THE CANADIAN CHAMBER OF COMMERCE
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Le porte-parole des entreprises Canadiennes^MD

BUDGET 2018:

Long on Spending, Short on Growth

Long on spending. Short on growth. Some important fixes. But, Budget 2018 does little to prepare the Canadian economy for the risks that lie ahead.

Budget 2018 is primarily about spending—new spending initiatives and enhanced spending for programs that aim to support low-wage Canadians, address gender inequality, support First Nations development, strengthen indigenous rights and self-determination, promote skills and research, improve health and environmental stewardship and enhance justice and security.

Some of the spending initiatives announced in the budget will help business, particularly women entrepreneurs and small businesses, but they are limited in scope. There are also some important improvements in government policies—particularly with respect to the tax treatment of small business and the simplification of business support programs.

The government is intent on tightening tax rules and clamping down on tax avoidance. It should be focused even more intently on bringing its books back to balance and creating a tax and regulatory environment to support business investment and economic growth. The budget projects the federal debt will increase by almost $80 billion over the next five years, although the government's debt-to-GDP ratio is expected to decline slightly, thanks to continued strong economic performance.

The government is counting on a buoyant economy to fund its spending initiatives and meet its fiscal targets. Its rosy economic assumptions will be put to the test by the risks it identifies itself in the budget—growing protectionism and uncertainty over NAFTA negotiations, tightening monetary policies worldwide and the risk higher interest rates pose for an already overextended household sector in Canada. Recent U.S. tax reforms are another serious risk to business investment in Canada that is missing from the budget's calculations—we are awaiting further analysis.

Higher interest rates are certain to throw the government off its fiscal course—a 1% increase in the cost of borrowing alone translates into a $3-billion increase in the federal deficit over a period of five years. But, what is even more of a concern is that the government now has very little room to respond to an economic slowdown or any other problem affecting the Canadian economy. The leeway it has enjoyed to reduce taxes and increase spending in an era of low interest rates is quickly coming to an end.

Now, more than ever, Canada needs to undertake a comprehensive review of its tax competitiveness—and act with urgency to implement measures that will retain and attract business investment in Canada. That is the only way we can shield the Canadian economy against the headwinds that lie ahead. And, ultimately, it is the only way we will be able to pay for the government's ambitious spending plans.

Budget 2018: What's Important for Business

Tax Treatment of Passive Investment Income:

- *New rules for the tax treatment of small business passive income are simpler than previously proposed and will mitigate negative impacts on savings and investment for most small business owners. They will, however, still increase taxes for a small percentage of Canadian Controlled Private Corporations with passive investment income over $50,000.*
  - *The government will maintain its commitment to:*
    - *Protect passive investments already made by private corporations, including income earned from those investments*
    - *Establish a $50,000 threshold on passive investment income per year*
    - *Maintain incentives for venture capital and angel investors*
  - *The small business deduction limit will be reduced by $5 for every dollar of passive investment income in excess of the $50,000 threshold. Once passive investment income reaches $150,000, a small company will be subject to the general corporate tax rate. This is a much simpler approach to limiting the tax benefits available to smaller companies than the government proposed last July and does not involve changing refundable taxes or dividend tax rates.*
  - *The budget also proposes to end the tax advantage that larger CCPCs have by paying out lower taxed dividends from active income taxed at the general corporate tax rate and then claiming refunds of taxes paid on their investment income intended to be taxed at the higher tax rate.*

Other Tax Measures:

- Eligibility for Mineral Exploration Tax Credit for flow-through share investors is extended for one year.
- 50% declining-balance accelerated depreciation on energy conservation equipment (Class 432. Assets) is extended until the end of 2014.
- Stricter tax treatment of artificial losses using equity-based financial arrangements, share repurchase transactions, at-risk rules for tiered partnerships, health and welfare trusts and foreign affiliates dealing in debt or investment income.
- A "stop-the-clock" rule will be applied to all CRA information requirements and compliance orders, extending the period of assessment to cover any time those orders are contested.
- CRA will be given an additional three years to reassess loss carry-backs involving non-resident, non-arm's-length corporations.
- GST/HST will apply to management and administrative services provided by the general partner to investment limited partnerships rendered only on or after September 8, 2017.
- Excise taxes on tobacco will be increased and adjusted for inflation annually.
- Rules for the taxation of cannabis are proposed, which will come into effect when cannabis for non-medical purposes becomes available for retail sale.

