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Backgrounder

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Getting a Grip:

A Shadow Federal Budget for 2004

Finn Poschmann and
William Robson

The Backgrounder in Brief

This Shadow Budget sets out a multi-year fiscal plan that applies recently announced program review criteria to restrain unsustainable growth in federal spending. The resulting improvement in Ottawa's bottom line allows for more competitive taxes and creates tax room for provinces struggling with mounting health-care bills and for municipalities faced with large infrastructure needs. Along with continued debt paydowns that reduce interest costs, this budget enhances Canada's prospects for growth and gets a fresh grip on the country's long-term fiscal challenges.

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Canada's weaker-than-expected economy in 2003 and a rapid growth in federal government operating expenditures have reduced the government's ability to address new priorities. Reconciling Ottawa's limited resources with inflated expectations requires finding substantial savings from a federal program review, while carefully selecting new initiatives that will produce the biggest bang for the buck.

This shadow budget aims to create a sustainable taxing-and-spending environment for Canada. It restores discipline to spending by rigorously applying the program review criteria that the Minister of Finance and Treasury Board President announced in December 2003, reducing funding for programs that fare poorly by those measures and increasing spending in areas that provide greater returns. This budget also improves and reorganizes Canada's tax system to promote work and investment, while providing room for provincial and municipal governments to address their priorities in a cost-effective manner.

Economic Developments and Prospects

A review of recent economic developments, as well as the economic outlook for Canada, highlight some near-term constraints and some longer-term imperatives.

Recent Economic Developments and Outlook

The Canadian economy's 2003 performance fell short of most forecasts. A series of setbacks limited gross domestic product (GDP) growth to 1.7 percent in real terms, well below the 3.2-percent rate that the federal government expected at the time of the 2003 budget. The outlook for growth in 2004 is also below forecasts made at this time last year, and the consensus of private-sector economists surveyed by the finance department in preparing its March 23 budget was for a prolonged period of lower real growth with subdued inflation, restricting increases in nominal incomes through the forecast period.

In view of the planning advantages offered to both government and private-sector decision makers, this budget adopts a five-year outlook for taxation and spending that has been a feature of recent economic and fiscal updates, rather than the two-year rolling targets the government used to manage its elimination of the federal deficit in the 1990s. Table 1 summarizes the economic situation for the five-year budget-planning period.

This forecast has critical implications for federal finances. On the revenue side, despite robust tax collections toward the end of fiscal year 2002/2003, largely because of higher-than-expected remittances from the major banks, the outlook indicates weakness in tax revenue through 2004/2005.

In spending terms, lower interest rates help contain federal debt-servicing costs. At the same time, however, rapid growth in operating expenditure and transfer payments, as well as a steady increase in federal hiring have sharply

Table 1: *Key Economic Indicators*

	2002	2003	2004	2005	2006/08
			percent		
Real GDP Growth	3.3	1.7	2.8	3.3	3.0
GDP Inflation	1.0	3.4	1.3	1.7	1.9
Nominal GDP Growth	4.3	5.2	4.2	5.3	5.0
3-Month Treasury Bill Yield	2.6	2.9	2.7	3.9	4.3
Long Government Bond Yield	5.3	4.8	4.9	5.5	5.7

Source: Statistics Canada, CANSIM; Finance (2003); authors' calculations.

narrowed the federal government's spending room. Table 2 shows the fiscal outlook — based on a policy that assumes only modest expenditure restraint.[1]

The projections include the impact of the policy initiatives announced in previous budgets, notably the tax reductions set out in the October 2000 Economic Statement and Budget Update and in the 2003 budget. They also reflect increased health-care transfers to the provinces and territories as agreed by first ministers in

