IDA – Industry Association
ACCOVAM – Association professionnelle

Ian CW Russell
President & CEO

April 19, 2006

The Honourable James Flaherty
Minister of Finance
140 O'Connor Street
19th Floor, East Tower
L'Esplanade Laurier
Ottawa ON
K1A 0G5

(sent via email: budget2006consult@fin.gc.ca)

Dear Minister;

Pre-Budget Recommendations of the Canadian Securities Industry

The IDA-Industry Association is the representative for over 200 investment dealers employing 39,000 Canadians and is the authoritative and respected voice for Canada's capital markets. Well functioning capital markets entails promoting public policy initiatives that improve the competitiveness of Canadian corporations and facilitate the formation of capital. It is with this in mind that we submit our pre-budget recommendations.

Canada surpasses other OECD countries on almost every measure, except the most important – productivity gains. Productivity is the key to investment and growth in Canada and Canada's financial infrastructure contributes significantly to the country's economic growth, providing important direct and indirect benefits to governments, businesses and Canadians. We recommend that the federal government take a series of steps to ensure growth in Canada's capital markets, supporting growth in the broader economy and in Canadians' independent saving for retirement.

We believe that there is a need for tax measures to promote capital formation and growth. To this end, we support the reduction in the personal tax burden as good policy, but this is not enough. We urge the federal government to re-balance and lower investment-related taxes and corporate taxes to a level closer to that in the U.S. Specifically, the federal government, during the first two years of its mandate, should:

- Balance dividend and capital gains taxes to achieve tax neutrality between companies financing by debt or equity and improve after-tax returns by raising the dividend tax credit and federal dividend gross up rate to bring the effective tax rate on dividends down from 32% to 20%.

- Reducing the capital gains inclusion rate from 50% to 25% on shares of small publicly traded companies. Current tax relief for small business is aimed towards private companies. These incentives, coupled with high regulatory costs, tend to encourage companies to stay private longer, and do little to promote public participation in Canadian junior public markets or keep Canadian junior companies in Canada.

- The Government should proceed with the innovative capital gains tax proposal outlined in their election platform which would exempt from taxes capital gains earned by individuals on real and financial assets where proceeds are reinvested within a six month period. The proposal however needs to be structured properly to ensure the correct systems and procedures are in place. The Canadian securities industry has the expertise to assist in this initiative and we offer to work with your officials at your earliest convenience.

- Eliminate federal capital taxes – a tax on capital is contrary to encouraging investment in capital

- Eliminate the 1.12% corporate income surtax and, on top of reducing personal income taxes, reduce the general corporate income tax rate by two percentage points from the current 21% to 19%, accelerating the reductions if possible. Higher taxes reduce disposable income and the amount that people and business can set aside for savings and investment.

The financial services industry is among the most regulated in the country. While protecting the public interest is paramount, the costs of unnecessary regulation are born by the public – investors and taxpayers – who see their returns diminished. Our Government needs to make strides in lowering the regulatory burden and achieving cost-effective regulation – an important ingredient in market competitiveness. We recommend the Government:

- Update federal legislation where necessary to reflect the financial industry of today. The law governing the transfer, holding and pledging of securities and interests in securities is found in a patchwork of provincial and federal statues in Canada. The federal government must make it a priority to implement consequential changes to federal legislation to support implementation of the Uniform Securities Transfer Act, now enacted in Ontario, and support efforts to see this legislation enacted across the country.

- Support efforts to harmonize and simplify the provincial-based securities regulatory system, a relic in fast-paced global markets.

In conclusion, government policies should be geared to productivity gains and economic growth. Growth opportunities coupled with the elimination of unnecessary cost burdens will benefit Canadian businesses, which rely on financing through capital markets; employees and investors, who spend in Canada and rely on investments to save for their retirement; and recipients of government services paid for by Canadian business and individual taxpayers.

For your reference, we have attached along with this letter our 2005 Pre-budget submission dated November 2005 as well as speaker notes from my appearance before you at the recent pre-budget consultation.

Yours Sincerely,

Ian Russell

Speaker Notes

Ian Russell, President and CEO

IDA – Industry Association

At Finance Minister's pre-budget consultation

Ottawa - April 13, 2006

Good afternoon, Minister. On behalf of the investment dealers of Canada, thank you for providing us with the opportunity to participate in this pre-budget consultation.

