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Backgrounder

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Focus on the Future:

A Shadow Federal Budget for 2003

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The Backgrounder in Brief

Growing tax revenue has recently enabled the federal government to meet current budget-balance targets despite its rapidly increasing spending. That spending growth, left unchecked, will threaten the tax relief needed to promote national competitiveness and prosperity. This shadow budget, by reorganizing spending to suit future priorities, creates room for lower tax rates for Canadians and their businesses, consolidating gains achieved through past budgets.

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This shadow budget sets out a plan to build Canadian prosperity through more investment, better jobs and faster growth. Past fiscal actions have positioned Canada to move ahead in the global competition for investment. Tax reforms and strategic reorientation of spending can make Canada the place of choice to invest and to work in North America — and the world.

Canada's strong economy in 2002 and the robust growth of federal tax revenue blurred the government's focus on the constraints of meeting zero-deficit targets, permitting precipitous spending growth that has purchased little of lasting value. Burgeoning tax revenue loosened the constraint that the commitment to budget balance placed on spending in the mid- to late-1990s. And rapid spending growth, left unchecked, will threaten Canada's ability to provide the tax relief needed to promote national competitiveness and prosperity.

This shadow budget aims at a better fiscal environment — one that will enhance Canada's attractiveness for workers, their savings and the investments that link them. Its approach is two-fold:

- It restores discipline in federal spending. It is time to ask of each federal program whether it meets Canadians' current needs, whether Ottawa is best equipped to administer it and whether that program is effective. By reallocating funding from low- to high-priority areas, the federal government will reassure Canadians that their tax dollars are well managed.
- It builds on recent progress to ensure that Canada's tax system promotes work, saving and investment. Resources freed up by spending review are available to reduce debt, lower tax rates and raise tax thresholds.

Economic Developments and Prospects

While recent economic events and the current outlook shape the budget choices of the government, these choices are designed to provide a sustainable framework for multi-year planning.

Recent Economic Developments and Outlook

The Canadian economy surprised forecasters with its strong performance in 2002. Spending, output and job creation recovered rapidly from softness in the previous year. While worries about the US outlook remain, Canadian consumers and businesses are displaying confidence through their spending and investment plans. Interest rates and inflation, for the moment at least, are at moderate levels.

The baseline forecast for this shadow budget assumes that economic growth will continue at a pace consistent with underlying expansion in Canada's productive capacity through 2003. Timely action to reduce inflationary pressure in Canada (as recommended in Laidler and Robson, forthcoming) will restrain rises in interest rates.

Table 1: *Key Economic Indicators*

	2001	2002	2003	2004	2005–08
Real GDP Growth	1.4	3.5	3.0	2.6	3.0
GDP Inflation	1.0	1.1	2.7	2.1	1.9
Nominal GDP Growth	2.6	4.5	5.7	4.7	5.0
3-Month Treasury Bill Yield	3.7	2.6	3.5	3.7	3.8
Long Government Bond Yield	5.8	5.7	6.1	6.5	6.0

Source: Statistics Canada, CANSIM; Finance (2002); authors' calculations.

This government believes that global economic and military uncertainty make it more than usually helpful for fiscal policy to adopt a longer-term horizon within which Canadians can judge its intentions. Accordingly, this budget adopts the five-year timeframe for the fiscal plan that has been a feature of recent Economic and Fiscal Updates. Table 1 summarizes the outlook over the five-year budget-planning period.

This outlook has important implications for the evolution of federal finances. Looking at revenue, in spite of the slowdown and difficult forecasting conditions that characterized 2001/02, steady output growth boosted federal collections and more than offset the moderating impact of the phased-in tax reductions initiated in the February 2000 budget.

In the spending area, solid job growth held down expenditures for regular benefits under the Employment Insurance program.[1] As well, the credibility of the government and Bank of Canada's inflation-target regime limited the impact of inflationary pressure on longer-term interest rates. At the same time, however, rapid growth in operating spending and other transfer payments severely eroded the surpluses that were projected in the October 2002 *Economic and Fiscal Update*.

