



Submission to the House of Commons Standing Committee on Finance

2007 Pre-budget consultations

Prepared by the Canadian Bankers Association

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CANADIAN BANKERS ASSOCIATION

Building a Better Understanding

Executive Summary

The Canadian Bankers Association (CBA) welcomes the opportunity to participate in the Standing Committee on Finance's 2007 pre-budget consultations. We are pleased that the Committee has chosen to focus on the tax system that the country needs for a prosperous future. Creating a competitive tax advantage in Canada is one key factor required to strengthen the economy and build long-term prosperity for Canadians, along with a competitive regulatory structure and sound infrastructure. Given that Canadians face fierce competition in the global marketplace, and given that both capital and jobs are mobile, the tax system for both domestic and international operations can materially impact business and investment decisions.

Canadian businesses are partners with the government in promoting economic prosperity for all Canadians through the creation of employment opportunities, dividends to shareholders, and contributions to communities. As businesses grow and prosper, they pay increasing amounts of tax to support the programs and services that are so important to Canadians. Creating a tax advantage which encourages innovation and business growth and which provides incentives for individuals to work and save can lead to a stronger and more prosperous economy, which benefits all Canadians.

Given the importance of international competitiveness, the Committee's questions about the criteria that should be used to guide changes to the tax system, as well as the appropriate form and level of taxes, are most timely. The CBA's key recommendations in response to the Committee's questions are as follows:

Question 1 – Criteria for Tax Policy

Enhancing international competitiveness should be the key criteria guiding federal decisions about the changes to be made to taxes and other charges levied by government. Specifically, when making decisions about the tax regime in Canada, the government should weigh the impact on domestic firms in light of their opportunity to compete at home and abroad with international peers.

Tax measures should be broadly-based, allowing both small and larger businesses to be innovative, productive, compete and grow on the basis of a strong business case, without regard for distorting tax measures. A neutral, efficient, equitable and predictable tax system is one of the best means by which to ensure that businesses can compete on a level playing field and succeed on their own merits.

Question 2 – Corporate Income Tax (CIT)

To allow Canadian businesses to compete effectively on an international basis, thereby further increasing employment and productivity which increase revenues for government, corporate taxation in Canada should, at a minimum be competitive with other key jurisdictions, but preferably create an advantage for Canadian firms. We recommend that the schedule of legislated reductions in the CIT rate (currently scheduled to be reduced to 18.5% by 2011) should be accelerated and then reduced to 16.5% by 2012.

Question 3 – Personal Income Tax (PIT)

To ensure appropriate incentives for Canadians to work and contribute to Canada's prosperity we recommend that the marginal effective tax rate on individuals be reduced. There are several ways in which this can be achieved, such as through PIT rate reductions, PIT bracket extensions or reduction in tax back rates. While relief for all tax brackets should be addressed in the future, we believe that the short term focus should be on reducing the tax burden for the lowest income tax bracket, where workers face the highest marginal effective tax rate on their income.

Conclusion

Our recommendation to reduce both the corporate and personal income tax burden is based on the need for Canada, as a relatively small player on a global stage, where both capital and jobs are mobile, to create tax and regulatory advantages to encourage increased innovation, productivity, and prosperity in our own economy. Canada currently has the fiscal room to make such changes. Creating tax and regulatory advantages in Canada will position our country for more stable and sustained growth in the future.

Canada in the International Context

As the Committee notes in its request for submissions, Canadians operate in an increasingly global world. It is within this international context that the government designs a system of taxation that results in the collection of revenues needed to fund its activities, thereby ensuring the prosperity and productivity of residents and businesses. Therefore, the questions posed by the Committee are both timely and important.

Question 1 –Tax Policy

“What criteria do you believe should guide federal decisions about the changes that should be made to taxes, fees and other charges, and about whether they should be broadly based or targeted to a specific group of residents or business sectors?”