I head the newly formed IDA Industry Association which represents 205 member firms and 39,000 employees working in the Canadian capital markets. Our association's mandate is to address issues regarding capital markets. I am cognizant of our time restraints, and will present my organization's points succinctly.

Canada surpasses other OECD countries on almost every measure – except the most important one: productivity gains. Since the beginning of the decade, productivity in Canada has fallen well behind that of the United States and other OECD countries. In fact, annual average productivity gains in the United States are four times higher than in Canada. We believe that productivity is the key to investment and growth in Canada, and to restoring economic balance in the country. Productivity should indeed be the overriding theme guiding this government's actions.

To that end, we strongly recommend that the federal government take steps in three specific areas:

- dividend taxes
- corporate taxes
- and capital gains

Allow me to elaborate.

With respect to dividend taxes, we recommend that the government reduce the effective rate on dividends from 32 per cent to 20 per cent. Lower dividend tax rates encourage business investment and achieve a better balance with the tax rate on capital gains, thereby eliminating distortions such as excessive income trust conversion.

Secondly, we recommend that the government focus on corporate tax measures that we believe most directly relate to improving productivity. Specifically, we recommend that the government eliminate the 1.12 per cent corporate income surtax. As well, we recommend that the general corporate income tax rate be reduced by 2 percentage points from 21 per cent to 19 per cent.

Our tax regime has a significant impact on business capital spending decisions. Excessive corporate taxation reduces investment in capital, severely restricts our ability to innovate and grow, and reduces our competitiveness to attract foreign capital. In our view, higher levels of business capital spending can make a significant difference in boosting labour productivity and Canada's standard of living.

Further, making reductions in dividend tax rates in conjunction with lower corporate taxes would help achieve neutrality in the tax treatment between the corporate and trust tax structures.

And finally, we strongly urge the government to provide relief on capital gains. We encourage you to proceed with the innovative capital gains tax proposal that was part of your election platform. It was to create tax exemptions for the capital gains earned by individuals on real and financial assets, provided the proceeds are reinvested within a six-month period. Such a move would have a positive impact on both capital formation and productivity in the country. It would induce investors to unlock invested capital, which is often committed to uncompetitive returns, enable an efficient rebalancing of portfolios, and redirect investment to new opportunities in public and private markets.

The government should also consider lowering capital gains taxes on the treasury shares of small public companies. This measure will encourage capital-raising by small business at minimal cost to the federal treasury.

We believe our recommendations are achievable in the current financial environment – and necessary to create an economic environment that is conducive to growth, that increases productivity and enhances long-term competitiveness for Canada.

As industry experts on Canada's capital markets, our member association stands ready to provide further input to government in bringing forward initiatives to foster strong capital markets, a cornerstone of productivity.

Thank you.

Capital Markets: Notes and Commentaries

November 2005

Federal 2005 Pre-Budget Submission
Improving Competitiveness

Executive Summary

Canada's productivity performance needs improvement

A nation's productivity performance affects its standard of living and is an important factor influencing a nation's long-term economic growth potential. While historically Canada's labour productivity growth has modestly lagged the U.S., it has recently become an issue of growing concern. In the first half of this decade, Canada's annual average productivity growth significantly trailed the U. S. and also fared poorly among OECD countries.

Business investment plays an important role in productivity growth and Canada has had a less than stalwart capital investment performance. We are drawn to the impact that our tax regime has on business capital spending decisions. Canada has been hampered by a non-competitive tax regime. Using a measure of a marginal effective tax rate (METR), which takes into account factors in addition to statutory tax rates, Canada compares poorly against other countries.

As a first step to bolstering productivity, we believe there must be concerted efforts to increase business capital spending in buildings and in machinery and equipment investment. This enables companies to increase employment and raise wages of workers who produce goods and services, while keeping costs down and helping profits. To help ensure our future prosperity, Canada must act to enhance its investment attractiveness.

Measures to help increase Canada's labour productivity

We have keyed on corporate tax measures that we believe most directly relate to improving productivity and which are achievable in the current financial environment. However, we do not dismiss the pressing need for personal tax relief. Lower tax rates in Canada would increase Canadians' ability to save and invest, help the country retain skilled workers and enhance incentives for entrepreneurial activity.