The fiscal outlook on the basis of unchanged policy — including sustained growth in program spending along recent lines[2] — is shown in Table 2. Note that, consistent with the presentation in last year's shadow budget,[3] the revenue and spending items are shown here on a gross basis: several items that have traditionally been netted against revenue and spending in the budget presentations — most notably the transfer programs that are delivered through the personal income tax system — are included in the numbers. This accounting presents a fuller picture of the scope of federal activity; it does not change the budget balance or the accumulated debt.

As the summary makes clear, recent growth in spending presents a formidable obstacle to a continuation of the debt reduction and tax relief that marked Canada's recently happy fiscal performance. Subtracting the contingency reserve and prudence factors that insulate the government's bottom line from adverse

1 The story for other components of the EI program is not nearly as happy because expenditures unrelated to job-loss have ballooned uncomfortably to almost half of total EI expenditures.

2 Overall compound growth rates for program spending in the "status quo" projection are slightly below those of the past three years, reflecting presumed restraint in the defence budget.

3 Jack M. Mintz, Finn Poschmann and William Robson. "Budgeting for Security and Prosperity: A Shadow Federal Budget for December 2001." C.D. Howe Institute Backgrounder. Toronto: December.

Table 2: ***Summary Statement of Transactions: Status Quo Fiscal Outlook***

	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
				($ billions)			
Non-Interest Revenue*	177.9	179.2	189.7	197.8	207.6	217.6	227.7
Program Spending*	137.2	147.0	156.7	167.3	178.4	189.9	202.1
Primary Balance	*40.8*	*32.2*	*33.0*	*30.5*	*29.3*	*27.8*	*25.7*
Net Debt Charges	31.8	28.2	28.0	27.8	27.8	27.8	27.9
Total Balance	*8.9*	*4.0*	*5.0*	*2.7*	*1.5*	*0.0*	*-2.2*
Memo Items							
Contingency Reserve		3.0	3.0	3.0	3.0	3.0	3.0
Economic Prudence			1.0	2.0	3.0	3.5	4.0
Total Balance after Memo Items		*1.0*	*1.0*	*−2.3*	*−4.5*	*−6.5*	*−9.2*

* Gross of Child Benefits and GST Credit.

Source: Receiver General of Canada (2002), Finance (2002); authors' calculations.

events makes obvious the risk of a return to deficits in this scenario. That is why this budget makes the containment of spending through re-allocations from low- to high-priority areas the first pillar of its fiscal strategy.

Long-Term Challenges and Priorities

Neither Canadians nor their governments can be complacent about a prospective erosion of fiscal probity. Further shoring up of federal finances is an essential precondition for successfully meeting the challenges of an aging population and a more competitive world.

An aging population will affect governments' fiscal positions in many ways. The Canada and Quebec Pension Plans recently reinforced the sustainability of public pensions by pre-funding, with the result that investment returns, rather than rising payroll taxes, will cover more of the future cost of pensions. The baby-boomers' retirement nevertheless suggests that additional resources to cover benefits for seniors (OCA 2002) and the impact of aging on government revenues and health care remain looming challenges. As more of the population switches from building retirement savings to drawing them down, payroll and income taxes will become less important than consumption taxes. And the increased demand for publicly funded health care resulting from population aging presents Canada's provinces with the equivalent of an unfunded liability of about $640 billion (Robson, 2002) and a continuing need for more revenue.

The greatest challenges and the best opportunities for responding to these pressures lie with provincial governments. As taxpayers and consumers of health services, Canadians can more readily hold governments to account when responsibilities are clear and governments are free to respond. For these reasons, this shadow budget does not propose extensive new transfers to the provinces tied to specific health spending. Instead, it proposes to further reduce the federal government's claims on taxpayers, giving the provinces room to find new funds and to improve the manner in which they raise them.

Thanks to recent solid fiscal results and pension reforms, Canada is well situated to enhance its attractiveness as a place to work and to invest. Building on this advantage involves further reducing the effective marginal tax rates faced by companies contemplating job-creating investments. Canada taxes business more heavily than key competitors such as the United States, the United Kingdom and Ireland (Chen and Mintz, 2003), countries that are working to offer more attractive combinations of taxes and public services to individuals and companies.

