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Submission to the Independent Tax Review Committee, Newfoundland and Labrador

Introduction

The Investment Industry Association of Canada (IIAC) welcomes the opportunity to present our views to the Independent Tax Review Committee as it considers the important issue of tax reform in the Province of Newfoundland and Labrador. The IIAC is the national association representing 120 investment dealer firms on securities regulation and public policy. Our members are the key intermediaries in Canadian capital markets, accounting for the vast majority of financial advisory services for individual investors, and securities trading and underwriting in public and private markets for governments and corporations.

The IIAC supports tax reform that enhances economic opportunities for Canadians, wherever they may live across the country, promotes savings and investment, encourages foreign investment, and enabled Canadian business to prosper and compete both here and internationally.

We applaud the Government of Newfoundland and Labrador for conducting a review of the Province's tax system. We are living in an era of rapid technological change, changing demographics, changing work practices and rising economic uncertainty. The government must re-think how it raises taxes and analyze the role the tax system plays in promoting or hindering productivity and economic growth. Importantly, in reviewing the Province's tax system, Newfoundland and Labrador is setting an example for other provinces and the federal government to follow suit.

In our view, the Province of Newfoundland and Labrador can significantly enhance its competitiveness and growth potential by:

- Keeping tax bases as broad as possible, enabling lower rates of tax for a given revenue objective;
- Relying less on economically-damaging income and profit taxes, and more on consumption taxes, like the HST;
- Creating a more neutral business tax system;
- Exploring the possibility of a made-in-Newfoundland tax incentive to attract investment capital for new business formation and expansion of existing small and medium-sized businesses, and to support the transition of businesses in light of the anticipated large-scale retirement of small business owners;
- Refraining from increasing personal income taxes to attract and retain skilled labour and encourage entrepreneurship;
- Simplifying the tax system to reduce compliance and administration costs.

Newfoundland and Labrador Faces Challenges, But There Are Also Opportunities

The Parliamentary Budget Officer projects the Province's population to decline continuously over the next 75 years and its senior dependency ratio to rise to levels well above all other provinces and territories. The labour force will shrink and labour productivity growth will slow. This will weight on economic growth. Real GDP is projected to decline 0.1% annually, on average, over the 2017 to 2022 period. This is well below projected real GDP growth of 1.7% at the national level and Newfoundland and Labrador's historical average growth of 2.3% from 1982 to 2016.

These projections have implications for fiscal policy in general, and tax policy in particular. They suggest the personal tax system may yield less revenue in future years. The consumption tax yield may also fall. There may be revenue gains from the taxation of withdrawals from private pension plans (RRSPS, RPPs). Taxes on investment income may become relatively more important.

New sources of revenue may materialize. Newfoundland and Labrador is home to an increasingly diversified economy with growth opportunities in traditional sectors, like oil and gas and agriculture, but also in the advanced technology sector and aquaculture. Several leading-edge technology companies, for example, are competing globally and continue to expand, creating new employment opportunities and a more robust and resilient tax base.

Principles of Sound Tax Policy

Tax reform should be guided by long-standing principles of good tax policy. Tax experts would generally agree that a 'good' tax system is one that is neutral, fair, efficient and simple. It should not favour one sector over another, or distort individuals' economic behaviour, and it should be relatively simple to administer and comply with. The 'fairness' principle is most subject to value judgments, but there is general agreement that those with a similar ability to pay taxes should be taxed at the same rate.

Tax Neutrality

- Economic activities should receive similar tax treatment.

Tax Equity or 'Fairness'

- Tax burden is distributed fairly among the population. Taxpayers in similar economic circumstances should bear a similar tax treatment (horizontal equity). Taxpayers in better circumstances should bear a larger share of the tax burden in proportion to their income – ability to pay (vertical equity).

Efficiency

- Tax system should minimize negative effects of tax distortions.

Simplicity

- Tax system should be simple, transparent and easy to understand and comply with.

The Tax Base

A tax system that reflects sound policy employs tax bases that are as broad and inclusive as possible. Increasingly, the tax system in Canada has been used to advance economic and social objectives through various exemptions, deductions, rebates, deferrals and credits – typically referred to as tax preferences or tax expenditures – rather than funding the initiative through spending programs.

The government should undertake a critical review of these tax expenditures. While introduced with good intentions, some may not be meeting intended policy goals or delivering value for money. They should be eliminated or scaled back. The resulting revenue can then be used to lower tax rates, reduce future deficits, or both, to enhance the Province's competitiveness.

