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# Restoring Purpose:

## *A Shadow Federal Budget for 2005*

Finn Poschmann and
William B.P. Robson

***In this issue...***
*After more than a decade of sluggish income growth, boosting Canadians' living standards requires more than rhetoric. Restoring a sense of purpose requires tax relief, steady debt reduction, a major review of federal-provincial transfers and discretionary spending targeted on areas where federal programs can deliver meaningful results.*

## *The Study in Brief*


Recent federal tax and spending decisions have lacked focus, with larger-than-expected surpluses dissipating through across-the-board increases in spending and unsustainable commitments for more. This budget restores serious purpose to federal fiscal policy, re-energizing the expenditure-review process and initiating a major reallocation of federal and provincial tax and spending powers, providing significant tax relief and maintaining the path to lower public debt.

While the outlook for the federal budget balance remains good, forecasts of continuing surpluses on current policy imply a rising tax burden and assume spending restraint that recent experience suggests will not occur. Stagnating living standards and looming fiscal pressures from demographic change require a focus on measures that promote work and investment and direct federal money to where it is most effective.

This budget reaps the reward from recent measures reining in spending on subsidies and internal operating costs by redirecting funds to border infrastructure, disease control, foreign aid and national defence. It initiates a major review of federal-provincial transfers to correct recent ad hoc decisions that have put them on an unsustainable path, and it puts more resources into the hands of provincial governments themselves. As well, it proposes a major revamp of the Employment Insurance program, ending the siphoning of employee-paid premiums into non-insurance programs that would be operated more efficiently and accountably by provincial governments.

Canada currently taxes personal incomes too heavily, especially at low income levels, and inhibits saving and investment with rates that are too high and regulations that are needlessly restrictive. This budget proposes lower rates of tax on personal and business incomes, higher personal tax thresholds, more generous treatment of expenses related to children and post-secondary tuition, and changes to the treatment of investment income and retirement saving that will lower tax and regulatory barriers.

Controlling low-priority spending to ensure that the federal government offers further tax relief and can make significant investments in high-impact areas is a critical challenge for the 2005 Budget. This budget responds to that challenge, restoring serious purpose to federal fiscal policy.


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Canada's strong economic performance in 2004 masked continued deterioration in the federal government's capacity to steer resources to key priorities and reduce Canadians' tax burden. Growth in spending has far outpaced improvement in results. This shadow budget shows that we can do better.

This budget focuses squarely on tax relief and program enhancements that will improve Canadian living standards. Personal income taxes are too great a drag on workers' incomes at too-low income levels. Canada taxes investment relatively heavily, limiting the growth in capital stock that creates new products and jobs. Ad hoc changes to federal-provincial transfers have put them on an unsustainable path. Federal subsidies and operating expenditures are rising indiscriminately. This budget launches a new approach: It expands and re-energizes the expenditure-review process to ensure that the federal government has the resources to make needed investments in high-impact areas.

The critical challenge for 2005 and beyond is providing Canadians with a budget that takes on fiscal policy with a serious sense of purpose. This budget does just that.

## Fiscal Outlook and Challenges

While the federal government's record of substantial budget surpluses remains intact, the high taxes required to achieve that result in the face of burgeoning spending create concern about the ability to maintain that record in the years ahead.

### *Economic Developments and Outlook*

Strong global growth in 2004 supported Canadian exports, and job gains boosted consumer spending and investment in housing. Final figures for the year will likely show that real gross domestic product (GDP), which started the year at a depressed level as a result of setbacks in 2003, grew at an annual rate of 2.8 percent. Signs of weakness late in the year, as the adjustment to the higher Canadian dollar damped some sectors, point to more subdued quarterly growth rates in the first half of 2005, as well as average real growth for the year of barely 3 percent.

Looking further out, robust consumer and business demand should offset pressure on Canada's external balance as the United States strives to reduce its trade deficit, yielding overall growth at the average 2.9-percent pace consistent with growth in Canada's productive capacity. Combined with 1.9-percent GDP inflation, this outlook indicates an average 4.9-percent annual growth in nominal income through the 2006-to-2009 budget planning period, with interest rates increasing only modestly toward long-term equilibrium levels (Table 1).

### *Fiscal Outlook*

Fiscally, federal finances continue to benefit from rich tax revenues. As many advocates of tax relief predicted, lower rates of personal and business income tax

**Table 1:** *Key Economic Indicators*

| | 2003 | 2004 | 2005 | 2006 | 2007-09 |
|---|---|---|---|---|---|
| | | | *percent* | | |
| Real GDP Growth | 2.0 | 2.8 | 3.0 | 2.9 | 2.9 |
| GDP Inflation | 3.2 | 3.3 | 2.3 | 1.9 | 1.9 |
| Nominal GDP Growth | 5.3 | 6.2 | 5.3 | 4.9 | 4.9 |
| 3-Month Treasury Bill Yield | 2.9 | 2.3 | 2.8 | 3.7 | 4.2 |
| Long Government Bond Yield | 4.8 | 4.6 | 4.6 | 5.5 | 6.1 |

Source: Statistics Canada, CANSIM; Department of Finance (2004); authors' calculations.

following the 2000 budget fostered healthy growth in taxable incomes. Personal and business tax revenues since then have been growing. With further help from one-time factors, such as the positive impact of the strong Canadian dollar on taxable business income, gross federal revenue in 2004/2005 should be $201 billion.[1]

During 2005, the revenue outlook on unchanged policy is less buoyant. Quarterly growth rates will likely be slower, the stimulus to the tax base from past tax relief is fading, and a less business-friendly climate in Ontario will subdue revenue growth. Over the five-year budget projection period, tax-and-fee revenue is expected to rise at a 4.7 percent average annual rate.