Even after the phase-in of the 2000 budget's tax reduction plan, the burden of taxation on business in Canada will remain above the *current* rate in the United States. In fact, effective tax rates on capital are likely to fall as recent US proposals are enacted and other countries push forward with their tax reforms. Lower tax rates and other measures can shrink the tax gap between Canada and its peers, bringing Canada more investment and better jobs.

Program Review and Reallocation

Capitalizing on Canada's current and potential advantages requires the federal government to be no less focused and effective in its programs than Canadian families and businesses are in their activities. The spending restraint of the mid-1990s, so critical in restoring federal fiscal soundness, required careful prioritizing, asking of each program:

- Whether it was truly needed;
- If it was needed, whether the federal government was best placed to undertake it, and
- If the federal government was best placed to undertake it, whether its existing approach could be improved.

The effect of these reviews was to scale back federal obligations in high-profile areas, such as EI and transfers to the provinces, as well as in funding for crown corporation subsidies and the government's own operating expenditures.

Once deficits gave way to surpluses, however, larger revenue growth relieved the pressure to prioritize. Recently, program spending has been growing at an unsustainable rate. Transfer payments are rising; more problematically, non-defence operating spending has risen at a 10-percent annual rate since 1999 (Robson 2003) — growing twice as fast as the economy and five times faster than federal revenue. As Table 2 illustrated, spending that outpaces growth in the economy and in tax revenue will lead, inevitably, to deficits or tax increases. Curbing spending in low-priority areas with internal operating costs first and foremost — is an essential task to which this budget responds.

Ending the EI Rip-Off

Since the difficult economic circumstances of the early 1990s, the Employment Insurance program has collected premiums from Canadian workers and employers far in excess of its payments of benefits to displaced workers. The EI account now has a notional surplus of more than $42 billion, roughly 2.5 times the amount needed to finance the program through an economic trough without raising the premium rate (now set at 5.04 percent of insurable wage earnings below $39,000 yearly).

The damage that this tax of dubious legality does to the image of accountable government is an issue that Canada's Auditor General and the C.D. Howe Institute (Poschmann and Robson, 2001) have repeatedly flagged. Canadian workers pay substantial payroll taxes ostensibly to fund insurance benefits to temporarily unemployed workers when, in fact, regular benefits paid to the unemployed amount to only 45 percent of annual inflows to the EI account. The bulk of EI collections provides financing for income transfers to non-workers, as well as money for the miscellaneous spending plans of the federal government — an abuse that this budget proposes to end.

At present, employers' contributions to the EI fund more than cover the cost of regular sickness and maternity benefits. This budget proposes that in future, employers' premiums should fund the entire program.

Employers' contributions to EI more than cover the cost of regular sickness and maternity benefits. This budget proposes that employers' premiums should fund the whole program.

Employee contributions have been used in part to fund special measures, including skills development and transfers to provincial agencies. There is little evidence that such programs improve recipients' job prospects and there are many reasons to think that this record would improve if the provinces, which already run social assistance and education programs, take greater responsibility for labour-market development. This budget therefore proposes to phase out employee-premium assessments over the planning period. To the extent that provinces wish to maintain programs now funded by federal EI money, this phase-out will provide room to raise revenues of their own; otherwise the money freed up by lower payroll taxes will stay in workers' pockets.

As for employer premiums, the government will begin consultations immediately on establishing an experience-rated system in which premiums will reflect employers' experience in generating eligible-benefit claimants (see Canada, 1998). The objective is to ensure that companies that lay off relatively few workers will be rewarded with lower, risk-adjusted premium assessments, reducing unemployment and the future cost of the EI program.

This reform will focus federal activities more effectively, restore accountability and reduce unemployment. The net impact of these changes on federal spending will be to reduce annual non-insurance EI spending by $3 billion by the end of the projection period.

