FEDERAL PRE-BUDGET BRIEF

Submitted To:

The House of Commons Standing Committee on Finance

Submitted By:

Toronto Financial Services Alliance

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TAX REFORM IN SUPPORT OF A STRONG ECONOMY AND A STRONG FINANCIAL SERVICES SECTOR

Executive Summary

The Toronto Financial Services Alliance (TFSA) is a unique public-private partnership between the City of Toronto and the financial services sector, and the affiliated business services, consulting and IT services, post-secondary and training institutions that support the sector. Its mandate is to promote and strengthen the Toronto region as a financial services hub. Currently ranked third in North America by employment and one of the fastest growing, its goal is to become one of the two pre-eminent financial hubs on the continent and to be one of the top ten internationally. The financial services industry is one of the most important sectors in the Canadian economy, given its size, employment, stable growth and the valuable role it plays as an economic facilitator. But it is also a highly mobile sector, subject to growing international pressures. Its future success cannot be taken for granted. Tax changes that benefit the general economy will also benefit the sector.

In this pre-budget submission, TFSA recommends:

- Aggressive program reviews to support tax reform and tax reduction instead of the excessive growth of program spending that has occurred since 2000;
- Benchmarking Canada's tax rates against those of our competitors and setting goals so that our tax system remains competitive;
- Tax reforms that treat all sectors in a neutral fashion;
- A mix of taxes so that marginal rates can be kept as low as possible;
- A continuation of current efforts to reduce the tax on capital and to harmonize provincial sales taxes with the GST;
- Significant personal income tax reductions to assist with the attraction and retention of critical skills for sectors like financial services and to ensure the appropriate incentives are in place to promote economic growth.

TFSA welcomes the opportunity to participate in the 2008 pre-budget consultations of the House of Commons Standing Committee on Finance. We also appreciate the Committee's focus on tax policy as this is an important part of public policy that has not received the attention it deserves and we will consequently focus most of our comments on tax matters, both broadly as they affect Canadians in general and more narrowly, with an emphasis on tax matters that are important to the financial sector.

Importance of the Financial Sector

Financial services constitute one of the largest sectors in the Canadian economy. The industry employs over 750,000 Canadians directly, representing over 4% of total employment, at wages and salaries well above the national average. The sector also contributes directly to economic output in a substantial way, accounting for over 6% of GDP, up from about 4% of GDP twenty years ago. Moreover, the industry relies upon, and supports, a number of ancillary, high value-added services that are important contributors to the economy in their own right; and in the GTA, the financial sector creates approximately one indirect job for every direct job.

This sector's value to the economy is also evident from the fact that it has been a source of steady growth as well. Unlike other sectors such as manufacturing which have experienced much more cyclical variation, the financial sector has provided much needed stability to the economy. The importance of such stable growth should not be undervalued on the one hand but nor should it be taken for granted on the other. To continue to achieve these results, the sector needs to be globally competitive and needs a legislative, regulatory and tax environment that supports it. As London, the world's number one financial services centre has realized,

"Cities that are financial centres face greater competitive forces than most, for the financial services industry is at the heart of the global economy, acting as the facilitator of world trade and investment."[1] These competitive forces come about because financial services are highly mobile, making use of modern technology that allows these services to be delivered from anywhere in the world, and relying upon highly skilled workers who are themselves highly mobile.

The financial services sector – located primarily in Toronto but also with a significant presence in Montreal, Vancouver and Winnipeg – is in a unique position to be a driver of economic growth. The structure of the economy, the nature of competitiveness, and the role of cities have changed significantly. Over the past decade, Toronto has undergone an unparalleled transformation as it adjusted to a combination of forces including amalgamation, free trade, globalization, and new information and communication technologies.

This year, the City of London commissioned a survey of global financial centres that ranked those centres on the basis of a wide variety of criteria. Not surprisingly, London and New York ranked first and second and stood apart from the rest of the field. Toronto by contrast came in 12th, with Montreal ranking 21st and Vancouver 27th.[2] One area where Canada ranks poorly is on taxation, however. Using the C.D. Howe Institute's calculation of the effective tax rate on capital in the services industry, Canada's 39.6% rate stands well above the effective tax rates in the countries that contain the top ten global financial centres. In fact the median effective tax rate applying to those top ten is about 26%. Canada's tax rate, at 39.6%, is about one and a half times as high, a substantial competitiveness penalty.

