Federal budget 2019

Implications for
Canada's competitiveness

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Introduction

Budget 2019 was many things, but with a fall federal election looming, it was mostly a budget designed to appeal to target voter groups. And while the Government of Canada's aim was to provide something to each of these constituencies, with limited fiscal capacity to make big new commitments, new funding was spread widely across a host of initiatives. The budget was not aimed at addressing key business challenges, but many of the measures will affect the Canadian economy and business prospects. The question is: to what extent?

In this report, we will explore Budget 2019 through the lens of competitiveness. Since 2011, Deloitte has been examining issues at the heart of challenges to Canada's productivity and competitiveness and looking for ways to overcome them in order to ensure our country's long-term prosperity. Competitiveness is a fundamental issue since a more competitive economy grows at a faster pace, creates more and better-quality jobs, generates stronger income growth, and ultimately drives a rising standard of living.

To understand how Canada compares and competes with its peers, Deloitte analyzed over 500 data points across a set of 12 key countries: United States, United Kingdom, Sweden, Italy, Mexico, Netherlands, South Korea, Germany, Australia, France, Spain, and Japan.

Figure 1
With a broad lens, Deloitte assessed competitiveness using the following eight dimensions:

Talent
Do Canadian businesses have access to a globally competitive labour force?

Economic stability
Are Canadian businesses operating in a stable macroeconomic environment?

Capital and investments
Do Canadian businesses and entrepreneurs have adequate access to the capital they need to succeed?

Customers
Are Canadian businesses selling into a healthy domestic market and taking full advantage of foreign opportunities?

Infrastructure
Is the quality of Canadian infrastructure on par with its peers?

Innovation
Are Canadian businesses operating in a globally competitive environment for innovation?

Tax
Do Canadian businesses and talent carry higher tax burdens than their peers?

Regulation
Do Canadian businesses face more regulatory burden than others in their peer group?

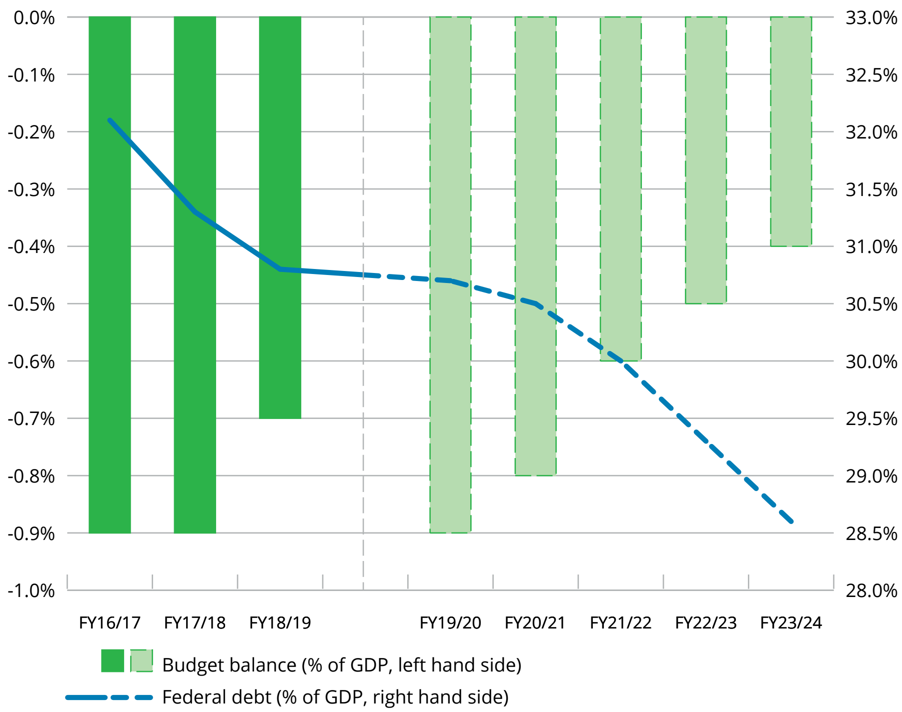
Canada's competitiveness scorecard

In February 2019, Deloitte collaborated with the Business Council of Canada to develop a new scorecard evaluating Canada's competitiveness. The scorecard uses 500 indicators to judge Canada's performance against 12 peer countries along eight broad—yet critical—dimensions of competitiveness: talent, economic stability, capital and investment, customers, infrastructure, innovation, tax, and regulation. Our analysis suggests that Canada's economic success is being constrained by important competitiveness challenges. While the country performs very well in some areas, such as talent and economic stability, we perform poorly in others, including innovation, tax, and regulation (see Figure 1). And there is room for improvement in every category.

