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COMMENTARY

FISCAL POLICY

A Faster Track to Fiscal Balance:

The 2011 Shadow Budget

Alexandre Laurin
William B.P. Robson

In this issue...
Demographic pressures and sovereign debt concerns put a premium on an accelerated path back to budget surpluses in Ottawa. Targeted program restraints and cost control can position the federal government to deliver new growth-friendly fiscal reforms by mid-decade.

The Study in Brief

The Authors of This Issue

WILLIAM B.P. ROBSON is President and Chief Executive Officer of the C.D. Howe Institute.

ALEXANDRE LAURIN is Associate Director of Research of the C.D. Howe Institute.

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This 2011 Shadow Budget presents a program to eliminate the federal deficit a year ahead of the track in the federal government's October Update of Economic and Fiscal Projections. We show how Ottawa can return to budget surpluses in four years through more ambitious spending restraint.

This accelerated track to budget surplus will position the federal government to launch new tax and spending initiatives around mid-decade, while protecting Canadians from possible debt-market disruptions arising from sovereign-debt concerns, and putting federal debt back on a downward track before the pressure of population aging on government finances intensifies.

We present a five-point plan for return to fiscal balance.

Seeing Budget 2010 Measures Through: The 2010 federal budget outlined a series of measures projected to save $17.6 billion over five years. The government must deliver on these commitments, and conclusively halt stimulus transfers on their already extended deadline of October 31, 2011.

Restraining Federal Public Service Compensation Costs: The number of federal public servants, excluding military and RCMP uniformed personnel, jumped 35 percent from 1999 to 2009, while Canada's population grew some 11 percent – some 24 percentage points slower. Cutting employment 2 percent per year for the next four years combined with better control of compensation costs can deliver more than half the improvement needed to achieve a surplus by 2014/15.

Tackling the Cost of Ottawa's Employee Pension Plans: In the longer term, the solution to the federal government's pension challenge must include reductions in benefits, particularly those that encourage early retirement. Nearer term, contributions should rise to fund the plans better, and the employee share of those contributions should rise.

Trimming Transfers to Crown Corporations: As a spur to greater efficiencies in consolidated Crown corporations, along the lines of what private-sector enterprises have achieved in recent years, their aggregate subsidies should fall 10 percent from their currently planned level.

Review of Tax Preferences: The federal tax system contains a myriad of exemptions, deductions, rebates, deferrals or credits to achieve various economic and social objectives. We propose reducing or eliminating preferences for activities, such as home buying, purchasing health insurance through employers, traveling by public transit, or fitness, that people would largely do anyway.

Besides protecting Canadians from adverse consequences of chronic federal borrowing, this accelerated track to surplus sets the stage for further economic and fiscal gains, such as prolonging eligibility for tax-deferred saving, a phase-out of trade barriers and cartels in agricultural goods, tax relief for travelers and international investors, and better tax treatment of related businesses.

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INDEPENDENT • REASONED • RELEVANT

The world economy suffered a major setback in 2009. Although Canada fared better than many developed countries, the resulting downward revisions of economic capacity and potential growth have continuing difficult implications for Ottawa's budget. Weak demand, slowing workforce growth and capacity constraints resulting from our record of weak investment in plant and equipment, as well as chronic concerns over public-sector debts in the United States, Europe and Japan, likely mean a slower pace of expansion than after previous recessions over the next few years (Bank of Canada 2011).

The slow pace of expansion implies modest increases in the tax base. The same factors weighing negatively on growth, and most particularly sovereign debt concerns, also make chronic borrowing problematic – which puts a premium on a rapid and credible path back to fiscal balance. For that reason, this Shadow Budget presents a program to eliminate the federal deficit a year ahead of the track projected in the federal government's October Update of Economic and Fiscal Projections (hereafter the Fall Update) (Canada 2010a). Notwithstanding explicit recognition of downside risks to revenue in our projections, which incorporate a new buffer for prudence, we show how Ottawa can balance its budget in four years and achieve a small surplus in five through a more ambitious program of restraint in federal spending.