It is within this international context that we will address the Committee's questions.

Question 1 – Tax Policy

The Committee's question refers to taxes, fees and other charges. Taxes are usually thought of as means by which the government raises revenues to fund its activities in the broad sense. Fees and other charges are often levied where there is a clear link between a specific service and beneficiary of that service. The financial sector is subject to a variety of fees; for example the sector directly pays for the operations of the agencies that regulate it. It is important that these fees be appropriate to the services they finance and not used as a source of government revenues in general. Having said that, our comments will focus on taxes, not fees.

Criteria to Guide Tax Policy

Governments at all levels levy a wide range of taxes that, in total, take up a large proportion of the income of Canadians. On a National Accounts basis, general government tax and non-tax revenue accounts for about 41% of Canada's Gross Domestic Product.[3] Given the extent of these tax revenues, it is important that the tax system be structured in such a way that it supports economic growth and productivity enhancement and ultimately leads to an improvement in the standard of living of Canadians. Specifically, the tax system should support investment, savings, work effort and risk taking and should not hinder them.

We believe that there are several basic principles that provide a good guide to tax policy and a good guide to tax reform.

- In seeking to create an efficient tax system, it should be realized that the statutory burden of a tax is often a poor guide as to the ultimate economic burden of a tax. Individuals ultimately bear the burden of taxes, in their roles as consumers, employees, or owners of capital through savings and investment. Canadian and UK research suggest, for example, that labour ultimately bears the primary burden of corporate taxes due to reduced labour productivity, which in turn leads to lower real wages.[4] When making decisions about tax rates and the mix of taxes, it is important to understand who ultimately pays for taxes.

[1] City of London, **The Global Financial Centres Index**, March 2007.
[2] Interestingly, another survey of more general business conditions came up with very similar results. According to the 2007 **Worldwide Centers of Commerce Index**, Toronto ranked 12th internationally while Montreal ranked 27th and Vancouver ranked 28th.
[3] Canada, Department of Finance, **Fiscal Reference Tables**, September 2006.
[4] See D. Chen et al., **Federal and Provincial Tax Reforms: Let's Get Back on** Track, C.D. Howe Institute Backgrounder No. 102, p.9.

- While taxes tend to influence the way the economy works and hence impose a welfare cost on the economy, not all taxes are created equal. Some taxes tend to be highly distortionary and consequently impose a high cost on the economy for every dollar of taxes raised while other taxes are much more benign.[5] Analysis at the Department of Finance shows for example that the greatest increase in economic well being comes from reductions in taxes on capital, achieved via increasing capital cost allowances or reducing sales tax on capital goods, reducing personal taxes on capital income, and reducing the capital tax. As much as possible, tax revenues should rely upon the least distortionary taxes and avoid those taxes that impose high costs on the economy.
- Economic research suggests that the distortionary costs imposed by taxes increase more than proportionately as marginal tax rates are increased. Consequently there should be a mix of taxes so as to avoid very high marginal taxes rates due to an over reliance on some taxes.
- Taxes should be neutral as much as possible so that decisions made by individuals or businesses are based on economic conditions and not preferential tax treatment. As much as possible, all sectors of the economy should be treated the same.
- The tax regime should recognize the fact that Canada is a small open economy that needs to attract and retain highly mobile factors of production such as capital and skilled labour, and needs to compete against foreign producers both in Canada and in export markets.

We recognize that there are a variety of other criteria that governments consider when tax decisions are made. ***Taking into account the principles set out above would provide good guidance for tax policy that supports economic growth and an improved standard of living.***

Decisions made by businesses and individuals should be driven by economic circumstances and not be dictated by tax policy that favours one sector over another or favours one type of activity over another. In addition, for any given level of tax revenue, disproportionately low effective tax rates in one sector mean disproportionately high effective tax rates elsewhere, leading to greater economic distortions. In Canada, the effective tax rates on capital investment vary substantially from one industry to another, with the highest taxed sector facing a tax rate more than twice that of the lowest taxed sector.[6] Jack M. Mintz has noted in last year's competitive report that "growth oriented service sectors face the highest tax rates" with federal tax rates almost twice as high as they are for manufacturing and four times higher than for forestry.[7] Not only should tax cuts be broadly based rather than targeted, the government should use such a process of reform to reduce the existing non-neutrality of the tax system. In its budget documents, the government has recognized the negative impact of a non-neutral tax system when it stated that "…the tax system should be neutral to ensure that tax considerations do not unduly influence business and investment decisions."[8] ***The TFSA believes that the government should create a neutral tax system.***

