# SPECIAL REPORT

## TD Economics

August 19, 2015

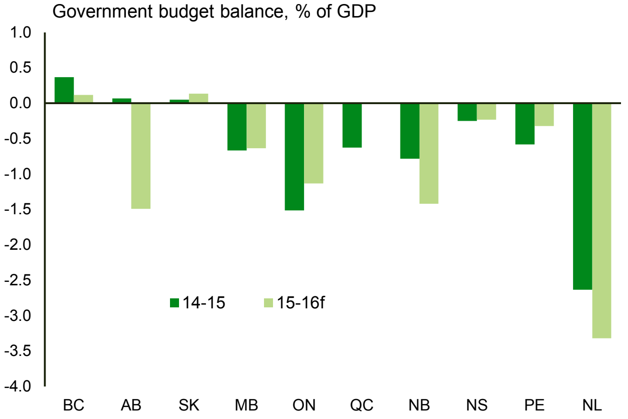
# TAXES IN CANADA: A MIXED BAG OF TAX CHANGES ROLES OUT IN THE 2015 BUDGET SEASON

### Highlights

- Partly reflecting the weak oil price environment, reigning in deficits and containing upward pressures on debt burdens remained the key theme of this year's budget round. With all budgets now on the table (with the exception of Alberta), we take stock of the tax policy changes in the 2015 budget season, and provide a bird's-eye view of how these changes will affect various groups of taxpayers.
- The federal government managed to find room for promised tax relief, while keeping its projected 2015-16 fiscal balance in positive territory. Personal and general corporate income tax rates were left unchanged, but businesses now expect to benefit from a reduction in the small business tax rate. Meanwhile, changes to the contribution limit of the Tax Free Savings Account and the minimum withdrawal factors for Registered Retirement Income Funds will benefit households, particularly those with seniors.
- Provincial governments charted different tax-policy paths based on their individual circumstances. Those hardest hit by the oil shock were left scrambling to address large budget deficits. Alberta and Newfoundland & Labrador erred on the side of raising personal and corporate taxes, while Saskatchewan achieved a fiscal surplus largely through spending restraint.
- Outside of the oil-producing regions, most provinces managed to either cut taxes or announce only modest revenue raising measures. The notable exception was New Brunswick, which introduced two new personal income tax brackets in 2015, taking the province's combined top marginal tax rate to 54.8% – the highest rate in Canada.
- Despite the challenging fiscal environment, this year's budget season was also an opportunity for some governments (notably Quebec and Nova Scotia) to announce future tax reforms regarding personal and corporate taxation. In doing so, these provinces could secure significant longer term benefits to investment and growth.

Against the backdrop of a collapse in oil prices, reigning in deficits and containing upward pressures on debt burdens remained the key theme of this year's federal and provincial budget round. While spending restraint remained a mantra across provinces, several governments also elected to raise revenues through personal and corporate income tax increases. In contrast, provinces such as Québec, Saskatchewan and British Columbia steered clear of income tax hikes while announcing balanced budgets or surpluses (Chart 1). The federal government, which targeted a budget surplus in fiscal 2015-16 in spite of lower revenues, also managed to cut taxes.

**CHART 1: ONLY A FEW PROVINCES WITH A BUDGET SURPLUS IN 2015-16**



Source: 2014 and 2015 Provincial budgets.

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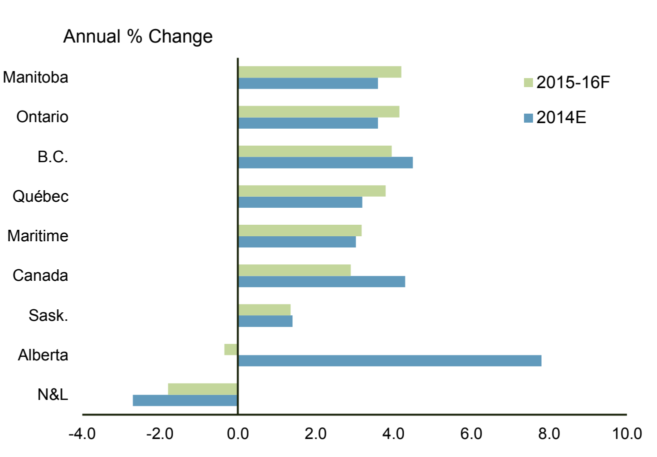
This year's budget season was also an opportunity for some governments to go further by announcing plans to implement significant tax reforms. For instance, Québec and Nova Scotia look to be moving toward reducing personal and corporate income tax (PIT and CIT, respectively) rates over the longer term, instead opting for more economically efficient forms of taxation, such as consumption taxes. Although these reforms are not expected to considerably increase short-term revenues, they could eventually pay-off in the long run by improving the efficiency of the tax system, thereby helping to lift economic growth.