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

	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
				$ billions			
Taxes and Fees	181.5	188.6	196.0	205.9	215.5	225.9	237.6
Investment Income	8.7	6.3	4.8	4.9	5.1	5.3	5.3
Total Revenue	*190.2*	*194.8*	*200.8*	*210.8*	*220.6*	*231.2*	*242.9*
Program Spending	146.0	157.6	161.1	170.1	178.1	186.6	194.8
Gross Debt Charges	37.3	35.0	35.1	36.4	37.0	36.9	36.4
Total Expenditure	*183.3*	*192.7*	*196.2*	*206.5*	*215.1*	*223.5*	*231.3*
Primary Balance	35.6	30.9	34.9	35.8	37.4	39.3	42.7
Net Debt Charges	(28.6)	(28.7)	(30.3)	(31.6)	(31.9)	(31.6)	(31.1)
Total Balance	*7.0*	*2.2*	*4.6*	*4.3*	*5.5*	*7.7*	*11.7*
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 Memo Items		*2.2*	*0.6*	*(0.7)*	*(0.5)*	*1.2*	*4.7*

Source: Receiver General for Canada (2003); Finance (2003); authors' calculations.

1 The projections in Table 2 are based on those in the fall Economic and Fiscal Update. Revenues, Employment Insurance expenditures and public debt charges have been modified to reflect recent experience and the economic outlook shown in Table 1. The fiscal figures in the Economic and Fiscal Update also netted some revenue items against spending items, which makes federal revenues and expenditures look smaller than they are. This practice has been abandoned in the federal government's reformed Public Accounts figures, and Table 2 modifies the projections to match the Public Accounts presentation.

2000 and 2003, including the additional $2 billion in 2002/2003 that Ottawa pledged to deliver if its surplus can accommodate it. They also take into account the flurry of new spending announced since the February 2003 budget, notably on defence, transfers related to SARS and mad-cow disease, and new subsidies to fishing, airlines, television, sports, Aboriginals and VIA rail. At the same time, the totals reflect the cost to Ottawa of financing federal political parties — a total cost of $1.2 billion in 2003/2004, $0.2 billion in 2004/2005 and $0.4 billion in 2006/2007. The projections also assume that the spending review will secure savings of $1 billion a year over the period 2003/2004-to-2008/2009, and that the Contingency Reserve is applied against the federal debt, reducing annual interest costs.[2]

After providing an economic-prudence factor along the lines of those in past budgets, the projected balance would provide little cushion against a return to borrowing in the event of unforeseen developments or adverse economic events. The challenge is to gain a fresh focus on federal finances that will enhance Canadian competitiveness and put the financing of government services at federal, provincial and municipal levels on a more sustainable footing: in short, to get a grip.

Long-Term Challenges and Priorities

The need to bring spending and revenue more closely in line gains urgency from the situation Canada faces as its population ages and other countries enhance their attractiveness to families, workers and investors.

An aging population will, on balance, boost demand for many public services and transfer payments, while limiting the growth of the traditional working-age group, which is a key support to production and incomes. Robson (2003) calculated that a reasonable estimate of the net implicit liabilities of public programs would add some $300 billion to the liabilities of Canadian governments. The federal government is in many respects better positioned to meet this challenge than the provinces, which face the particularly daunting challenge of paying for and managing publicly funded health care. Along with reforms to intergovernmental arrangements that will prepare Canada to better handle the change, this budget maintains the process of debt reduction to ensure that the fiscal constraints imposed by an older population do not undermine key programs.

Recent debt pay-downs have positioned Canada to enhance its attractiveness as a place to work and invest. Building on this advantage requires an additional reduction of effective marginal tax rates for companies contemplating job-creating investments. Even after the phase-in of the 2000 budget's tax-reduction plan, the burden on business in Canada is still higher than that in key competitors, particularly the United States, and the movement to lower taxes abroad shows no signs of abating (Chen and Mintz, 2003). Lower effective tax rates on investment can shrink this gap, bringing Canada more investment and better jobs.

2 Perhaps because of the speed with which the federal government was making new spending commitments in late 2003, the printed version of the October 2003 Economic and Fiscal Update omitted from its list of spending initiatives a $200-million commitment for VIA Rail in 2008/2009, understating spending and overstating the surplus for planning purposes.

Program Review and Reallocation

This budget takes the first steps to reap the benefits of the spending review announced in December 2003, with the creation of an Expenditure Review Committee to look at all aspects of government expenditures, including operating and capital outlays.

The full report of the review committee will be available next fall, but its activities are under way, and the prime minister has ordered the treasury board to refer recent spending decisions with significant capital components to it for additional consideration.