For spending, a bright spot is the result of debt pay-down: Since the advent of surpluses in 1996/1997, the lower stock of debt has reduced annual interest costs by more than $3 billion. Meanwhile, program spending has been growing rapidly — by an average of 4.7 percent since 1996/1997, accelerating to 6.5 percent over the past five years. Recent private-sector projections that include the increases in federal-provincial transfers announced in the fall of 2004 indicate that program spending will grow at an average rate of 4.4 percent over the planning period.

Allowing for the influence of changing interest rates on investment returns and interest costs, and assuming that the 2004/2005 surplus and future contingency reserves are applied against federal debt, the status quo fiscal picture created by these revenue and spending trends produces the pattern shown in Table 2.

On the surface, this overall picture is reassuring. Slower spending growth in the farther-out years appears to ensure that sizeable surpluses will keep federal debt on a steep downward track, even after contingency reserves and a prudence factor to cover possible setbacks. Two facts, however, show there is something wrong with this picture.

One is the rising federal tax burden that Canadians bear as workers, as investors and as consumers. Total annual federal non-interest revenue now averages more than $25,000 per family of four. Adjusted for population growth and inflation, this burden rose by some $2,500 since 1996/1997. These projections

1 This figure, and the tax-and-fee revenue and program spending figures shown in Table 2, are based on those in the Fall 2004 Economic and Fiscal Update (Department of Finance 2004). The fiscal figures in the Economic and Fiscal Update, like those in past federal budgets, net child benefits and several other revenue items against spending. This practice makes revenue and spending appear smaller than is actually recorded in the Public Accounts. Table 2 presents the gross figures on a basis comparable to those in the Public Accounts.

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

| | 2003/04 | 2004/05 | 2005/06 | 2006/07 | 2007/08 | 2008/09 | 2009/10 |
|---|---|---|---|---|---|---|---|
| | | | | *$ billions* | | | |
| Taxes and Fees | 190.5 | 200.3 | 206.9 | 216.2 | 226.9 | 239.0 | 251.4 |
| Investment Income | 8.0 | 7.4 | 6.3 | 7.7 | 8.8 | 8.8 | 8.8 |
| *Total Revenue* | *198.5* | *207.7* | *213.2* | *224.0* | *235.7* | *247.8* | *260.2* |
| Program Spending | 153.7 | 163.6 | 172.9 | 181.3 | 189.0 | 195.9 | 202.9 |
| Gross Debt Charges | 35.8 | 35.6 | 34.2 | 34.3 | 37.7 | 39.9 | 40.9 |
| *Total Expenditure* | *189.5* | *199.1* | *207.1* | *215.6* | *226.7* | *235.8* | *243.9* |
| Primary Balance | 36.8 | 36.8 | 34.0 | 34.9 | 37.9 | 43.1 | 48.4 |
| Net Debt Charges | (27.8) | (28.2) | (27.9) | (26.6) | (28.9) | (31.1) | (32.1) |
| *Total Balance* | *9.1* | *8.6* | *6.0* | *8.3* | *9.0* | *12.0* | *16.4* |
| 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 Reserves and Prudence* | *9.1* | *8.6* | *2.0* | *3.3* | *3.0* | *5.5* | *9.4* |

Source: Receiver General for Canada (2004), Department of Finance (2004); authors' calculations.

Note: Calculation of gross debt charges assumes debt paydowns equal to each year's contingency reserve.

envision taxes running well ahead of population growth and inflation over the planning period, pushing the bill up a further $4,000 in real dollars by 2009/2010. Canadians face additional claims on their income, both personal and from other levels of government, which such an increase in taxes does not acknowledge.

A second problem evident from recent experience is that healthy surpluses in budget projections turn out, in fact, to dissipate in new spending. Recent federal budgets have anticipated barely half the increase in program spending that actually happened in the fiscal years for which they were presented. In the seven federal budgets from 1997 to 2003, the spending increases forecast for the upcoming years (which, in some cases, were already under way) amounted, cumulatively, to $22.5 billion (see Robson and Poschmann 2004). The actual increases over that period amounted to $42.4 billion. Last year was worse: The 2004 Budget projected an increase in spending of $4.5 billion for 2004/2005; on current projections, the actual increase will be $9.9 billion.[3] On average, since 1997, budget-year spending has grown 2.4 percentage points faster than projected. If over-runs on that scale were to persist over the planning period, they would deflate the cushion provided by the contingency reserve and the prudence factor:

2 The primary balance is the difference between tax-and-fee revenue and program spending; net debt charges represent the difference between investment income and gross debt charges. This presentation enables a readier comparison of net interest payments with the government's accumulated deficit than the approach in recent presentations, which have highlighted interest paid on the government's gross liabilities, but combined investment income on the assets (mainly foreign-exchange reserves and crown corporations) on the other side of the balance sheet with other revenue.

3 Based on the rate of increase in net spending shown in the 2004 Economic and Fiscal Update (Department of Finance 2004).

notwithstanding mounting tax revenues in the projections, the budget would be back in deficit as early as 2006/2007.