## A year of economic and fiscal challenges

It goes without saying that the 2014-15 fiscal year occurred amid significant economic challenges, from the sharp decline in oil prices to the contraction of the U.S. economy in Q1 2015. Although oil prices have broadly stabilized and the U.S. has re-gathered some strength in Q2, the effects of these developments will continue to be felt as the 2015-16 fiscal year unfolds.

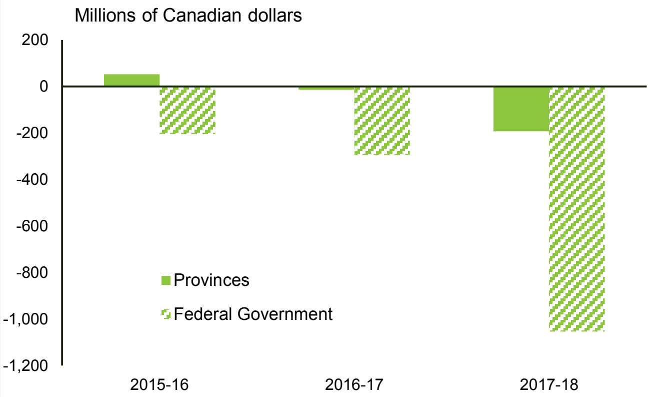
The most notable among these challenges is the impact of last year's dramatic slide in oil prices on the economies of oil-producing provinces, including Alberta, Newfoundland and Labrador (N&L), and Saskatchewan (Chart 2). After peaking at nearly US$110 per barrel in mid-2014, the price of West Texas Intermediate (WTI) has recently been hovering in the US$45 to US$50 range. The result was a sharp drop in corporate profits, particularly in the energy sector, which quickly led to a pullback in investment. This is expected to feed into employment – albeit with a lag – and, hence, personal income and consumption growth. Notable downward pressure is likely to be put, in order of severity, on the growth in revenue from corporate income, personal income, and consumption in the regions affected. What's more, oil royalty revenues, which have historically accounted for around 31% and 19% of own-source revenues in N&L and Alberta, respectively, have also been impacted. Indeed, prior to tabling its 2015 Budget the previous Alberta government estimated that the drop in oil prices had resulted in a $7 billion shortfall in its 2015-16 fiscal plan. For more information on our provincial economic outlook, please see the July 2015 Provincial Economic Forecast.

CHART 2: PROVINCIAL NOMINAL GDP, 2014-16



Forecast by TD Economics as at July 2015.

CHART 3: IMPACT OF NEW BUDGETARY MEASURES ON REVENUES



Source: 2015 Provincial and Federal budgets, TD Economics.
Note: Due to a difference in accounting practices, total provincial fiscal values should be considered as rough approximations only.

In contrast, other provinces have generally been faring better, as they benefit from the lower Canadian dollar and ultra-low interest rates. Thanks to this tailwind, Ontario, British Columbia, Québec, and the Maritime provinces are expected to experience stronger growth over the next couple of years than they are accustomed to. That said, nominal GDP growth – which is a good proxy for revenue intake – is projected to be constrained across all regions this year on account of lower domestic prices and weaker terms of trade.