Controlling the Growth of Transfer Payments

Reining in unproductive spending requires attention to many programs that fail to achieve their objectives or do so in needlessly expensive or problematic ways. One major concern in this regard is the impact that the clawback of the Child Tax Benefit as incomes rise has on the marginal effective tax rates faced by modest-income families. Further enhancements of the Child Benefit without further investigation of these effects is unwise. While the value of Child Tax Benefits will increase with inflation, there will be no more discretionary increases in the program during the planning period.

Reductions in the myriad transfer payments made by various government departments in the mid-1990s were inspired by a view that too much of the money was subsidizing business activities that would not stand the test of the open market. Recent rebounds in transfer spending and in subsidies to crown corporations fly in the face of this logic. While some transfers, mainly those to aboriginal people, will rise in the years ahead, this budget will impose a one-year freeze on such payments, limit their aggregate increase to 2.5 percent over the following four years,[4] and roll back transfers to crown corporations.

As noted, this budget sets the stage for a disentanglement of federal-provincial responsibilities in health care. It confirms that the federal government will provide a top-up of the CHST of $2.5 billion in 2002/03, in line with the agreement reached with the provinces on February 5, 2003.[5] It will provide additional funds for 2003/04, amounting to another $1.0 billion relative to the status-quo projection, which will maintain CHST funding at $21 billion in 2003/04. Rather than proceeding with more increases in federal spending tied to still-to-be finalized federal direction on provincial health services, however, this budget proposes to freeze CHST spending after that date. The additional resources provinces will need for their health systems will be provided by a transfer of tax room through a lowering of federal tax rates, as described below.

This budget proposes to increase military spending by 5 percent each year over the next three years and by 2 percent in the two years afterward.

Controlling Operating Spending

Since the restraint budgets of the mid-1990s, the federal government's operating costs have grown prodigiously. Non-defence operating spending rose from $19.0 billion in 1996/97 to $22.1 billion in 1999/00, and will come in around $29 billion in the 2002/03 fiscal year. The government spent most of this on hiring based on questionable priorities, in particular EI-revenue-supported adding of staff in the department of Human Resource Development and gun-registry related costs in the Department of Justice.

This budget imposes a one-year freeze on aggregate non-defence operating spending. As part of this restraint package, the government will institute an immediate net hiring freeze on all non-defence departments pending review of its internal operations. Along with other restraint measures, this freeze will hold increases in non-defence operating costs to 2.2 percent annually over the projection period.

An Effective Military Force

Canada's security and sovereignty depend on a strong national defence. Recent increases in defence spending have merely slowed the rate of decline in Canada's

4 Specific measures to achieve this goal include: a freeze on subsidies delivered through the departments of agriculture and industry and conversion of the Canada Education Savings Grant to a one-time bonus on opening an RESP (as recommended in Milligan 2002).

5 This amount is provided for in the fiscal plan by the contingency reserve for 2002/03.

Table 3: ***Impact of Spending Restraint and Reallocation***

	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
			($ billions)			
Restraint of Transfers to Persons		–0.9	–2.7	–4.8	–6.7	–8.5
Health Funding Reforms	2.5	1.0	–0.6	–2.3	–4.2	–6.2
Restraint of Other Transfers #		–2.7	–4.7	–6.9	–9.4	–12.1
Restraint of Non-Defence Operations		–2.0	–3.3	–4.8	–6.4	–8.1
Enhanced Defence		0.2	0.5	0.8	1.0	1.1
Net Change in Program Spending	2.5	*–4.3*	*–10.8*	*–18.1*	*–25.7*	*–33.8*

\# Including Crown Corporation Expenditures.

Source: Authors' calculations.

military capability and have not been sufficient to equip our armed forces for the new role a more unstable world requires.

This budget proposes to increase military spending by 5 percent in real terms each year over the next three years and by 4 percent in real terms during the 2 years after that. This will bring about only small advances in the share of national income put to national defence, though carefully directed funding, added to recent increases, will bolster the numbers of our professional armed forces staff and better equip them.

Summary of Spending Measures

The impact of the restraint measures just described on major program categories is shown in Table 3. Relative to the status-quo projections shown in Table 2, the budget outlook improves dramatically, providing room for the second pillar of this budget: a tax system that is friendlier to work, saving, investment and rising living standards.