This accelerated track to budget surplus will position the federal government to launch some new tax and spending initiatives around mid-decade, while protecting Canadians from possible debt-market disruptions arising from events abroad, and ensuring that federal debt is back on a downward track before population aging puts additional pressure on government finances in Canada.

The Case for Accelerating the Return to Budget Surpluses

The downgraded economic outlook has lowered expectations for federal government revenues. One possible response would be to accept larger deficits and a slower return to surpluses. Such a course would be unwise.

The demographic pressures that will slow the growth of the workforce and intensify demands for many government programs are no longer a long way off (Robson 2010). Both the federal and provincial/territorial governments will experience the damping effects of slower workforce growth on their tax bases. While the provinces and territories will experience the most relentless spending pressures because of their direct responsibilities for healthcare, the federal government has key roles in financing their programs and in shaping the country's broad fiscal and economic policies. So Ottawa, too, must prepare for this demographically constrained future by limiting its on-budget liabilities before the implicit liabilities of demographically sensitive programs turn into demands for cash payments.

Limiting Canada's exposure to adverse developments in debt markets is another priority that argues for aggressive deficit elimination. Central banks' response to financial crisis and recession has driven short-term interest rates to remarkable lows. As the economy picks up speed, monetary policy will tighten and short-term

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interest rates will rise toward historic norms. At least as important, government debt is burgeoning around the world as a result of the accumulation of continuing deficits, stimulus spending, and bailouts. At the moment, long-term interest rates in North America are low, reflecting investors' views of this continent as a safe haven in times of trouble. The grim fiscal situations of many governments, including Japan, some European countries, US sub-national governments, and ultimately the US federal government itself, however, are raising fears of default and inflation. For these reasons, the rise in long-term interest rates that would normally accompany a growing economy may be punctuated by sharper upward jumps in the next few years. An interest rate rise of one percentage point above the government's baseline fiscal projections in 2012 would add more than $10 billion to the federal debt by 2015, and also adversely affect the finances of other governments and much of Canada's private sector. The sooner Ottawa stops borrowing and starts repaying, the better Canadians will weather bad news on that front.

One particular element in the federal debt – the unfunded liabilities of pension plans for federal-government employees – gives additional urgency to a program to reduce it. Ottawa discounts its pension obligations at rates that reflect high assumed rates of return on investments. It would be more prudent, and in line with emerging private-sector practices, to use discount rates that reflect the rates of return currently available on assets that match its liabilities. Using this latter fair-value approach puts the unfunded liability in federal-employee pensions some $65 billion higher than the amount reported in the public accounts (Laurin and Robson 2010). Although we do not restate the public accounts in this Shadow Budget, we anticipate that fiscal concerns at home and abroad will make the understatement of public-sector pension liabilities through aggressive discount rates increasingly unacceptable in the years ahead. An appropriate response to this pressure would be to recognize this higher liability – and the worse historical budget balances it implies – and to fund federal pension obligations better through a mixture of higher contributions and actual financial-market borrowing. A more ambitious program of deficit reduction will better prepare the federal budget and fiscal-policy watchers for this change.

Slower growth in productive capacity and the potential for renewed debt-market troubles suggest a fourth reason for an ambitious approach to deficit elimination: the possibility that the current expansion will not last long. Periods of growth are naturally periods when budgets should show more black ink, to offset periods when weakness tends to push them toward the red. The Fall Update shows a very modest surplus of $2.6 billion in 2015/16, following cumulative borrowing of $109.6 billion in the years 2010/11 to 2014/15. Setbacks due to domestic weakness or shocks abroad should not jeopardize the return to debt repayment.

Finally, the expenditure restraint measures announced in the 2010 Budget were more akin to targets than to a detailed plan. The experience of the mid-1990s, which bolstered an aggressive deficit-cutting plan by shortening the forecast horizon from the traditional five years to two, showed how effective a shorter horizon was in focusing efforts and achieving results. While the federal government's own situation is less serious now than it was 15 years ago, the overall environment for fiscal consolidation is less favourable: an aggressive plan to get back to surpluses will prove a valuable aid to execution.