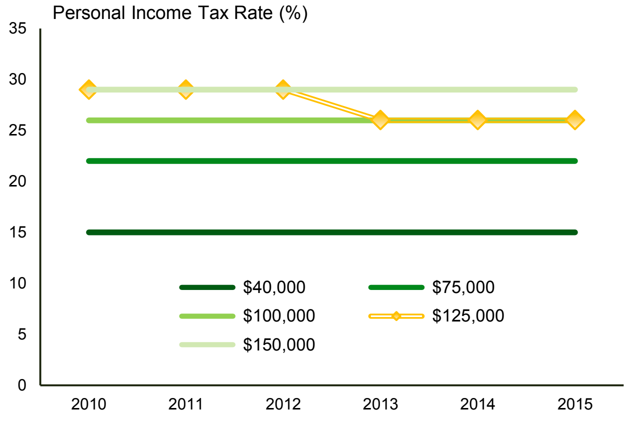
## Despite lower revenues, the Feds manage to cut taxes

While not receiving revenues directly from oil production in the form of royalties, the income shock from lower oil prices has found its way into the federal government's bottom line. As such, the federal government was forced to revise down its outlook for corporate profits dramatically over the next five years in Budget 2015. However, the government managed to find room for promised tax relief while expecting to keep its 2015-16 projected fiscal balance in positive territory, thanks to spending restraint, a lower outlook for debt servicing costs and a smaller contingency reserve. While tax relief measures contained in Budget 2015 totaled about $5 billion over 5 years (Chart 3), the federal government chose to leave personal and general corporate income tax rates unchanged (Charts 4 and 5). Instead, it opted for more targeted tax measures.

Among the tax relief in Budget 2015 were some of the measures promised in the 2011 Conservative Party of Canada election platform. This included the increase in the Tax Free Savings Account (TFSA) contribution limit, from $5,500 to $10,000 annually. The federal government also used the budget to reiterate its introduction of other election commitments announced in October 2014 – notably the Family Tax Cut (better known as 'income-splitting') and the doubling of the Children's Fitness Tax Credit. Seniors also made out particularly well in Budget 2015, thanks to changes in the minimum withdrawal factors for Registered Retirement Income Funds (RRIFs). This allows seniors to keep more savings in their RRIFs longer than was previously the case. In total, tax relief for households in Budget 2015 added up to $2.1 billion through fiscal 2019-20.

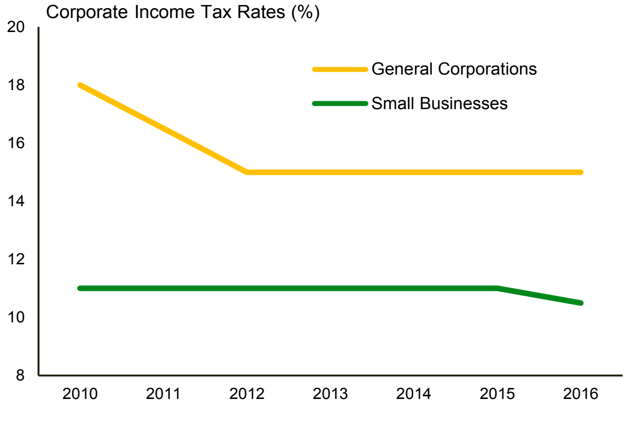
But households weren't the only beneficiaries of tax cuts in Budget 2015. The federal government is planning to gradually lower the small business tax rate from 11% today to 9% in 2019. Not all of these savings will be passed on to taxpayers, however, given the reduction in the non-eligible dividend tax credit introduced at the same time.[1] Another big ticket item was an extension of the accelerated capital cost allowance for manufacturers purchasing machinery and equipment. That said, the government moved to partially offset the net cost of these reductions by continuing to close some tax loopholes. Totaling about $2.7 billion through fiscal 2019-20, the net tax relief provided to businesses in Budget 2015 is still expected to be substantial.

CHART 4: FEDERAL MARGINAL TAX RATES RELATIVELY STABLE



Source: Canada Revenue Agency.

CHART 5: FEDERAL CORPORATE INCOME TAX RATES UNCHANGED IN 2015



Source: Canada Revenue Agency.