More Competitive Taxes

The key to continuing improvements in Canadians' living standards is investment that creates jobs and adds to productivity growth. Other things being equal, investors will choose locations offering the best combination of taxes and supporting public services. This budget aims to deliver a very attractive combination.

Fairer Personal Taxes and Accountable Government

The personal income tax reductions of the February 2000 budget have mostly run their course. It is time to do more for three reasons. First, the bracket schedule lost significant ground to inflation in the mid- to late-1980s, ground that higher tax thresholds have not yet made up (see Poschmann, 1998). Second, personal tax rates affect the cost of entrepreneurial capital, a cost that reduces Canada's attractiveness to entrepreneurial investment (see Chen and Mintz, 2003). Finally, as productivity improvements raise wages faster than inflation, Canadians move into higher tax brackets. Without legislative action to lower tax rates and raise thresholds, the government claim on the economy rises, without explicit authority from the voting population.

This budget, therefore, proposes to adjust all indexed amounts of the personal income tax system for 2004 and afterwards by the greater of 3 per cent or the annual inflation rate, making up lost ground and ensuring that inflation neither raises peoples' income taxes nor erodes the value of benefits they receive.

Mending the gap in the fiscal framework demands stronger measures to match federal revenue with federal program responsibilities. Federal taxes provide far more money than required to fund federal program spending. Accordingly, this budget proposes to reduce the bottom personal income tax rate by one percentage point in 2004 and all rates by a further percentage point in 2006.

Improving Savings and Lifetime Security

Beyond public pensions, Canadians who are in a position to bolster their retirement living standards through their own resources should be encouraged to do so. This budget increases the scope and attractiveness of retirement saving for all Canadians.

A New Savings Vehicle: TPSPs

For many workers with modest earnings, saving through employer-sponsored pension plans (RPPs) or Registered Retirement Savings Plans (RRSPs) makes little sense. The deduction of contributions from taxable income is less valuable to people in low tax brackets, while the clawback of means-tested benefits for the elderly (such as the guaranteed income supplement) can subject their incomes in retirement to very high marginal effective tax rates. Discouraging saving in this manner undermines the ability of the people affected to prepare for retirement, threatens to make future social programs more costly and reduces the savings that help fuel Canadian investment and prosperity.

This budget, therefore, proposes a new vehicle for retirement saving: tax-prepaid savings plans (TPSPs). Workers will receive no tax deduction for their contributions to TPSPs, but they will pay no tax on earnings inside the plans or on withdrawals of funds in retirement.[6] TPSPs are thus a mirror image of RRSPs, supporting saving by eliminating the double taxation of income set aside for the future.

Unlimited Foreign Content for Pension Plans

Most Canadian pension plans cannot have more than 30 percent of their assets in the form of foreign securities. The foreign property rule affects all Canadians who save for retirement through RRSPs and RPPs, increasing their risks and lowering

6 The obvious attractions of this mechanism, including simplicity, have put TPSP-equivalents front and centre of the 2003 US budget agenda.

their returns, while providing no benefit to Canadian investment (Fried and Wirick, 1999). Increasingly, moreover, large sophisticated investors are able to use financial instruments that enable investments in foreign securities to qualify as Canadian assets. In view of these developments, this budget proposes to eliminate the foreign property rule immediately. This action has no impact on federal revenue.

Higher Contribution Limits for Pension Retirement Savings Plans

Inflation has lowered the real value of pension-plan contribution limits: they are lower now than they were in 1976 and lower than they would have been had the 1991 Pension Reform blueprint been followed. This budget proposes to raise RRSP contribution limits to $15,500 or 20 percent of earned income for 2003, $16,500 for 2004, $18,500 for 2005 and index them to inflation afterwards, returning the limits close to the schedule originally set out in the 1991 blueprint and approximately to their 1976 position relative to average labour income.