Containing Ottawa's Spending

Preserving or improving the bottom line in the face of a downward revision in the tax base means either raising tax rates or reducing planned spending. Last year's C.D. Howe Institute Shadow Budget (Laurin et al. 2010) argued for expenditure restraint; happily, the 2010 federal budget announced a series of targeted expenditure reductions over the medium term. This year's Shadow Budget advocates additional measures to reinforce this effort.

While some may argue that the spending restraint already planned will be hard to achieve,

the passage of another year has reinforced some of the arguments that supported restraint earlier. Ottawa does not need to resort to tax increases instead, and would be sensible to stay on the course of tax relief. The rapid growth of business investment in 2010 – real spending on non-residential structures and equipment expanded at annual rates of 11 percent, 16 percent and 20 percent in the first three quarters of the year – testifies to the value of a more growth-friendly tax environment. That is, one in which corporate income tax reductions and sales tax harmonization reduce the current and prospective tax bite on capital investment. Recent research (Dahlby and Ferede 2011 forthcoming) reinforces a long-standing concern of economists about the impacts of taxation on behaviour and consequent costs to the economy and society – especially taking into account the tendency for tax increases by one level of government to erode the tax base of the other. These estimates of the cost to society from the economic distortions created by federal-government taxes put the marginal cost of raising a dollar in revenue at almost $1.20 for the personal income tax, and more than $1.70 for the corporate income tax. The large economic burden of corporate income taxes particularly underlines the desirability of completing the rate reductions currently under way. These figures also mean that each additional dollar of spending must clear a high hurdle – and we are convinced that not every dollar of federal spending, even after the envisioned restraint, will pass this test.

Prudent Economic and Fiscal Planning

For our baseline economic and revenue forecasts, we rely on the Fall Update. The Update drew on a September 2010 survey of private-sector forecasters, with a slight downward adjustment that diminished over time to reflect greater-than-usual near-term risks to the economic outlook. Some recent forecasts, such as those from the Organisation for Economic Cooperation and Development and the International Monetary Fund, were more guarded in their outlook than the Fall Update. To account for the downside risks, we subtract a further prudence buffer from our revenue projections in the farther out years. This adjustment brings down federal revenues by a net additional $0.9 billion in 2013/14, and $2.2 billion in both 2014/15 and 2015/16 (Table 1).

Other than this extra prudence factor, we project revenues from all sources in line with those in the Fall Update. Revenues from EI premiums increase substantially over the projection period as the labour market firms and premiums rise to repay the accumulated deficit in the EI account. Other revenues, mostly investment income from Crown corporations and other assets, have grown substantially in the last few years, mainly because of credit extended to households and businesses through the Extraordinary Financing Framework;[1] higher rates of return should produce modest increases in these revenues as well.

Priorities for the 2011 Federal Budget

Extra prudence on revenues and the desirability of an accelerated path toward budget surplus mean that the expenditure control plan announced in the last federal budget – and largely maintained in the Fall Update[2] – needs augmenting. While we proceed to other initiatives with the potential to yield long-term economic and fiscal benefits later in this Shadow Budget, the main focus is further expenditure discipline to bolster the promise of an early end to red ink.

1 The Extraordinary Financing Framework measures, most of which have ended, include: the Insured Mortgage Purchase Program; a new 10-year maturity in the ongoing Canada Mortgage Bond program; the Canadian Secured Credit Facility; support for the Bank of Canada's emergency liquidity measures; increased flexibilities and capacities for financial Crown corporations, including the introduction of the Business Credit Availability Program; and assurance facilities for banks and insurance companies.

2 Leaving aside accounting changes that affected the timing of payments to British Columbia and Ontario related to GST harmonization in those provinces, and also affected some revenues and spending related to Crown corporations, the main changes in the Fall Update relative to the budget were modest increases in transfer payments, more than offset by lower interest costs resulting from lower-than-expected interest rates.