Criteria to Guide Tax Policy

A country’s overall tax regime is one key factor in determining where investment will locate, along with a competitive regulatory structure and sound infrastructure. We applaud the government for acknowledging the importance of a competitive business tax regime in contributing to the economic strength and long-term prosperity of our country. Budget 2006 made important steps in this direction, including the elimination of the federal capital tax and the corporate surtax, along with a scheduled reduction in the Corporate Income Tax rate. The government’s Advantage Canada plan and Budget 2007 both reiterated the importance of creating a competitive tax environment for Canada. Budget 2007 notes the following:

“Creating a Canadian Tax Advantage will allow us to attract and retain business investment. This is more important than ever because world economies have become increasingly integrated. Countries with high taxes discourage investment and those with competitive tax rates reap the benefits of more investment. Canada must work to increase the competitiveness of its business taxes and be more responsive to the actions of other countries.”¹

We fully agree with this commentary, and appreciate the government’s goal of establishing the lowest Marginal Effective Tax Rate in the G-7. We acknowledge that meeting this goal by 2011 will require cooperation from the provinces (i.e. elimination of remaining capital taxes and harmonization of retail sales taxes) and as such, we congratulate the government for their vision and leadership in providing an incentive to the provinces to eliminate their capital taxes. After the introduction of this incentive, we have seen movement in a number of provinces to eliminate all capital taxes, including Quebec and Ontario. We will continue our discussions with other provinces on the need to eliminate the capital tax on financial institutions given that it applies regardless of profitability and is a tax on investment and jobs which stifles innovation, productivity and business growth.

Continuing the theme of ensuring international tax competitiveness, the government also announced an agreement in principle with the United States to update the Canada-U.S. Tax Treaty to facilitate cross-border investment and commerce with the elimination of non-resident withholding tax on interest payments. Thereafter Canada will unilaterally remove the withholding tax from arm’s length interest payments to other countries. We applaud this agreement, given that withholding taxes operate as a tariff on the free flow of capital, impose a premium on the cost of capital, reduce access to borrowed funds and act as an impediment to foreign direct investment in Canada. Therefore, we look forward to the timely conclusion and ratification of the updated Canada – U.S. Tax Treaty.

The government has also recently announced that it will be creating an expert panel to study taxation issues in the context of international tax fairness and competitiveness. We support this announcement, given that it is important to ensure that Canada’s tax policy decisions are viewed in light of actions taken by other key jurisdictions. Multinational businesses obviously pay taxes to the governments of all countries in which they do business. Therefore, Canada’s tax policies cannot be taken in isolation from the realities of global markets, given that capital, investment and jobs can and do flow around the globe. Rather, tax policy should be part of a broader strategic vision for the creation of a competitive business environment in Canada.

The progress shown by the federal government to date in creating a business tax advantage for Canada is important. We encourage the government to maintain their vigilance in this respect, particularly given that other jurisdictions’ tax rates will not remain static for long as countries compete for business investment by continuing to create more competitive business tax regimes.

¹ The Budget Plan 2007 - Aspire to a Stronger, Safer, Better Canada, March 19, 2007, pg 233.

Finally, the tax system should be designed in an efficient manner to foster competitiveness, thereby attracting quality jobs to Canada. The increasing complexity of provisions relating to foreign affiliates of Canadian companies may well discourage head office activity in Canada. Similarly, recent proposals on GST application to imported supplies may lead to Canadian financial institutions' relocating certain key functions offshore. Additionally, we encourage the government to create certainty for businesses by enacting tax legislation in a timely manner.

Need for Broadly-Based Tax Measures

The Committee has also asked whether tax policy should be broadly based or targeted to a specific group of residents or business sectors. Budget 2007 clearly acknowledged the need for a neutral business tax regime. "Business taxes must be competitive for all sectors, industries and business structures and the tax system should be neutral to ensure that tax considerations do not unduly influence business and investment decisions."² We agree wholeheartedly with the need for a neutral tax system.

A neutral and competitive tax system is one of the best means by which to ensure that businesses can compete on a level playing field and succeed on their own merits. Lower tax rates for all businesses, large and small, can support innovation and productivity which lead to growth in the economy by assisting in attracting and retaining a broad range of business investment, which translates into a broader base of business taxpayers. A broader tax base provides a sustainable source of funding for government programs in the longer term. Taxing different industry sectors at different rates does not reflect the contribution to GDP made by more highly taxed sectors such as the services sector. Lower rates for all businesses would create neutrality and therefore not penalize smaller businesses as they grow and succeed. By contrast, targeted tax measures tend to be costly and can erode the fiscal room to finance broad rate reductions. The CD Howe Institute concludes that "Canadian governments should get back to an agenda of tax reform, looking to reduce personal and corporate rates to internationally acceptable levels while keeping tax bases broad and neutral. This is the only approach that makes sense if policies are to maximize economic growth while ensuring fairness in the tax system."³