The review assesses federal spending against seven tests — criteria which, if met, may establish the rationale for using public funds in a program (Box 1). Rigorous evaluation of federal activity according to these criteria will limit growth in program spending to a rate consistent with Canadians' long-term capacity to pay taxes at internationally competitive rates.

Box 1: ***Expenditure Review Committee Tests for Federal Spending***

1. Public Interest Test: Does the program area or activity continue to serve the public interest? What public policy objectives is the initiative designed to achieve? How does it align with current government priorities and the core mandate of the organization?
2. Role-of-Government Test: Is there a legitimate and necessary role for government in this program area or activity? Who else is involved? Is there overlap and duplication?
3. Federalism Test: Is the current role of the federal government appropriate, or is the program a candidate for realignment with the provinces? What is the initiative's impact on other levels of government? Could they play a greater role?
4. Partnership Test: What activities or programs should or could be transferred in whole or in part to the private or voluntary sector? What is the initiative's impact on the private and voluntary sectors and on other key stakeholders? Could they play a greater role?
5. Value-for-money Test: Are Canadians getting value for their tax dollars? What is the evidence that the initiative is achieving the stated policy objectives? Is the program citizen-centred?
6. Efficiency Test: If the program or activity continues, how could its efficiency be improved? Does the program exploit all options for achieving lower delivery costs through intelligent use of technology, public-private partnership, third-party delivery mechanisms, and non-spending instruments?
7. Affordability Test: Is the resulting package of programs and activities affordable? If not, what programs or activities would be abandoned? How do program delivery costs compare to those in other jurisdictions and in the private sector for similar activities? What actions have been taken to manage future spending pressures? What more can be done?

Source: Department of Finance and Treasury Board (2003)

The following sections detail key initiatives to contain and enhance the effectiveness of federal government spending.

Lowering Unemployment through EI Reform

Since the mid-1990s, the Employment Insurance (EI) program has collected far more in premiums from workers and employers than it has paid in benefits to displaced employees. The cumulative amount credited to the EI account now tops $46 billion, more than twice the amount needed to sustain the program through a typical economic slump without raising the premium rate (currently 4.75 percent of insurable wage earnings below $39,000 yearly).[3]

Canada's Auditor General has flagged the growing size of the surplus every year since 1999, and the C.D. Howe Institute has repeatedly drawn attention to the mislabeling and doubtful legality of funding general government operations from EI premiums.[4] Regular benefits paid to laid-off workers since 1995 have averaged less than half the cash inflow to the EI account. The bulk of EI collections have supported growing administrative costs and other spending, such as training and transfers to provincial agencies.

These expenditures do not pass the tests associated with spending review. They represent a federal intrusion into areas where provincial governments have primacy and better scope to respond to varying needs and conditions. As well, the expenditures' poor record in promoting long-term workforce attachment makes them dubious on grounds of value-for-money and sustainability.

Over the past year, the federal government held useful consultations on the process for setting EI premium rates that are relatively stable and ensure adequate program funding. The process revealed that the rate-setting process is only part of a larger problem best addressed through structural reform.

From 1995 through 2003, the EI premiums charged to employers more than covered the cost of regular benefits, as well as those for sickness and maternity. This budget therefore proposes to phase out the portion of EI premiums charged to employees over the planning period — a change that, after allowing for the resulting reduction in EI-related credits in the personal income tax, will reduce taxes on labour income by some $6.3 billion by the end of the planning period. At the same time, EI spending on other programs and one-third of its administrative costs will be eliminated. At the end of the period, employers' premiums would fund the entire program. To the extent that provinces wish to maintain plans now funded by federal EI money, this phase-out will provide scope to raise provincial revenues; otherwise the money that lowering payroll taxes frees up will stay in workers' pockets. This change will reduce annual non-insurance EI transfers by more than $7 billion by the end of the projection period.

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3 Previous budgets referred only to the portion of EI premiums formally charged to employees (1.98 percent in 2004). This practice is misleading because the total EI charge, including the portion charged to employers (2.77 percent in 2004), is 2.4 times the employee-paid portion. Federal budget and financial documents will henceforth refer to the total rate.