To make saving plans more flexible, responding to the growing demand for life-long learning and new arrangements for older workers, this budget also proposes that for 2003 and beyond, taxable withdrawals from an RRSP in a year will generate new RRSP contribution room that may be carried forward indefinitely. In addition, earned income above the amount that generates the maximum RRSP contribution will be allowed to be carried back or forward to create additional RRSP contribution room in years when earned income is below the RRSP maximum contribution amounts.[7] Consistent with this lifetime treatment of RRSP contributions and withdrawals, recipients of pension payments from RPPs will create future RRSP contribution room in the same way as withdrawals from RRSPs.

Forced Annuitization and Conversion of Retirement Saving

The government lowered the age limit at which RRSPs must be annuitized or converted to RRIFs from 71 to 69 in the federal budget of 1996. Because Canadian life expectancy at age 70 is now more than two years longer than 25 years ago, this measure will be reversed. The age at which RRSPs must be wound down will be restored to 71 for 2003 and raised to 73 in 2004. The government will consult over the possible elimination of forced annuitization and conversion in future years.

More Competitive Business Taxes

This budget proposes a package of reforms to improve Canada's investment environment and address shortcomings in the current treatment of entrepreneurial capital.

7 Consistent with this lifetime treatment of RRSP contributions and withdrawals, recipients of pension payments from RPPs will create future RRSP contribution room in the same way as withdrawals from RRSPs.

Dividend Taxation

Dividend taxes impede the smooth functioning of Canadian capital markets and investment. Since 2001, one-half of capital gains have been included in personal taxable income. Dividends are now more highly taxed than capital gains, giving business managers and owners an incentive to retain earnings, rather than pay dividends to shareholders who might make different investment decisions, raising the cost of equity finance and making taxation a major factor in decision-making. High dividend taxes have also promoted new, potentially distortionary financing vehicles such as income trusts. If Congress approves President George W. Bush's proposals to eliminate dividend taxation in the United States, Canada's attractiveness for business finance will deteriorate.

This budget proposes, effective in 2004, to increase the federal dividend gross-up rate to 133 percent and the federal dividend tax-credit rate to 18 percent from 13.13 percent for grossed-up dividends, for dividends paid by public corporations and high-tax pools of income earned by private corporations. The tax credit would remain at the lower rate for dividends paid by Canadian-controlled, private corporations from low-taxed sources of income.

The capital tax is an obvious discouragement to domestic investment and is particularly onerous for the financial and other service industries.

Corporation Income-Tax Rate Reductions

The 2000 budget set on track a multi-year package of reductions in the general tax rate applying to business income. While helpful, that package had three shortcomings: It did not move as quickly or as far as federal finances would have permitted; it did not cut deep enough to substantially reward entrepreneurial investment in Canada, and it left out the resource sector.

This budget proposes to reinvigorate the CIT reduction schedule by bringing the general and manufacturing and processing federal CIT rates to 20 percent for 2005, 19 percent for 2006, 18 percent for 2007 and 17 percent for 2008. With provincial taxes, Canada's representative corporate income tax would be about 26 percent by 2008, among the lowest in industrialized economies. To remove sectoral distortions in the Canadian economy, this budget proposes to bring the tax rate on resource profits into the same reduction schedule and to phase out the resource allowance as the tax rate on profits is reduced (resource royalties will become deductible up to a maximum of 30 percent of resource revenue — see Mintz 2001b).

Capital-Tax Changes

Capital taxes are important contributors to the gap between US and Canadian effective tax rates on new investment.[8] The capital tax is an obvious discouragement to domestic investment, a hindrance to successfully expanding companies and is particularly onerous for the financial and other services

8 The large corporations tax is set at 0.225 percent of assets; it is reduced by the amount of any liabilities under the corporation income surtax, which is 1.12 percent of profits.

industries. Reducing the capital tax would limit governments' role in directing resources among economic activities and increase the ability of companies to adopt technologies and processes that put Canadians' innovative energies to work.

This budget proposes to phase out the federal large-corporations tax over the planning period. Because most profitable companies will then become exposed to the corporate income surtax, that surtax also will be phased out beginning in 2006.

