Canadian Manufacturers’ & Exporters – New Brunswick Division submission to the House of Commons Standing Committee on Finance
Pre-Budget Consultations 2011

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EXECUTIVE SUMMARY

Canadian manufacturers and exporters are an essential part of our economic and social fabric. They account for more than 20% of Canadian GDP and directly employ nearly two million Canadians. The sector is also critical to New Brunswick, which has the third most manufacturing intensive economy in the nation. As well, trade of goods and services is essential to the generation of real wealth for the country. This is particularly true for New Brunswick, which is the most trade dependant province in Canada.

Canada’s manufacturing sector, however, has been undergoing a metamorphosis. The emergence of aggressive, low cost producers in developing countries has forced Western World producers to ‘rethink’ their business. Now more than ever, a focus on innovation and productivity is essential to the growing innovative capacity and ensuring the continued contributions of this sector.

In response to the ‘Great Recession’, the federal government tabled the “Economic Action Plan”. This included a stimulus package, which represented unprecedented public intervention in the marketplace. Recovery of the global economy from the ‘Great Recession’ picked up through last year, led largely by demand for commodities from developing countries. With an economy weighed toward resources, Canada emerged from the worst economic crisis in seven decades in better shape than most industrialized countries.

Last year’s federal budget introduced the next phase of the Action Plan. It focused on creating the right conditions for long-term economic prosperity (ie. improved taxation and regulatory regimes), with the expectation the private sector will move ahead as the engine of growth and job creation. CME commended government for its initiatives to deal with the global economic crisis, as well as its focus on ‘getting the fundamentals right’. Manufacturers, however, still face real challenges.

Previous budgets had instituted income tax cuts and incentives to spur productivity-enhancing investments. However, even if companies are making money (to take advantage of tax cuts or claim tax credits), the cash flow for investments is very limited. Hence, adjustments are required to increase the effectiveness of these incentives:

- *Subject to defined criteria and time frames, companies should be allowed to ‘cash out’ previously earned tax credits (as opposed to being required to carry them forward)*.

Canada’s tax incentives for business sector R&D, though among the best in the world, are underutilized. This is largely due to difficulties in accessing the SR&ED program. It’s value could be greatly enhanced simply by improving its administration:

- *‘New’ restrictions on SR&ED eligible activities should be removed and CRA should use the current policy reviews as an opportunity to more strongly support research, innovation and productivity*.
- *CRA should undertake a value stream mapping analysis of the SR&ED program, provide uniform technical training for its SR&ED auditors and establish an ‘interchange program’ to allow CRA to employ technical specialists from industry or other government agencies (eg. NRC, IRAP)*.

While economic growth is a key factor in ensuring sustainable public services, it is clear that steps must be taken to deal with public debt. (The European debt crisis and downgrading of US debt are clear demonstrations of such.) Governments must do all they can to improve their efficiencies, but taxpayers (including industry) must also adjust their expectations of governments. Thus, these recommendations are focused on maximizing the value of existing incentives. This will help spur much needed private sector investment without putting additional strain on the public purse.

1.0 BACKGROUND… '*a whole new world*'

Canadian Manufacturers & Exporters (CME) has been representing the country's industrial sector since 1871. CME membership is largely comprised of small & medium enterprises, but we represent some of the largest companies in Canada (and most of them in the Province). In New Brunswick, CME is been 'front and centre' on tax-related issues. Our members have been actively involved in many advisory and consultative processes established by government to reform the taxation and regulatory regimes. Indeed, perhaps at no time in the last three generations, have governments played a more important role in ensuring a competitive and sustainable economy.

Canada's manufacturing and exporting sectors are an essential part of our economic and social fabric. They account for more than 20% of Canadian GDP and directly employ nearly two million Canadians. Many more have jobs providing supplies and services to the sector. Every dollar in value added by manufacturers generates an estimated $3.05 in total economic activity – the largest economic multiplier of any business sector. These figures are not lost on New Brunswickers, as the province has the third most manufacturing intensive economy in the nation.

Even as the global economy was on the road to recovery from the 'Great Recession', European and US 'debt crises' now threaten another economic detour. Of course, this too will pass; but the world will likely be a different place when it does, as the US consumer may no longer be 'king'. Canadian manufacturing is also undergoing a metamorphosis due to competition from emerging economies, higher energy prices and our 'petrocurrency'. Now more than ever, a focus on innovation and productivity is essential to the sector's survival. Diversification of markets is also increasingly important. Indeed, while the US was the destination for 73% of Canada's merchandise exports in 2009, down five points from just a year earlier.

This is particularly germane for New Brunswick, as Canada's most export-dependant province and most dependant on the American marketplace (88%). Despite strong 'head winds' of rising exchange rates and a soft US market, New Brunswick's economy grew 2.0% in 2010. Manufacturers, who account for about 13% of provincial GDP, also showed their trademark resiliency. Shipments rose 21.2%, recovering to pre-recession levels. The increase, though, was largely due to a rise in the price of petroleum and mineral products. Provincial manufacturers shed 1600 jobs, or 4.7% of the workforce. Recovery of the New Brunswick, and Canadian, economy has been projected to continue through 2011, albeit at a slower pace.