Broader tax bases come with benefits: lead to a simpler tax system; taxes are easier to file and administer; improve fairness and efficiency; and reduce the potential for revenue shortfalls as economic circumstances change.

The Tax Mix

The tax mix is also important. It has a far-reaching impact on economic growth.

Not all taxes are created equal. Corporate income taxes and personal income taxes impose relatively high economic costs while consumption taxes, impose less cost.

Because corporate income taxes reduce the after-tax return to capital, they hinder capital investment and stifle productivity. They are passed on to workers through lower wages, consumers in the form of higher prices for goods and services, and shareholders (including pensioners who own equity through RPPs, RRSPs and mutual funds) through lower returns.

Personal income taxes reduce the net return from working, saving or pursuing advanced training and education and entrepreneurial activities. They also reduce investors' rate of return and incentives to save and invest.

Consumption-based taxes, like the HST, are the least economically damaging form of taxation because they do not affect the pattern of savings and investment.

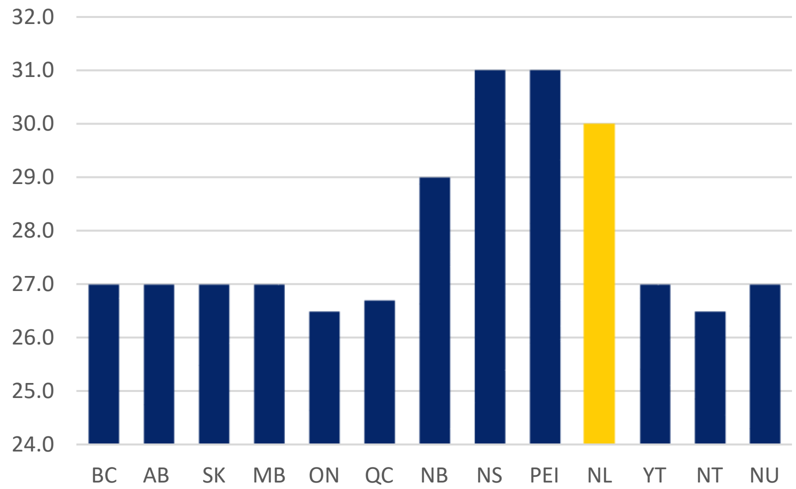
A greater focus on consumption taxes would encourage work and capital formation, enhance productivity and economic growth.

The current tax mix will likely face changes of its own due to the aging of the population. Taxes on capital income (for example, interest and dividends) and consumption (for example, the HST) may become more important, and taxes on labor income less so, as a source of future revenue.

Corporate Income Taxes

Newfoundland and Labrador has the second highest corporate tax rate in the country (30% federal/provincial combined) which can discourage large businesses from setting up operations in the Province. The need to improve tax competitiveness is now more urgent with the U.S. tax reforms that have lowered the U.S. statutory tax rate to 21% from 35%, allowed firms to immediately write off investments in equipment and removed taxation on dividends.

Combined Federal and Provincial/Territorial General (Statutory) Corporate Income Tax Rates (%) as at June 20, 2018



Source: Canada Revenue Agency; Provincial/territorial budget documents

Marginal Effective Tax Rates on Capital

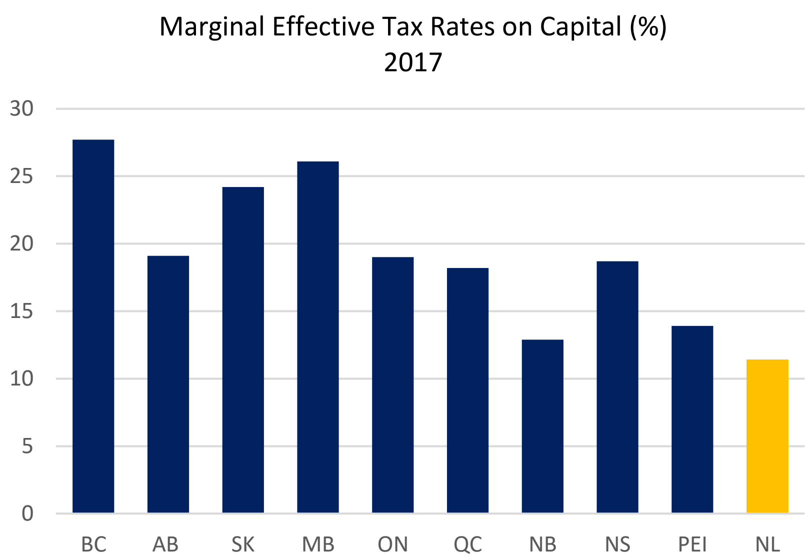
On the other hand, Newfoundland and Labrador has the lowest marginal effective tax rate (METR) on capital investment at 11.4%, an indicator designed to measure incentives for business investment.

