Canadian Manufacturers & Exporters

Manufacturiers et Exportateurs du Canada

2012/13 FEDERAL BUDGET RECOMMENDATIONS

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Executive Summary

Budget 2012 must set the framework for sustaining economic growth and at a time of significant market uncertainty. To that end, it must ensure responsible fiscal management while continuing to support business investment in productivity enhancement and innovation.

The Government is already committed to taking some very positive measures as part of Canada's Economic Action Plan. It has set deficit reduction targets that it needs to meet. The program spending review it is currently undertaking is important in increasing efficiencies and lowering public sector costs. These measures will be instrumental in improving fiscal management and reflect the responsible management decisions that many Canadian businesses have had to make in these challenging economic times.

The Government has also introduced a number of important fiscal measures that are already making a significant positive contribution to business investment, innovation, and job growth. Reductions in the business tax rate, the extension of the two-year write-off for investments in manufacturing and processing machinery and equipment, the elimination of import duties on materials and equipment used in manufacturing, and the agreements that have been reached with the provinces to encourage them to adopt the HST have together made Canada's system of business taxation one of the most attractive in the world.

However, further improvements in the tax system aimed at boosting productivity and innovation can still be made. To that end, CME recommends that the Government should:

1. Sustain business investment in machinery and equipment by making two-year write-off for manufacturing and processing machinery and equipment a permanent part of the tax system;
2. Encourage greater business investment in innovation by improving the current Scientific Research & Experimental Development (SR&ED) tax credit system; and,
3. Support business investment in workforce development by providing an Employersô Training Tax Credit creditable against Employment Insurance premiums.

The Importance of Manufacturing and Exporting

Manufacturing and exporting represent the two largest business sectors of the Canadian economy. Manufacturing alone accounts for more than 13% of Canadaøs GDP and offers high-paying, full-time employment to more than 1.7 million Canadians.

The direct and indirect contributions that manufacturers and exporters make to the Canadian economy are critical to the countryøs economic well being. Every dollar in value added output by manufacturers generates an estimated $3.05 in total economic activity ï the largest economic multiplier of any business sector. One in every three jobs in Canada depends on our export success. Manufacturing is the source of two-thirds of Canadaøs goods and services exports and three-quarters of all private sector research and development activity in the country. These are our innovative businesses ï manufacturers account for over 85% of all new products brought to market in Canada.

Itøs imperative that the importance of these two critical sectors of the Canadian economy be considered in the next federal budget because they are currently facing challenges that are fundamentally changing the nature of their business and will undoubtedly have an impact on the wealth-creating capacity of the Canadian economy as a whole.

Background

The updated fiscal presented in the last budget projected that the federal government will be in surplus by 2015ï 16. The Government remained committed to balancing the budget one year earlier, by 2014ï 15. CME strongly supports this commitment and encourages the government to keep this target for the elimination of the deficit. The debt crisis in some European countries, and the recent downgrade of U.S. credit rating by one of the major credit rating agencies point to the importance for Canada to stay focused on elimination of deficit and debt reduction. Control of the public debt has proved to be one of the most important determinants of Canadaøs resilience during the international financial crisis and the current economic recovery.

In recent years, the federal government has also implemented a number of tax policies to improve the economic environment in which manufacturers operate in Canada. For example, the federal government kept its commitment to reduce the corporate income tax rate to 15% as of January 1, 2012. These corporate income tax reductions gave Canadian corporations the lowest tax rate on new business investment in the Group of Seven (G7) in 2011. Provincial governments are also lowering their corporate tax rates. Planned reductions in federal and provincial tax rates will reduce Canadaøs average combined statutory corporate tax rate from 31% in 2010 to 25% in 2012, which will give Canadian businesses the lowest statutory tax rate in the G7.

In a report published in January 2011, *The Economic Impact of Corporate Tax Rate Reductions*, CME found a close relationship between reduced corporate income tax rate and investment in business R&D activity, by increasing businessesô after-tax profitability. The report also found that reduced corporate income tax rate will reduce unemployment rate, boost Canadaøs GDP and improve individual incomes and government revenues over the long term.

CME strongly believes that tax measures implemented by governments should encourage first and foremost the development of more R&D activity in the Canadian private sector.

Taxation of corporate groups: the next reform needed to increase Canada’s global competitiveness

We applaud the governmentõs decision to initiate consultations regarding the taxation of corporate groups. CME feels that the most important benefits that would be expected from a new system of taxation of corporate groups would be:

- Improving fairness - treating all closely controlled legal entities within the same corporate group as one economic unit
- Reducing cost - allowing companies with a common parent greater flexibility with respect to the offsetting of profits and losses within the corporate group ï the current ad hoc regime is costly to implement and is highly dependent on CRA rulings which can be unpredictable
- Increasing competitiveness of the corporation tax system relative to the U.S. and other jurisdictions (over 80 countries already either allow for the filing of group-consolidated returns or have some form of loss-transfer mechanism)

Canadaõs current loss-utilization rules are uncompetitive, particularly with respect to the United States where group consolidation is permissible with an 80 percent ownership threshold and a wide array of tax attributes that can be combined. From a competitiveness standpoint, the preferred policy approach should therefore be an attempt to ñlevel the playing-fieldò in terms of arriving at a substantially similar tax base.

We strongly encourage the federal government to cooperate with the provinces and make sure we do not miss this opportunity to improve Canadaõs global competitiveness through a reform of corporate group taxation.

