THE INTEGRATING NORTH AMERICAN MARKET PLACE: PROSPECTS FOR FINANCIAL SERVICES

By

Jack M. Mintz
President and CEO
C. D. Howe Institute

And

Arthur Andersen Professor of Taxation
J. L. Rotman School of Management
University of Toronto

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I am pleased to have the opportunity to speak to the Canadian Finance and Leasing Association about the impact of an integrating North American marketplace on financial services. Financial services, more than most industries, are substantially influenced by economic trends since financial capital moves quickest to those sectors that show the greatest profitable opportunities for investment. In my discussion below, I hope that I will provide a succinct analysis of how the events of 2001 – global recession and September 11 – will impact especially on the tax policies directed at financial services in the next several years.

Events of 2001

By way of introduction, let me underline the two most important general economic events of 2001.

The first has been the onset of global recession, first beginning in the North America but engulfing Asia and Europe in a short period. One could argue that the lengthy period of economic growth in the 1990s finally stalled due to capacity constraints and perhaps over-investement in some sectors, such as the hi-tech industry. Certainly, higher interest rates in 2000 led the way to a cut back in demand for consumer durables by late 2000. Further retrenchment from a deceleration of demand for goods and investment in the information technology industry scaled down growth in North America. By the summer of 2001, the US manufacturing sector had contracted and US growth stalled. Expectations that the federal governments in both Canada and the United States were going to enjoy huge surpluses were being sharply revised by the summer. US state governments were beginning to cut expenditures in face of falling tax revenues. Canadian provincial governments, less encumbered by balance budget requirements, knew by early September that the next fiscal year was going to be much more difficult to deal with than in the past.

The second event is the obvious one – it has dominated our newspapers, political discussions and economic analysis in the past four months – the terrorist actions of September 11. The United States, confronted with a tragedy never felt before, discovered the immense challenge of making its borders safe. Heightened US concern over security resulted in tougher monitoring of borders with Canada and Mexico. Businesses faced substantial delays as trucks and passenger cars were checked carefully. Just-in-time delivery began to be threatened as an efficiency measure as businesses had more difficulty moving parts and supplies across North American borders. The border between Canada and the United States began to look much thicker as people feared travel – the travel industry, making up more than 10% of the economy, became a casualty itself just like the hi-tech industry before then. Whatever doubt some had about the global recession was erased – the North American economies, after stalling in the summer, contracted in September and October. No one was afraid to use the "R" word anymore.

Implications of the events in 2001

The global recession of the latter part of 2001 and the aftermath of September 11 will have immense implications for the North American economies over the coming years. The financial services industry will be particularly affected since it is so sensitive to changes in industrial structure and economic relations.

A less restrictive border

The first implication of the events of 2001 has been to create a new sense of urgency for North American economic integration. The US concern over security has become a foremost objective. For Canada, we do not want to see the end of substantial economic gains achieved from trade with the US in the past decade. Canada exports almost $350 billion a year to the US -- $1 billion per day – in goods and services ranging from natural gas to automobiles and business services. Should there be a sudden increase in security requirements at the border then Canadian exporters would face a substantial rise in costs, which operates like a tariff on goods and services flowing into the United States. Canadians understand the implications of a slowdown in trade – lower incomes and employment overall. Thus, the immediate response of the Canadian government has been to enter negotiations with the United States to deal with border security issues. The US and Canadian governments have agreed to co-ordinate security operations at borders and to facilitate greater ease for Canadians and Americans to travel between the two countries. The ultimate aim is for Canada and the United States to have a less restrictive border for North American trade with tighter security to protect countries from terrorist attacks.

But the September 11 attack has made it very clear to Canadians that our relatively unprotected border with the United States cannot be taken for granted. Further terrorist attacks could easily result in disruptions and closings. If businesses find that the border becomes a barrier to trade, they will be more inclined to invest whether the market is largest, forgoing viable Canadian locations in favour of US factories where the border is less of a nuisance. Therefore, Canada could be at the losing end if disruptions frequently happen. Coming to a resolution of keeping the border relatively frictionless will be high on Canada's political agenda.

I believe Canada and the US will keep our border as frictionless as possible. Both countries will want to maintain the significant economic gains from trade and mobile factors. Integration will therefore be enhanced over time.