A competitive taxation regime was consistently near the top of the list of strategic challenges facing manufacturers in CME's *Issues Management Survey*. Reduction of corporate and personal income taxes and elimination of capital taxes have traditionally 'topped the list' of priorities for reform. A fallout of the 2008 credit crisis, though, has been increasingly restrictive (and expensive) credit terms. The federal government has taken some measures to improve the situation, but access to credit still remains a major issue for manufacturers.

2.0 BUDGET 2011-'12… '*getting back on track*'

The last federal budget featured the next phase of the "Economic Action Plan", which was introduced in the 2009 budget. That year, the federal government tabled the largest budget in Canadian history in order to blunt the impact of the meltdown of the world's economy. It injected $40 billion of 'stimulus' into the economy, equivalent to 2.5% of GDP, over two years. CME responded to the 2009 budget favourably, recognizing that measures to 'prime the capital pump' and to invest in necessary public infrastructure were required to avoid a collapse of historic proportions.

The 2011-'12 federal budget reaffirmed the commitment to cut the corporate income tax rate to 15%. As well, it extended the accelerated (2-yr) write-off of capital investments (introduced in 2007) to 2013. This measure was very well received by manufacturers, as decisions to make major capital purchases aren't typically made in a short time frame. The extension provides greater confidence to make necessary investments in productivity-enhancing technologies. It is estimated that this provision translates into a return on investment of 12% over three years and as much as $600 million in 2012-'13, alone.

It is noteworthy that implementation of the first comprehensive reform of New Brunswick's tax regime in a quarter century commenced last year, as corporate income tax rates were reduced (by one point) to 11%. Rates were to be cut to 8% by 2013 (the lowest rate in Canada), but it was subsequently decided to limit the rate cut to 10%. (Small business rates will be halved to 2.5%, though.) This was, at least partially, due to the dire fiscal situation where the provincial debt rose $1.7 billion to $10.2 billion over three years.

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Indeed, the significant 'run up' in public debt is cause for concern. Taking out a mortgage for future generations can not be taken lightly. The 2011-'12 federal budget projected that the deficit will be eliminated by 2014-'15. Deficits incurred since the last balanced budget (2008-'09) will have totaled $145 billion and the net debt will have risen to $622 billion (or 30.8% of GDP).

While it is recognized that an infusion of public funds was required to deal with the 'Great Recession, it is clear that steps must be taken to deal with public debt. The European debt crisis and downgrading of US debt are clear demonstrations of such. Governments must do all they can to improve their efficiencies, but taxpayers (including industry) will also have to adjust their expectations of governments.

Of course, economic growth is also a key factor in ensuring sustainable public services. In this regard, a strategic plan is required to deal with seismic shifts in the global economy. Further steps are required to encourage investment in new technologies, new markets, skills, and innovation to well position Canadian industry as the global economy emerges from recession.

3.0 BUDGET 2012-'13… '*a longer term view*'

It is anticipated the next federal budget will continue with implementation of the "Low-Tax Plan for Jobs and Growth", which focuses on the "key drivers of economic growth - innovation, investment, education and training". It has been stated that the Government will return its focus toward creating the right conditions for long-term economic prosperity, with the expectation the private sector will move ahead as the engine of growth and job creation.

CME has long argued that it is essential to 'get the fundamentals right' to ensure sustainable growth. This involves institution of globally competitive regulatory and taxation regimes. CME has applauded the federal and provincial governments for steps taken to bring corporate income tax rates 'in line' with many of our most important competitors. Even with lower income taxes, however, incentives for investments in human and physical capital and R&D are a powerful, and necessary public policy tool.

Discussion regarding the effectiveness of various tax credits has been ongoing for the past half century. It is clear, though, that non-refundable tax credits and tax incentives that can't be realized in the near term are ineffective, particularly in these economic times. As well, even if companies are making money (to claim tax credits), the cash flow for capital investments is very limited. Clearly, there are steps that can be taken to (cost-effectively) maximize the effectiveness of tax credits to spur private sector investment.

3.1 INVESTMENT TAX CREDITS…'*unlocking capital* '

Investment tax credits (ITCs) are closely related to capital cost allowance as a tax policy lever for capital formation. *Canada Income Tax Act* provides for ITCs to be claimed for investments research & development, apprenticeships and child care, as well as pre-production mining costs. It also provides for a 10% ITC for investments in "qualified property" to be used in for manufacturing and processing in Atlantic Canada and Gaspe. There are also provisions for ITCs in various provincial and territorial tax legislation. For instance, the New Brunswick government previously instituted a two-year, 50% ITC for certain forestry sector equipment purchases.