Summary of Recommendations for Question #1 – Criteria for Tax Policy

- Enhancing international competitiveness should be the key criteria guiding federal decisions about the changes to be made to taxes and other charges levied by government. Specifically, when making decisions about the tax regime in Canada, the government should weigh the impact on domestic firms in light of their opportunity to compete with international peers.
- Tax measures should be broadly-based, allowing both small and larger businesses to compete and grow on the basis of a strong business case, without regard for distorting tax measures. A neutral, efficient, equitable and predictable tax system is one of the best means by which to ensure that businesses can compete on a level playing field and succeed on their own merits.

Building a Business Tax Advantage

Question 2 – Corporate Income Tax

"Given that corporations provide employment, are owned by individuals and contribute to the economic growth of a nation:

- *What is the appropriate form and level of corporate taxes, fees and other charges?*
- *To what extent should federal revenues be derived from corporations rather than from individuals?*
- *Should the federal government ensure that corporate taxation in Canada is competitive with that in other countries, and what consideration should be given to the various levels and types of public goods provided by countries?"*

Canadian businesses are partners with the government in promoting economic prosperity for all Canadians through the creation of employment opportunities, dividends to shareholders, and contributions to communities through charitable endeavours. As businesses grow and prosper, they pay increasing amounts of tax to support the programs and services that are so important to Canadians. Growing businesses also create jobs, which in turn leads to an increase in personal income tax revenues. Creating a tax environment which encourages businesses to grow and which provides incentives for individuals to be productive and innovative can lead to a stronger and more prosperous economy, which benefits all Canadians.

² The Budget Plan 2007, *Aspire to a Stronger, Safer, Better Canada*, March 19, 2007, pg 233.

³ Duanje Chen, Jack Mintz, Andrey Tarasov, "Federal and Provincial Tax Reforms: Let's Get Back on Track" C.D. Howe Institute Background, No. 102, July 2007, pg. 13

The Canadian banking industry is one of the strongest industries in Canada, employing and serving Canadians throughout the country and abroad. It creates wealth for Canadians by being 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 and by being a large employer of Canadians, the industry is a partner with the government in acting as a crucial catalyst for economic growth.

The Canadian banking industry employs almost one quarter of a million people in Canada. While the banking industry represents 1.4% of all employees in Canada, our employees generate 3.1% of the country's GDP. To support our employees and to continually improve the quality of service we provide our customers, Canada's banks invest over \$1350 per employee per year in training. Canadian banks provided over \$225 billion in consumer credit to Canadians in 2006 and Canadian households currently benefit from \$421 billion in outstanding residential mortgages from Canada's banks. Moreover, Canadian banks donated more than \$136 million to Canadian charities in 2006. In fact, there has been more than a four-fold 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 investment vehicles, Canadian bank shares are widely held by many Canadians as noted in the chart below.

Fund	# of Members	Bank Shares as % of the Fund's Canadian Equity Holdings
Canadian Pension Plan (2006)	16,000,000	13.0%
Ontario Teachers (2006)	350,000	9.4%
Ontario Municipal Employees Retirement System (OMERS–2006)	372,000	21.3%
Ontario Pension Board (2006)	76,300	23.0%
OPSEU Pension Trust (2006)	77,577	16.5%
Nova Scotia Teachers' Pension Plan (2006)	25,889	19.8%
Local Authorities Pension Plan – Alberta (2006)	168,000	13.1%
Saskatchewan Pension Plan (2006)	31,199	22.71%
British Columbia Investment Management Corporation (2006)	375,000	17.1%
Caisse de dépôt et placement du Québec (2006)	N/A	3.3%

Canada's 6 largest banks also paid approximately \$6.4 billion in taxes to Canadian governments in 2006 (\$8 billion globally). The size of the industry's tax bill underscores the important contribution that banks make to governments in Canada to meet their expenditure requirements. In fact, the banking industry pays more in taxes than any other industry in Canada.