The METR measures the tax burden on each new dollar of investment, and includes the statutory corporate tax rate, sales taxes on capital inputs as well as deductions or credits associated with purchasing capital goods. The Province's favourable ranking on this measure is due to the 10% federal Atlantic Investment Tax Credit, targeted at qualifying investments in resources and manufacturing industries, and the fact the Province has already harmonized sales taxes with the federal GST, a very smart move because it reduced the cost of doing business.

The problem, however, is the tax structure is biased against services. Research by the University of Calgary's School of Public Policy indicates that service providers, e.g. retail and wholesale trade, face a marginal effective tax rate on capital of roughly 25%; communications 21%. In contrast, METRs on capital are very low for forestry and manufacturing. This is concerning because services are a major source of job creation and are increasingly exposed to international trade and competition.

When taxes are not neutral across industries, it hurts economic growth because capital tends to gravitate towards industries with the most favourable tax rate rather than to where growth prospects may be higher. Tax treatment should not drive investment decisions.

The government should strive to achieve a business tax system that does not favour or disadvantage particular sectors of the economy.



Source: *2017 Tax Competitiveness Report*; University of Calgary, The School of Public Policy

Small Business

Small businesses are the backbone of communities across this Province and in communities across Canada. Ninety-eight percent of businesses in Newfoundland and Labrador are small (i.e. have fewer than 50 employees). At the same time, with 56 small businesses per 1,000 population, Newfoundland and Labrador has the fewest small businesses per capita among Canadian provinces, and well below the national average of 70. Also, the Province has the smallest proportion of GDP generated by small business, 25%, well below the Canadian average of 31%. (Source: *Small Business Profile 2017*, BC Ministry of Jobs, Trade and Technology. 2016 data).

This raises an important question as to what can be done to incentivize small business growth in the Province. Small businesses can be a source of new products and innovations and play a crucial role in promoting competition and economic renewal. The gap between the general corporate income tax rate and the small business rate in the Province is 12 percentage points, compared to an average of 10 percentage points across provinces. This may act as a disincentive to growth.

There a number of options the government should consider to encourage small business formation and help small businesses realize their full potential, for example, make the tax system simpler, more transparent and easier to understand; facilitate access to capital through a wide scope of partners; explore ways to facilitate the succession planning process; and explore tax incentives to spur investment in small and mid-sized successful businesses.

Providing an Incentive for Investment in Growing Small and Medium-Sized Businesses

The IIAC has proposed a Canadian version of the UK Enterprise Investment Scheme. The EIS provides a 30% personal tax credit for the purchase of shares of eligible small and medium-sized businesses, an exemption from capital gains tax for shares held for 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. Businesses must have gross assets of less than £15 million and less than 250 full-time employees to qualify for EIS relief.

EIS has funded more than 26,000 small and medium-sized businesses in the UK, providing overall equity capital of £16 billion. Program is dominated by small-sized investments, with 80% of the investors making a claim for tax relief for investments of less than £50,000.

Investments in EIS-qualifying shares have a solid track record of success because the investor's own capital is at stake—unlike the professional fund manager. Many investors are knowledgeable and acquainted with EIS qualifying investments, as many of the businesses are local.

Cost-benefit analysis by the UK EIS Association has demonstrated that the employment gains from small business expansion are worth the expenditure. Moreover, the tax expenditures of the EIS Program are more than offset by the revenues generated from corporate taxes, taxes paid on salaries to employees, and VAT paid by EIS-financed companies.

This type of an investment incentive in the Province of Newfoundland and Labrador would make it easier for smaller companies to raise capital to prosper, encourage start-ups, and strengthen the exit strategy for the anticipated large-scale retirement of small business owners, enabling them to transition operating businesses to new owners.