This report takes stock of the new initiatives announced in Budget 2019 and assesses how they will influence Canada's competitiveness over the long term. Although the budget does feature some initiatives that will enhance competitiveness, their impact will be modest. As a budget aimed primarily at "investing in the middle class," it doubled down on what is already Canada's greatest competitive advantage—our people—with limited new investment in advancing other key dimensions of competitiveness.

Figure 2

Government of Canada fiscal position



Talent

Canada performed the best in talent on the competitiveness scorecard. Our labour force is world-class, and outperforms its peers on educational attainment.

We also have broad labour force participation, including low barriers for female workers and the highest rate of employment for newcomers among our peers.

However, challenges to Canada's talent advantage remain. One of the most pressing is labour shortages. In the latest Bank of Canada *Business Outlook Survey*, 37 percent of organizations reported labour shortages and 43 percent reported a rising intensity, and these labour shortages may be restraining the willingness of companies to make investments. While the national unemployment rate is at a four-decade low, signs of underemployment for many workers suggest a skills challenge. Technological change is also disrupting the market demand for specific skills.

In response to these challenges, the government has made significant investments through Budget 2019 to further secure Canada's competitive advantage in talent. It announced nearly $4.6 billion over five years in a suite of programs to help Canadian workers reskill or upskill. This includes major changes meant to improve access to retraining for workers, with a new Canada Training Credit to defray the cost of education and an Employment Insurance Training Support Benefit to supplement a worker's income while on leave from work for education. The budget also contains investments in reducing education costs by lowering interest rates on Canada Student Loans. And it introduced broad support for work placements for young people.

These changes are a welcome upgrade to the competitiveness of the nation's workforce. The Canada Training Credit in particular aligns with recommendations Deloitte made in its *Bold bets for our country* report. Deloitte has also called for expanded use of experiential learning models—such as apprenticeships for the skilled trades, articling for law, residencies for medicine, or practicums in teaching and accounting—to a broader range of professions.

Opportunities remain to increase the involvement of business in training and skills development for workers. Deloitte research has found a need for businesses to be more involved in the design of training programs to ensure that the skills being developed are those that are in demand. Incentives to support this type of employer-led training would be a powerful tool to address labour shortages. Overall, the government's actions on talent in this budget are a welcome step, further building out Canada's talent advantage.

Economic stability

Our scorecard identified economic stability as Canada's second-greatest strength. Our country scores high on macroeconomic stability, such as the Bank of Canada's inflation-fighting success.

The Canadian economy stalled at the end of 2018, and the prognosis for this year looks even bleaker. A more acute or pronounced slowdown would pose a threat to the government's targets for the debt-to-GDP ratio.

Canada's general government net debt is well below that of our peers on average, and prudent fiscal policy has been one of Canada's historical competitive strengths.

Risks remain in our economic outlook. The economy is vulnerable to fluctuations in commodity prices as the recent decline in oil prices demonstrates. And, the government has a structural deficit that is expected to remain in place until 2040.

In this budget, the government has reiterated its commitment to a stable or declining debt-to-GDP ratio. At less than one percent of GDP, projected deficits are not large in relative terms. Canada's competitive position is enhanced by the fact the federal government's fiscal balances are in much better shape than those of its international peers, particularly on the basis of net debt-to-GDP.

Budget 2019 keeps Canada on a similar path to the one set out in the 2018 Fall Economic Statement. Better-than-expected year-to-date revenues and fiscal assumptions left the government with extra room in this budget, which it used to finance its new initiatives. Meanwhile, federal debt in the coming years should continue to decline incrementally relative to the size of the economy, falling from its current 30.7 percent to 28.6 percent in five years' time.

Still, it is important to note that such an outcome hinges on a relatively benign economic environment. The government assumes low economic growth in the coming years, but the assumptions remain relatively optimistic. The Canadian economy stalled at the end of 2018, and the prognosis for this year looks even bleaker. A more acute or pronounced slowdown would pose a threat to the government's targets for the debt-to-GDP ratio.