Like all businesses in Canada, the banks' investment decisions are impacted by the applicable tax rate in the countries in which they do business. While the government has committed to creating a business tax advantage in Canada, unfortunately, Canada still does have a relatively high combined federal-provincial corporate income tax rates at 34% (falling to 30.5% by 2011). This compares to the current average in OECD countries of 28%.⁴ Of course, these rates do not remain static as countries continually compete to attract investment to their own jurisdictions. As such, we believe that Canada must continue on the path already started by the federal government, but we recommend that deeper and faster corporate income tax cuts are necessary to create a meaningful tax advantage in Canada.

Recommendations for Question #2 – Corporate Income Tax

- To allow Canadian businesses to compete effectively on an international basis, thereby further increasing employment and productivity which increase revenues for government, corporate taxation in Canada should, at a minimum be competitive with other key jurisdictions, but preferably create an advantage for Canadian firms. We recommend that the schedule of legislated reductions to the CIT rate (currently scheduled to be reduced to 18.5% by 2011) should be accelerated and then reduced to 16.5% by 2012, per the chart opposite.

Corporate Income Tax Rates - %		
Year	Scheduled Rates	CBA Recommendation
2008	20.5	20.5
2009	20.0	19.0
2010	19.0	18.0
2011	18.5	17.5
2012	18.5	16.5

⁴ Jack Mintz, "A Plan for Flaherty – Canada's corporate tax system should have low rates and a broad base" National Post, May 23, 2007, pg FP19.

- We estimate that this recommendation would cost between \$1.2 billion to \$1.5 billion in the first full fiscal year of the 1% rate cut.

Part VI Capital Tax

The preceding recommendations are relevant to all businesses operating in Canada. However, the federal government continues to apply a minimum tax on financial institutions in the form of a minimum capital tax. When the Part VI tax was first introduced in 1988, it was intended to be a temporary measure to ensure financial institutions would pay a minimum amount of tax at a time of a high federal deficit, effectively levelling the tax revenues from the financial sector. At the time of the introduction of this tax, the federal CIT rate was significantly higher than today's CIT rate. The reduction in the CIT rate has not, however, been accompanied by any reduction in the Part VI tax. The 2006 Federal Budget addressed these issues on a short-term basis by increasing the threshold for the application of the Part VI tax. However, given that the policy environment in which this temporary measure has now changed significantly with the elimination of the deficit, we call on the government to eliminate the Part VI tax entirely.

GST/HST Draft Legislation

For several years, representatives from the Department of Finance have been in discussions with the CBA and its members regarding draft legislation that among other things imposes goods and services tax on imported supplies for financial institutions. The draft legislation is flawed in many respects including the fact that it seeks to impose conditions that are retroactive and adopt a process of taxation that is almost impossible to implement and more importantly, is uncompetitive with other jurisdictions. We encourage the government to reconsider its position on this draft legislation as it could result in driving the delivery of international financial services currently located in Canada to foreign jurisdictions. This could translate into a loss of investment in Canada and a loss of jobs for Canadians. We recommend that the government work closely with stakeholders on this proposed legislation to ensure that these outcomes do not occur.

Question 3 – Personal Income Tax

“Given that Canadians contribute to the nation as employees, corporate shareholders, volunteers and community residents:

- *What is the appropriate form and level of personal taxes, fees and other charges?*
- *To what extent should federal revenues be derived from individuals directly rather than from corporations?*
- *Should the federal government ensure that personal taxation in Canada is competitive with that in other countries and what consideration should be given to the various levels and types of public goods provided by countries?”*

While we have argued for cuts to the CIT rate in order to cultivate a business tax advantage in Canada, maintaining a competitive personal taxation regime is also important. Like capital, people and jobs are mobile. To a certain extent, people will seek to live and work in jurisdictions where they can earn more in after-tax dollars and thus improve their quality of life. Canada also needs to increase innovation and productivity. To do so, it must attract and retain a viable labour force, especially with its ageing population and labour shortages. Perhaps even more urgently, we need to make the best use of the resources that we have, and that includes creating incentives to work. A tax regime that encourages a strong work ethic through economic rewards will increase Canada's global competitiveness. As the government itself has indicated, real improvement in productivity and efficiencies will be gained by providing work incentives for Canadians.⁵