Question 2 – Corporate Income Tax

The general principles cited above suggest that Canada needs an appropriate mix of taxes that improves the standard of living of Canadians through higher productivity. The economic evidence is quite clear that our high levels of taxation on capital lead to lower investment in Canada than in both the United States and the OECD in general – "capital investment has been $3,200 and $1,400 per worker less in 2006 than in the United States and the OECD respectively."[9] This is a significant deterioration from similar data collected a year earlier which indicated a shortfall of $2,000 and $1,000 respectively. This same study was able to quantify the relationship between taxes and the impact on investment. For example, it showed that:

- A 10% reduction in the cost of capital can increase investment in machinery and equipment by 10%;
- A 10% increase in the overall cost of production, including taxes on labour and capital, can reduce the number of manufacturing establishments by 3%; and
- A 1% reduction in the effective tax rate on capital can increase the stock of foreign direct capital by 3.3%.

[5] "Taxation and Economic Efficiency: Results from a General Equilibrium Model" in Canada, Department of Finance, **Tax Expenditures and Evaluations**, 2004.
[6] D. Chen et al., **Federal and Provincial Tax reforms: Let's Get Back on Track**, C.D. Howe Institute Backgrounder No. 102, July 2007.
[7] Jack M. Mintz, **The 2006 Tax Competitiveness Report: Proposals for Pro-Growth Tax Reform**, C.D. Howe Institute Commentary, September 2006.
[8] The Budget Plan 2007 - Aspire to a Stronger, Safer, Better Canada, March 19, 2007, pg 233.
[9] Jack M. Mintz, **The 2006 Tax Competitiveness Report: Proposals for Pro-Growth Tax Reform**, C.D. Howe Institute Commentary, September 2006.

Canadian families are the ones who pay the price for this lower productivity through smaller salaries and wages. Given the fact that demographic changes over the next decades will reduce the rate of growth of the workforce, and even lower the proportion of the population that is working, the focus of tax policy needs to be on productivity improvements.

Moreover, there is a growing body of evidence that Canada's tax system is internationally uncompetitive. Canadian corporations are taxed at rates that are too high, with negative implications for investment, labour productivity, and real wages and employment. The reality is that Canada is a small country in an increasingly open world economy. We compete with others – both developed economies such as the US and newly emerging countries such as India and China – for capital and markets. ***In order to improve standards of living for Canadians, Canada's tax system needs to be competitive with other jurisdictions.***

Question 3 – Personal Income Tax

Canada relies much more heavily on personal income taxation than do most other OECD nations.[10] Not surprisingly, we have relatively high marginal tax rates as a result which leads to economic inefficiencies and we have relatively high average tax rates which means, that households keep less of their earnings than do households in other countries. These high tax rates have negative impacts on work effort, investment in human capital and risk taking, all of which are important for a dynamic economy.

The financial services sector relies upon a highly skilled workforce that is highly mobile and whose skills are much sought after. And through the use of modern technology, certain financial services can be provided from a location that is far removed from the ultimate customer.

Consequently, there is a need for substantial reductions in personal income taxes for Canadians.

Affordability of Recommendations

Canadian governments have achieved a remarkable turnaround in their collective fiscal position over the past 15 years. Canada is today the only one of the G-7 countries to be in surplus. Not that long ago, by contrast, our government sector was running deficits that were well above the G-7 average. The federal government also deserves credit for its own fiscal turnaround. The accumulated deficit is now about 35% of GDP, down almost half from its peak of 68% in the past decade. Debt service charges now consume 2.5% of GDP whereas they consumed as much as 6.6% in the early 1990s. These statistics demonstrate strong fiscal success that we should be proud of.

A strong fiscal balance sheet and a strong income statement do not mean there is no room for improvement. Nor should we conclude that there is no room for substantial tax reform because it would threaten our fiscal position. We believe that there is room to fund such reform through a program of spending review.