### Oil producers raise taxes to shore-up revenues

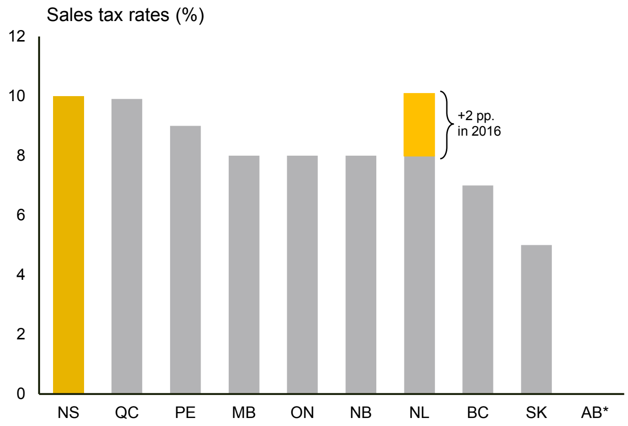
The provinces hardest hit by the oil shock were left scrambling to address large budget deficits. In Alberta, the former Progressive Conservative (PC) government had unveiled earlier this spring – and then later campaigned on – a three-year deficit elimination plan that leaned heavily on revenue-raising measures. The Alberta New Democratic Party (NDP), which won a majority government in May 2015, will table its first budget in the autumn. The new Premier, Rachel Notley, has indicated that the upcoming budget will include a one-year extension in the deficit elimination timetable. Changes to PIT rates have also been introduced in late June and echoed the NDP's electoral platform. They featured the introduction of four new top tax brackets, raising the provincial marginal tax rate for the highest income earners to 15% as of October 1, 2015. This will effectively push the combined federal-provincial top marginal PIT tax rate to 44% in 2016 for Albertans earning $300,000 or more. While this could bring the personal income tax system in Alberta closer to that of the rest of Canada, taxpayers in Wild Rose Country will continue to be subject to the lowest PIT rates in Canada (Table 1). Official estimates suggest these changes to the PIT system will generate between $800 million and $1 billion in addition revenues for fiscal 2016-17.[2]

The Government of Alberta went even further, raising CIT rates to 12% from 10% and announced revisions to the oil and gas royalty regime. According to the Government of Alberta, the CIT rate increase should improve revenues by at least $350 million in the next fiscal year.[2] Meanwhile, a sales tax remains off the table, although many of the levies and increases to user fees, introduced in the previous government's budget, will be unwound. It also appears that the government will be renewing its carbon policy legislation in the near future, and has already announced the doubling of its carbon tax levy from the current $15 to $30 per metric ton by 2017. In all, the government forecast that new tax measures should provide around $1.5 billion in additional revenues.

Expected to be the worst economic performer in Canada over the 2015-16 period, the Government of N&L announced in its 2015 budget that it would raise tax rates to reduce a budget shortfall that has been generated  by the sharp decline in oil prices. This will take the form of two new top personal income tax brackets, an increase in the financial corporations' capital tax rate, and a two percentage point hike to the provincial portion of the Harmonized Sales Tax (HST), bringing the latter to 15% as of January 1, 2016 – matching rates in Nova Scotia and Québec. These three provinces will have the highest provincial sales tax rates in Canada in 2016 (Chart 6). Looking more closely at the PIT rate increases, they became effective as of July 1, 2015 – meaning individuals in the top income bracket will be taxed at 43.3% in 2015 and a percentage point higher in 2016, at 44.3%. Our estimates indicate that these changes are likely to garner around $150 million in extra revenues from 2015-16 to 2017-18.[3] However, this does not include the impact of the new royalty regime that will be introduced in the coming weeks in an attempt to boost prospects in the oil and gas sector, estimates of which are not yet available.

Rounding out the oil-producing provinces is Saskatchewan, which managed to keep its fiscal balance in the black without raising taxes. While the expected positive fiscal outcome is almost entirely tied to spending restraint, it is complemented by modest short-term revenue raising measures, such as the reduction of the Research and Development Tax Credit and a change to the potash production tax which spreads out capital deductions over a longer time horizon. That said the government also managed to provide some modest tax relief to manufacturers.