Spending

- ***Employment Insurance Benefits:***
  - EI Working while on Claim pilot rules will be made permanent.
  - Training funds to assist workers in seasonal industries are increased.
  - $1.2 billion over five years to establish a new EI Parental Sharing Benefit.
  - *Note: In spite of significant investments from the EI fund, total EI benefits are expected to decline because of the budget's low unemployment forecast.*

- ***Skills:***
  - A new Apprenticeship Grant for women and Pre-Apprenticeship Program will encourage under-represented groups to explore careers in skilled trades.
  - $2 billion over five years to create a new Aboriginal Skills and Employment Training Program.

- ***Trade:***
  - $75 million over five years to increase Canada's diplomatic and trade presence in Asia.
  - A Canadian Ombudsman for Responsible Enterprise will be appointed to ensure Canadian companies operating abroad "exercise leadership in ethical, social and environmental practices."

- ***Innovation:***
  - $1.7 billion over five years to Canada's granting councils and research institutes.
  - $573 million over five years to implement a Digital Infrastructure Strategy.
  - $140 million over five years for collaborative projects between business and colleges/polytechnics.
  - $540 million over five years to strengthen research and collaboration at the National Research Council.
  - $2.8 billion dollars over five years to renew federal research laboratories.
  - Simplification and consolidation of business support programs (with additional funding) through an Accelerated Growth Services focusing on the Industrial Research Assistance Program, Strategic Investment Fund, Trade Commissioner Services, and Regional Development Agencies.
  - Launch of a new Women Entrepreneurship Strategy with $105 million over five years to regional development agencies to promote women-led businesses.
  - $85.3 million over five years to help Canadian companies access and share intellectual property, including the establishment of patent pools, a patent advisory service and the creation of an IP marketplace.
  - Establishment of a new electronic procurement platform to simplify and widen the scope of procurement processes.
  - $100 million over five years to develop the next generation of rural broadband.
  - $392 million over five years to create a new Centre for Cybersecurity and support its cybersecurity strategy.

- ***Regulatory Reform:***
    - A new Regulatory Reform Agenda aimed at supporting innovation and investment, including regulatory reviews, further regulatory cooperation with the United States and a new e-regulation platform to improve consultation and awareness.

- ***Pharmacare***
    - A new Advisory Council will recommend options for moving forward on the implementation of a National Pharmacare Program. While the objective is laudable, it will be important that the Council work closely with those businesses that already provide pharmacare-related benefits to Canadians.

The Fiscal Outlook

	5-Year Fiscal Impact of Budget 2018	**Fiscal Projections**	
		2017/2018	**2022/2023**
Total Spending	+$18.3 bn. +0.13% GDP	$329.0 bn. 15.3% GDP	$383.2 bn. 14.9% GDP
Revenue	+$2.0 bn. +0.01% GDP	$309.6 bn. 14.5% GDP	$373.9 bn. 14.5% GDP
Deficit	+$21.5 bn. +1.6% GDP	$19.4 bn. 0.9% GDP	$12.3 bn. 0.5% GDP
Net Federal Debt		$651.5 bn. 30.4% GDP	$730.1 bn. 28.4% GDP

Economic Assumptions: Sunny Days Ahead?

In Canada:

- Low unemployment rates will persist over the next five years.
- Earnings and confidence will continue to underpin growth, although growth rates will slow.
- Ongoing business investment gains.
- Stronger export performance will offset slower growth in domestic spending.
- Housing market pressures easing.

Internationally:

- Global economy is firming up.
- Global financial conditions remain positive.

- U.S. economy operating at potential.
- European economies strengthening.
- Strong growth in China and emerging economies.

