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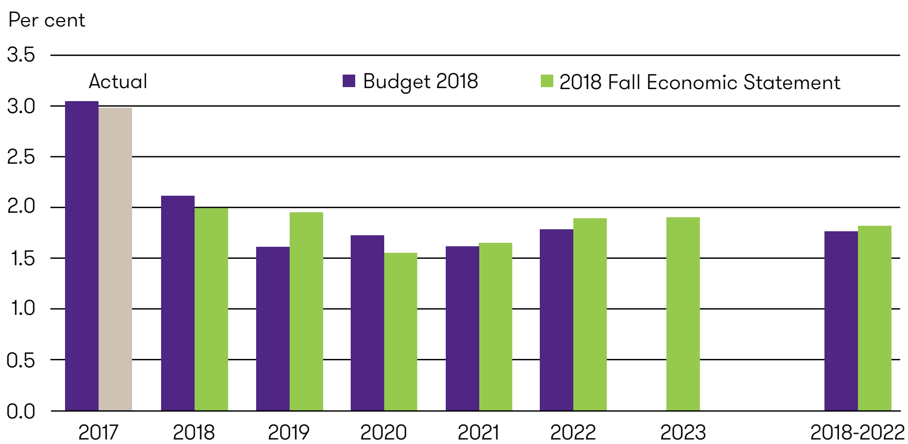
Pre-alert

Budget 2019

Making sense of what's next.

Budget 2019 sees the current federal government providing its last budgetary update prior to the election expected to occur later this year. This timing provides the government with an opportunity to set priorities for their upcoming campaign and potentially push through any remaining policy changes from its current mandate. In thinking about the types of changes we may see in the budget it is helpful to first take stock of where Canada currently is at.



Economic overview

From an economic standpoint, Canada is performing well but there is evidence that this growth is beginning to slow. Based on projections included in the federal government's Fall Economic Statement, Canada is expected to see 1.8 percent annual growth in its real gross domestic product (GDP) over the next five years, which is less than the 3.0 percent growth we saw in 2017.

Furthermore, despite campaign promises to run a balanced budget by 2019, a recent report issued by the Department of Finance indicates that, if current trends continue, the government will not be able to meet this goal until the 2040-41 fiscal year.

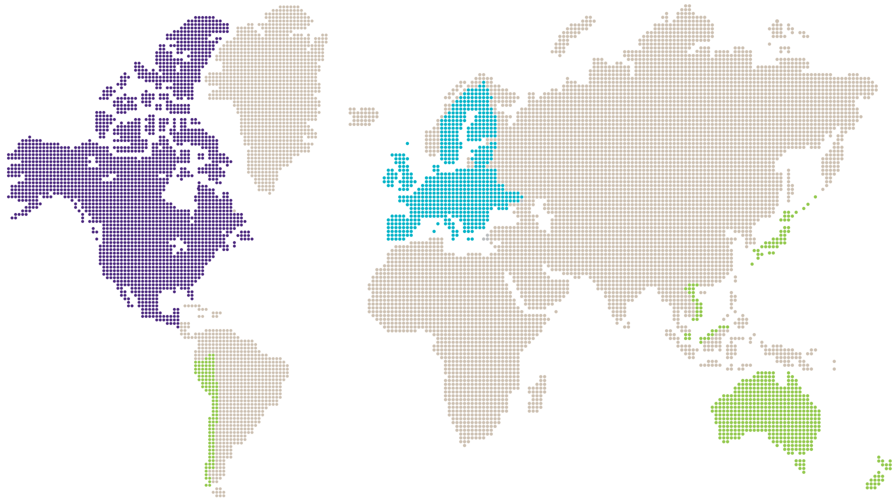
With growth beginning to slow, there is a question as to how the federal government will address the challenges facing Canada in its upcoming budget.

If the 2018 Fall Economic Statement provides any indication, the current priority is to improve Canada's competitiveness on the international stage. Based on the themes identified in that Fall Statement, we are looking to see what additional changes, if any, will be proposed in the 2019 federal budget, particularly in the areas of trade and innovation.

Trade

Increasing Canadian competitiveness has been a major topic over the past year since the onset of the large-scale tax reform in the United States at the end of 2017.

The desire to facilitate trade and increase Canada's competitiveness internationally was a major focus of the federal government's 2018 Fall Economic Statement and it is expected that this trend will continue to influence government policy in the upcoming federal budget.



Recent trade agreements

The government's focus on trade has been evidenced by the multiple trade agreements that Canada has recently entered into.

- The Canada-United States-Mexico Agreement (CUSMA) which provides an update to the NAFTA and facilitates trade within North America, was signed on November 30, 2018, but has not yet been ratified.
- The Canada-European Union Comprehensive Economic and Trade Agreement (CETA) which reduces or eliminates trade barriers with Canada's second largest trading partner, the European Union, was ratified on September 21, 2017.
- The Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) focuses on free trade in the Asia-Pacific region. This free trade agreement was ratified by six countries (out of 11, thus far), including Canada on December 30, 2018.