But this integration will have significant impacts on Canada's economic policies. In particular, tax and regulatory policies that interfere with the efficiency of capital markets will come under greater scrutiny by Canadian policy makers in order to make Canada's businesses more competitive. Some examples of the specific policy areas include the following:

- Improving the regulation of financial markets to allow Canadian companies to have access to the cheapest cost of finance.
- Eliminating tax and regulatory barriers that make it more difficult for Canadian businesses to compete worldwide.
- Make it more attractive for businesses to locate headquarter facilities in Canada to serve the North American market.

The agenda for economic reform in face of greater economic integration in the North American economic space will result in a careful evaluation of many of our policies. I will come back to this further below.

A tighter fiscal outlook for governments

The global economic recession has certainly dampened the economic outlook for federal and provincial governments. In the coming year, tax cuts are far less likely to occur as a result. The question, however, is what we can expect in the medium term. As economies begin to bounce back at the end of 2002 and more strongly through 2003, federal and provincial governments will be less fiscally constrained making it possible to consider possible tax cuts in the future.

The problem, however, is that some people believe that the latest round of federal and provincial tax cuts have made Canada sufficiently competitive relative to the United States. Some believe that no further actions are necessary to cut taxes. Even the federal budget of 2001 suggests that Canadian corporate tax levels are competitive relative to the United States, once all the corporate rate reductions are put in place by 2005. The federal corporate rate will drop to 22.12 and provincial rates will fall to 9 per cent on average across the provinces. Canada's general statutory corporate income tax rate will be about 31 per cent, almost 8 points below the US rate.

However, as I showed in my book recently published by the C. D. Howe Institute, *Most Favored Nation*, Canada's effective tax rate on capital will remain somewhat higher than that in the US once taking into account all the features of corporate tax system such as capital cost allowances and inventory deductions, capital taxes, sales taxes on capital inputs and other taxes that influence capital decisions. Further, in comparison to some other countries including Ireland, Sweden and the UK, Canada imposes much higher taxes on capital investments as well. Thus, even though governments have made significant progress, our tax system is not competitive when it comes to encouraging investment in Canada.

Unlike previous studies, I also show how all the features of tax and expenditure system impact on the cost of doing business in Canada compared to the United States. When one takes into account all taxes on capital and labour and government subsidies for infrastructure, research and development, education and health care, Canada's effective tax rate, net of subsidies, on the cost of doing business will be almost 10 points higher than that in the United States even after all the planned cuts have taken place. In other words, Canadian tax and expenditure policies add the equivalent of a 10 per cent excise tax on costs compared to the United States, making Canada less competitive.

In my view, we need tax policies that make Canada the most attractive location for business activity in North America. In other words, our objective should be to make Canada a "northern tiger" with the most business friendly location for investments in North America. Not only do we need to erase disadvantages created by government policy but also have better policies than found in other countries.

Instead, Canada's tax system remains a burden for businesses to locate here. We still much further to go to reduce taxes on businesses if we are to create a substantial advantage for businesses to locate in Canada to serve the North American market.

Specific tax policies for the financial sector

I have tried to make two claims so far. First, the lesson of September 11 is that it will critical for Canada to keep its border with the United States frictionless. In doing so, however, we will see deepening economic integration with the United States. Second, the global recession will make it difficult for governments to cut taxes in the near term. However, in the medium term, it will be urgent for governments to go further to cut taxes than what has been achieved so far.

I believe there are several significant areas for improving the tax system, particularly with respect to the treatment of financial services. And I expect that policy discussions in the next few years will concentrate on a number of important areas of taxation affecting the industry. Here are four policies I would watch for.

1. *Capital Taxes*: Canada relies more highly on capital taxes compared to many other countries. It is difficult to comprehend why capital taxes have been such a substantial part of the corporate tax system. After all, unlike corporate income taxes that are sensitive to the profit cycle, capital taxes have to be paid even when businesses are facing financial difficulty. Further, capital taxes have distorted financial markets to the extent the leasing and securitization has allowed businesses to avoid capital tax payments. The only positive thing that one might say for capital taxes is that these taxes have made it possible for governments to avoid raising corporate income taxes even further in the past, given that Canada already had one of the highest corporate tax rates in the world. With corporate income tax rates falling to a level close to 31 per cent by 2005, it is now sensible to reduce and eliminate capital taxes. Alberta has already eliminated the capital tax on financial institutions. British Columbia is also eliminating its capital tax. I would think that both the federal Large Corporations Tax and other provincial capital taxes would likely be reduced or eliminated in the near future as the fiscal situation improves.