### *Challenges and Priorities*

The lesson from those problems is that the status quo fiscal profile does not do enough. The leading edge of the baby boom will begin retiring during the planning period, thinning the ranks of taxpayers, while an aging population intensifies demands for public pensions and health-care. Net demographically driven liabilities add more than $300 billion to recorded government debts in Canada (Robson 2003). This argues for continued declines in the federal debt-to-GDP ratio, as promised in the 2004 Budget, and highlights the need for a sharper approach that will keep fiscal policy on track to achieve it.

Boosting living standards will increasingly require Canada to present workers and savers with attractive opportunities. On both fronts, Canada could do better. Canada's personal income taxes severely crimp the net rewards from working, and the government share of incremental wage earnings rises sharply at low income levels (TD Bank Financial Group 2005). Canada also taxes saving and investment income relatively heavily (Chen and Mintz 2005) and the nation is adding to its capital stock more slowly than competitors (Robson and Goldfarb 2004), reducing potential future growth.

Controlling low-priority spending to ensure that the federal government offers further tax relief and can make meaningful investments in high-impact areas is a critical challenge for the 2005 Budget — a budget that restores serious purpose to fiscal policy.

## Getting Serious About Spending

The spending over-runs of the past eight years were no accident. They reflect a lax fiscal environment in which Parliament's scrutiny of public money broke down — a breakdown this budget will remedy.

In December 2003, the government established an Expenditure Review Committee to apply seven tests to determine whether programs warrant the use of taxpayers' funds (Finance and Treasury Board 2003):

1. Does the program area or activity serve the public interest?
2. Is there a legitimate and necessary role for government in this area?
3. Is the current role of the federal government appropriate?
4. What activities or programs should or could be transferred to the private or voluntary sector?
5. Are Canadians getting value for their tax dollars?
6. If the program or activity continues, how could its efficiency be improved?
7. Is the resulting package of programs and activities affordable?

Another year of better-than-expected fiscal results and the election of a new Parliament have not made these criteria less relevant. Indeed, the need to withstand adverse long-term pressures, end indiscriminate increases in federal operating spending and ensure that savings from one low-priority program do not simply end up in another one makes them more pertinent than when they were first framed. This budget presents the first results of the spending review, and reaffirms the government's commitment to the process — expanding its scope beyond the discretionary items highlighted to date and emphasizing up-front savings, rather than vague hopes for future reallocation.

## *Returning EI to Insurance Principles*

Since the mid-1990s, Employment Insurance (EI) premiums collected from workers and employers have far exceeded benefits to displaced workers. Cumulative net credits to the EI account now exceed $46 billion — three times the amount needed to sustain the program through a typical slump without raising the premium rate (currently 4.68 percent of insurable wage earnings below $39,000 yearly, of which 1.95 percent is formally charged to employees, and 2.73 to employers).

For the past five years, Canada's Auditor-General has objected to the ballooning EI surplus (Receiver General for Canada 2004, p. 2.29). EI revenues for a decade have run at more than double the value of regular benefits paid to laid-off workers. The excess has supported non-insurance-related transfers, including grants to provinces, or promoted other spending by padding the federal government's surplus.

C.D. Howe Institute publications have pointed out that the trend to fund non-insurance programs from EI premiums is economically and politically indefensible (for example, Poschmann and Robson 2001) and, as current litigation by the Quebec government and a pending Supreme Court decision highlight, legally questionable. This diversion of what should be an insurance premium does not pass the expenditure-review tests. Provincial governments can better design programs linking welfare and work and Ottawa's poor record on this front makes non-insurance EI spending doubtful on value-for-money and sustainability grounds.

A better approach would be to fund job-loss-related insurance payments from employer-paid EI premiums alone and wind down federal labour-market development in favour of an expanded provincial financing role that matched provinces' responsibility for delivering training and social welfare services. This budget therefore proposes a four-year phase-out of employee-paid EI premiums and of non-insurance EI spending and associated administrative costs. Provinces may choose to occupy some of this tax room to maintain plans now funded by federal EI money, or they may choose to let payroll tax relief flow into workers' pockets. Net of the EI-premium credit in the personal income tax, this change will reduce the tax burden on workers by $5.5 billion by 2009/2010. At the same time, non-insurance EI expenditures will fall by $6.5 billion.

During this transition, the government will consult on an experience-rating system for employer premiums. Charging lower premiums to employers with low and steady lay-off records will reduce the subsidy EI provides layoff-prone establishments (Corak and Chen 2003), lowering unemployment and permitting even lower EI premiums in future.

## *Reform of Federal-Provincial Health, Social and Equalization Transfers*

Recent and hasty changes have put federal-provincial transfers into disarray.

In the health area, recent increases in federal transfers have confirmed two hard lessons. First, new money buys time, not reform. Second, the temptation for the federal government to line up with opponents of change when provinces do try to innovate is overwhelming.

Equalization is also in trouble. Since its inception in the 1950s, equalization has topped up the revenues of provinces with less remunerative tax bases using payments geared to the gap between the tax base in each province and a representative standard. Recent ad hoc changes have severed this link: in the medium term, the federal government is committed to continuing increases to provinces that currently receive equalization. On current policy, those transfers would persist even if those provinces became more prosperous than provinces that do not receive equalization.

