INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

LETTER FROM THE PRESIDENT

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Governments need to boost flagging capital formation

HIGHLIGHTS:

Capital formation is a key driver of economic growth and job creation in Canada.

The pace of capital spending has fallen back in the last three years, despite a strengthening economic recovery.

Eroding corporate tax competitiveness, rising government debt burdens and the uncertainties surrounding NAFTA dampen the outlook for capital formation, economic growth and job creation.

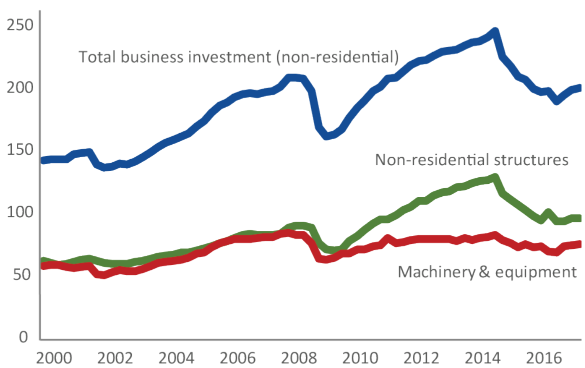
Private sector capital formation is the key to future economic growth in Canada, reflecting its impact on direct spending and its significant multiplier effect on employment and national income. Efforts to encourage direct investment in the technology sector to stimulate innovation and growth are an important policy objective. But the greatest benefit to economic growth and job creation comes from stimulating broadly-based capital spending right across the corporate sector, encouraging conventional manufacturing and services businesses to enhance competitiveness through the application of innovative processes and practices.

So how successful has Canada been in boosting capital formation in recent years, and what policy mix is needed to stimulate business spending to improve the living standards for all Canadians?

BUSINESS INVESTMENT LAGS OTHER COUNTRIES

Total business investment in Canada increased from $141.8 billion in 2000 to $207.5 billion in mid-2008, and then dropped to $160.5 billion as the financial crisis wreacked havoc on the global economy.

Business Investment (Non-Residential) in Canada
Billions 2007$, quarterly



Source: Statistics Canada

We know that just after the 2008 financial crash, from 2009 to late 2014, the country experienced a substantial investment boom in the energy sector—a spending boom on energy projects that overshadowed all other capital spending in the country. Over this period, total business spending rose 46% to peak at $244 billion in late 2014, with nearly all the spending increase accounted for by energy infrastructure investment, notably spending on oil sands plants, pipeline expansion and power generation. This spending then fell back by nearly 20% in the next two years, in reaction to the collapse in world crude oil prices. If measured over a longer period, say the past ten years, business spending has increased only 2.5%.

Canada has been well down in the list of OECD countries (where comparable data is available) when it comes to business spending as a share of GDP, generally ranking 15th or 16th out of 17 OECD countries in 12 of the last 18 years. Canada ranks second lowest among the major industrialized nations. Of the 17 OECD countries that directly report private business investment, only the UK invests less than Canada.

PERSISTENT WEAKNESS IN SPENDING ON MACHINERY AND EQUIPMENT

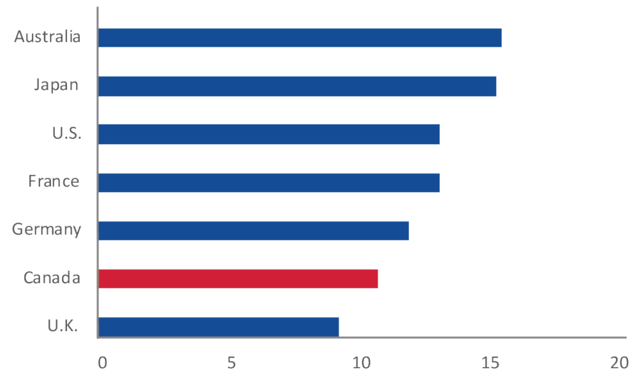
Investment in machinery and equipment increased from $56.9 billion in 2000 to $82.0 billion in mid-2008, and then fell with the financial crash and ensuing recession.