2. *Withholding Taxes*: Withholding taxes on dividends, interest and other payment to non-residents can impose a significant barrier to the free flow of capital across national boundaries. To extent that such taxes are not credited against foreign taxes, the withholding tax erodes the efficiency of global capital markets. Withholding taxes undermine economic integration in the North American space since it makes it more difficult for taxpayers to move capital across the US and Canadian boundary. Several years ago Canada and the United States agreed to lower the dividend withholding tax from 10% to 5% for direct dividends. Currently, an exemption from withholding tax is being considered for non-arm's length and short-term arm's length interest under the Canada-US treaty. Businesses should welcome further reductions and the elimination of withholding taxes under the Canada-US treaty, especially if the policies facilitate the easier access to cheaper sources of finance in the North American market.

3. *Dividend Tax Credit*: In the latest rounds of federal and provincial budget, capital gains taxes were reduced to effective rates close to 23 per cent. However, dividends are more highly taxed at about a 32 per cent making some financial transactions less appealing from a tax point of view. For example, the higher tax rate on dividends discourages the issuance of new equity and preferred shares to fund investments. Further, businesses have been buying back shares to provide individuals lower taxed income in the form of capital gains. Distortions like these in financial markets can create some harmful effects, such as reducing company capitalization that could ultimately impact on health of the company. To correct for this anomaly, look for Canadian governments to seek provisions that would lower taxes on dividends to bring them in part with capital gains. However, to achieve such changes, some difficult adjustments would be needed with respect to the taxation of small business income.

4. *Corporate Tax Reform*: While federal and provincial governments have recently improved corporate taxation by lowering the tax on corporate income, especially for services, the reform movements have left many unresolved issues for tax reform. The tax treatment of international income remains a difficult policy area for taxation but, without any changes, cross-border transactions will be favourably treated compared to domestic-only transactions due to the vagaries of the global tax system. The differential treatment of capital gains and other income, as discussed above, raise a number of problems for tax authorities especially with respect to the taxation of new financial products. The growth of pension funding has provided opportunities for new tax structures to develop that effectively eliminate the unintegrated part of the corporate income tax.

   Competitiveness and complexity continue to undermine corporate tax systems throughout the world. Back in 1980, the average corporate income tax rate among industrialized economies was 48 per cent. Today it is 32 per cent and still falling. Countries competing for the corporate tax base will continue to look for ways to reduce rates and broaden tax bases. In Canada we have seen so far the lowering of rates with some limited base-broadening such as tighter thin-cap rules. But there is a need to undertake more base measures including a revision of our outdated capital cost allowance rule, the elimination of ineffective investment tax credits and other special provisions that favour some forms of business activities. In a quest for lower corporate tax rates of 25% by 2010 – which I think will be the typical corporate income tax rate in industrialized economies – Canadian governments and businesses will find that base-broadening measures would help pay for a far more efficient tax system.

Conclusions

And so these are my predictions for tax reform as they affect financial services in the coming years. We will see further reductions and possible elimination of the capital taxes. The elimination of the withholding taxes in the North American market will become increasingly important issue since governments will wish to ensure a level playing field for Canadian businesses. Governments will have to continually make sure that different financial instruments are treated as similarly as possible, beginning with a reduction in dividend taxes to a level similar to capital gains. Finally, watch out for further corporate tax reform where the base-broadening issues will play a bigger role in Canadian tax reform as governments will want to cut tax further.

Of course, my view is that these policy changes will be welcomed. If the US continues to fail to address its business tax structure issues, Canada has a great opportunity to make its business tax structure far more attractive than that found in the US for capital investments here. Given the inevitable deepening integration of Canadian and US economies, my bet is that Canadians will accept that a road for higher incomes and employment is best taken by making Canada open for business. The tax system can be an important lever to accomplish this objective.