Uncertainty in global trade

Despite these recent agreements, much uncertainty still remains in the global trade climate. Canada's competitiveness is currently being impacted by:

1 **US tariffs on steel and aluminum.**
As of June 1, 2018, the United States has imposed the following tariffs:

25% on imports of Canadian steel

10% on imports of Canadian aluminum[1]

According to a survey conducted by Export Development Canada, these tariffs have negatively affected one third of Canadian exporters who have responded by raising prices, finding alternate markets, and sourcing locally.

2 **Deteriorating relations with China**
China presents a significant market for Canadian trade, but recent diplomatic events have created tensions between the two trading partners. Where previously Canada was pursuing a deeper trade relationship with China, there is now a question as to whether these talks will continue given the significant areas of disagreement between the two countries as well as the restrictions imposed by the United States in the CUSMA.[2]

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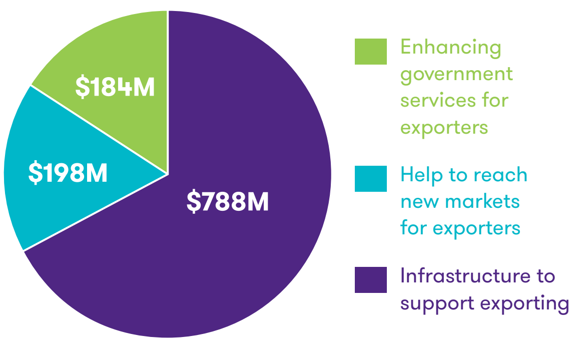
1 Canada has responded to these tariffs by imposing its own retaliatory tariffs on $16.6 billion in imports of steel, aluminum and other products imported to Canada from the US.

2 CUSMA restrictions demand that each member country notify the other members if they plan to negotiate a free trade agreement with any non-market country (such as China), providing the other members with the ability to terminate the CUSMA. This clause therefore has the potential to present a powerful deterrent to the establishment of a free trade agreement between Canada and China.

Funding Uncertainty

The government has prioritized the diversification of Canada's exports by including a funding commitment of $1.1 billion in the 2018 Fall Economic Statement. While a portion of this funding has been allocated towards certain projects, such as the CanExport program, which helps Canadian businesses reach foreign markets; the Canadian Technology Accelerator program, which assists Canadian technology firms in connecting with global technology hubs; and other initiatives to expand global internships and create mentorships for new entrepreneurs, there are still many details around this funding that are currently unknown.

EXPORT DIVERSIFICATION STRATEGY



A more level playing field

Over the last few years, the implementation – or lack thereof – of a sales tax on digital and online sales has been a contentious issue, especially with the proliferation of online services such as Netflix and Spotify. Many companies that sell digital goods and services online are located outside of Canada, and the argument has been made that since these companies are not required to charge a sales tax on the digitals goods and services they provide, it puts Canadian businesses at a disadvantage. And while the legislation already imposes a self-assessment requirement on Canadian customers, few if any actually comply.

Canadian interest groups, as well as federal opposition parties, have called on the federal government to introduce rules that would require foreign companies that have digital and online sales to collect and remit sales tax on these sales. However, the federal government has repeatedly insisted that it will not do so.

Budget 2019: Making sense of what's next

1 Government Funding for exporters

Federal Budget 2019 may provide further details as to how entrepreneurs may access government funding, such as from the CanExport program mentioned above, to help address the need to get their products to market. The upcoming federal budget may even earmark additional funds to address Canadian competitiveness in additional ways not yet explored.

2 Reduced Regulation

Additional changes we may see to increase Canadian competitiveness could involve the removal of cumbersome regulations that hinder effective business. The World Economic Forum has previously indicated that inefficient government bureaucracy is the most problematic factor related to doing business in Canada.

3 Reduced tax rates on businesses

From a tax perspective, Canada's competitiveness could be strengthened through a reduction to the corporate income tax rate, as Canada's corporate income tax rate is currently higher than the US and OECD average. In an increasingly global economy, Canada's ability to compete in this regard should not be underestimated.

4 Taxing the digital economy

Further increases to competitiveness could be achieved through modifications to the Canadian tax system that would tax businesses operating in the digital economy that are doing business with, or selling products to, Canadians. E-commerce, cloud-based services, and business models built around digital platforms in particular have presented significant tax policy challenges and created an incentive for corporations to base themselves in low tax jurisdictions while earning income globally, resulting in an erosion of the tax base for countries considered to be higher tax jurisdictions.

5 Digital sales tax

Although the federal government has not introduced rules that would require sales tax to be collected on digital and online sales, effective January 1 2019, Quebec became the first province in Canada to require non-residents to become registered within a special Quebec Sales Tax (QST) system and begin collecting sales tax on certain goods and services purchased online, such as digital software and music downloads, and streaming services. Companies that are resident in Canada, but not in Quebec, have until September 1, 2019 to register under the QST system. Despite the federal government's hesitation to bring these taxes forward due to mounting pressures from Canadian businesses, unions and other interest groups, as well as from rising government deficits, we may see Budget 2019 begin to establish a framework for a digital sales tax regime.