4 See Office of the Auditor General of Canada (2003, Chapter 7 p. 6) and Poschmann and Robson (2001).

As for employer premiums, the government will redirect its rate-review consultations to focus on designing experience-adjusted premiums that will reward employers with superior lay-off records. By reducing the subsidy EI currently provides to layoff-prone establishments (Corak and Chen, 2003) and lowering the premium to employers that provide steadier work, this reform will reduce unemployment and, over time, permit even lower EI premiums.

Limiting Growth of the Child Benefit

Although the Canada Child Tax Benefit provides valuable support to modest-income families with children, the claw-back that reduces the transfer as family income rises creates major problems. This claw-back stacks on top of personal income taxes to impose marginal effective tax rates well above 50 percent on many modest-income families with children. In the light of the spending-review tests, this structure raises concerns about efficiency and sustainability.

Pending further investigation of these relatively high effective tax rates and consultation over ways to reduce them, the government will limit to the inflation rate any increases in the value of the Canada Child Tax Benefit, the National Child Benefit supplement and other cash transfers, forgoing discretionary increases through the planning period. In combination with the wage-indexation of personal income-tax thresholds, holding these increases to inflation will reduce the range where claw-backs and personal taxes stack on top of each other. This change will reduce federal expenditures by as much as $680 million by the end of the projection period.

Health Finance Reform

The fulsome claims made for benefits to Canadian health from the federal government's health-related transfers to the provinces are at odds with many of their practical effects. The results of recent increases in federal-provincial transfers have been disappointing, partly because the prospect of new money distracts provincial governments from managing their health systems more effectively, with the result that new money tends to raise costs more than it expands services (Boothe and Carson, 2003), and partly because the conditions attached to federal funds actively discourage needed reforms. Further increases in these transfers would not satisfy the spending-review tests of federal principles, value-for-money, efficiency, or sustainability.

This budget, therefore, proposes a different approach: further reductions in federal taxes that will provide room for the provinces to raise the revenue they need themselves. While this budget confirms the $2 billion agreed to in the 2003 First Ministers' Accord, it will not proceed with further increases in federal spending. Instead, it will provide the additional resources that provinces need for their health systems by a transfer of tax room through a lowering of federal tax rates. Holding Canada Health and Social Transfer (CHST) payments to their planned level in 2003/2004 and keeping them at that level in the years ahead will lower federal program spending by as much as $8.6 billion annually by the end of the planning period. The normal operations of the equalization program will help compensate provinces with less lucrative tax bases as they take up the tax room provided by this change. It is not possible to predict in advance exactly how equalization payments will change because the amounts depend on how all provinces respond, thereby influencing the national average tax rates that enter the equalization formula. The fiscal plan in this budget makes provision for additional equalization payments equal to one-tenth of the personal income-tax revenue that the federal government will forego as a result of the changes described below.

Restraining Other Transfer Payments

The rebound in spending on other transfer payments and in subsidies to crown corporations since the restraint of the mid-1990s also does not pass many of the tests of spending review. Subsidies to declining industries and sector-specific supports serve narrow interests, not broad public purposes, and fare poorly when measured against considerations of value-for-money and efficiency.

While some transfers, mainly those to Aboriginal people, will have to rise in future, the government will hold the line on the end-of-year splurge that has been a feature of recent budgets, impose a two-year freeze on the total of these transfers, and limit their aggregate increase to 2.5 percent annually over the following three years. 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.[5] This budget also proposes to roll transfers to crown corporations back to their 1999/2000 levels by 2005/2006 and hold them there through the rest of the planning period.

Controlling Operating Spending

Since the restraint budgets of the mid-1990s, the federal government's operating costs have risen sharply. Driven in large part by the growing number of federal public servants, non-defence operating spending rose to $29.4 billion in 2002/2003 from $19.7 billion in 1995/1996. Based on current trends, that spending will handily surpass $33 billion in 2004/2005. The cumulative increase to date — one-third more than compound inflation since 1995/1996 — has far outstripped any improvements in performance as measured by the tests applied by spending review.

As a result, the government will take special measures to prevent year-end, use-it-or-lose-it spending in the 2003/2004 fiscal year, impose a two-year freeze on aggregate non-defence operating spending, and continue for that time the hiring restraints announced by the treasury board in late 2003. Along with other restraint measures, including the saving in EI administrative costs, this freeze will hold increases in non-defence operating costs to an average of 2.2 percent annually over the projection period.