To increase Canada's tax competitiveness that would lead to higher business investment, the IDA recommends the following tax and tax-related adjustments (cost estimates of the proposed initiatives are presented where feasible);

1. Corporate tax reductions. We urge the government to restore measures to eliminate the 1.12% corporate income surtax and the schedule to reduce the general corporate income tax rate by 2-percentage points from 21% currently to 19%, as originally announced in the 2005 Budget. (The first-year revenue impact would be $1.8 billion.)

2. Increase the dividend tax credit. We recommend that the dividend tax credit be raised to 18% from 13% currently and the federal dividend gross-up rate be increased to 33% from 25%. The adjustment in the inclusion rate we are proposing would largely remove the discrepancy in the tax treatment of capital gains and dividend income. The adjustment would also bring Canadian dividend tax rates more closely in line with the U.S. and become more competitive internationally. (The cost of raising the federal dividend tax credit from approximately 13% currently to 18% would be $200 million per year in lost tax revenues, according to C.D. Howe Institute estimates.)

3. Reduce the capital gains inclusion rate. The capital gains inclusion rate should be reduced from 50% to 25% on shares of small publicly traded companies. Current tax relief for small business is skewed towards private companies. While important, these incentives, coupled with high regulatory costs, tend to encourage companies to stay private longer, and do nothing to promote public participation in Canadian junior public markets, or keep Canadian junior companies in Canada. Targeted relief can be channelled in this way, at a negligible cost to the government, to the benefit of increased small business funding in public markets.

Improving Competitiveness

Canada's productivity performance needs improvement

The Standing Committee on Finance has noted that there is statistical evidence indicating a positive relationship between a nation's productivity performance and its standard of living. Some analysts have suggested that productivity is possibly the most important factor influencing a nation's long-term economic growth potential.

Given Canada's expansion in recent years, it may appear that productivity is not a leading issue in this country. After all, Canada's economic growth exceeded the U.S. in five of the past ten years to 2004, and we surpassed the OECD average seven times in the past decade. We caution, however, that these admirable headline figures belie some areas of vulnerability.

First, credit must be given to the favourable impact that the boom in mining, metal and energy prices has had on our economic performance. Oil and gas prices, in particular, have shot up a high annual average 11% in the past decade, double the 5% annual growth in the economy and contributing importantly to increases in overall business investment. Capital formation has also reflected robust residential construction spending, which increased at triple the pace of growth in the overall economy in the past half-decade. Additionally, we have been the beneficiary of the strength in U.S. consumer spending that has provided momentum to our manufacturing and export sectors.

There is no denying the importance of these types of stimuli to growth. But they do leave us vulnerable to downturns in global economic activity. Commodity prices have historically followed a cyclical pattern and will fall as surely as they have risen. Similarly, U.S. economic expansion will weaken at some point to the detriment of our manufacturing and exports.

The recent economic boom, moreover, is leaving Canada vulnerable to growing regional imbalances. Provinces endowed with energy resources, particularly Alberta, are gaining fiscal strength that will allow them to more easily cope with a period of slower growth. Fiscal strength is also enabling energy and resources rich provinces to significantly increase their corporate competitiveness and re-evaluate sensitive issues such as single-tier health care.

Central Canada, on the other hand, with limited energy resources and heavy dependence on exports, would feel the full brunt of a sluggish North American economy. Any major slowdown in the U.S. expansion will have serious impacts on growth and employment in central Canada that would permeate across the country. In view of the precarious nature of external factors and disparate makeup of our country it behooves us to structure our economy in a fashion that mitigates the adverse impacts of these forces as much as possible. One important means to accomplishing this is improving productivity growth.

Canada's labour productivity growth has modestly lagged the U.S. historically, but it has recently become an issue of growing concern. In the two decades from 1981-2000, Canadian productivity performance was not unduly worrisome. Annual productivity growth averaging 1.5% was only slightly behind the comparable 1.9% in the U.S.