Lower Taxes on Crossborder Investment

Canada levies a 15-percent withholding tax on dividends paid to US residents and residents of other tax treaty nations (or 5 percent if the US recipient owns 10 percent or more of the voting shares of a Canadian company) and a 10-percent withholding tax on arm's length (for indebtedness with less than a five-year term) and non-arm's length interest payments. These taxes inhibit cross-border investment and reduce the amount of capital available for investment in Canadian jobs and growth opportunities (see Mintz 2001a).

The government of Canada will commence negotiations of tax-treaty changes with the United States to eliminate the Canada-US withholding tax on non-arm's-length interest payments. This budget proposes to eliminate the withholding tax on arm's-length interest payments under domestic legislation. The government will also negotiate with major tax treaty partners, including the United States, the eventual elimination of dividend and interest withholding taxes.

Health Measures

The quality and cost of publicly funded health care is a critical issue for Canadians. This budget proposes major reform of the way Canadian governments finance the health-care system — reform that will improve accountability in the near term and the quality of care Canadians receive in the future.

Improving Support for Health Care

Provincial governments have long emphasized the difficulty of keeping pace with Canadians' demands for readily accessible, state-of-the-art health services. The federal government, its revenue boosted by growing personal income-tax payments, responded with supplements to the funds it provides under the Canada Health and Social Transfer (CHST) in 1999, again in 2000 and in 2001.

This mismatch of taxing and spending authority makes it impossible for the federal government to ensure that money it collects is spent on health, while provincial voters cannot point to the tax dollars they wish spent on health care and demand accountability for their disposition. Repeated infusions of cash and solemn promises that money will be directed toward health funding do not provide a framework within which provincial governments can confidently set health budgets and undertake reforms to the delivery and financing of health programs. It is time for a new approach.

Table 4: ***Impact of Revenue Measures***

	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
			($ billions)			
Personal Taxes						
Reduced PIT rates		–0.6	–2.4	–3.7	–7.4	–7.6
Minimum 3% indexation of all PIT parameters		–0.1	–0.1	–0.6	–0.9	–1.2
Increased dividend tax credit		–0.1	–0.2	–0.2	–0.2	–0.2
Pension contribution and withdrawal changes		–0.2	–0.3	–0.5	–0.6	–0.7
Employee EI premium phaseout		–0.3	–1.7	–3.3	–4.9	–6.8
Business Taxes						
Continued corporate tax reductions			–0.2	–0.8	–1.6	–2.4
Capital tax phaseout		–0.1	–0.2	–0.7	–1.2	–1.8
Corporate income tax surtax phaseout				–0.1	–0.5	–0.8
Resource industry tax changes		–0.0	–0.1	–0.1	–0.1	–0.1
Elimination of Canada-US withholding tax		–0.0	–0.1	–0.0	–0.0	0.0
Fuel Tax Room for Municipalities			–0.4	–1.9	–2.0	–2.1
Total Revenue Measures	*0.0*	*–1.3*	*–5.7*	*–11.8*	*–19.3*	*–23.6*

Source: Authors' calculations.

The change will give provinces more vehicles for providing cost-effective coverage for all medical services.

This budget proposes to reduce the bottom personal income-tax rate by one percentage point in 2004 and all rates by a further percentage point in 2006. This will serve two purposes: It will signal to Canadians that the federal government will not idly watch its grip over the national economy expand unchecked and it will show this government's desire to see the disposition of tax revenues duly accounted for by creating room for provinces that wish to devote more public resources – to health care or elsewhere – to do so, provided they are willing to accept political responsibility for raising the tax money they wish to spend.

The vacated tax room, a permanent transfer worth more than $7 billion annually, must stand in lieu of additional cash for health. This will aid in the federal project because the uneven incidence of aging across Canada indicates that some provinces will experience the pressure of higher health spending and more subdued growth in their tax bases earlier and more intensely than others. As well, provinces will differ in the extent and pace at which they take up vacated tax room. For the poorer provinces, the normal workings of the provincial fiscal equalization program will largely offset the lower value of their tax bases.[9]

The federal government wishes to facilitate the process of health-care reform and in particular the integration of coverage for core hospital and physician services under provincial health plans with coverage for pharmaceuticals, long-term care and other areas of growing need. For this reason, the government will shortly introduce legislation to eliminate the non-patient-oriented provision of the *Canada Health Act* that requires public administration of all health insurance for

9 The exact offset will depend on which provinces take up how much of the tax room the federal reductions make available.