5 As Milligan (2002) points out, the benefit of inducing Canadians to open these accounts might justify an up-front subsidy, but sustained subsidies do relatively little to improve access to post-secondary education for low-income families.

Table 3: *Impact of Spending Restraint and Reallocation*

	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
			$ billions			
Phase-out of non-insurance EI spending	(0.1)	(1.4)	(2.6)	(4.1)	(5.7)	(7.4)
Indexation of child benefits to inflation	0.0	(0.1)	(0.5)	(0.7)	(0.7)	(0.7)
CHST freeze	0.0	(1.6)	(4.2)	(5.8)	(7.4)	(8.6)
Increased Equalization		0.1	0.3	0.5	1.0	1.1
Restraint of subsidies, crown corp. expenditures & other transfers	(1.3)	(2.8)	(5.4)	(6.4)	(7.6)	(8.6)
Restraint of non-defence operations	(1.5)	(2.2)	(4.1)	(5.0)	(6.0)	(7.0)
Net Change in Program Spending	*(2.9)*	*(8.0)*	*(16.4)*	*(21.5)*	*(26.4)*	*(31.2)*

Source: Authors' calculations.

Summary of Spending Measures

The impact of the measures just described on major program categories is illustrated in Table 3. Relative to the status-quo projections in Table 2, the improvement in the budget outlook sets the stage, not just for the larger and more secure debt pay-downs, but also for a tax system that more effectively promotes rising living standards.

More Competitive Taxes

Like improving the efficacy and cost-effectiveness of transfers and public programs, creating a tax system that makes Canada attractive to families, workers and investors is a work in progress. Other countries are not standing still, and recent tax increases in the Province of Ontario have harmed Canada's competitive position. This budget sets out a series of steps to improve the nation's tax competitiveness and prosperity.

Easing the Burden of Personal Taxes

With the main impact of the personal income tax reductions of the February 2000 budget and October 2003 update in the past, it is time for fresh initiatives to ease the burden of taxes on Canadian individuals and families.

Recent actions to raise tax thresholds have still not made up ground lost to inflation in the mid- to late-1980s (Poschmann, 1998). Productivity improvements lift wages even faster than inflation, moving Canadians into ever-higher tax brackets. Higher personal tax rates affect the cost of entrepreneurial capital, reducing Canada's attractiveness to business-venture investments (Chen and Mintz, 2003). This budget proposes to adjust indexed amounts of the personal income tax system (exclusive of cash transfers) for 2005 and beyond by the rate of wage growth, rather than the rate of inflation. Over time, this change will restore the ground lost to inflation and remove the penalty that higher personal taxes impose on productivity gains.

As part of its initiative to re-balance the respective revenue-raising powers of the federal, provincial and municipal governments, this budget proposes to reduce the lowest personal income tax rate by one percentage point in 2005, and all rates by a further percentage point in 2007, while lowering the nonrefundable tax credit rate accordingly.[6] By 2008/2009, the revenue foregone as a result of these measures will exceed $8 billion annually, or more than $500 per family. To the extent that provinces do not occupy this tax room to support health and education programs, these amounts will flow through to Canadians' after-tax income.

Enhancing Canadians' Ability to Save

Better opportunities to save will help prepare the country for a future when more Canadians are retired and enhance the nation's capacity for entrepreneurship and investment.

Employer-sponsored registered pension plans (RPPs) and Registered Retirement Savings Plans (RRSPs) are valuable for many Canadians. However, those with modest incomes whose tax rates will be higher in retirement than when they are working are not well served by these instruments. This budget 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. Like RPPs and RRSPs, TPSPs will support saving by eliminating the double taxation of income set aside for the future. By exempting TPSP income from all federal taxes and clawbacks, including the 50-percent reduction of the Guaranteed Income Supplement and the 75-percent reduction of the Allowance (formerly called the Spouse's Allowance), the federal government will set a precedent for the provinces, so that TPSPs can become a vehicle for lower-income Canadians to save without fear of losing other means-tested benefits, such as coverage by provincial drug and long-term care plans. The federal revenue impact, while small, will depend on the extent to which TPSPs house new savings as opposed to money that otherwise would have flowed to RRSPs.

