Working Paper 7, March 2005, referencing "Taxation and Economic Efficiency: Results from a General Equilibrium Analysis", 2004, Department of Finance.

and capital markets. Under the SR&ED program, input tax credits (ITCs) are fully refundable only for smaller companies, and as a result, firms with insufficient taxable income cannot immediately access the help they need in challenging economic circumstances. In order to make research and development more attractive in Canada for foreign investors, we urge the government to make SR&ED credits refundable for all claimants, regardless of size. Alternatively, if companies cannot otherwise use them, we urge the government to consider allowing an offset through which ITCs are creditable against an employer's portion of EI premiums.

### Sales Tax Harmonization

Additional progress is also needed in achieving sales tax harmonization that would stimulate growth in the provinces that continue to maintain their own retail sales tax. The government should aggressively pursue sales tax harmonization by providing carefully limited financial incentives to the three remaining provinces with retail sales taxes.

### Strengthening the Fiscal Framework

Against the backdrop of the global financial crisis, it is understandable that the government brings forward short-term solutions to provide stimulus to the economy. The challenge is to ensure that resulting deficits are temporary: short term deficit financing cannot be allowed to continue unchecked and risk returning Canada to a chronic deficit scenario.

Program spending must be closely monitored to ensure this cannot happen. A recent C.D. Howe report<sup>20</sup> shows that over the last 10 years, there were only two instances in which federal program spending came in lower than announced in the budget. According to TD Economics<sup>21</sup>, annual program spending growth since the late 1990s has been in the order of six to eight per cent every year. To illustrate the concern over excess growth in spending, TD's analysis shows that if annual spending growth is held to just two per cent starting in 2012/2013, the budget would not be balanced for another six years.

We believe that a framework should be established under which overall program spending – in all categories – does not rise at a rate faster than the rate of inflation (adjusted for population growth). At the same time, Canadians need to see a detailed plan put in place for eliminating the deficit at the earliest possible juncture.

## Conclusion

The government faces a difficult balancing act – it must deal with the impacts of a global economic and financial crisis, while paving the way for Canadian businesses to create prosperity, boost job creation and facilitate capital mobility.

Delivering on the government's commitment to cutting corporate taxes is essential to this happening. As noted earlier, analysis by the C.D. Howe Institute shows that taxes on capital investments have the most profound effect on our productivity, compared to all other taxes. As such, we believe that further business tax reductions must be undertaken in order to truly drive wealth creation and increased prosperity in Canada.

In order to further improve business competitiveness and reduce Canada's METR, we urge the government to aggressively pursue sales tax harmonization by providing financial incentives to the three remaining provinces with retail sales taxes.

Finally, although it is clear that the country's economic challenges require additional stimulus, the government must ensure that such measures do not result in a return to the structural deficits of the past. It is essential that our fiscal situation be brought back into line through carefully controlled spending and a plan to eliminate the deficit at the earliest possible juncture.

<sup>20</sup> *Near Hits and Big Misses: Canada's 2009 Fiscal Accountability Rankings*, C.D. Howe Institute, No. 117, April 2009.

<sup>21</sup> TD Economics, 5-Year Federal Fiscal Forecast, June 2009.