With the Bank of Canada overnight rate still at historical lows, the government will need to provide fiscal stimulus in the event of an economic slowdown. As explored in the *January 2019 outlook* of Deloitte Chief Economist Craig Alexander, current conditions suggest the government should look to limit deficits, creating fiscal capacity to respond to tougher economic times in the future.

Overall, this budget continues to build upon Canada's relative strength in economic stability and historical competitive strength of prudent fiscal policy.

Figure 3
Government of Canada fiscal position
All figures in $ millions unless otherwise stated

	Actual			Budget 2019 plan				
Fiscal year	**FY16/17**	**FY17/18**	**FY18/19**	**FY19/20**	**FY20/21**	**FY21/22**	**FY22/23**	**FY23/24**
Revenues	**293,495**	**311,200**	**332,200**	**338,800**	**351,400**	**366,700**	**380,700**	**395,500**
% change	-0.7%	6.0%	6.7%	2.0%	3.7%	4.4%	3.8%	3.9%
% of GDP	14.5%	14.5%	14.9%	14.7%	14.8%	14.9%	14.8%	14.8%
Expenditures	**312,452**	**330,200**	**347,100**	**355,600**	**368,200**	**378,500**	**389,800**	**402,300**
% change	4.7%	5.7%	5.1%	2.4%	3.5%	2.8%	3.0%	3.2%
% of GDP	15.4%	15.4%	15.6%	15.4%	15.5%	15.3%	15.2%	15.1%
Programs	**291,220**	**308,300**	**323,500**	**329,400**	**339,700**	**348,300**	**358,400**	**369,100**
% change	5.3%	5.9%	4.9%	1.8%	3.1%	2.5%	2.9%	3.0%
% of GDP	14.4%	14.4%	14.6%	14.3%	14.3%	14.1%	14.0%	13.8%
Debt charges	**21,232**	**21,900**	**23,600**	**26,200**	**28,500**	**30,200**	**31,400**	**33,200**
% change in net debt	-2.8%	3.1%	7.8%	11.0%	8.8%	6.0%	4.0%	5.7%
% of revenue	1.0%	1.0%	1.1%	1.1%	1.2%	1.2%	1.2%	1.2%
Balance	**-18,957**	**-18,961**	**-14,900**	**-16,800**	**-16,700**	**-11,800**	**-9,100**	**-6,800**
% of GDP	-0.9%	-0.9%	-0.7%	-0.7%	-0.7%	-0.5%	-0.4%	-0.3%
Reserve	-	-	0.0	-3,000.0	-3,000.0	-3,000.0	-3,000.0	-3,000.0
Final balance	**-18,957**	**-18,961**	**-14,900**	**-19,800**	**-19,700**	**-14,800**	**-12,100**	**-9,800**
% of GDP	-0.9%	-0.9%	-0.7%	-0.9%	-0.8%	-0.6%	-0.5%	-0.4%
Federal debt*	**651,540**	**671,254**	**687,700**	**707,300**	**725,500**	**740,600**	**753,200**	**764,700**
% of GDP	32.1%	31.3%	30.8%	30.7%	30.5%	30.0%	29.3%	28.6%

* Federal debt is defined as gross debt net of both financial and nonfinancial assets.

Capital and investments

To be competitive, Canadian organizations need access to funding to help scale and to make core investments in productivity-enhancing machinery and equipment. Our scorecard analysis shows that Canada does well on access to finance, but business investment has been disappointing in comparison to our global peers.

The 2018 Fall Economic Statement made progress by introducing the accelerated depreciation allowance, and Budget 2019 follows up with several small measures targeted at clean energy and sector-specific initiatives.

To promote and support green energy in Canada, the government introduced an initiative that supports business investment in zero-emission vehicles. This measure will enable businesses to fully write off the cost of eligible vehicles in the year they are put into use. The measure should promote investment by converting fleets into more energy-efficient ones, enabling businesses to retain more money for other investments.

The budget also had several sector-specific initiatives that were meant to spur private-sector investment in traditional sectors such as forestry and wood products, oil and gas, and tourism.

The challenge is that business investment is affected by many factors beyond access to finance. Indeed, strong business investment would likely come from a reduction in labour shortages, investing in infrastructure and innovation, and reforming tax, and regulations. Meaningful progress in the other dimensions of competitiveness would be the most impactful way to improve prospects for investment.

Customers

Being the last budget of this government before the next federal election, it was expected that it would include a number of targeted measures for key consumers groups. With the limited fiscal room to accommodate significant new spending, this meant most measures would be limited and focused in nature.