Table1: Assumptions and Projections, 2010-2016

	($ billion except as noted)					
	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
Economic Growth *(Percent)*						
Real GDP Growth	3.0	2.5	2.8	2.9	2.6	2.5
GDP Inflation	2.8	2.0	2.3	2.0	2.0	1.9
Nominal GDP Growth	5.9	4.6	5.2	5.0	4.6	4.4
Federal Revenues						
Taxation Revenues	189.2	201.0	212.1	225.6	238.3	248.7
EI Premiums	17.5	18.8	20.6	22.6	24.6	25.9
Other Federal Revenue	25.7	26.5	28.6	29.5	30.3	31.2
Total Revenues	**232.4**	**246.3**	**261.3**	**277.7**	**293.2**	**305.8**
Fiscal Prudence						
Shadow Budget Revenue Adjustment for Economic Prudence	-0.5	-1.5	-1.5	-2.0	-3.0	-3.0
less: Fiscal Prudence Already Included in Projections	0.3	1.5	1.5	1.1	0.8	0.8
Net Adjustment for Fiscal Prudence	-0.2	0.0	0.0	-0.9	-2.2	-2.2
Total Revenues Adjusted for Fiscal Prudence	**232.2**	**246.3**	**261.3**	**276.8**	**291.0**	**303.6**

Source: Canada (2010a); authors' calculations.
Note: Columns may not sum exactly due to rounding.

a. Spending Restraint

Continuation of Budget 2010 Measures

The 2010 federal budget outlines a series of expenditure reductions: ending temporary stimulus measures as scheduled; restraining growth in defence and foreign aid spending; containing the cost of government, mainly by holding non-defence departmental budgets at their 2010/11 level for two years; and strategic reviews of government operations. Along with some improvements in tax collection, the plan was projected to save $17.6 billion over five years. We assume that the government will deliver on these commitments, and thus we use the Fall Update's projections as our baseline for projected expenditures.[3]

Letting Unspent Stimulus Money Lapse

Although the 2010 Budget committed to ending stimulus spending as scheduled, difficulties in coordination and implementation, as well as imperfect project choices that were inevitable in the crisis-accelerated conditions surrounding the stimulus package, mean that not all federal funds allocated to buffer the 2009 slump could be spent in the original timeframe. The end-date for these transfers has already been extended once.

3 The scheduled end of accelerated capital cost allowances for certain categories of equipment highlights the perennial challenge of keeping tax and economic depreciation rates in line with each other, as technological change is tending to shorten the useful lives of much equipment. During the year, the government should establish a permanent advisory group of accounting and industry experts to review various asset classes on a rotating basis to keep ordinary capital cost allowances closer to economic reality.

The danger now is that expectations of further extensions could result in spending no longer needed to fight a slump that ended in the third quarter of 2009, or feed expectations of yet more money for projects, such as professional sports facilities, that would not pass a reasonable cost/benefit test. This Shadow Budget therefore anticipates a final end to these transfers as of October 31, 2011, and books a small amount – $100 million – representing funds unspent by then as an expenditure saving in 2011/12.[4]

Restraining Federal Public Service Employment

The federal public service has grown rapidly in the last 10 years: excluding military and RCMP uniformed personnel, the number of federal public servants jumped 35 percent from 1999 to 2009. If labour productivity improvements do not occur in government – an unsatisfactory assumption to start with – one might expect maintaining constant quality in the services delivered per Canadian to produce growth in numbers of public servants in line with growth in population. In the 10 years to 2009, however, Canada's population grew some 11 percent – some 24 percentage points slower than federal employment.

Escalating compensation costs augmented the fiscal impact of this remarkable margin of federal civilian employment growth over population growth. From $12.8 billion[5] in 1999/2000, the total cost of Ottawa's non-military/RCMP personnel increased almost 7 percent annually to reach $24.4 billion[6] in 2009/2010. Over that period, total compensation per employee went from about $67,000 to about $94,000.[7]

The federal government should immediately reverse the growth in employment that has fuelled this higher spending. Cutting employment 2 percent per year for the next four years would still leave per capita federal employment at a level above its 1999 level. Ideally, considerations of merit and value for money within each program and department would guide this exercise, but since federal-government workforce practices complicate that approach, we frame our numerical targets in terms of attrition. Data from the Public Service pension plan suggest that nearly one-fifth of current contributors are nearing retirement.[8] Eliminating one in every two positions (excluding RCMP and military personnel) that open through retirement – a policy in place in the province of Quebec since 2004 – would achieve the reduction we recommend. Far better than attrition would be reduction or elimination of lower-value programs and the associated personnel through the review process; the attrition-based figures simply show what might be achieved should a more surgical approach elude the government.