Current income-tax rules prevent Canadians from holding more than 30 percent of assets in registered saving plans in foreign securities. The foreign property rule affects all Canadians who save for retirement through RRSPs and RPPs, increasing their risks and lowering their returns, while providing no benefit to Canadian investment (Fried and Wirick, 1999). Increasingly, sophisticated investors use financial instruments that allow investments in foreign securities to qualify as Canadian assets. In view of these developments, this budget proposes to eliminate the foreign property rule immediately. There is no impact on federal revenue.

6 This requires lowering by one percentage point in 2007 the credit rate for charitable contributions over $200.

In search of budget-balancing revenue, Ottawa lowered the age at which RRSPs must be annuitized, or converted to Registered Retirement Income Funds (RRIFs), from 71 to 69 in its 1996 budget. This measure was unwise: It yielded little revenue, and with life expectancy rising, many Canadians will extend their working lives and will wish to continue saving longer. This budget therefore proposes to move the age at which RRSPs must be wound down back to 71 for 2004 and raise it to 73 for 2005. The government will consult over the possible elimination of forced annuitization and conversion in future years. The near-term reduction in current federal revenue will depend on the extent to which seniors defer their RRSP withdrawals, but is expected to be small.

More Generous Treatment of Post-Secondary Tuition

For many families with children in post-secondary school, the relief associated with tuition tax credits is vital to financing school attendance, while keeping the family budget intact. Yet the dollar amount of transferable credits (from a student to a supporting spouse or parent) has not changed since 1996, even as schooling costs rose sharply. This budget raises, effective immediately, the maximum transferable to $10,000 from $5,000 per student, with an annual saving for the families affected of about $22 million for calendar 2004, rising to $31 million by 2008.

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.

High effective tax rates on dividends discourage the distribution of earnings, promote tax-driven investment vehicles, such as income trusts, and widen the tax gap between Canada and competing countries, particularly the United States — all of which distort investment decisions.[7] This budget therefore proposes to set the federal dividend gross-up at 133 percent and the federal dividend tax credit at 18 percent (up from 125 percent and 13.13 percent, respectively) for dividends paid by public corporations and high-tax pools of income earned by private corporations. 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. This measure will lower personal taxes payable by as much as $200 million in 2004 and successive years.

Effective tax rates on invested capital (Table 4), especially in communications and power generation and transmission, remain substantially higher in Canada than in the U.S. These high tax rates are serious impediments to promoting investment in business and infrastructure in Canada, as well as to improving the economic growth outlook. As a result, this budget also proposes to bring the general, and the manufacturing and processing federal corporate income tax (CIT)

7 After the reforms of 2003, the U.S. statutory tax rate on long-term capital gains is 15 percent, well under Canadian taxes on similar holdings.

Table 4: *Effective Corporate Tax Rates on Capital for Large Corporations: 2004 and 2008*

	Canada 2004	United States 2004*	Canada 2008
		percent	
Forestry	28.7	17.6	25.7
Manufacturing	28.8	21.3	25.2
Construction	33.8	23.2	30.8
Transport	30.5	14.8	26.6
Communications	28.3	5.4	23.9
Electrical Power	24.3	2.3	19.2
Wholesale Trade	37.2	24.1	34.5
Retail Trade	39.7	24.2	37.0
Other Services	33.3	23.8	30.2
Aggregate	*31.5*	*20.1*	*28.0*

* With 50 percent first-year bonus depreciation.

Source: Chen and Mintz, 2004.

rates, to 20 percent for 2005, 19 percent for 2006, 18 percent for 2007 and 17 percent for 2008. To reduce sectoral distortions in the Canadian economy, the budget proposes to bring the tax rate on resource profits nearer to the same reduction schedule after the resource allowance is phased out under the terms of the 2003 budget. The resource-profits tax rate will drop to 19 percent in 2008 and to 17 percent in 2009 from the current level of 21 percent.

As announced in the 2003 budget, Ottawa is phasing out the federal large corporations capital tax over the planning period. However, this phase-out exposes more profitable companies to the corporate income surtax, mitigating the intended improvement in tax competitiveness. That surtax also will be phased out beginning in 2006.