Innovation as the new economic challenge

Innovation is the most important determinant of business competitiveness, productivity growth, and economic prosperity in a world of global markets and rapid technological change. CME strongly believes that Government should be encouraging businesses to invest in productive assets, such as technology, skills development, as well as R&D. Government also has a role to play in encouraging businesses in improving productivity, and redesigning products and retooling processes to meet new customer requirements.

Innovation is driven by investments in productive assets ï in knowledge (R&D), technology (machinery and equipment) and workforce training. These business investments are in turn driven by after-tax cash-flow performance (e.g. the amount of money companies have available to invest after business costs and taxes are paid). In manufacturing and other sectors of the Canadian industry, available data shows a close relationship between after-tax cash flow on one hand, and R&D spending and investments in machinery and equipment on the other hand. The most democratic way for governments to increase business after-tax cash-flow, and indirectly R&D spending and investments in machinery and equipment, is to keep improving the business tax environment and make sure it is as competitive as it can be with other jurisdictions.

New policy priorities and strategies are required for new economic circumstances. They must focus above all on how to facilitate the transformation that Canada's business sector must now make in order to succeed in domestic and international markets. While many countries around the world still see the development of economic policy through the eyes of domestic manufacturing, we believe that the new way to look at economic development is through the lens of innovation: we are no longer promoting products made in Canada – we must promote the idea of products and services "innovated in Canada" The manufacturing sector will not escape from this new challenge: in fact, the manufacturing sector is already going through a deep transformation that will change the way we make things.

Recommendations

The 2012 federal budget will play a critical role in shaping Canada's economic future. Addressing the challenges and leveraging the opportunities of economic recovery will require a concerted approach on the part of government and industry to enhance Canada's innovation, and productivity.

Canadian Manufacturers and Exporters see the next federal budget as an opportunity to make innovation the focus of all levels of government for the future. Our three recommendations aim at improving innovation and productivity among all the sectors of the Canadian manufacturing industry, from large Multinationals to Small and Medium Entities. Long-term economic growth will require governments to work together to address the various aspects of Canada's tax system.

1. **Make two-year write-off for manufacturing and processing machinery and equipment a permanent part of the tax system**

In its 2011 budget, the federal government adopted a measure aimed at allowing businesses to write business manufacturing and processing machinery investments off over three calendar years - although this is usually referred to as a two-year straight-line depreciation (or two-year accelerated capital cost allowance or ACCA). A company can write off 50 percent of half of the investment in the first year (equals 25 percent of total), 50 percent during the second year, and the remaining 25 percent during the third year. Given Canada's low record of productivity compared to its industrial partners, CME has strongly supported this measure as a way to boost company's investment in productivity and innovation. It should be noted that all federal political parties has been supportive of this measure during the 2011 election campaign.

The old way of calculating depreciation is on a 30 percent declining balance basis - 30 percent of 50 percent the first year, 30 percent of the balance the next year, and so forth. Under the old rules, it would take 12 years to write off 95 percent of the investment. So, the existing accelerated write off provides additional up-front cash amounting to about 48 percent of the value of the investment during the first three years. This incentive speeds up capital replacement and adoption of more productive, energy efficient, and green technologies.

CME is now arguing that it is in the countryês interest to make the accelerated write-off a permanent feature of the tax system. This permanent extension is supported across business sectors and political stripes. Doing so will definitely help Canada filling the gap of productivity with other industrialized nations.

2. Help businesses to increase R&D spending by improving the current Scientific Research & Experimental Development (SR&ED) tax credit system

The SR&ED tax credit is crucial for the Canadian economy because it increases cash flow for companies investing in R&D - and according to Finance Canada's own analysis, generates much more taxable income as a result.

CME strongly believes however that the tax credit could be made refundable to allow companies to take advantage of the cash credit in the year their investments are made (regardless of whether they are profitable or not)

CME also suggests that the administration of the system should be made simpler and easier to understand - so companies don't have to rely so much on consultants to claim the credit.

Finally, we believe that the credit should be made available for all product and process innovations - right now eligibility for the credit is becoming more and more narrowly defined in terms of basic research leading to a new product - it is becoming harder for a company doing shop floor innovation to claim.

3. Provide an Employers’ Training Tax Credit creditable against Employment Insurance premiums

It is far more productive to keep people employed and to upgrade their skills on the job than to attempt to provide transitional training for unemployed workers. At the same time, improving Canada's productivity and innovation performance also requires a world-class, highly skilled workforce.

In a context where businesses are facing Employment Insurance premium increases, and where sustaining highly qualified, highly-paying jobs is key to Canada's economic future, it is good public policy to encourage employers to invest in upgrading the skills and capabilities of their workforce. CME therefore recommends that the government encourage businesses to further invest in workplace training by providing an Employersô Training Tax Credit creditable against EI premiums.

About Canadian Manufacturers & Exporters

Canadian Manufacturers & Exporters (CME) is Canada's leading trade and industry association and the voice of manufacturing and global business in Canada. The association directly represents more than 10,000 leading companies nationwide. More than 85% of CME's members are small and medium-sized enterprises. As Canada's leading business network, CME, through various initiatives including the establishment of the Canadian Manufacturing Coalition, touches more than 100,000 companies from coast to coast, engaged in manufacturing, global business and service-related industries.

CME's membership network accounts for an estimated 82% of total manufacturing production and 90% of Canada's exports.