Our experience in the first half of this decade, however, is considerably poorer. Since 2000, Canada's annual average productivity growth was a mere 0.9%. This is a particularly disappointing result when viewed against solid productivity growth in the U.S. averaging 3.8%, or four times higher in the same period. Canada also fared poorly on a wider global comparison. Our annual average growth in productivity in the decade to 2003 was ranked 14th among OECD countries. Canada's 1.6% annual average growth was a bit below the 1.8% OECD average but far from the leading countries, Ireland and Korea with 4.1% averages.

Business investment plays an important role in productivity growth and this explains part of Canada's recent dismal productivity performance. In a recent publication, the C. D. Howe Institute illustrated how business investment in Canada has weakened in relation to the U.S. The C. D. Howe Institute's report used purchasing-power adjustments to convert currencies to a Canadian dollar basis for comparisons. In terms of business spending on structures and equipment per employee, Canada's spending in 2005 will be 20% lower than the peak reached in 2001. There has also been a reduction in spending in the U.S. but this was a more moderate 12%. As a result of these trends, investment spending per worker in Canada this year will be about $2,700 less (or 23% lower) than in the U.S., a gap that has widened from $2,000 (15% lower) in 2001. The report also showed Canada comparing poorly against OECD countries, where our investment per worker is about $1,200 (or 11%) lower.

Investment per capita 2005 (C$)					
	Canada	OECD	U.S.	Canada share of OECD (%)	Canada share of U.S. (%)
1990	5,930	6,578	6,114	90	97
1991	5,588	6,503	5,822	86	96
1992	5,528	6,814	6,244	81	89
1993	5,925	7,131	7,151	83	83
1994	6,932	7,776	8,116	89	85
1995	7,244	8,358	8,901	87	81
1996	7,542	8,763	9,419	86	80
1997	9,417	9,534	10,351	99	91
1998	10,511	10,712	11,876	98	89
1999	10,470	11,214	12,619	93	83
2000	10,892	12,027	13,368	91	81
2001	11,326	12,350	13,309	92	85
2002	10,803	11,889	12,241	91	88
2003	9,279	10,339	11,134	90	83
2004	8,973	10,218	11,373	88	79
2005	9,081	10,233	11,774	89	77

Source: C.D. Howe Institute

In attempting to explain Canada's less than stalwart investment performance, we are drawn to the impact that our tax regime has on business capital spending decisions. In particular, it would appear that business investment in Canada has been hampered by a non-competitive tax regime. Using a measure of a marginal effective tax rate (METR), which takes into account factors such as depreciation allowances, inventory cost accounting, capital and sales taxes in addition to statutory tax rates, Canada compares poorly against other countries.

An analysis on this basis by the C.D. Howe Institute has determined that Canada's METR was 31.3% in 2004, the third highest among 20 countries examined. And we compared very poorly regionally where the METR for the U.S. was markedly lower at 23% and for Mexico 12.8%. The lowest METRs were for Ireland (11.5%), Sweden (11.2%), Singapore (7.6%) and Hong Kong (5.7%).

The C.D. Howe analysis noted that these four countries were among five top destinations of foreign direct investment in the five-year period to 2001, measured as a share of their gross domestic product. A high tax regime has been detrimental to Canada's prosperity and we concur with the Institute's view that "taxation of businesses reduces their incentive to invest in capital and restricts their ability to expand and innovate, making it harder to hire new workers or pay existing one higher salaries."

In a review of Canada's productivity experience, the Bank of Canada has noted that machinery and equipment investment as a portion of GDP tends to be an important determinant of productivity growth. One observation it makes is that new capital goods incorporate productivity –enhancing technological progress. Notably, average machinery and equipment investment as a share of GDP was higher in Canada in the first half of the 1990s, but fell below the U.S. in the second half. This gap with the U.S. has widened in the first half of the current decade.

Canada's relative underinvestment in M&E has likely contributed to the deterioration in Canada's relative productivity performance. Without constant replenishment and additions, our capital stock will continue to become less effective over time in utilizing our labour and maintaining productivity.

One of the major concerns of Canada's weak productivity performance is the detrimental impact it has on increases in output, real incomes and our standard of living. Using purchasing-power conversion rates to allow for comparison in Canadian dollars, Ontario's provincially supported Institute for Competitiveness and Prosperity estimated that Canada's standard of living has deteriorated significantly. Measured in real terms, the gap in GDP per capita between Canada and the U.S. has widened from $1,800 in the early 1980s to $7,200 (2003). As the Institute warns, this prosperity gap with our most significant trading partner is worrisome. We agree with the Institute's conclusion that Canada must strive to remain internationally competitive with the U.S. to be able to maintain and raise our standard of living.