Reducing the personal income tax burden is a necessary step to foster further innovation and growth in Canada. Such changes will improve individuals' incentives to work, save, invest and act entrepreneurially.⁶ Indeed, Canadian workers have a heavy taxation burden with the average Canadian worker receiving somewhat less than 55% of any additional pre-tax earnings from extra work or bonuses. The result of having this high marginal effective tax rate on employment income can provide a disincentive to work and therefore decrease productivity and prosperity.⁷ While there would be benefit to reducing the personal taxation burden for all income brackets over time, there is a pressing need to focus on tax relief for the lowest income tax brackets, where the marginal effective rate of taxation on employment income is the greatest, which discourages the transition from welfare to work. We

⁵ Advantage Canada – Building a Strong Economy for Canadians, November 2006, pgs 44 and 45

⁶ Niels Veldhuis, Jason Clemens and Milagros Palacios, “Cutting the right income taxes” – Fraser Forum, May 2007, pg. 7

⁷ Duanje Chen, Jack Mintz, Andrey Tarasov, “Federal and Provincial Tax Reforms: Let's Get Back on Track” C.D. Howe Institute Background, No. 102, July 2007, pg. 7

commend the government for starting this process through the personal tax relief offered by the Working Income Tax Benefit introduced in Budget 2007.

Recommendation for Question #3 – Personal Income Tax

- To ensure appropriate incentives for Canadians to work and contribute to Canada's prosperity we recommend that the marginal effective tax rate on individuals be reduced. There are several ways in which this can be achieved, such as PIT rate reductions, PIT bracket extensions or reduction in tax back rates. While relief for all tax brackets should be addressed in the future, we believe that the short term focus should be on reducing the tax burden for the lowest income tax bracket, where workers face the highest marginal effective tax rate on their income.

Affordability of Recommendations

In the past, federal budgets have worked to address key challenges such as large deficits and federal debt repayment. Thanks to concerted government action and sound policies, Canada is in a surplus position with solid fiscal results. While these surpluses exist, it is appropriate for the federal government to move to take steps to encourage the longer term competitiveness and sustainability of the Canadian economy by reducing the tax burden on Canadians.

Additionally, given the rise in government spending, it would be prudent for the government to continue to review program priorities and allocations and reduce program spending to equal growth in inflation plus population growth. The government itself has committed to limiting growth in program spending, on average over a four year period, to below the rate of growth in the economy⁸, which we commend. Given that program spending was projected to increase faster than growth in the economy over 2006-07 and 2007-08, the government will need to be particularly vigilant in reducing program spending growth in the coming years to meet that goal.

According to a recent OECD report⁹, many OECD countries that have deeply cut tax rates show rising tax revenues measured as the ratio of tax to Gross Domestic Product (GDP). The report states that "recent increases in income tax revenues – both personal and corporate – have come despite the fact that statutory rates of corporate and personal income taxes remain stable or are falling in many OECD countries. There were no increases in personal or corporate tax rates in the three countries with the largest tax ratio increase: Iceland, the United Kingdom and the United States".¹⁰ The OECD experience suggests that the increased ratios have resulted from stronger economic growth which has increased profitability of companies and the level of personal incomes, leading to an overall increase in levels of taxes paid. The CBA believes that this pattern of growth and revenue increase can occur in Canada under a competitive tax regime which includes the recommended changes to the CIT and PIT regimes.

The impact of the CBA's recommendations to cut CIT rates is estimated to be a revenue cost in the range of \$1.2 billion to \$1.5 billion in the first full fiscal year of the 1% cut. The PIT tax relief is one that the government could achieve through a variety of different options which would have varying impacts on revenue. In light of the government's commitment to keep program spending lower than growth in the economy and the promise to use savings from interest payments as a result of debt repayment to reduce PIT rates, these recommendations should be affordable.

This is the time for the government to outline a vision and implement steps that will ensure Canada's long-term growth and continued prosperity through competitiveness on a global scale.

Conclusion

Our recommendation to reduce both the corporate and personal income tax burden is based on the need for Canada, as a relatively small player on a global stage, where both capital and jobs are mobile, to create tax and regulatory advantages to encourage business growth, productivity and innovation which will translate into success and prosperity in our own economy. Canada currently has the fiscal room to make such changes. Creating tax and regulatory advantages in Canada will position our country for more stable and sustained growth in the future.

⁸ The Budget Plan 2007, *Aspire to a Stronger, Safer, Better Canada*, March 19, 2007, pg 31, 282.

⁹ OECD Revenue Statistics, October 2006

¹⁰ *Ibid*