The Risks Ahead:

- Growing protectionism and uncertainty over the outcome of NAFTA negotiations.
- Higher than expected interest rates. A one-percentage point increase in interest rates would increase the federal deficit by about $3 billion over five years.
- High household debt and the risk of a housing market correction.
- *An important omission: Loss of tax competitiveness in the face of US tax reforms.*

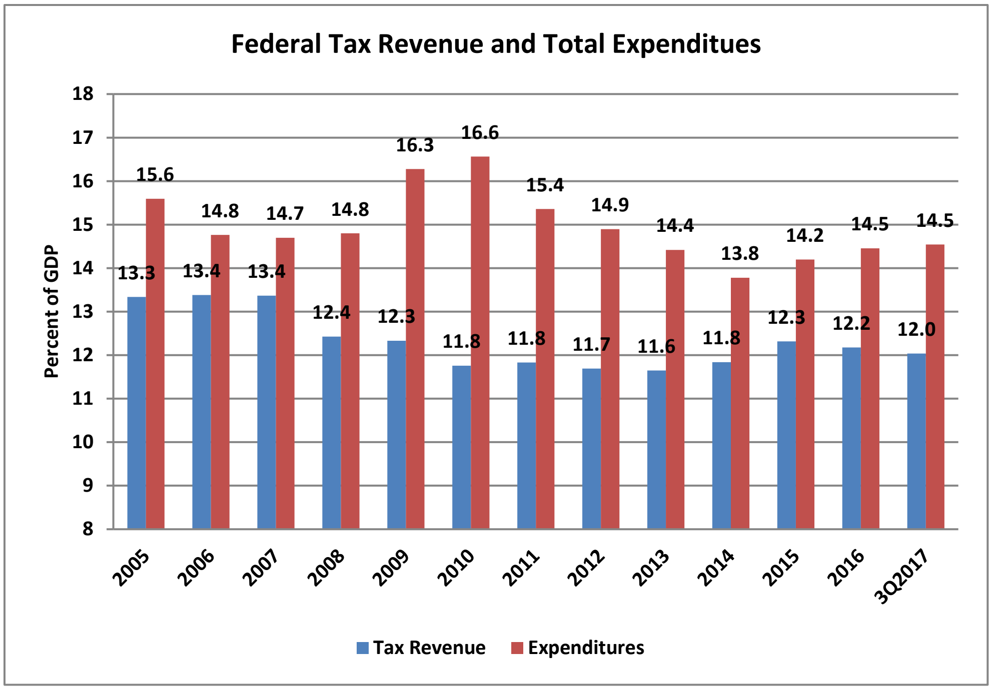
Just in Case – A Risk Adjustment:

- The budget includes a $3.0 billion annual risk adjustment provision going forward
- *Note: This is just enough to cover a one-percentage point increase in interest rates.*

Projections	2017	2018	2019	2020	2021	2022	2017-22
Nominal GDP	+5.2%	+4.0%	+3.5%	+3.8%	+3.6%	+3.8%	+4.0%
Real GDP	+3.0%	+2.2%	+1.6%	+1.7%	+1.6%	+1.8%	+2.0%
Consumer Prices	1.6%	1.9%	2.0%	1.9%	1.9%	2.0%	1.9%
Unemployment	6.4%	6.0%	6.0%	6.1%	6.0%	6.1%	6.1%
10-Yr. Bond Rate	1.8%	2.3%	2.8%	3.1%	3.2%	3.3%	2.7%

The Fiscal Outlook

The government's fiscal projections are pretty much in line with current trends. As a percentage of GDP, federal spending and tax revenue projections for the next five years look very much like the reality of the past five years. And, based on those assumptions, the government's debt-to-GDP ratio is expected to continue its gradual decline to 28.4% by 2022. The problem is the economy is unlikely to maintain its current course.