4 When the federal government announced the deadline date extension of infrastructure projects under the Economic Action Plan, it said that about 10 percent of the 23,000 infrastructure projects across the country would likely miss the original deadline of March 31, 2011. Since we do not know how many of these projects will be able to meet the new deadline – or will qualify for an extension – we book a nominal amount in recognition for the high probability that at least a small portion of the planned infrastructure transfers will be unspent by the extended deadline.

5 Public Accounts of Canada. 1999-2000. Volume II, Part 1, Table 3 (Ministerial Expenditures by Standard Object: Personnel). Total for all departments or agencies except National Defence, RCMP, and Parliament.

6 Public Accounts of Canada. 2009-2010. Volume II, Table 3 (Ministerial Expenditures by Standard Object: Personnel). Total for all departments or agencies except National Defence, RCMP, and Parliament.

7 Total cost per federal civilian employee is $24.4 billion (supra note 6), divided by the number of employees as calculated from Statistics Canada's CANSIM Table 183-0021, Public Service Commission's Annual Report 2009-2010, and Canadian Broadcasting Corporation's website information. The head-count is total federal government employees as per Statistics Canada's statistical universe, less Department of National Defence military and civilian personnel, Royal Canadian Mounted Police uniformed and civilian personnel, and CBC personnel. (Same methodology applies to the 1999/2000 estimate.) Exact comparisons with the private sector are difficult because of variations and inconsistencies in the measurement of payroll taxes and the value of pension and benefit entitlements, but data on total compensation per business sector job for all industries from Statistics Canada's CANSIM Table 383-0009 put average total employee compensation per private sector job at $47,500 in 2009. Average human capital is probably higher inside the federal government than outside it, but a margin of about 2:1 in total compensation costs is nevertheless startling.

8 Active contributors who have accumulated more than 25 years of service.

Containing the growth in compensation per employee will take longer. The October 2010 settlement with the Public Service Alliance of Canada provided for wage increases of 5.3 percent over three years, which sets a problematic precedent for upcoming negotiations. Although the government has announced its intention not to accommodate the resulting compensation costs in departmental budgets, escalation in per-employee costs will make preserving services within a given budget envelope harder. It also creates problems for provincial governments, who are struggling to hold the line on costs, and whose employee unions naturally use advantageous federal precedents in pressing their case. This Shadow Budget therefore anticipates a move over three years to rein total per-employee compensation back to annual growth of 1 percent for the remaining years of the projections.

Tackling the Cost of Ottawa's Employee Pension Plans

The federal government has many deferred compensation arrangements for its employees, notably its pension plans, in which the largest obligations are for the Public Service (PS), Canadian Forces (CF) and Royal Canadian Mounted Police (RCMP) pension plans. Since the 2000 reforms that partially funded these plans, employee and government contributions have been invested by the Public Sector Pension Investment Board.

The normal practice in public-sector pension plans, including in Ontario, Québec, and Alberta, is for employers and employees to split required contributions roughly equally. The public-service pension plans in British Columbia and New Brunswick, along with the Ontario hospitals pension plan, have similar contribution ratios, with employers covering about 55 percent of contributions. The Ontario Teachers' Pension Plan and the Ontario Municipal Employees Retirement System both have equally shared contributions. Employer contributions to the federal plans, however, have typically been a larger share of the total: the government's share is currently about two-thirds, and the latest actuarial reports for the PS, CF, and RCMP plans together anticipate a ratio of 64 percent in 2015.

