



Submission for 2006 Pre-Budget Consultations

Ontario

Prepared by the Canadian Bankers Association

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CANADIAN BANKERS ASSOCIATION

Building a Better Understanding

The Canadian Bankers Association (CBA) welcomes the opportunity to participate in the 2006 pre-budget process. As part of the process of collecting stakeholder input on the government's budgetary policies and priorities, we are pleased to offer the following comments and recommendations which we believe will improve the future productivity of the Ontario economy and the standard of living of Ontarians.

At the outset, we would like to commend the government for Ontario's solid economic performance and for its progress towards eliminating the deficit by 2008-09, while making key investments in education and health care. We agree that the province needs to carefully weigh future fiscal policy options given external issues such as high oil prices, the strong Canadian dollar, higher interest rates and a downturn in the U.S. economy. And we fully support the view that government should focus on improving services for Ontarians and creating a more productive economy. It is our strong belief that one of the most effective ways to improve productivity and ensure the necessary funds to improve public services, is to create a competitive tax regime. We also believe that now is the time for Ontario to focus its attention on tax policy and to make the necessary improvements to ensure overall tax competitiveness in order to ensure that the government has a sustainable source of revenue to finance those programs that are important to the province.

About the Canadian Banking Industry

The CBA is a professional industry association, which provides information, research, advocacy, education and operational support services to its members, the chartered banks of Canada, as well as to Canadians through its website and free publications. The CBA's mission is to be a leading contributor in the development of public policy on issues that affect the financial services sector.

The Canadian banking industry is one of the strongest industries in Canada. It creates wealth for Canadians by serving as an important intermediary between savers and investors on one hand, and borrowers and entrepreneurs on the other. By providing access to capital for businesses of all sizes as well as Canadian households, the industry serves as a crucial catalyst for economic growth.

Taxes Paid By Canadian Banks

Canada's banks paid over \$7.6 billion in taxes to Canadian governments in 2004 (\$9.0 billion globally). In Ontario, the six largest Canadian banks paid \$1.95 billion in taxes in 2004, including \$283 million in capital taxes. The treasuries of Canada's governments benefited from the banking industry since 85% of the taxes paid by Canada's banks went to Canadian governments, while only 73% of the banks' earnings were generated in Canada.

The size of the industry's tax bill underscores the important contribution that banks make to Canadian governments' ability to meet their expenditure requirements. In fact, the banking industry pays more in taxes than any other industry in Canada. The CBA's members paid more in annual corporate income taxes than the total annual corporate income tax bill for the oil and gas, construction, real estate and insurance industries combined.¹

Other Banking Industry Contributions

The Canadian banking industry employs almost one quarter of a million people in Canada and over 132,000 in Ontario. While the banking industry represents 2.1% of all employees in Ontario, these employees generate 3.9% of the province's GDP. To support our employees and to continually improve the quality of service we provide our customers, Canada's banks invest over \$1500 per employee per year in training.

Canadian banks provided over \$92 billion in consumer credit to Ontarians in 2004 and Ontario households currently benefit from \$183 billion in outstanding residential mortgages from Canada's banks. The banks also provided over \$286 billion in authorized credit to almost 450,000 Ontario businesses in 2004, most of which were small and medium-sized enterprises.

¹ *Financial and Taxation Statistics for Enterprises*, 2003, Statistics Canada.

Further, Canadian banks donated more than \$115 million to Canadian charities in 2004, of which \$72 million went to Ontario charities. In fact, there has been a quadruple increase in banks' charitable donations since 1990.

And finally, Canadians are more than just bank customers, they are bank owners. Through their pension plans and other investments vehicles, Canadian bank shares are widely held by many Canadians as noted below.