Since 2009, spending on machinery and equipment to expand and improve the productive capacity of manufacturing and service businesses in the country held relatively steady, averaging about $70-$80 billion per year.

It is surprising that spending on productivity-enhancing machinery and equipment has not accelerated at a faster rate. From the beginning of the millennium until the financial crash, Canada had an attractive business climate and attractive public policies in place. Canada had made great progress whittling down the marginal effective tax rate (METR) on capital investment from over 45% in 2000 to 17.5% in 2012, the lowest in the G7. Public finances in

Canada were sound, with the federal government posting annual budget surpluses over the 2000-01 to 2007-08 period and the federal debt falling from 42.7% of GDP to below 30% of GDP over this period. Also, Canada came out of the financial crisis relatively unscathed, with its financial institutions in much better shape than most countries, notably compared to the United States and Europe. Finally, the NAFTA provided Canadian business and the affiliates of foreign companies based in Canada unfettered access to the U.S. marketplace.

Non-Residential Business Investment
% of GDP, average 2015-2017



Source: Fraser Institute; OECD

Since 2014, business investment has fallen back substantially, even though the economies of Canada and the United States picked up steam, in line with gathering momentum in the global economy. To be sure, the METR on capital investment has been rising, and large government budget deficits and debt levels have undermined business confidence. Heightened uncertainty about foreign demand and falling corporate profits are also contributing factors to the weakness in business investment. The tepid latest figures, and modest Bank of Canada projections for business spending in 2018-19, leave little optimism.

The biggest negatives for corporate tax competitiveness are the recent U.S. corporate tax reforms that lower the U.S. corporate tax rate to 21% and enable immediate write-off of capital expenditures. Further, the difficult NAFTA negotiations are raising business expectations that the NAFTA will undergo significant amendments, to the disadvantage of Canada, or the possibility of the United States withdrawing from the Agreement altogether, leaving even greater uncertainty of the eventual outcome. These concerns will put a damper on direct investment flows into Canada, and could result in a shift of capital spending by Canadian business to operations south of the border. These consequences will have a serious impact on the outlook for economic growth and job creation.

WHAT CAN BE DONE?

Federal and provincial government policies need to be re-oriented to take advantage of the improving global recovery and encourage private sector capital formation. Even though infrastructure spending will increase in the coming year, it will not be sufficient to boost long-term economic growth.

The immediate priority is to continue efforts to put pressure on U.S. negotiators to preserve and limit amendments to the NAFTA. Second, the federal government should present Canadians with a credible plan and clear timeline for balancing the budget. Fiscal discipline is the cornerstone of business, consumer and investor confidence, and critical to robust private sector investment spending and overall economic growth. Third, the federal and provincial governments will need to collaborate to improve the competitiveness of the Canadian tax system, particularly corporate tax rates, requiring hard choices on program spending to make room for lower taxes. Finally, access to equity capital has been an obstacle for many small and mid-sized operating businesses, and measures need to be put in place to address this issue.

One policy option is a deferral on capital gains earned on asset sales (such as real estate), as long as the proceeds are re-invested in the shares of small public and private Canadian businesses. While the tax deferral could be limited to minimize the tax loss, the related capital gains would not have been realized in the first place without the tax deferral. Another policy option is a tax incentive modeled along the lines of the U.K. Enterprise Investment Scheme. The EIS Program provides a 30% personal tax credit for EIS eligible share purchases, an exemption from capital gains tax for EIS shares held more than three years, and a rollover provision exempting capital gains taxes on the sale of an asset, if the proceeds are reinvested in EIS shares. For businesses to qualify for the EIS relief, they must have gross assets of less than £15 million and no more than 250 full-time employees. Implementing a broadly based, market-driven tax incentive will enable small and mid-sized successful businesses to grow, invest and create jobs in Canada.

Yours sincerely,

Ian C. W. Russell, FCSI
President & CEO, IIAC
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