The changes also have put federal-provincial transfers on an unsustainable path. The formula for health transfers formerly reduced them when provincial revenues were buoyant, just as the equalization formula geared its support to the fortunes of the recipient provinces. Now, however, the federal government is expected to increase transfers indefinitely at a rate that exceeds growth in the Canadian economy and in federal revenue. Inevitably, Ottawa cannot deliver on such a promise.

None of the principles of federalism, value-for-money, efficiency or sustainability supports federal-provincial transfers in their current form. This budget therefore announces two initiatives.

First, the mandate of the panel of experts announced in October 2004 to examine reforms to Equalization and Territorial Formula Financing will be broadened. Health and social transfers, as well as equalization payments, all share the goal of reducing the impact of fiscal disparities on key public services delivered by provinces and territories. The panel will be asked to define the public finance principles on which a transfer system should be based and to advise on specific formulas that would guide the distribution and growth of major federal-provincial transfers, considered together, and evaluated according to their effectiveness in meeting the intended purpose of the payments. Among the mechanisms for consideration are tax-base-related calculations, macro-economic indicators, and government cash-flow formulas that would reward fiscal prudence on the part of recipients (Mintz and Poschmann 2004), as well as a cross-province distribution of payments that responds to the spending needs of provinces where population aging is pushing up health costs faster than the national norm (Robson 2001).

Second, pending receipt of recommendations from the panel and legislation based on them, the government will act to reduce the claim of these transfers on federal finances so provincial and territorial governments will have more room to raise revenues of their own. After 2005/2006, equalization payments will rise at a rate equal to the rate of population growth and inflation in the receiving provinces. And transfers for health and social programs will grow 10 percent in

2005/2006, rather than at the 15 percent or more that would otherwise occur — and remain constant in dollar terms afterwards.

The tax relief described in the next section will create room for provinces to raise additional funds for their health systems. Together, these measures will lower federal-provincial transfers by $7.0 billion annually by the end of the planning period.

### *Restraining Other Transfer Payments*

The sharp rebound in spending on transfers and subsidies to Crown corporations since the mid-1990s also does not pass the tests of spending review. Industries on the receiving end of such grants argue that ripple effects to the broader economy justify the spending. Yet government investments in public goods, infrastructure and tax relief would promote economic activity, while ensuring that the needs of customers, not the desires of government officials, are the core focus of business. Several measures will curb excessive growth in direct grants and expenditures.

The government will impose an immediate freeze to prevent the annual use-it-or-lose-it March burn-off that typically ramps up spending at the end of the fiscal year. The government's expenditure review has found sufficient savings to freeze agricultural and industrial subsidies, hold the total dollar value of all miscellaneous transfers constant through to 2007/08 and limit growth in these categories of spending to no more than inflation over the following two years.

Crown corporation subsidies, which have been growing at more than 7 percent per year, will be rolled back to their 1999/2000 level ($5.2 billion in aggregate) by 2007/2008 and held there through the rest of the planning period.

To encourage the opening of Registered Education Savings Plan (RESPs), while limiting the Canada Education Savings Grant's subsidy to higher-income taxpayers (Milligan 2002), the grant will be converted to a one time bonus when an RESP is set up. The Canada Learning Bond established in the 2004 Budget will ensure that low-income families continue to receive a significant federal subsidy when they save for post-secondary education.

These measures will hold growth in miscellaneous federal transfer payments to an average rate of 0.4 percent annually through the planning period and save $8.0 billion annually by 2009/2010.

### *Lower Claw-backs on Modest-Income Working Seniors*

The 50-percent guaranteed income supplement (GIS) claw-back and 75-percent Allowance claw-back make work and saving unattractive to many modest-income seniors who might like, if they could, to add to their incomes before retirement. Particularly perverse is the way these claw-backs undermine the actuarial adjustment in the CPP and the QPP, which is intended to reward continued work by increasing or decreasing pensions for every month that receipt is delayed or advanced from age 65 (Milligan forthcoming).

This budget proposes to ensure that the rewards for continuing to work are no less for seniors who receive GIS or the Allowance than they are for their higher-income counterparts. All Canadians who turn 60 in 2006 or later and receive CPP or QPP pensions will have the difference between their actual pensions and the pensions they would have received had they taken them at age 60 excluded from income when calculating GIS and Allowance claw-backs. The long-term cost of this measure will depend on affected indivduals' responses to the lower claw-back: its cost during the planning period will be small.

### *Controlling Operating Spending*

Since the restraint budgets of the mid-1990s, the federal government's operating costs have risen sharply. Non-defence operating costs have risen more than 8 percent annually over the past five years, far outstripping any improvements in performance as measured by the spending review tests.

Savings identified by expenditure review will restrain these costs. End-of-year restraint will hold growth in operating spending to 5 percent in 2004/2005. Operating spending will be held at that level in 2005/2006, rolled back by 0.5 percent in 2006/2007 — which will still leave it 4.5 percent above last year's level — and held there in 2007/2008, increasing no faster than inflation over the rest of the planning period. These measures will hold increases in non-defence operating costs to an average of 1.2 percent annually over the projection period, while lowering annual program spending by $5.8 billion by 2009/2010.