CHART 6: SALES TAX TO INCREASE IN NEWFOUNDLAND AND LABRADOR



Source: 2015 Provincial budgets. *Alberta has no sales tax.
Note: There is a 5% federal sales tax.

TABLE 1: COMBINED FEDERAL AND PROVINCIAL TOP MARGINAL TAX RATES

| | 2010 | | 2015 | |
|---|---|---|---|---|
| | Taxable Income ($) | Tax rate (%) | Taxable Income ($) | Tax rate (%) |
| Alberta | 127,022 | 39.00 | 300,001 | 40.00 |
| British Columbia | 121,022 | 43.70 | 151,051 | 45.80 |
| Manitoba | 127,022 | 46.40 | 138,587 | 46.40 |
| New Brunswick | 127,022 | 43.30 | 250,001 | 54.75 |
| Nfld. & Lab. | 121,022 | 43.40 | 175,001 | 43.30 |
| Nova Scotia | 150,001 | 50.00 | 150,001 | 50.00 |
| Ontario | 127,022 | 46.41 | 220,001 | 49.53 |
| P.E.I | 127,022 | 47.37 | 138,587 | 47.37 |
| Quebec | 127,022 | 48.22 | 138,587 | 49.97 |
| Saskatchewan | 127,022 | 44.00 | 125,796 | 44.00 |

Source: Canada Revenue Agency and Quebec Revenue Agency.
Note: In 2016, BC's top marginal PIT rate will be reduced to 43.7%, while increasing in N&L (44.3%) and NB (54.8%). Alberta's top PIT rate will rise to 44% for individuals earning $300,000 or more. The current rate is prorated by the number of days in the 2015 tax year.

## A scattershot of tax changes in non-oil producing provinces

Outside of the oil-producing provinces, governments charted different tax-policy paths based on their individual circumstances. For instance, British Columbia was the first province to publish a budget – and a balanced one at that. Indeed, the outlook is better than was previously anticipated, thanks to a combination of fiscal prudence and better-than-expected economic growth. Accordingly, the government enjoyed sufficient wiggle room to implement some modest tax cuts. It decided not to extend the temporary two per cent PIT hike on individuals earning over $150,000 that was introduced two years ago. This will reduce the top combined marginal tax rate by 2.1 percentage points to 43.7% in 2016. Generally speaking, the new initiatives introduced in the budget are expected to shrink government's coffers by about $68 million in fiscal 2015-16 alone.

Unlike British Columbia, the Manitoba government pushed back its anticipated return to surplus for the second time in two years – with fiscal 2018-19 being the revised target date – and sharpened its focus in this year's budget season on expenditure restraint. Leaving PIT and CIT rates unchanged, the government raised the tobacco tax rate as well as the Corporation Capital Tax on financial institutions, with the latter increasing to 6% from 5%. There were also some tweaks around the margins in the form of targeted increases in tax expenditures. For example, the budget enhances the Small Business Venture Capital and the Primary Caregiver tax credits, and extends several existing tax credits up to 2019. The net cost of changes in tax measures included in the 2015 budget was forecast at $7 million for the current fiscal year.

Ontario followed a similar track in its 2015 budget, choosing not to change tax rates after last year's increase in the top marginal PIT rate. However, the government implemented tweaks to the taxation of trusts and estates, so that those entities will now be subject to the highest provincial PIT rate starting in 2016, which is similar to the federal tax treatment. These changes, in combination with some more marginal measures, are forecast to net the Ontario government roughly $545 million in additional revenues over the next three years. Looking further out, the Government of Ontario is planning to implement additional levies on employees and employers to fund the Ontario Retirement Pension Plan, which will begin in 2017. Furthermore, it will push ahead with a cap and trade system for carbon pricing. This would make Ontario the third province, after British Columbia and Québec, to implement a carbon pricing policy (albeit more closely tied to Québec). While these measures are likely to act like taxes following their introduction, legislators will aim to balance that drag against the potential long-term benefits.