We cannot help being reminded of Ireland's success in dramatically boosting growth over the past decade. That country's annual growth significantly exceeded Canada's expansion and the OECD average in most years since 1994, twice reaching the 10% mark. Notably, for six straight years between 1994-1999, annual increases in real gross capital formation was in a lofty 12-18% range as businesses responded to Ireland's attractive investment climate. In large part, the latter was fostered by an aggressive tax reduction strategy that saw the general corporate income tax rate decline from 50% in 1988 to 12.5% by 2003. Personal tax rates were also reduced sharply, with the top marginal rate dropping from 65% in the mid-1980s to 42% by 2002.

With its rapid growth, Ireland's standard of living has increased dramatically. Based on US dollars using purchasing power parity estimates, the OECD calculated that Ireland's GDP per person in 1994 was $16,000, about 25% lower than Canada's $21,414. By 2001, however, Ireland's GDP per person was nearly $30,000 and slightly ahead of Canada. In this time period, Ireland's ranking among the 31 OECD countries vaulted from 21st position to 5th highest, moving subsequently into 4th position.

In an address early this year, central bank governor David Dodge stressed that productivity "plays a critical role when it comes to our national standard of living. Productivity growth is the main element that contributes to continued improvements in real incomes and overall prosperity." As a first step to bolstering productivity, we believe there must be concerted efforts to increase business capital spending in buildings and in machinery and equipment investment. This enables companies to increase employment and raise wages of workers who produce goods and services, while keeping costs down and helping profits. To help ensure our future prosperity, Canada must act to enhance its investment attractiveness.

Recommendations to increase Canada's labour productivity

Increasing productivity is a complex issue for which there is no simple solution. A range of factors such as education/training, technical innovation, type and amount of investments, organization and management practices and others affect productivity performance. In proposing recommendations for improving productivity, however, we believe a primary focus should be on means to increase business investment. Higher levels of business capital spending in our view can make a significant difference in boosting labour productivity and our standard of living.

To make Canada a more attractive destination for business investment, there is an urgent need to significantly increase our tax competitiveness. We regret that the original tax cutting plan in the 2005-06 Budget was substantially modified. The original plan would have boosted capital investment by $56 billion, added $5 billion annually to GDP and created up to 340,000 jobs, according to C.D. Howe estimates. The elimination of the scheduled corporate tax cuts and limited relief from the corporate surtax in the modified plan greatly reduces the benefits to businesses. The C.D. Howe Institute estimates the revised tax reduction plan will produce a smaller $25 billion in capital investment and $2.3 billion in annual gains in GDP, less than half the original $5 billion figure.

With this year's theme in pre-budget consultations focussed on ways to improve productivity, we have keyed on corporate tax measures that we believe most directly relate to this issue and which are achievable in the current financial environment. However, we do not dismiss the pressing need for personal tax relief. Lower tax rates in Canada would increase Canadians' ability to save and invest, help the country retain skilled workers and enhance incentives for entrepreneurial activity.

We note that federal surpluses this year are again higher-than-expected and may allow the government to revisit the possibility of introducing a new personal tax reduction plan in the near future. In view of the relatively high costs to the federal treasury of personal tax cuts, however, it will be imperative that the government place additional priority on expenditure restraint in the upcoming budget. It is paramount that the government prevent a repeat of the experience of the past five years when program spending growth was double annual increases in revenues.

To increase Canada's tax competitiveness that would lead to higher business investment, the IDA recommends the following tax and tax-related adjustments (cost estimates of the proposed initiatives are presented where feasible);

1. Corporate tax reductions. We urge the government to restore measures to eliminate the 1.12% corporate income surtax and the schedule to reduce the general corporate income tax rate by 2-percentage points from 21% currently to 19%, as originally announced in the 2005 Budget. Significant economic and employment benefits noted above were foregone when the scheduled tax cuts were revoked and the elimination of the surtax became applicable only to small businesses. As well, the C.D. Howe Institute estimates that the revised schedule means the effective tax rate on capital investment will only decline to 26.8% in 2010 (assuming cuts begin in 2008) from 28.8% this year. Had the cuts been implemented, the rate would have fallen to a more competitive 25.0%. Restoring the two measures would provide an important signal that Canada is increasing its tax competitiveness as it welcomes and strives to stimulate business investment. (The first-year revenue impact would be $1.8 billion.)