Personal Income Taxes

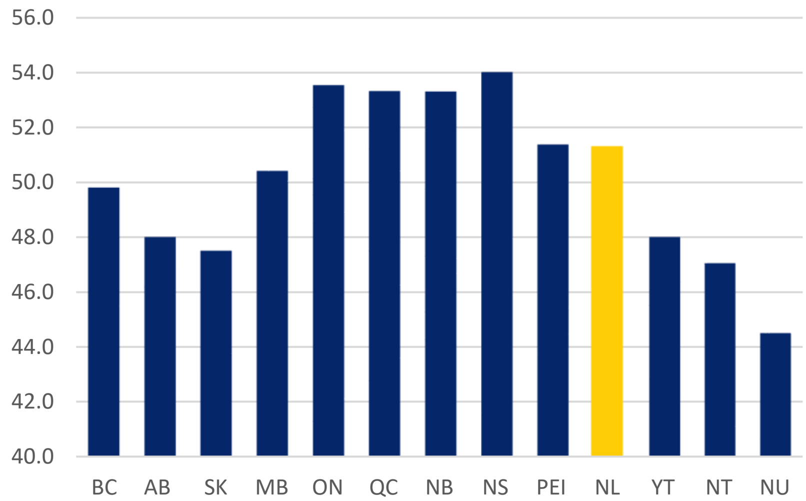
Newfoundland and Labrador will continue to face the challenge of attracting and retaining skilled labour. The combined federal/provincial top marginal personal income tax rate, at 51.3%, is high relative to Western Canadian provinces, where there is positive net migration, but lower than its neighbours in Atlantic Canada. The provincial top marginal personal income tax rate of 18.3% kicks in on taxable income over $184,591. This too compares favourably in the Atlantic region.

The Province should always be mindful about increasing personal income tax rates. Studies, for example by the Fraser Institute, show high personal income tax rates discourage entrepreneurship. The reason is, the more successful entrepreneurs are, the more taxes they pay on all their income – labour income, capital gains or dividends. High marginal tax rates can be viewed as a tax on success and may discourage entrepreneurship and stifle business creation. Conversely, the government can encourage entrepreneurship with personal income tax rate cuts. Entrepreneurs are fundamental to innovation, economic growth and job creation.

Reducing personal income tax rates can cost the treasury millions of dollars in forgone revenue, which is a major roadblock for the cash strapped government. Personal income tax cuts can be paid for by phasing out special tax preferences. Reining in spending and improving efficiencies in government programs, including in the areas of service delivery, can also yield savings that can be applied to reducing tax rates.

Newfoundland and Labrador must keep its tax rates competitive – especially with its workforce set to shrink.

Combined Federal and Provincial/Territorial Top Marginal Personal Income Tax Rates (%)
as at June 20, 2018



Source: Canada Revenue Agency; Provincial/territorial budget documents

Tax Complexity

Newfoundland and Labrador, like all provinces and territories, has much to gain by simplifying the tax system.

The Fraser Institute undertook a detailed examination of the tax package associated with each of the province's personal income tax system, looking at the number of documents for each province, the number of pages for each document and the total number of lines associated with tax calculations in the various forms. What it uncovered is quite interesting. In Newfoundland and Labrador, for example, the number of documents increased from 2 in 2000 to 6 in 2015. The number of pages in these documents increased from 3 in 2000 to 15 in 2015, and the number of lines associated with these documents increased from 19 in 2000 to 163 in 2015. These figures point to growing tax complexity. Newfoundland and Labrador is not unique; personal income tax complexity has increased in all provinces.

Personal Income Tax Package

Newfoundland & Labrador	2000	2005	2010	2015
Number of documents	2	7	6	6
Number of pages	3	13	15	15
Number of total lines	19	149	162	163

Source: Fraser Institute; *Measuring Personal Income Tax Complexity in Canada*, April 2016.

The big jump in tax complexity between 2000 and 2005 is a result of the federal government giving the provinces more freedom in setting their provincial income tax. By 2001, all provinces had moved to a "tax on taxable income" method of calculating provincial personal income tax. This method provides more flexibility to the provinces in determining tax rates, tax brackets and basic personal income tax credits. Consequently, it increases the number of pages and lines on the income tax form.

Simplifying the Tax System

Simplification of the tax code can bring enormous benefits to taxpayers and the economy. It would reduce compliance costs for individuals and businesses, and administration costs for government.

The government should undertake a review, and clarify the language used in tax legislation. It should review tax expenditures (exemptions, deductions, credits and rebates) to ensure they are cost effective and are achieving their intended purpose. It should then streamline the tax system accordingly. It should identify areas of the tax system that cause the most day-to-day complexity and uncertainty, and it should study the length of tax legislation and the number of documents, pages and total lines in tax forms.

In Summary

In summary, the Province of Newfoundland and Labrador can significantly enhance its competitiveness and growth potential by:

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