While the federal government continues to run regular surpluses, according to the most recent issue of The Fiscal Monitor[11], program spending appears to continue to be growing excessively. The most recent data indicate program spending was up $2.3 billion or 8.2% from the previous year. Unfortunately, this is not an aberration but a continuation of a trend that started at the turn of this decade. From 1999-00 to 2005-06, program spending increased by $56.5 billion (47%), well in excess of the rate of growth of the economy. Indeed, if program spending had been limited to a 4% annual growth rate, spending in 2005-06 would have been <u>$25 billion lower</u> which could have financed significant, permanent across the board tax cuts at the personal and corporate levels.

Program review would provide ample opportunity to kickstart a program of tax reform that could improve productivity, economic growth and standards of living and lead to even higher tax revenues. According to a recent OECD report[12], "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".

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[10] Jason Clemens et al., **Tax Efficiency: Not all Taxes are Created Equal**, Studies in Economic Prosperity, January 2007, Fraser Institute.
[11] Department of Finance, The Fiscal Monitor – April 2007
[12] OECD Revenue Statistics, October 2006

Recommendations

Appropriate Level of Taxation: Tax rates that allow program spending to increase by 8% per year are clearly too high. Tax rates that are based on the rapid escalation of program spending since the turn of the decade are also too high. The TFSA believes that there is ample opportunity through program review to continue paying down the debt while supporting substantial tax reduction.

Tax Benchmarks: The Institute for Competitiveness and Prosperity continually benchmarks Canada's competitiveness position against peer jurisdictions to determine how well we are doing and to gain insights into what would improve our progress. We recommend that the federal government do the same with respect to taxes and set specific goals with respect to competing jurisdictions. For example, we have noted in this submission that Canada's effective tax rate on capital in the services sector is about one and a half times that of the median rate amongst the top ten financial services centres. An appropriate benchmarking goal might be to remain competitive with the median tax rate and such benchmarking could be applied to a variety of taxes such as personal income taxes and taxes on business.

Tax Neutrality: The TFSA recommends that the government not only pursue broadly based tax cuts instead of targeted cuts, but that it actively work to narrow the gap that now exists between tax rates imposed on different sectors of the economy.

Tax Mix: The government should employ a mix of taxes so that it can keep marginal tax rates as low as possible.

Tax Efficiency: The TFSA welcomes the fact that the federal government has recognized the importance of tax reductions for Canadians and has implemented several substantive tax initiatives. In further pursuing tax reform, we recommend that the government concentrate its efforts on those taxes that impose the greatest economic penalty on the economy. In this regard, the federal government's elimination of the capital tax and its offer of incentives for provincial governments to do the same is welcome and encouraging. The same is true of its efforts to harmonize provincial sales taxes with the GST. Both initiatives go a substantial way towards reducing the tax on capital, promoting increased investment and improving our standards of living.

Personal income tax (PIT): The TFSA believes that personal income taxes should be reduced by lowering marginal tax rates. While the government might have a number of equity-related priorities that would dictate how it implements PIT reductions, we would like to make several observations regarding where and how these cuts could be made.

Any personal income tax comparison with the United States cannot help but notice the large difference in marginal tax rates for higher income earners and the fact that the top tax bracket takes effect in Canada at a much lower level of income. This makes it difficult to attract and retain highly skilled labour in Canada. Multinational enterprises often find it difficult to rotate executives into Canada as a result of these high taxes. This is a barrier to growth of the financial services sector in Canada and indeed a barrier to growth of any sector where migration of skilled labour is important.

Secondly, the combination of personal income tax rates and social program clawback rates means that some lower income workers are subject to excessively high effective marginal tax rates on labour income and hence have little incentive to work, while others have little incentive to save for retirement. While the solution may be more complex than just reducing marginal rates at the lower end, it is clear that the current system presents substantial economic distortions that need to be addressed especially in light of the fact that the population is aging.

Finally, the Department of Finance has identified personal income taxation of capital income as one of the most inefficient aspects of our tax system. Given the fact that we need to encourage Canadians to save, invest and engage in entrepreneurial activity, lowering the tax on capital income should be a key component of PIT tax reform.