Allowing consumers more room to spend moves Canada in the right direction, by improving businesses' access to customers and, as a result, our country's overall competitiveness.

Introducing the First-Time Homebuyer Incentive, modernizing the Home Buyer's Plan, and creating the Canadian Drug Agency in this budget all move us in the right direction. Other initiatives, such as the increase to the Guaranteed Income Supplement (GIS), aim to increase income, especially for seniors. Overall, these measures build on previously announced programs in housing and support to seniors. They are also designed in a way to be targeted enough to limit their cost while still achieving some of the desired outcomes.

While the 2017 National Housing Strategy sought to offer housing options to those "who need it the most," the newly announced First-Time Homebuyers Incentive is targeting the young middle class considering entering the homeownership market, expanding the scope of federal housing programming. The incentive will apply to insured mortgages, but first time homebuyers will still be required to meet the income stress test on mortgages. By making mortgages more attainable for first-time homebuyers, this incentive is likely to increase home prices across the board. However, for those households that meet the criteria, it will make home ownership more affordable. The incentive is designed to prioritize new-build homes over existing stock, providing additional stimulus for builders to create new supply.

By topping up the GIS and starting auto-enrollment of Old Age Security, the federal government is making it easier for seniors to earn an income and to access their Canadian Pension Plan.

These steps will support consumers, and increase overall market demand in a positive and welcomed way.

Infrastructure

The scorecard found Canada to be generally uncompetitive on infrastructure. Surveys show that the business community ranks Canada just below our peers on average, and that it's getting worse over time.

This reflects a lack of confidence by the Canadian business community in the efficacy, coverage, or accessibility of national infrastructure. Our trade and transportation infrastructure has been a particular challenge—we ranked 21st in the world in 2018 on this measure according to the World Bank, well behind peers such as the United States (seventh) and Germany (first).

Infrastructure is critical to business competitiveness, as it facilitates the movement of goods and people. It is instrumental in accessing domestic and international markets. In Deloitte's 2017 report *Bold bets for our country*, we argued that investment in infrastructure that supports trade is especially necessary to help create the global business champions Canada needs to compete internationally.

The current government has made infrastructure a national priority. In its first budget in 2016, the government announced a massive infrastructure commitment called the Investing in Canada Plan (IICP) that encompasses an impressive $190 billion in investments in infrastructure. The government is now in the stage of implementing this ambitious promise, turning these dollars into tangible projects. The federal infrastructure investment increased to $14.3 billion for 2018-19, and the government projects an average of $16 billion in annual spending over the fiscal projection.

Budget 2019 also saw the government commit between $5 billion and $6 billion in new investments to expand access to rural broadband over the next 10 years. Under this plan, 100 percent of Canadians will have access to high-speed internet by 2030, giving citizens and businesses the speeds necessary to take advantage of services like cloud-based software, multiple government services, online learning resources, and more. This is a promising step in our national infrastructure, using both the IICP and private investment.

This government has taken some important steps on infrastructure, which should improve Canada's competitiveness as they are rolled out.

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Innovation

The competitiveness scorecard underscores Canada's innovation challenge. Our low levels of investment in research and development as well as low levels of patent creation are just a few of the indicators of our poor investment in innovation. This issue is critical because weak innovation reduces the productivity that drives economic growth.

The new announcements related to innovation in Budget 2019 were limited. It set aside $1.1 billion over the next five years to encourage innovation in a variety of areas. One measure was the establishment of a Permanent Global Talent Stream that will give Canadian businesses expedited access to top global talent when Canadian workers are unavailable.

The government committed to a small reform to the Scientific Research and Experimental Development (SR&ED) Tax Incentive Program. This program gives small and medium-sized businesses (SMEs) a 35-percent refundable tax credit on qualified research and development expenditures. This credit drops to 15 percent and becomes non-refundable when companies reach certain income and capital thresholds. To help them to scale, the government will eliminate the income threshold in determining eligibility for the more generous tax treatment. Larger firms (based on the value of their capital), however, will not be eligible.

Budget 2019 also provided $459 million in funding for science, research, and technology organizations.

More meaningful changes to the existing innovation incentives would be beneficial. Deloitte's pre-budget submission recommended that the SR&ED investment tax credit be made refundable for all corporations carrying on business in Canada rather than only for certain private companies, and that capital spending eligible for the tax credit be expanded.