As noted previously, the intrinsic value of such incentives is dependant on the time frame over which they will likely be realized. As one CME member put it, "tax credits are largely useless during a recession". In this regard, *there is real opportunity to maximize the value of ITCs through a government 'buy back' of tax credits*. *Subject to defined criteria and time frames, companies should be allowed to 'cash out' previously earned tax credits (as opposed to being required to carry them forward)*. The criteria might include the company's plans for future investments, the public policy 'value' of the investment, the creditworthiness of the firm, etc. The time frame for any 'buy back' might be varied accordingly.

Such a measure would provide operations with the necessary funds to make the requisite productivity-enhancing investments in the ongoing recovery of the global economy. It would also inject much needed capital into the Canadian economy. It does so without making unsustainable public investments or providing subsidies to business. This approach stops short of making such all ITCs fully (and immediately) refundable. It would not reduce overall, existing tax revenues for government, thereby providing a measure of protection for the public purse.

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3.2 SR&ED TAX CREDITS…'*redefining innovation* '

The Scientific Research and Experimental Development (SR&ED) tax incentive is the most important federal program in support of business R&D in Canada. The economic benefit of the SR&ED program is widely acknowledged. It's estimated that the ($4 billion) eligible tax credits leverages four times as much private sector R&D. As well, the SR&ED tax credit creates a gross economic gain of $1.11 for every dollar of spent on it. Hence, the economic spillovers more than offset the costs of the credit.

In this 'new world order', a focus on innovation in products, processes and marketing is essential to the competitiveness of Canadian manufacturers and their continued contribution to our standard of living. Today, manufacturers account for more than half of all R&D investments by Canadian business. For each dollar spent on R&D, manufacturers invest $32 in design, engineering, production and marketing of new goods & services. Manufacturers are among the main beneficiaries of the SR&ED tax credit, accounting for about 40% of companies claiming tax credits and 47% of the total value of tax credits earned annually.

Given the importance of the SR&ED tax incentive, several former Ministers of National Revenue committed to maintain the program. However, Canada Revenue Agency (CRA) has developed new policies that narrow the definition of eligible activities, excluding practices perceived by CRA as "routine". A particular issue is CRA's proposed definition of technological advancement. Eligible activities now seem to only include development of new, core technologies. Incremental improvements in application of existing technologies to improve existing materials, products, devices or processes no longer seem to be accepted as eligible. These interpretive changes by CRA are not based on any legislative amendment.

Despite the fact that the CRA policy review is still ongoing, a number of leading Canadian R&D performers have reported that many claims that were once accepted by auditors are now being refused. As well, the Government of Canada had launched a comprehensive review of federal support for R&D last year led by an expert (Jenkins) panel. A consultation paper is now being reviewed by industry. Coordination of the CRA policy review and the panel's deliberations is essential to ensuring cohesive, effective public policy. *'New' restrictions on SR&ED eligible activities should be removed. As well, CRA should use the current policy reviews as an opportunity to more strongly support Canadian research, innovation and productivity*.

3.3 SR&ED TAX CREDITS…'*leaning the process* '

Canada's SR&ED tax program offers, on paper, one of the most generous tax incentives for business sector R&D among developed countries. However, the program isn't being utilized to its fullest extent. This is borne out by CME's last *Management Issues Survey* of more than a thousand companies across Canada. It showed that only 34% of survey respondents take advantage of the program. Of course, there are a number of reasons for the low participation rate. It's clear, though, that complex and inconsistent administration has resulted in long delays in audits and increased transaction costs and, for many, has eroded the value of the program. It also raises questions as to its role as an incentive for innovation.

There has been considerable discourse about program administration for, at least, the past decade. The 2008 federal budget committed to implement a plan to deal with this issue. This included simplification of the claim form (T661) and guide; development of an eligibility self-assessment tool; and (as noted above) a review of SR&ED policies and (dispute resolution) procedures. Additional resources were also allocated to enhance quality assurance methodologies and increase the scientific capacity of service delivers.

While Government - and CRA - is commended for this initiative, it is still taking several years to receive the benefits of this program. CME members report that the documentation required by CRA auditors has been steadily increasing and becoming overly burdensome. Given the 'crisis' facing the Canadian manufacturing sector, however, it is critical that more be done on this 'front' and at a faster pace. With regard to streamlining the claim review process, *CME recommends that CRA undertake a facilitated value-stream mapping analysis*. Experience has shown that this can result in time and efficiency savings of 30% to 40% by way of reallocation of existing resources and identifying gaps in training.

It is appreciated that CRA officials are trained to recover money, and not give it away. Hence, there is a natural tendency to evaluate SR&ED claims with a 'critical eye'. While a rigorous evaluation is essential for the program integrity, this must not unduly erode the benefits of the program. With regard to instituting a more consistent interpretation of eligibility criteria, *it is recommended that auditors receive uniform technical training and that CRA consider an interchange program for their audit staff that would allow the agency to employ technical specialists from industry or other government agencies, such as NRC or IRAP*.