The tax treatment of capital assets has a powerful influence on infrastructure investment. The *Income Tax Act* regulations require steady adjustment to ensure that capital cost allowance rates properly match the economic life of the relevant assets. This budget launches a review of asset-class definitions and appropriate rates, and directs attention specifically to computers, other data processing equipment and pipelines and their integral components. These assets and others have a shorter economic lifetimes than envisaged when class definitions were last reviewed.

Canada levies a 15-percent withholding tax on dividends paid to residents of the United States and other tax treaty nations (or 5 percent if the U.S. recipient owns 10 percent or more of the voting shares of a Canadian company), and a 10-percent withholding tax on arm's-length indebtedness of less than five years' term and non-arm's-length interest payments.

These taxes inhibit cross-border investment and reduce the availability of capital in Canada (Mintz 2001b). The government will negotiate tax treaty changes to eliminate the Canada-U.S. 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.

Since the 1980s, Canadians who bought shares in approved labour-sponsored venture funds have received tax credits from federal and provincial governments. This subsidy has promoted the growth of funds with high management fees and low return on investment. Furthermore, many labour funds invest alongside unsubsidized venture-capital funds, suggesting good projects can attract funding without subsidies.

This budget therefore eliminates the federal labour-funds credit, effective Jan. 1, 2005, with a saving to Canadian taxpayers of approximately $100 million annually.

Enhancing the Financial Autonomy of Provinces and Municipalities

Federal transfers to other levels of government are an awkward response to vertical fiscal imbalance in the Canadian federation. Accountability suffers when one level of government levies taxes and raises revenue for others to spend, making provincial and municipal governments less responsive to their own voters. This budget therefore proposes two major reforms intended to broaden the taxing capacity needed by provincial and municipal governments to finance their health, social and infrastructure programs.

New Tax Room for Health Care

As described earlier, this budget proposes to reduce the lowest personal income tax rate by one percentage point in 2005 and all rates by a further percentage point in 2007, lessening significantly the federal government's draw on Canadian incomes. That will leave room for provinces that wish to expand financial support for health programs to raise more tax money, if they are willing to accept political responsibility for doing so.

The spending-review principles of value-for-money, efficiency, and sustainability suggest a further, related change that will 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 that for pharmaceuticals, long-term care, and other areas of growing need. The government will introduce legislation to eliminate the non-patient-oriented provision of the Canada Health Act that requires public administration of all health insurance for medically necessary services. Over time, this change will allow provinces and Canadians generally a wider choice of vehicles, including competing publicly funded but arms-length administered plans, for cost-effective coverage for all medical services.

Support for Cities

This budget introduces two initiatives to provide Canada's cities with more of the funds they need.

Municipalities and their agencies currently pay the goods and services tax (GST) at an effective 3-percent rate after rebates. This budget will raise the rebate to 100 percent from 57.14 percent. This change will relieve Canada's municipalities of some $520 million in federal taxes, enhancing their ability to provided services and invest in infrastructure.

This budget will cut federal fuel excise taxes by 2 cents per litre in every province that provides a similar size reduction in its retail-level fuel taxes. The measure will come into force at the beginning of 2005 for provinces that lower fuel taxes in 2004, and when such reductions take place in other provinces. The resulting tax room of 4 cents per litre will be available to municipal governments. When this measure is fully in place, the annual federal revenue loss will be as much as $2 billion, yielding some $4 billion in potential tax room for Canadian municipalities.

Crown Assets

Crown holdings are reviewed too rarely. This budget sets in motion a searching review of Government of Canada assets, as well as the close application of the first two criteria in Box 1. As a first step in rationalizing its holdings, the government will dispose of its 18.6 percent share of Petro-Canada. At current market prices the value of that stake is roughly $3 billion, compared with its carrying value on the federal government's accounts of $1.2 billion. The difference between realized and book value will be applied against the net public debt.

Summary of Revenue and Fiscal-Capacity Measures

The combined impact of tax and fiscal-capacity measures is shown in Table 5. This budget brings the federal budget framework into line with the needs of a new era.

