A More Competitive Economy Needs a Lower Tax Burden on Savings

By

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The federal budget offered good news, continuing the government's policy of promoting Canada's economic growth by controlling spending and making corporate tax rates globally competitive. But one piece of the competitiveness puzzle is still missing: Reduced taxes on the savings of Canadians, whether in the form of capital gains, interest or dividends. That's what is needed now to promote investment – and boost economic growth and job opportunities. Canadians will respond to incentives to boost savings. The stand-out success of Tax-Free Savings Accounts (TFSAs) testifies to that.

The budget continues a multi-year commitment to keeping public finances on an even keel, achieving a near-balanced budget in four years, as well as reducing corporate income tax rates (now the most competitive among the G7 countries, about one-third below the United States) and improving capital depreciation allowances for investment.

These are important fiscal objectives. But at this stage of the recovery, Canada needs to transition from public-sector stimulus spending to encouraging investment in small and large companies, to build economic momentum as well as restore balanced growth in the national economy. The economies of central Canada, in particular, have been battered by weak demand – driven by a tepid recovery in the manufacturing sector's traditional U.S. export market, a high Canadian dollar and mixed business and consumer confidence. More competitive and growing Canadian businesses, especially smaller companies in the manufacturing and service sectors, will find attractive markets and growth opportunities in the United States and the global economy.

Canada's need for savings and productive capital is especially acute for three reasons.

First, capital translates into better technology and know-how, and improves the productivity and competitiveness of Canadian business in global markets.

Second, small and mid-sized businesses, even with lower tax rates, depend proportionately more than large companies on external capital to finance investment, reflecting limited cash flow and net earnings. These companies have found it more difficult to raise equity capital in public and private markets. In the last two years, initial public offerings (IPOs) by smaller businesses, an indicator of expanding enterprise and receptive market interest, were roughly half the average level in 2006-07.

Third, many existing tax breaks are badly skewed in favour of small *private* companies for defined small businesses, including even lower corporate rates, investment tax credits and tax relief up to $750,000 in capital gains on the sale of small business corporation shares. Mid-sized businesses with active business income over $500,000, and publicly listed companies, don't qualify for these tax breaks.

Yet these smaller businesses encountering financing difficulties are among the fastest growing in the country, offering the best prospects for employment and continued growth. So what's the solution? To begin with, lower capital gains taxes stimulating interest in common shares would improve access to capital and the cost of capital, making it easier for public companies to float new equity shares at attractive prices to finance expansion – an important alternative to acquisition by foreign and domestic companies. It is exactly these emerging and medium-sized companies that Canada needs to build a prosperous future.

The budget could have introduced a multi-year plan to lower the tax burden on savings. It could have reduced tax rates on capital gains, interest and dividends. Since the real need is to improve the cost of capital for mid-sized businesses dependent on outside capital, the tax focus could have been capital gains tax relief on listed common shares or, alternatively, eliminating capital gains tax rates for IPO shares for small and mid-sized companies.

The budget also could have exempted employer contributions to group RRSPs from CPP, EI and similar payroll taxes, similar to the practice for defined benefit, defined contribution and registered pension plans. This would have encouraged small and mid-sized businesses right across the country to establish group retirement savings plans, filling the retirement savings gap for the self-employed and Canadians employed by small business, and contributing to the pool of investable capital. While the government has announced plans to negotiate with the provinces over the proposed pooled registered pension plans to benefit from economies of scale, the suggested tax changes to group RRSPs would complement PRPPs and provide an immediate solution.

With lower corporate income tax rates in place and a balanced budget in sight, Canada has taken important steps towards economic growth and job creation. But there is more to do. Reducing the tax burden on individual savings will unleash the investment capital needed to compete effectively in global markets, both in the resource sector and beyond. This puts in place an essential and missing part of the competitiveness puzzle to achieve Canada's success in the 21st Century.

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