Table 5: *Impact of Budget Measures*

	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
			($ billions)			
*Non-Interest Revenue**						
Status Quo Projection	179.2	189.7	197.8	207.6	217.6	227.7
Impact of Revenue Measures		–1.3	–5.7	–11.8	–19.3	–23.6
Outlook after Revenue Measures	*179.2*	*188.4*	*192.1*	*195.8*	*198.3*	*204.2*
*Program Spending**						
Status Quo Projection	147.0	156.7	167.3	178.4	189.9	202.1
Impact of Restraint and Reallocation	2.5	–4.3	–10.8	–18.1	–25.7	–33.8
Outlook after Restraint and Reallocation	*149.5*	*152.4*	*156.5*	*160.3*	*164.2*	*168.3*
Primary Balance						
Status Quo Projection	32.2	33.0	30.5	29.3	27.8	25.7
Impact of Budget Measures	–2.5	3.0	5.1	6.2	6.4	10.2
Outlook after Budget Measures	*29.7*	*36.0*	*35.6*	*35.5*	*34.2*	*35.9*
Net Debt Charges						
Status Quo Projection	28.2	28.0	27.8	27.8	27.8	27.9
Impact of Budget Measures	–0.0	–0.2	–0.4	–0.7	–1.1	–1.6
Outlook after Budget Measures	*28.2*	*27.9*	*27.4*	*27.0*	*26.7*	*26.3*
Total Balance						
Status Quo Projection	4.0	5.0	2.7	1.5	0.0	–2.2
Impact of Budget Measures	–2.5	3.2	5.5	7.0	7.4	11.8
Outlook after Budget Measures	*1.5*	*8.2*	*8.2*	*8.5*	*7.4*	*9.5*
Memo Items						
Contingency Reserve		3.0	3.0	3.0	3.0	3.0
Economic Prudence		1.0	2.0	3.0	3.5	4.0
Total Balance after Above Items	*1.5*	*4.2*	*3.2*	*2.5*	*0.9*	*2.5*

* Gross of Child Benefits and GST Credit.

Source: Authors' calculations.

medically necessary services. Over time, this change will give provinces a wider choice of vehicles for ensuring that their populations have cost-effective coverage for all medical services.

This program for change will improve accountability for health-care finance and delivery. Responsibility for choices on how much and how to spend will rest more squarely on the governments that raise the money, enhancing provinces' ability to respond to local needs.

A Tonic for Urban Finances

Canada's cities have an antiquated tax base. The result is distortions related to heavy property taxes and fraying urban infrastructure.

This budget proposes to work with the provinces, which ultimately control municipal finance, to make a significant share of fuel-excise taxes available to municipalities. Beginning in 2005, this government will reduce the federal fuel excise tax by two cents per wholesale litre in provinces where governments make the same reduction with respect to their retail-level fuel excise taxes. These measures will create four cents per litre of retail fuel sales room for local governments to take up and spend as they see fit; the potential municipal revenue stream will amount to roughly $4 billion annually.

Summary of Revenue Measures

The total federal tax relief offered by these revenue measures is summarized in Table 4.

Conclusion

This budget brings the federal fiscal framework in line with the needs of a new era.

As Table 5 indicates, the net impact of the spending and revenue measures on federal revenue is positive. Even after deducting contingency reserves and economic prudence factors, it provides room for the surpluses necessary to keep reducing federal debt and interest costs.

On the spending side, it restores policy focus, subjecting federal activity to fresh scrutiny. Taxpayers' resources will be redirected to high-priority programs that are proper functions of the federal government and that are well designed to achieve key social and economic goals.

On the tax side, realignment of taxing power will enhance provincial and local flexibility and accountability. Within this restored framework, lower tax rates will enhance Canada's position as a place to live, work and invest.

Economic wellbeing makes an important contribution to Canadians' social wellbeing, or happiness. This shadow budget frames a sound fiscal future and an economic environment that enables individual Canadians to realize those goals.

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