### *Improving the Capacity and Security of Canada's International Trade*

Growing volumes of international trade and new security risks have highlighted the need for Canada to improve its trade-related infrastructure and maintain its attractiveness as a place to produce products for foreign markets. This budget therefore proposes to invest part of the saving realized through the reallocations in expenditure review to expand the capacity and enhance the security of Canada's international road and rail crossings, airports and sea ports. The funds for these purposes will amount to $200 million in the upcoming fiscal year, rising to $400 million by the end of the planning period.

### *Protecting Canadians From Infectious Disease*

The spread of avian flu to humans in several Asian countries, the vulnerability to new and emerging diseases that expanded travel creates and the threat of bioterrorism compel national governments to move more energetically to stockpile vaccines and enhance their ability to screen diseases at their borders. This budget allocates an additional $100 million in 2005/2006, rising to $300 million in 2009/2010, to bolster Canada's efforts in this area.

### *Enhanced Foreign Aid*

While Canadians think of themselves as generous to the less fortunate, Canada's foreign aid program is a poor reflection of that attitude. Canada is currently less generous than it should be. Aid is spread too thin and it focuses on alleviating immediate hardship rather than promoting sustainable development, with the result that government-funded agencies too often direct resources to countries where the quality of governance is low and aid dollars do not translate into effective help (Goldfarb 2001). This budget provides modest net increases to the foreign aid budget in each of the next three fiscal years, reflecting the reallocation of existing resources and the completion of the current review of the foreign aid program. In 2008/2009 and 2009/2010, net new amounts will be more substantial, reaching $500 million by the end of the planning period.

### *Strengthening the Armed Forces*

Without rapid infusions of new human and material resources, the deterioration in the operational capacity of Canada's armed forces will accelerate in the next decade. Recent reviews by parliamentarians and outside experts conclude that simply maintaining the numbers of people in uniform at current levels and ensuring that they have the equipment they need to serve effectively and safely requires increases in the defence budget of some $4 billion annually. At currently planned rates of increase, the defence budget would not achieve that level until after the end of the planning period, by which time inflation will have eroded its real value and further sizable investments would be required to repair deterioration in the interim. Accordingly, this budget brings forward planned increases in defence spending, raising planned expenditures some $2.5 billion above baseline levels by 2008/2009, and $3.5 billion above baseline levels by 2009/2010.

### *Summary of Spending Measures*

The impact of the measures just described on major program categories is illustrated in Table 3. By 2009/2010, federal spending will be more than $22 billion lower than under the status-quo projections. More than half of these savings come from the areas targeted by expenditure review. The remainder comes from an important restructuring of EI and intergovernmental transfers. These savings reflect a serious effort to refocus federal spending on priority areas and create room for important complementary tax relief.

## Getting Serious About Taxes

Recent large and unfocussed spending increases testify to the fact that the tax burden borne by Canadian workers and families is too high. Tax relief will improve the fairness of the current tax and enhance the rewards from working, saving and investing.

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

| | 2004/05 | 2005/06 | 2006/07 | 2007/08 | 2008/09 | 2009/10 |
|---|---|---|---|---|---|---|
| | | | | *$ billions* | | |
| Phase-out of non-insurance EI spending | | (1.2) | (2.5) | (3.7) | (5.1) | (6.5) |
| CHT/CST restraint | | (1.5) | (3.4) | (4.7) | (5.4) | (6.5) |
| Equalization reform | | | (0.1) | (0.2) | (0.3) | (0.5) |
| Restraint of subsidies and Crown corp. expenditures | (0.2) | (2.3) | (4.5) | (6.5) | (7.3) | (8.0) |
| Savings in non-defence operations | (0.2) | (1.6) | (3.3) | (4.7) | (5.3) | (5.8) |
| Exemption of C/QPP actuarial adjustment from clawbacks | | s | s | s | s | s |
| Investment in trade-related infrastructure | | 0.2 | 0.3 | 0.3 | 0.4 | 0.4 |
| Measures to contain and combat infectious diseases | | 0.1 | 0.2 | 0.2 | 0.3 | 0.3 |
| Increased foreign aid | | 0.1 | 0.1 | 0.1 | 0.3 | 0.5 |
| Enhancement of armed forces' capacity | | 0.8 | 1.2 | 1.6 | 2.5 | 3.5 |
| *Net Change in Program Spending* | *(0.4)* | *(5.4)* | *(12.0)* | *(17.7)* | *(20.1)* | *(22.6)* |

Note: s = negligible

Source: Authors' calculations.

## *Easing the Burden of Personal Taxes*

Even after the re-indexation of tax thresholds to inflation in the 2000 Budget, wage increases that — because of rising productivity — exceed inflation continue to move Canadians into higher personal tax brackets. To prevent this unlegislated increase in the federal tax take and make up ground lost while tax thresholds were not indexed, this budget proposes to raise the personal and spousal amounts used in calculating personal credits to $10,000 and $8,000 respectively in the 2006 tax year, and index personal income-tax thresholds to wage growth in later years. While the age amount (available to taxpayers 65 and over), will continue to be indexed to inflation, increases in the basic amount that exceed inflation will erode it dollar for dollar. While seniors will thus see the total value of the amounts they use in calculating credits protected from inflation, these changes will over time put Canadians of all ages on a more even footing with respect to personal tax liability.

To help rebalance revenue-raising powers of federal, provincial and municipal governments, this budget proposes to reduce the lowest personal income tax rate by one percentage point in 2006 and reduce all rates by a further percentage point in 2007.