Federal Tax Revenue and Total Expenditues
Percent of GDP
18
17
16
15
14
13
12
11
10
9
8
15.6
13.3
14.8
13.4
14.7
13.4
14.8
12.4
16.3
12.3
16.6
11.8
15.4
11.8
14.9
11.7
14.4
11.6
13.8
11.8
14.2
12.3
14.5
12.2
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2005
2006
2007
2008
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2010
2011
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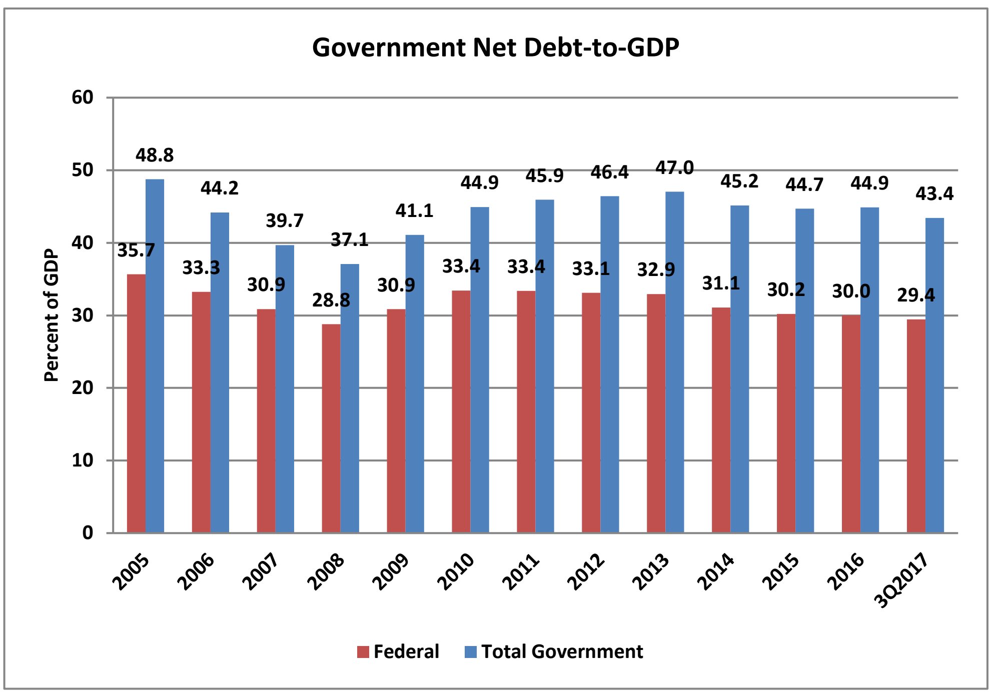
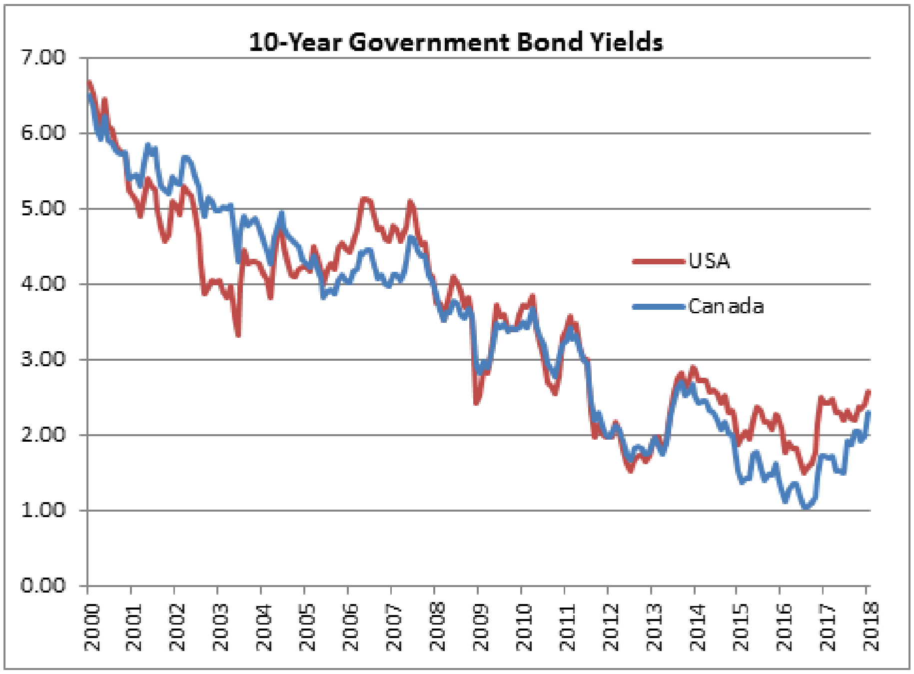
2013
2014
2015
2016
3Q2017
Tax Revenue
Expenditures