Innovation

A critical component to enhancing Canadian competitiveness is fostering innovation. Studies have shown that supporting innovation and entrepreneurs can lead to sustainable growth and prosperity for the country and economy as a whole.[3]

It has been noted that two of the greatest challenges faced by startups are accessing capital and attracting talent. To address these challenges, significant funding has been allocated towards supporting innovation within Canada over the past couple years.

Skills training

With innovation and technology changing the business environment in Canada, there is evidence that its workforce is struggling to adapt. The need for a skilled workforce is one that is integral to Canada's continued growth and overall productivity In fact, a report which estimated that 42 percent of the tasks that Canadians are currently paid to perform can be automated over the next two decades.

One of the major initiatives recently implemented to address the development of skilled workers within Canada is the creation of the Future Skills Centre. The federal government has so far allocated $225 million over four years and $75 million per year thereafter to this initiative with the goal of exploring new approaches to skills development, identifying skills gaps and sharing that information to form the basis for future programs. However, while this funding was announced in 2017, limited additional details have since been released.

Strategic Innovation Fund (SIF)

The government recently allocated an additional $800 million over five years, through the 2018 Fall Economic Statement, to the SIF. While companies in all sectors may access this funding, the SIF itself is separated into four streams to which it provides support:

- **Stream 1:** projects that encourage research and development that will accelerate technology transfer and commercialization of innovative products, processes and services
- **Stream 2:** projects that would facilitate the growth and expansion of firms in Canada
- **Stream 3:** Projects that would attract and retain large scale investment to Canada
- **Stream 4:** Projects that would advance industrial research, development and technology demonstration

As of January 2019, SIF had announced 31 agreements, totaling $795 million in SIF contribution, which will leverage total investment of $8.1 billion.

Superclusters

The federal government's 2017 budget introduced the Innovation Superclusters Initiative, which promised to invest up to $950 million to pull together technology clusters across the country into large collectives to build world-leading innovation ecosystems and accelerate economic growth by 2023.

The federal funding will be shared by five superclusters:

$153 million
announced in November 2018
Protein Industries Supercluster
(based in Prairies)

$153 million
announced in November 2018
Ocean Supercluster
(based in Atlantic Canada)

$230 million
announced in November 2018
Advanced Manufacturing Supercluster
(based in Ontario)

$230 million
announced in December 2018
AI-Powered Supply Chains (SCALE.AI) Supercluster
(based in Quebec)

$153 million
announced in November 2018
Digital Technology Supercluster
(based in British Colombia)

The five superclusters represent more than 450 businesses, 60 post-secondary institutions and 180 other participants who will match targeted investment.

According to a recent report published by Innovation, Science and Economic Development Canada in February 2019, the Innovation Supercluster Initiative is expected to grow Canada's economy by $50 billion over the next 10 years.

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3 Examples of such studies supporting this position include:
The Relationship between Entrepreneurship, Innovation and Sustainable Development
How Is Entrepreneurship Good for Economic Growth?
OECD Local Entrepreneurship Reviews

Budget 2019: Making sense of what's next

1 Connecting talent with Canadian employers

Canada has one of the most educated populations in the world, but skill gaps remain one of the biggest challenges faced by the STEM (science, technology, engineering and mathematics) industries today. The federal government's Innovation and Skills Plan introduced several programs to fill the skills gap, such as STEM training for youths, student work placements in STEM, connecting rural communities and low-income families to the internet, and providing faster and more predictable routes to bring global talent to Canada.

In addition to these existing programs, the federal government could also increase the incentive for STEM students to work with domestic companies, rather than foreign ones, in order to retain highly-skilled talent in Canada. For example, a recent news article proposed the idea of a targeted student loan interest relief program. This program would forgive the interest on student loans for STEM co-op students who take their final work term with Canadian companies, to encourage STEM talent to remain in Canada.

2 R&D tax incentive enhancements

From a tax perspective, several special interest groups have been advocating for changes to the current scientific research & experimental development (SR&ED) program such as raising the taxable income ceiling on the refundable Investment Tax Credits. Companies engaged in qualifying SR&ED activities receive less tax breaks on new R&D projects when their taxable income or capital grow over the years. Extending the refundable tax credits to benefit companies as they continue to scale up has the potential to encourage more innovation activities in Canada.

3 Personal tax rates

According to a Fraser Institute report released in January 2019, Canada has dropped more than 10 ranks in worldwide innovation rankings despite the billions of dollars invested in various innovation initiatives. The report suggests that, in addition to providing funding for various innovation initiatives, the government could reduce barriers to foreign investment and promote domestic competition by reducing marginal personal tax rates and the capital gain tax rate. This could enhance Canadian business owners' incentives to take risks and invest in innovation to maintain their competitiveness in the market.

In contrast to the Fraser Institute's position, many experts are speculating that the government may raise the capital gains inclusion rate to bring the tax rate on capital gains closer to the rate on dividend income. Although increasing the tax rate on capital gains may increase tax revenues, it could also have a negative impact on Canadian business owners' incentive to invest in innovation.

In today's world of economic uncertainty, we are hoping to see Budget 2019 address some of the challenges faced by business owners.

Visit Budget 2019 to get the latest information and analysis on provincial and federal budgets.

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