By 2009/2010, the revenue foregone as a result of these threshold and rate changes will exceed $14 billion annually, or more than $1,700 for an average family of four.[4] To the extent that provinces do not occupy this tax room to

4 Most personal income tax revenue figures were derived using Statistics Canada's Social Policy Simulation Database and Model, Release 10.1. Responsibility for the results and their interpretation lies with the authors.

support health and education programs, these amounts will boost Canadians' after-tax income.[5]

To ensure that Canadians' federal tax obligations do not in future again rise beyond the amounts that the federal government needs to finance high-priority spending, this budget commits to further personal income tax rate reductions in the final years of the budget plan. The precise measures will be determined in the light of the surpluses expected in the Economic and Fiscal Updates in 2007 and 2008. At present, it is anticipated that this further relief will amount to about $1.2 billion in 2008/2009 and $4.3 billion in 2009/2010.

### *Fairer Treatment of Families With Children*

The current system of child benefits and employment-related child-care deductions discriminates among families by level and type of income in recognizing the cost of raising children. Federal transfers to provinces in support of child-care programs that specifically preclude assistance to stay-at-home parents would exacerbate this unfairness. Basic expenses of raising children are non-discretionary. Fairness dictates that all families, whatever their work and child-care arrangements, should see the income they devote to those expenses protected from taxes and claw-backs.

For this reason, this budget proposes to introduce a standard deduction of $2,000 per dependent child. This wage-indexed deduction will replace the current employment-related child-care expense deduction. Families will gain discretionary income to use in institutional or home-based care, as they see fit. This change will reduce federal income tax revenue by approximately $2.9 billion annually by the end of the planning period. Increases in Child Benefit-related transfers will be held to the rate of inflation which, combined with the increases in thresholds just described, will reduce the range in which Child Benefit claw-backs and personal income taxes stack on one another.

### *More Generous Treatment of Post-Secondary Tuition*

Families with spouses or children in post-secondary education have seen the real value of credits transferable from students to supporting spouses or parents erode relative to tuition costs since the last increase in these amounts in 1996. This budget proposes to raise the maximum transferable credit to $10,000 from $5,000 per student. The annual saving for the families affected will be about $75 million in 2006, rising to $81 million by the end of the projection period.

### *Enhancing Canadians' Ability to Save*

Saving by Canadians finances major purchases, education and retirement, while providing funds with which to pay for new capital investments. Policies that

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5 Compensation for provinces with less lucrative tax bases through the allocation of equalization and other major federal-provincial transfers will be a subject for examination by the expert panel on transfer reform.

discourage saving and restrict the uses to which it can be put hurt savers and Canada's economy.

Employer sponsored registered pension plans and Registered Retirement Savings Plans (RRSPs) work poorly for Canadians with modest incomes, whose effective tax rates may rise when they retire. As a result, this budget proposes to establish tax-prepaid savings plans (TPSPs). In a mirror image of existing retirement plans, TPSPs will trigger no deduction from taxable income for contributions, while withdrawals will attract neither taxes nor benefit claw-backs. By protecting income in these plans from federal means-testing, the government also hopes to encourage provinces to protect income from, and assets in, these plans from provincial means-testing, so lower-income Canadians can save in TPSPs without fear of losing such benefits as subsidies for provincial drug plans and long-term care (Poschmann and Robson 2004).

The 1996 budget lowered the age at which RRSPs must be annuitized, or converted to registered retirement income funds, to 69 from 71. This measure yielded little revenue, while imposing a constraint that is inappropriate at a time when life expectancy is rising and many Canadians will wish to continue saving. This budget proposes to move the age at which RRSPs must be wound down back to 70 for 2006 and raise it by one additional year in each of 2007, 2008 and 2009.

Savers in RRSPs face cumulative limits on contributions. When holders of RRSPs find themselves obliged to draw on their savings before retirement, these limits can hamper later efforts to rebuild their savings. To remove this obstacle, this budget proposes to restore contribution room to individuals who withdraw RRSP funds, so that the same cumulative net lifetime contribution room will be available to savers with comparable lifetime incomes.

Current rules impose a 30-percent limit on foreign property in registered saving plans. While institutional plans can work around the rule with sophisticated financial instruments, this rule increases risk and lowers returns to small savers. Yet it does nothing to increase the availability of funds for Canadian investment (Fried and Wirick 1999). This budget proposes to eliminate the foreign property rule immediately.

Finally, the lifetime capital gains exemption, which is available on the disposition of shares of small businesses and family farm properties, is an arbitrary device that has outlived its usefulness. This budget proposes to eliminate the lifetime exemption, while allowing the proceeds of the disposition of assets to which it would otherwise have applied to be folded into an RRSP without current tax consequences (Mintz and Poschmann 1999). This simple and fair rollover provision would protect families whose retirement savings were locked in farm or small business properties, while streamlining and leveling the tax treatment of capital gains in individual hands.

None of these measures involves significant costs to federal revenue over the planning period.

## *Labour Sponsored Investment Funds*

Canadians investing in approved labour-sponsored venture funds get tax credits from federal and provincial governments. This subsidy has promoted the growth of funds with high management fees and low investment returns. Many labour funds invest alongside unsubsidized venture-capital funds, showing that good projects can attract unsubsidized funding. This budget therefore reduces by half the federal labour-funds credit, effective immediately, and eliminates the credit effective January 1, 2006.