Government Net Debt-to-GDP
Percent of GDP
60
50
40
30
20
10
0
35.7
48.8
33.3
44.2
30.9
39.7
28.8
37.1
30.9
41.1
33.4
44.9
33.4
45.9
33.1
46.4
32.9
47.0
31.1
45.2
30.2
44.7
30.0
44.9
29.4
43.4
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
3Q2017
Federal
Total Government

Reality Check

1. The government's economic and fiscal assumptions are highly optimistic. Given the risks that lie ahead, it would be an economic miracle if Canada is able to maintain a 6%-unemployment rate over the next five years, particularly if the economy slows to an average annual growth rate of only 2% as forecast. It doesn't make sense and would completely defy the business cycle. If these are the consensus forecasts of Canada's premier economists, it doesn't say much for the profession!



The Canadian government's long bond rate is already above 2% and heading higher along with U.S. interest rates. With Canadian household debt at record levels, even a slight jump in long-term interest rates—which will in turn affect mortgage and other long-term borrowing rates—is likely to have a significant negative impact on consumer spending and the housing market in Canada. The government, itself, estimates a one-percentage point reduction in Canada's economic growth rate would increase the deficit by about $3 billion per year, and that does not take into account the impact higher interest rates would have in slowing down economic growth.

2. The federal government is ill prepared to manage a period of rising interest rates or economic weakness. While overall federal spending as a percentage of Gross Domestic Product is approximately the same today as it was 10 years ago, the structure of the government's expenditures has changed significantly.

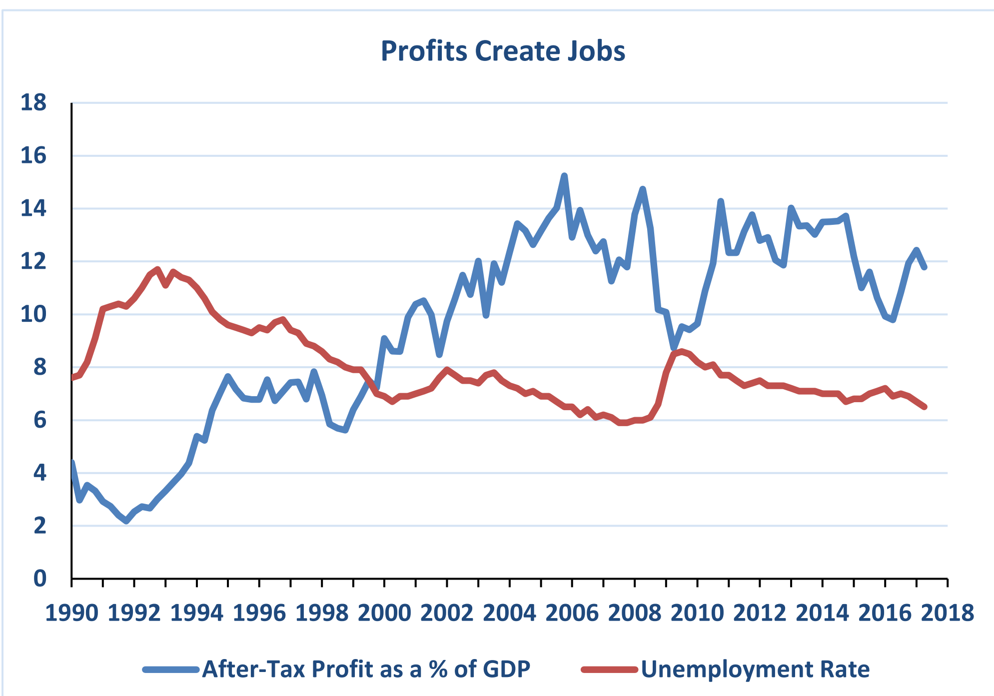
Federal Expenditures as a Percentage of Total Spending