2. Increase the dividend tax credit. We recommend that the dividend tax credit be raised to 18% from 13% currently and the federal dividend gross-up rate be increased to 33% from 25%. The tax environment for retail equity investors in Canada puts investments in equities at a disadvantage with other forms of investment. For example, the lowering of the federal capital gains inclusion rate to 50% resulted in a typical (top marginal personal) capital gains tax rate of 23%, significantly below the comparable 32% tax rate on dividend income. This differential can lead to "some distortions in capital markets by encouraging specific forms of corporate organisations, estate planning and financial products to take advantage of the lower tax on capital gains compared to dividends" (Jack M. Mintz, Taxes and Financial Markets in Canada). The adjustment in the inclusion rate we are proposing would largely remove the discrepancy in the tax treatment of capital gains and dividend income.

The adjustment would also bring Canadian dividend tax rates more closely in line with the U.S. and become more competitive internationally. The U.S. government recognized the importance of dividend-paying stock for American investors and has reduced its dividend tax rate to 15%. Canadian Chamber of Commerce estimates show that the combined U.S. federal-state (top marginal personal) dividend tax rate averages about 20%. The Chamber estimates that in Canada the comparable combined federal-provincial rate is significantly higher, averaging about 32%. Canadian investors have a much lower after-tax incentive than Americans to invest in the same dividend-paying stocks.

There is, accordingly, a need to reform the taxation of dividends. The Association recommends that the Government increase the dividend tax credit as a means to reducing or eliminating double taxation of dividends, thereby addressing these issues. (The cost of raising the federal dividend tax credit from approximately 13% currently to 18% would be $200 million per year in lost tax revenues, according to C.D. Howe Institute estimates.)

3. Reduce the capital gains inclusion rate. The capital gains inclusion rate should be reduced from 50% to 25% on shares of small publicly traded companies. Small and medium-sized businesses account for over two-fifths of Canadian Gross Domestic Product and about 50% of employment. These businesses, however, continue to face challenges to financing their growth. Investments by Canada's venture capital industry rose slightly in 2004 to $1.8 billion, ending three straight years of declines, but investments last year were less than a third of the peak $5.8 billion in 2000. Small businesses have also struggled to raise funding in public markets, with annual financings of about $2 billion last year only modestly above the 5-year average of $1.7 billion.

Current tax relief for small business is skewed towards private companies. While important, these incentives, coupled with high regulatory costs, tend to encourage companies to stay private longer, and do nothing to promote public participation in Canadian junior public markets, or keep Canadian junior companies in Canada. The federal government should reduce the capital gains inclusion rate to 25% for gains on initial public and treasury offerings of shares in small, publicly-listed companies. Targeted relief can be channelled in this way, at a negligible cost to the government, to the benefit of increased small business funding in public markets.

The Investment Dealers Association of Canada is the national self-regulatory organization and representative of the securities industry. The Association's mission is to protect investors and enhance the efficiency and competitiveness of the Canadian capital markets.

Also available on the Internet at http://www.ida.ca
Ce rapport est aussi disponible en français sur demande.

CALGARY Suite 2300, 355 Fourth Avenue S.W., Calgary, Alberta T2P 0J1
Tel.: (403) 262-6393 Fax: (403) 265-4603

HALIFAX T.D. Centre, Suite 1620, 1791 Barrington Street, Halifax, Nova Scotia
B3J 3K9 Tel.: (902) 423-8800 Fax: (902) 423-0629

MONTRÉAL Bureau 2802, 1 Place Ville Marie, Montréal, Québec H3B 4R4
Tel.: (514) 878-2854 Fax: (514) 878-3860

TORONTO Suite 1600, 121 King Street west, Toronto, Ontario M5H 3T9
Tel.: (416) 364-6133 Fax: (416) 364-0753