In the 2015 Québec budget, the government confirmed that it continues to make strides with respect to returning to balance. Indeed, the Government of Québec expects to reach that target this year, vaulting it into an exclusive club in Canada. A major part of this move can be tied to continued expenditure restraint and the province is also expected to benefit from an improved economic growth performance. This favourable outlook allowed the government to provide Quebecers with $1.2 billion in tax relief over the next three years (increasing to $3.4 billion over the next five years). This included the gradual elimination of the health contribution levy and the lowering of the general corporate income tax rate from 11.9% to 11.5%. The budget also contains changes to the Solidarity Tax Credit, which is now set to be revised annually rather than monthly.[4] Looking ahead, if the government continues to follow the recommendations of the Québec Taxation Review Committee, more PIT and CIT rates cuts are likely to be in the cards. Indeed, these recommendations – expected to optimize the taxation system – read like an economist's tax policy wish list. However, as one of the goals of these recommendations was to be longer-term revenue neutral, they won't come without some pain. The government has signaled its intention to raise consumption taxes and reduce available tax expenditures as it ultimately moves to offset the loss in PIT and CIT revenues.

The Government of Nova Scotia has also placed increased focus on the long term in outlining its plans for tax policy. While higher user fees are expected to generate more revenue in the near term, the Government of Nova Scotia also took a step forward in adjusting its tax mix toward a greater reliance on more efficient consumption and 'sin' taxes (higher tobacco taxes, for example), and away from more economically-inefficient personal and corporate income taxes. In addition, the government elected to scale back a number of tax preferences, the most widely discussed of which was the reduction in the refundability of the Film Industry Tax Credit. It also opted to reduce the tax credit for non-eligible dividends effective January 1, 2015, while introducing a new refundable Capital Investment Tax Credit for manufacturers. Overall, new measures contained in the 2015 budget plan should boost revenues by around $700 million over the next three years. However, more remains to be done in implementing the recommendations outlined in Charting a Path for Growth: Nova Scotia Tax and Regulatory Review, published in November 2014.

Meanwhile, a balanced budget for the current fiscal year remains elusive in Prince Edward Island (PEI), but is on the agenda for 2016-17. While keeping expenditures under control, the government managed to provide tax relief to low-income earners by announcing adjustments to the levels of basic credits, and also increasing the low income tax reduction threshold from $15,000 to $17,000. The Government of PEI also increased the taxation of tobacco products. Taken together, the measures announced in the budget are expected to cost around $250 million over the next 3 years.

In New Brunswick, the government moved to shore up revenues by implementing some modest tax hikes. For instance, the government increased taxes on its highest-income citizens by introducing two new top personal income tax brackets. This initiative takes the province's combined top marginal tax rate to 54.8% in 2015 – the highest rate in the country (Table 1). The government also opted to raise the fuel tax. However, there were some small tax measures introduced to spur investment, such as a reduction in the small business tax rate, changes to the New Brunswick Dividend Tax Credit, and an enhancement to the Small Business Investor Tax Credit. Taken together, the tax policy measures announced in the 2015 budget are expected to generate a modest $8 million in additional revenues in fiscal 2015-16.

### Implications of revenue changes on the overall fiscal outlook

Based on the 2015 budget plans, revenues in Newfoundland & Labrador and Saskatchewan are forecast to grow by a meagre 0.5% this fiscal year, while an 8.6% contraction should be expected in Alberta.[5] In contrast, respective 2015 budgets in non-oil producing provinces have assumed that revenues will grow at a moderate rate, increasing by 2.1% in fiscal 2015-16 on average.