Fund	# of Members	Bank Shares as % of the Fund's Canadian Equity Holdings
Canadian Pension Plan (2004)	16,000,000	20.7%
Ontario Teachers (2004)	343,000	8.6%
Ontario Municipal Employees Retirement System (OMERS – 2004)	354,619	18.3%
Ontario Pension Board (2004)	32,400	21.3%
OPSEU Pension Trust (2004)	74,000	18.2%
British Columbia Investment Management Corporation	375,000	18.9%
Local Authorities Pension Plan – Alberta (2001)	125,446	12.5%
Caisse de dépôt et placement du Québec (2004)	N/A	3.3%

Sound Fiscal Management

Given the province's solid economic growth, positive economic outlook and progress towards the elimination of the deficit, the Ontario government is well-positioned to meet the challenges that lie ahead. The CBA believes it is critical for the government to continue its prudent management of the province's finances and this trend of economic growth, in order to ensure continued prosperity in the years ahead.

We do believe, however, that a sound fiscal plan is a necessary, but not sufficient, condition to ensure Ontarians' quality of life continues to improve. That is to say that recent and forecasted economic growth (a prerequisite for growth in government revenue) cannot be taken for granted. Hard work, prudence and discipline has been, and should continue to be, the key factors underlying the government's budgetary decisions.

There are, of course, important programs and services that require investment – notably health care and education. It is also critical to invest in existing and new infrastructure to support Ontario's growth. As well, there is a need to ensure that the province's revenue base is strong enough to support the expenditure commitments over the long-term. We believe that Ontario should take steps to further strengthen the province's economic position by reducing the tax load borne by Ontario's households and businesses, which in turn will strengthen the government's tax base through increased investment.

Tax Competitiveness

The CBA's key message to the government is: Take the next steps to make Ontario's tax regime competitive. Lower taxes stimulate long-term economic growth which will strengthen the province's tax base. A broader tax base provides the government with the revenue it requires in the short-term and an ongoing assurance that there will be sufficient revenue for the province's future needs.

An uncompetitive tax regime undermines the long-term economic health of a jurisdiction. It sends a signal to would-be investors (both those who might expand their operations and those who might make an initial investment in Ontario) that Ontario is not, as it were, open for business. This leads to a loss of existing and new investment, including employment opportunities, new technology and expertise, and a reduced access to capital. Indeed, the Task Force on Competitiveness, Productivity and Economic Progress (Task Force) recently concluded that:

Ontario businesses have under invested in machinery, equipment and software relative to their counterparts in the United States. We estimate this under investment in capital lowers Ontario's productivity by \$800 per capita.²

The Task Force goes on to further conclude that "businesses are under investing because our tax structure does not motivate business investment."

An example of the impact of an uncompetitive tax regime is set out in Appendix "A". This example provides a high level overview of the tax impact should a major Canadian bank move its head office from Ontario to Alberta.

In addition to having a negative impact on investment and employment, uncompetitive taxes weaken the tax base that governments rely on for revenue. Fewer businesses and fewer working Ontarians make it more difficult for the government to fund necessary and important investments in health care, education and infrastructure to improve Ontario's standard of living.

We therefore recommend that Ontario continue to reduce taxes to create a competitive tax regime. This will lead to increased capital investment, improved productivity and innovation, and ultimately, a stronger economy.

Corporate Income Taxes

Increases in the general corporate income tax (CIT) rate from 12.5% to 14%, as announced in Budget 2004, undermine the province's economic growth. In particular, relatively high CIT rates discourage investment and employment, and make Ontario uncompetitive vis-à-vis other key jurisdictions. For example, Canadian jurisdictions with the most competitive tax regimes – namely Québec, Alberta and British Columbia – have general CIT rates at 8.9%, 11.5% and 12% respectively. Overall GDP growth in those provinces between 2000 and 2004 has been 2.2% in Québec, 3.0% in Alberta and 2.7% in British Columbia. Ontario's GDP growth rate over the same period has just matched that of Québec at 2.2%. Clearly, Ontario needs to reduce

² Task Force on Competitiveness, Productivity and Economic Progress, *Rebalancing priorities for prosperity*, Fourth Annual Report (November 2005).

its CIT rate to make it more competitive, and this in turn, will signal to investors that Ontario is open for business.