Table 5: *Impact of Revenue and Fiscal Capacity Measures*

	2004/05	**2005/06**	**2006/07**	**2007/08**	**2008/09**
			$ billions		
Personal Taxes					
Reduced PIT rates	(0.6)	(2.5)	(4.0)	(8.2)	(8.6)
Indexation of PIT thresholds to wage growth	(0.1)	(0.6)	(1.1)	(1.7)	(2.2)
Increased dividend tax credit	(0.1)	(0.2)	(0.2)	(0.2)	(0.2)
Pension annuitization andwithdrawal changes	s	s	s	s	s
Employee EI premium phaseout	(0.3)	(1.7)	(3.2)	(4.7)	(6.3)
Business Taxes					
CIT rate reductions	(0.1)	(0.5)	(0.9)	(1.4)	(1.8)
Corporate surtax phaseout	(0.0	(0.0)	(0.1)	(0.2)	(0.3)
Resource industry tax changes	0.0	0.0	0.0	(0.0)	(0.1)
Elimination of Canada-US withholding tax	(0.0)	(0.1)	(0.0)	(0.0)	0.0
Elimination of LSVCC credit	0.0	0.1	0.1	0.1	0.1
Full credit of GST for municipal purchases	(0.6)	(0.6)	(0.6)	(0.7)	(0.7)
Fuel tax room for municipalities	(0.4)	(1.9)	(2.0)	(2.1)	
Sale of remaining stake in PetroCanada	1.7				
Total Revenue Measures	*(0.1)*	*(6.6)*	*(12.0)*	*(18.9)*	*(22.2)*

Note: s = negligible
Source: Authors' calculations

Conclusion: Getting a Grip

As Table 6 indicates, the net impact of the spending and revenue measures is to increase the budget surplus significantly. Even after deducting contingency reserves and economic prudence factors, it provides added assurance that the government will run sustained surpluses that will yield further savings in interest costs, preparing Canadians for a future where demands on public services will be greater relative to the number of people of traditional working age.

On the spending side, it subjects federal activity to the test outlined in the spending review related to: public interest; respect for the role of government; respect for federal principles; scope for potential role of non-government partners; providing value for money; efficiency, and ensuring sustainability. It restrains spending in areas that fare poorly by those tests, and enhances the capacity of all governments to act in areas that perform well by them. On the revenue side, realignment of taxing power will enhance provincial and local flexibility, and lower tax rates will enhance Canada's position as a place to live, work and invest.

In short, this budget gets a grip on the challenge of enhancing Canadian competitiveness, and puts the financing of Canada's federal, provincial and municipal services on a more sustainable footing.

Table 6: *Impact of Budget Measures*

	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
			$ billion			
Non-Interest Revenue						
Status Quo Projection	188.6	196.0	205.9	215.5	225.9	237.6
Impact of Revenue Measures		(0.1)	(6.6)	(12.0)	(18.9)	(22.2)
Outlook after Revenue Measures	188.6	195.9	199.4	203.5	206.9	215.4
Program Spending						
Status Quo Projection	157.6	161.1	170.1	178.1	186.6	194.8
Impact of Spending Measures	(2.9)	(8.0)	(16.4)	(21.5)	(26.4)	(31.2)
Outlook after Spending Measures	154.7	153.1	153.6	156.6	160.3	163.7
Primary Balance						
Status Quo Projection	30.9	34.9	35.8	37.4	39.3	42.7
Impact of Budget Measures	2.9	7.9	9.9	9.5	7.4	9.0
Outlook after Budget Measures	33.9	42.8	45.7	46.9	46.7	51.7
Net Debt Charges						
Status Quo Projection	28.7	30.3	31.6	31.9	31.6	*31.1*
Impact of Budget Measures		(0.4)	(1.2)	(2.0)	(2.6)	(3.5)
Outlook after Budget Measures	28.7	29.9	30.4	29.9	29.0	27.6
Total Balance						
Status Quo Projection	2.2	4.6	4.3	5.5	7.7	11.7
Impact of Budget Measures	2.9	8.3	11.1	11.5	10.1	12.4
Outlook after Budget Measures	5.1	12.9	15.3	17.1	17.7	24.1
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	5.1	8.9	10.3	11.1	11.2	17.1

Source: Authors' calculations

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