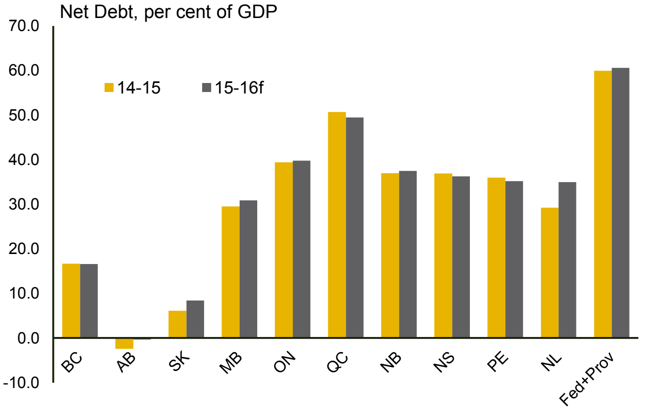
In general, budgets in non-energy provinces were built on expectations that the combination of higher revenues and ongoing spending restraint will lead to improvements in budget balances in the current fiscal year. For instance, Manitoba, Nova Scotia, PEI, Ontario and Québec all anticipate that their respective deficits will decrease as a share of their GDP, compared to the 2014-15 fiscal year (Chart 1). However, despite these positive developments, provincial budgetary balances will stay in negative territory this year, except in British Columbia, Québec and Saskatchewan. Alberta which enjoyed a surplus in fiscal 2014-15, is likely to record a deficit in 2015-16, alongside N&L. All told, total federal and provincial governments' budget balance will remain in the red this fiscal year, albeit a relatively small share of GDP – under 1%.

Provincial debt levels represent, however, a greater share of GDP (Chart 7). Although most regions should see their debt levels decline as a share of GDP in fiscal 2015-16, that ratio will remain in the 35-50% range. Furthermore, the slump in oil prices certainly didn't help oil-producing provinces, which are forecasting their net debt-to-GDP ratio to deteriorate significantly in the current fiscal year. As for the federal government, it has resolutely put its debt-to-GDP ratio on a downward path despite the hit from lower oil prices, and should meet its 25% target by 2021 as planned.

### Bottom line

There were both winners and losers in this year's budget season, and where you stand was generally dictated by where you live. Taxpayers in the oil-producing provinces of Alberta and N&L are bearing the brunt of tax hikes as government's work to bring down deficits to a more sustainable level. In contrast, Saskatchewan found room on the expenditures side to offset lower revenues. While the new Alberta government has not yet released its final budget, it has already introduced legislation that increases both personal and corporate tax rates.

CHART 7: DEBT LEVELS TO REMAIN ELEVATED IN SOME PROVINCES



Source: 2014 and 2015 Provincial budgets.

Contrast this with most oil-consuming provinces, which managed to either cut taxes (i.e., British Columbia did not extend the temporary PIT brackets) or, at least announced only modest new revenue-raising measures (i.e., New Brunswick being the notable exception). That said, the trend in recent years has been toward increased personal income taxes on higher-income earners. Despite slower expected growth in aggregate Canadian incomes, the federal government managed to provide much of its promised tax relief and then some. This was largely targeted toward seniors, families with children, and small business owners as opposed to broad-based tax relief.

This year's budget season was also about the longer term, with governments in Québec and Nova Scotia heading toward deep reforms, in terms of taxes on personal and corporate income as well as consumption. In doing so, these provinces could secure significant longer term benefits to investment and growth.

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## End Notes

1. Reducing the federal non-eligible dividend tax credit will raise the overall federal tax rate on that class of dividends. This, in turn, will increase the combined federal and provincial tax rate on non-eligible dividends.
2. More specifically: 12% on taxable income over $125,000 to 150,000; 13% on taxable income over $150,000 to $200,000; 14% on taxable income over $200,000 to 300,000; and 15% on taxable income over $300,000. http://alberta.ca/release.cfm?xID=382115614966E-96E1-ECF5-94576C284D150F61
3. The revenue impact has been estimated by TD Economics based on past and current provincial budgets, except for Alberta, British Columbia, Manitoba, New Brunswick, Ontario and Quebec, as official estimates were provided in these cases. Due to the lack of available information, Saskatchewan was excluded from the forecast. Official financial estimates have been recently revised for some provinces, but that does not materially change our estimations.
4. The Solidarity Tax Credit, whose objective is to offset the impact of tax increases on the purchasing power of low- and middle-income households, was introduced in Budget 2010 to replace tax credits for the Quebec sales tax, the property tax refund and the credit for individuals living in northern villages.
5. This is based on the NDP's electoral platform, but is likely to change when a new budget is released in the fall.

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