Recommendation No. 1:

The CBA strongly recommends that the government reduce the general corporate income tax rate to make it competitive with other key jurisdictions in Canada.

Capital Taxes

Annual capital taxes are almost a uniquely Canadian phenomenon that undermine business innovation and productivity because these taxes are profit insensitive. In the banking industry, capital taxes are a direct tax on employment to the extent that salaries and wages of our employees are required to be attributed to capital. Moreover, capital taxes are particularly punitive to our industry since our members are compelled by regulation to hold high levels of capital to support the safety and soundness of the financial system and then are taxed for doing so.

A highly regarded study - the C.D. Howe Institute's 2005 Tax Competitiveness Report³ - noted that Canada has the second highest effective tax rate on capital among 36 industrial and leading developing countries. A lesser known finding of this study is that Ontario's tax burden on capital is the second highest among Canadian provinces and 11.8 per cent above the Canadian average. Ontario's capital tax contributes 2.6 per cent to the overall marginal effective tax rate on Ontario capital. Another study by the federal Department of Finance estimates that a one-per-cent-of GDP reduction in revenue from cutting the cost of new capital would increase steady state GDP by 4.39 per cent, and concludes that capital tax cuts are the most beneficial to the economy.⁴

We commend the Ontario government for recognizing the negative implications of capital taxes and for its commitment, as announced in Budget 2004, to eliminate capital taxes in order to make Ontario more competitive and promote investment. In his 2004 Budget Speech, Finance Minister Sorbara stated that capital tax is "one that businesses must pay whether or not they are profitable" and expressly recognized that this tax "is in effect a tax on investment and job creation." This move keeps Ontario in step with the trend to eliminate some or all capital taxes in other Canadian jurisdictions such as Alberta, British Columbia, Newfoundland & Labrador, Prince Edward Island, Québec, Alberta, British Columbia and at the federal level. Alberta, for example, eliminated capital taxes in 2001, while the federal government is on track to eliminate this tax by 2008.

Given the perverse nature of this tax, the government's focus on improving productivity, and the need to create a competitive tax regime in Ontario, we strongly recommend an accelerated schedule to eliminate this tax as soon as possible.

³ J. Mintz et al., *The 2005 Tax Competitiveness Report: Unleashing the Canadian Tiger*, C.D. Howe Institute Commentary, September 2005.

⁴ M. Baylor and L. Beauséjour, *Taxation and Economic Efficiency: Results from a Canadian CGE Model*, Department of Finance Working Paper 2004-10, November 2004.

In addition to accelerating the elimination of the capital tax, we believe that the government should at least limit the negative effects of this tax on future investment and employment by capping the capital base for this tax at 2004 levels – the year of the government's pronouncement to eliminate this tax. By doing this, strong and growing businesses in the province will not be further penalized for increasing their investment and employment during the phase-out period for this tax. We believe that capping the capital base at 2004 levels would be a reasonable and principled move by the government, particularly given its express recognition of the negative aspects of this tax.

Recommendation No. 2:

The CBA strongly recommends an accelerated schedule to eliminate the capital tax as soon as possible. In addition, we recommend that the capital base for this tax should be capped at 2004 levels – the year of the government's pronouncement to phase-out this tax, to ensure strong and growing businesses are not further penalized for increasing their investment and employment in the province.

Tax Neutrality – Income Trusts vs. Corporations

The CBA believes that Canadian investors are sophisticated and therefore, Canada needs an integrated tax system to prevent investors from shifting to tax-favoured investments. A neutral tax system puts investors and businesses on a level playing field, and benefits the economy by allowing for an efficient allocation of resources.