Taxation

Deloitte's competitiveness scorecard also found Canada's tax environment to be uncompetitive relative to the United States. In the wake of US tax cuts and reforms, Canada now taxes corporate income at a higher rate than our main competitor does.

Canada's tax system has become very complex over recent decades, and a comprehensive tax review could provide the funding for general business and personal tax reductions that would improve the country's competitiveness.

Faced with less favourable tax rates, cost-sensitive companies based in Canada may rethink local expansion plans. Uncompetitive tax rates can also discourage new foreign direct investment in Canada.

Despite the impact on Canada's competitiveness, Budget 2019 does not focus on addressing these challenges. One noteworthy tax measure is intended to better align the Canadian tax system to that of the United States regarding stock options. Compensation in the form of stock options receives favourable tax treatment under Canadian tax law. Generally, the stock option benefit is taxed at 50 percent of the recipient's marginal tax rate. The budget proposes to cap the favourable tax treatment so that it is only available on the first $200,000 worth of stock options granted. Given the need for Canadian companies to attract and retain top talent, the elimination of the favourable stock option benefit treatment over the $200,000 threshold, coupled with Canada's relatively high personal tax rates, could hurt the ability of large, mature companies to attract or retain top talent.

While restoring our earlier tax rate advantage is too costly to consider, the government could consider coordinating a rate reduction with the provinces to maintain some competitive advantage. To improve Canada's competitiveness on personal income tax, it could be beneficial to coordinate with the provinces to reduce the top rate to 50 percent and/or consider increasing the threshold at which the top rate is reached.

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Regulation

Regulation is a key dimension of competitiveness. Sound regulations play an important role by addressing existing or potential market failures that would create undesired economic or social outcomes.

The goal is to have regulations that serve the public interest with the least economic disruption.

Despite the importance of a strong and efficient regulatory climate, Deloitte's competitiveness scorecard found this to be Canada's weakest dimension. Our position on the World Bank's 2019 Ease of Doing Business report has fallen since 2006, from fourth in the world to 22nd. In the 2018 World Economic Forum Competitiveness Index, Canada ranked 12th overall but came in 53rd for burden of government regulation.

The federal government has been working to reduce Canada's regulatory burden through a number of initiatives, including an Annual Regulatory Modernization Bill, changes to the Red Tape Reduction Act (to be implemented in 2019) to encourage better alignment with key trading partners, and the creation of an External Advisory Committee on Regulatory Competitiveness.

Budget 2019 reaffirms these earlier commitments, with an added promise in the coming weeks to release a full regulatory roadmap for each of the high-growth sectors: agri-food and aquaculture, health/bio sciences, transportation and infrastructure. These roadmaps will include creating a user-friendly regulatory system (including greater use of digital services), use of novel or experimental approaches (such as sandboxes), and efforts to create greater alignment and coordination across jurisdictions in Canada and abroad.

Many of the government's commitments are consistent with previous research reports and Deloitte's pre-budget submissions. Deloitte has consistently stressed the need to enhance regulatory competitiveness, which has also been highlighted in the budget. We are encouraged to see the government beginning to take action but results will need to materialize soon to address this critical deficiency in Canada's competitiveness.

Despite the importance of a strong and efficient regulatory climate, Deloitte's competitiveness scorecard found this to be Canada's weakest dimension.

Conclusion

From a competitiveness point of view, Budget 2019 doubles down on Canada's strength—its human capital. This will be done through measures to enhance skills development. There are budget measures to improve market demand, but these focus on housing affordability and seniors. There is a continued commitment to increase investment in infrastructure, but it is a continuation of initiatives launched in past budgets. Innovation and taxation are not significantly addressed, partly because they were the focus in past budgets and the 2018 Fall Economic Statement. These are areas where Canada faces a significant competitiveness challenge. The government is promising to make progress on regulatory reform, where Canada is arguably facing the greatest challenge, but the real issue is how much progress will be made.

On balance, Budget 2019 should move Canada in the right direction on competitiveness, but the overall impact is expected to be limited. Canada is fortunate to be in a position where our greatest competitiveness challenges—regulation, taxation, and innovation chief among them—are well within the government's control to change. Going forward, the government will need to take bold action in areas where we fall behind. Improving our productivity, innovation, and economic dynamism is essential to sustaining a rising standard of living for all Canadians over the long term.

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