Type of Expenditure	**2007**	**2015**	**2017**
Employee Compensation	12.9%	12.9%	12.7%
Use of Goods & Services	8.3%	7.4%	7.5%
Capital Consumption	3.0%	3.3%	3.1%
Interest Costs	**13.8%**	**8.4%**	**7.0%**
Subsidies	1.7%	0.9%	0.8%
Grants	**29.0%**	**31.7%**	**31.5%**
Social Benefits	**28.6%**	**33.1%**	**34.9%**
Other Expenses	2.6%	2.2%	2.4%

As interest rates have declined, government spending in the form of grants to other levels of government and social benefits have increased to fill the void. Today, there is little discretionary room left for the federal government to increase spending in the face of an economic downturn without significantly increasing its fiscal deficit and, in turn, generating higher interest costs at the expense of real economic stimulus.

3. Why do we need to ensure we have a competitive business tax and regulatory environment here in Canada? Because, business profits are important to the Canadian economy. They are what generate jobs. They are the mainstay of prosperity for the middle class—and for all Canadians.

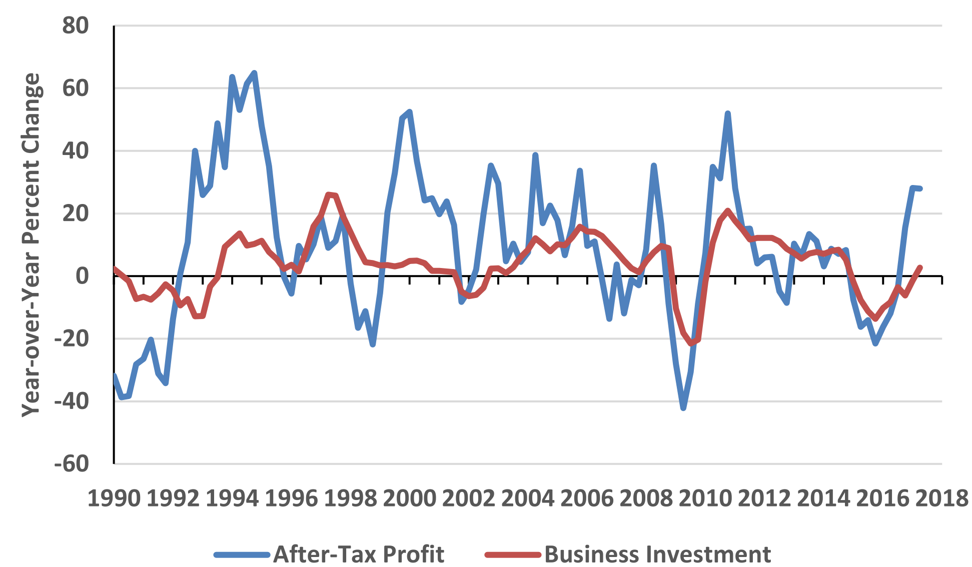
When businesses are profitable, they grow, create jobs and invest in the new products, processes and technologies required in order for them to meet customer and stakeholder expectations while remaining competitive.
The record of the past 30 years speaks for itself. The more profitable Canadian companies are, the lower Canada's rate of unemployment has been. Changes in



profitability (measured in terms of after-tax profits as a percentage of GDP) are followed immediately by changes in the unemployment rate. Canada's unemployment rate goes up only when profit margins come under pressure. Unemployment only goes down when profit margins improve.

Similarly, there is a strong relationship between corporate profits and capital investment by Canada's business sector. Changes in the amount businesses invest in non-residential structures, machinery and equipment follow closely on changes in after-tax profits. Simply put, profit drives business investment. The most effective thing governments can do to incent companies to invest more in innovation, productivity enhancing technologies and improved environmental performance is to leave more money in the hands of business to make those investments.

Profits Drive Business Investment



That is why we urgently need a comprehensive review of Canada's tax system. It is why we need a thorough reform of our regulatory system as well—to meet world-class standards when it comes to regulatory compliance at the least cost possible for Canadian business.

Canada needs a business investment strategy in order to support ambitious public sector investments in health care, social programs, inclusiveness, the environment, security—even innovation. That must be the focus for the federal government over the year ahead!