### *Foundations*

Because private charitable foundations play a role in Canadian society that government and public foundations and other charities are not suited to fill, policy should encourage, not discourage, their development (Payne forthcoming). Regulations and tax provisions for foundations should focus more on strengthening them.

Accordingly, this budget will implement core recommendations from the December 2004 Interim Report of the Standing Senate Committee on Banking, Trade and Commerce. The tax on capital gains applied to donations of selected assets to both private and public foundations and other charities will be eliminated. Establishing basic provisions to guard against self-dealing will set the stage for an end to the discrimination that currently exists in the treatment of certain donations to private versus public foundations.

### *More Competitive Business Taxes*

Canada’s disappointing performance in attracting investment points to the need to improve the climate for investment and entrepreneurial capital.

Effective tax rates on invested capital remain substantially higher in Canada than in the United States, especially in industries such as communications and the generation and distribution of electricity. This budget proposes to reduce the general corporate income tax (CIT) rate to 20 percent for 2006 and to reduce it by one percentage point in each of the following three years. To create more neutral treatment of different industries, the budget also proposes — after the resource allowance is phased out as described in the 2003 Budget — to harmonize the rate on resource profits to this same schedule, lowering it to 19 percent in 2008 and to 17 percent in 2009.

The 2003 Budget established a phase-out schedule for the federal large corporations capital tax. The phase-out will expose more businesses to the corporate income surtax, limiting the improvement in tax competitiveness. This budget proposes to phase out the surtax in three equal amounts in 2007, 2008 and 2009. After allowances for a positive response of taxable income to these CIT and surtax changes, the resulting reduction in federal revenue is expected to be no more than $1.7 billion by the end of the planning period.

To avoid distorting and discouraging investment, capital cost allowances should match the economic lives of the assets they affect. The 2004 Budget adjusted capital cost allowance (CCA) rates applying to computers and data network infrastructure. This budget proposes to also raise CCA rates applying to pipelines and components, which usually have shorter economic lives — especially because oil and gas fields, by definition, are depleting — than the current 4-percent rates make allowance for. It will also raise CCA rates for electricity generation and transmission equipment, recognizing the greater need to expand and upgrade equipment in a more competitive and energy-scarce environment. And over the coming year, it will consult over reforms to CCA rates applying to manufacturing plant and equipment on a wider scale, to ensure that these reflect actual experience, and do not inappropriately disadvantage capital investment in Canada relative to other countries. The precise impact on federal revenues will depend on the new rate schedules; this budget anticipates lower revenues of some $200 million annually during the planning period.

### *More Competitive and Neutral Treatment of Investment Income*

Canada levies a 15-percent withholding tax on dividends to residents of the United States and other tax treaty nations (5 percent where U.S. recipients own 10 percent or more of a Canadian company's voting shares), and a 10-percent withholding tax on interest paid to arm's-length creditors on debt of less than five years' term and to non-arm's length creditors. These taxes reduce the availability of capital in Canada (Mintz 2001). This budget proposes to eliminate the withholding tax on arm's-length interest payments. The government will negotiate tax treaty changes to eliminate the Canada-U.S. withholding tax on non-arm's-length interest payments and ultimately to eliminate dividend and interest withholding taxes.

High effective taxes on dividends discourage the distribution of earnings, encourage re-packaging of earnings as capital gains, distort how business is organized — income trusts being a case in point — and widen the tax gap between Canada and competitors such as the United States, where dividends constitute a higher and growing share of relatively buoyant personal incomes. Raising the federal dividend gross-up to 133 percent from 125 and the federal dividend tax credit to 18 percent from 13.33 for dividends paid by public companies and high-tax pools of income in private companies[6] will bring the net tax treatment of dividends more closely in line with the tax treatment of capital gains, and lower personal taxes by more than $450 million in 2006 and successive years.

### *Fuel Tax Reform in Support of Municipalities*

Federal transfers to municipalities offend the principle of federalism, making it difficult for voters to hold various levels of government accountable for their actions. Rather than establishing new grants, this budget proposes a further step toward better alignment of taxing and spending responsibilities among the federal, provincial and municipal governments by creating new fuel tax room.

The federal fuel excise tax will fall in 2006 by 2 cents per litre in every province that provides a similar size reduction in its retail-level fuel taxes, and when later reductions take place in other provinces. The resulting tax room of 4 cents per litre

6 The gross-up and credit would remain at the lower rate for dividends paid by Canadian-controlled private corporations from low-taxed sources of income.