The CBA also supports the corporate structure and the income trust structure as effective financing vehicles for certain companies. While the corporate structure may be best suited to growing businesses, income trusts are an effective financing structure for companies in the more mature stage of development. The income trust option widens the pool of investors to these companies and lowers the cost of capital. The income trust structure also provides an alternative to the common equity IPO for launching small companies into the public marketplace. We are of the view that both business structures should exist and that similar regulatory obligations should be applied to these entities. Like the federal government, we believe that the tax system for these investment structures needs to be neutral and efficient, to ensure decisions concerning corporate structure are based on financial, economic and other business factors, and not on tax arbitrage considerations.

We appreciate the federal government's efforts to move to a level playing field in terms of the tax treatment for income trusts versus corporations, and in particular, we commend the federal government for doing its part to eliminate the "double taxation" of corporate dividends in the hands of investors. Unfortunately, the federal initiatives will only be fully effective once the federal corporate tax rate is reduced. Until then, the reduction in the tax on dividends only partly restores tax neutrality. More importantly, however, the federal measures will only be fully effective if provinces also undertake reductions in their tax on dividends through an increase in their dividend tax credits. Moreover, given the way in which provincial taxes are calculated, the failure of provinces to increase their dividend tax credits in light of the federal measures could actually increase the tax on dividend income.

Therefore, the CBA strongly recommends that the Ontario government take the necessary steps to ensure that tax neutrality in the treatment of corporate and income trust income is enhanced by making the appropriate changes to its dividend tax credit.

Recommendation No. 3:

The CBA recommends that the Ontario government increase its dividend tax credit, thereby reducing the tax on corporate dividends, to enhance the tax neutrality in the treatment of corporate and income trust income.

4. Conclusion

The CBA commends the Ontario government for its prudent fiscal plan and progress to date. Many important initiatives to improve the quality of life for all Ontarians and create an even more prosperous Ontario are now possible. We, therefore, encourage the government to make its tax regime more competitive in three ways. First, we strongly recommend that the government reduce the taxation burden on the corporate sector generally by lowering corporate income taxes. Secondly, we recommend that the government accelerate the schedule to eliminate capital taxes as soon as possible – a particularly punitive tax for the financial sector. In addition, we recommend that the capital base for the capital tax be capped at 2004 levels so as to ensure strong and growing businesses are not further penalized for their additional investment and employment in Ontario during the phase-out period. We believe that a combination of lowering of the corporate income tax rate and the expedited elimination of capital taxes will make Ontario's tax regime competitive vis-à-vis other provinces. Finally, we recommend that the Ontario government take the necessary steps to ensure that tax neutrality in the treatment of corporate and income trust income is enhanced by making the appropriate changes to its dividend tax credit.

We believe that a competitive tax regime will bolster investment in Ontario, improve productivity and innovation, and ultimately, strengthen the province's tax base. The current and future investments of the government depend upon a strong tax base and a strong economy.

APPENDIX “A”

Example: Impact of an Uncompetitive Tax Regime

We believe that an uncompetitive tax regime, over a protracted period of time, poses a real threat to the Ontario economy, and may in fact precipitate the flow of capital and investment from Ontario to more business-friendly jurisdictions. Consider, for example, the tax impact should a major Canadian bank move its head office from Ontario to Alberta. In terms of the annual business tax impact to Ontario, this would result in an annual tax loss of about \$325 million.⁵ In addition, the province would experience significant personal income tax losses from the movement of bank employees and their families from Ontario to Alberta. From the bank’s perspective, this move would result in an estimated annual business tax savings of more than \$80 million based on Alberta’s more favourable CIT rate (i.e., 11.5%) and 0% capital tax alone. While this example may appear unrealistic at first, this type of scenario in fact occurred during the 1980s’ exodus of business and investment from Montreal to Toronto. While other factors in Québec contributed to this movement, it is fair to say that the economic strength of Ontario relative to the rest of Canada played a significant role.

⁵ Estimate includes \$180 million in corporate income tax, \$47 million in capital tax, \$36 million in sales tax, \$27 million in payroll tax, and \$35 million in municipal taxes.