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

| | 2004/05 | 2005/06 | 2006/07 | 2007/08 | 2008/09 | 2009/10 |
|---|---|---|---|---|---|---|
| | | | | *$ billions* | | |
| *Personal Taxes* | | | | | | |
| Raised and wage-indexed PIT thresholds | | (1.1) | (4.5) | (5.2) | (6.0) | (6.6) |
| Offsetting reduction of age amount | | 0.1 | 0.5 | 0.6 | 0.6 | 0.7 |
| Lower personal income tax rates | | (0.6) | (3.6) | (7.5) | (8.0) | (8.5) |
| Further rate relief contingent on budgetary resources | | | | | (1.2) | (4.3) |
| Child deduction | | (0.7) | (2.8) | (2.8) | (2.9) | (3.0) |
| Offsetting reduction of CCED | | 0.1 | 0.6 | 0.6 | 0.6 | 0.6 |
| Increased tuition credit maximum transfer | | (0.0) | (0.1) | (0.1) | (0.1) | (0.1) |
| Pension contribution and withdrawal changes | | s | s | s | s | s |
| Increased dividend tax credit | | (0.1) | (0.5) | (0.5) | (0.5) | (0.6) |
| Employee-paid EI premium phase-out | | (0.3) | (1.5) | (2.9) | (4.4) | (5.5) |
| LSVCC phaseout | | 0.0 | 0.1 | 0.1 | 0.2 | 0.2 |
| *Business Taxes* | | | | | | |
| CIT rate reductions | | (0.1) | (0.4) | (0.7) | (1.1) | (1.4) |
| Corporate surtax phaseout | | | (0.0) | (0.1) | (0.2) | (0.3) |
| CCA rate adjustments | | (0.1) | (0.2) | (0.2) | (0.2) | (0.2) |
| Elimination of Canada-U.S. 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* | | *(2.6)* | *(12.9)* | *(20.7)* | *(25.1)* | *(31.0)* |

Note: s = negligible

Source: Authors' calculations.

will be available to municipal governments that choose to take it up. When this measure is fully in place, the annual federal revenue loss will be around $2 billion, depending on provincial take-up of the standing offer, yielding some $4 billion in potential tax room for Canadian municipalities.

### *Summary of Revenue Measures*

The total impact of tax and fiscal-capacity measures produces significant gains for Canadians over this budget's planning horizon (Table 4).

## Conclusion: Restoring Purpose to Fiscal Policy

The budget restores a sense of purpose, serious purpose, to federal fiscal policy. In recent years, over-padding of the surplus has fostered repeated over-runs and inadequate prioritizing of spending. The spending and revenue measures laid out in this budget put an end to that practice. The contingency reserves, along with economic prudence factors that are slightly larger in the final years of the fiscal plan — a more realistic reflection of the greater uncertainties that exist over long

**Table 5:** *Impact of Budget Measures*

| | 2004/05 | 2005/06 | 2006/07 | 2007/08 | 2008/09 | 2009/10 |
|---|---|---|---|---|---|---|
| | | | | *$ billions* | | |
| *Non-Interest Revenue* | | | | | | |
| Status Quo Projection | 200.3 | 206.9 | 216.2 | 226.9 | 239.0 | 251.4 |
| Impact of Revenue Measures | | (2.6) | (12.9) | (20.7) | (25.1) | (31.0) |
| Outlook after Revenue Measures | *200.3* | *204.3* | *203.3* | *206.2* | *213.8* | *220.4* |
| *Program Spending* | | | | | | |
| Status Quo Projection | 163.6 | 172.9 | 181.3 | 189.0 | 195.9 | 202.9 |
| Impact of Restraint and Reallocation | (0.4) | (5.4) | (12.0) | (17.7) | (20.1) | (22.6) |
| Outlook after Restraint and Reallocation | *163.2* | *167.6* | *169.3* | *171.3* | *175.8* | *180.3* |
| *Primary Balance* | | | | | | |
| Status Quo Projection | 36.8 | 34.0 | 34.9 | 37.9 | 43.1 | 48.4 |
| Impact of Budget Measures | 0.4 | 2.7 | (0.9) | (3.0) | (5.0) | (8.4) |
| Outlook after Budget Measures | *37.1* | *36.7* | *34.0* | *34.9* | *38.1* | *40.1* |
| *Net Debt Charges* | | | | | | |
| Status Quo Projection | 28.2 | 27.9 | 26.6 | 28.9 | 31.1 | 32.1 |
| Impact of Budget Measures* | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Outlook after Budget Measures | *28.2* | *27.9* | *26.6* | *28.9* | *31.1* | *32.1* |
| *Total Balance* | | | | | | |
| Status Quo Projection | 8.6 | 6.0 | 8.3 | 9.0 | 12.0 | 16.4 |
| Impact of Budget Measures | 0.4 | 2.7 | (0.9) | (3.0) | (5.0) | (8.4) |
| Outlook after Budget Measures | *8.9* | *8.8* | *7.4* | *6.0* | *7.0* | *8.0* |
| *Reserves and Prudence Factors* | | | | | | |
| Contingency Reserve | | 3.0 | 3.0 | 3.0 | 3.0 | 3.0 |
| Economic Prudence | | 1.0 | 2.0 | 3.0 | 4.0 | 5.0 |
| Total Balance after Reserves and Prudence | *8.9* | *4.8* | *2.6* | *0.0* | *0.0* | *0.0* |

Source: Authors' calculations.

* As in baseline, calculation of gross debt charges assumes debt paydowns equal to each year's contingency reserve, so is not affected by budget measures.

time horizons — will still ensure that unexpected setbacks do not put the budget back into deficit. But the over-taxation that promoted sizable annual spending binges will diminish sharply (Table 5).

Lowering and more fairly distributing the tax burden will improve Canada's attractiveness as a place to work, save and raise families. And rationalizing federal-provincial transfers while subjecting federal programs to continued scrutiny under the expenditure-review criteria will focus federal funds more tightly on those areas where the federal government is uniquely able to provide effective public goods and services.

Fiscal policy is more than rhetoric; it is a serious business. It affects families and businesses as they make their daily decisions, and its quality helps determine whether living standards rise or fall. By instilling federal taxation and spending programs with fresh purpose, this budget takes that responsibility seriously.

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# NOTES

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