A further distinctive feature of the federal government's pension plans that was highlighted at the outset is that a fair-value calculation of their liabilities reveals them to be larger than reported in the public accounts. Instead of using a discount rate that matches the returns available on assets with similar characteristics to its liabilities – a sovereign-backed, inflation-indexed instrument such as the federal government's real-return bonds – Ottawa discounts its pension liabilities using an assumed rate of return that is much higher. The government's aggressive assumptions appear to justify the current combined (employer plus employee) contributions to these plans, which as shares of pay are 19, 22 and 21 percent for the PS, RCMP and CF plans respectively (OCA 2009a, 2009b, 2009c). Discounting at the yield on real-return bonds as of the valuation date, however, shows that the value of benefits accruing in these plans is some 35 percent, 41 percent and 42 percent of pay respectively (Laurin and Robson 2010).[9] Unless actual contributions rise to the 35-percent-plus levels just mentioned, the $65 billion gap between the public-accounts figure for pension liabilities and their fair value will grow further.

In the longer term, the solution to the federal government's pension challenge must include changes in benefits, which are very rich: the value of accruals just mentioned is far greater than the 18 percent of pay up to a maximum of $22,450 available to participants in defined-contribution pension plans and RRSP savers, and the accrual of benefits in the pension plan for members of

9 These seemingly extravagant numbers arise for two main reasons. One is that the rate of return on the asset that best matches these pension liabilities – the federal government's real-return bond – is currently very low, so future promises are expensive to fund. The second is that the formulas governing benefits in these plans, and in particular their early retirement provisions, mean that typical members draw benefits for longer (much longer when survivor benefits are considered) than they work. Considering that returns of zero and equal periods of contributions and benefits would require contribution rates of 50 percent reveals that 35-percent-plus contribution rates are not implausible.

parliament is richer yet. One key factor behind these extravagant accruals is early-retirement provisions that pull experienced people out of the public service while they are at peak levels of productivity, and make delivering good services while controlling spending all the harder – an utterly counterproductive feature.

Such reforms will face massive resistance from the employee unions, however, and will take time. Nearer term, the unusually low share of employee contributions and the inadequate level of total contributions to the federal plans inspire two recommendations: that the employee share should rise, and that the total contributions should rise. We therefore propose a package of contribution rate increases and changes to the share of employee contributions that will better fund the plans and, over time, mitigate the exposure of taxpayers through the federal government to the costs of these pensions. A gradual move to a 50-50 employer/employee financing split alongside an increase in the combined contribution rate from nearly 20 percent of pay to about 24 percent over four years would raise employees' contributions and slightly reduce planned government contributions, yielding a small positive outcome for Ottawa's bottom line. We emphasize that this joint move toward actuarially fair contributions and a 50-50 split would apply to all federal pension plans, including those for members of parliament.[10]

Financial Assistance to Crown Corporations

Subsidies to Crown corporations have jumped by some 50 percent – about $2.5 billion – since 2006/07, spurred by measures to cushion the recession. The distinguishing feature of Crown corporations as opposed to government departments, however, is that they operate in a commercial environment, implying consistent attention to the bottom line as opposed to an increasing draw on the consolidated revenue fund.

As a spur to greater efficiencies in consolidated Crown corporations, along the lines of what private-sector enterprises have achieved in recent years, this Shadow Budget proposes to reduce their aggregate subsidies by 10 percent from their currently planned level.

Review of Tax Preferences

The federal tax system contains many exemptions, deductions, rebates, deferrals or credits to achieve various economic and social objectives. Some 260 tax preference measures are listed in the latest federal government's assessment of tax expenditures (Canada 2010b), a number that is rising with time. The 1999 assessment listed about 227 such measures (Canada 1999).

Defining and interpreting these preferences is not straightforward: implicit in the concept of preferences is an "ideal" tax system, the outlines of which are open to debate. Tax deferrals on retirement saving, for example, count as a tax preference if the ideal tax base is comprehensive income, but not if the ideal tax base is consumption.

Less controversial, however, are preferences that (i) exempt income from certain types of activity or transfer payments from tax, (ii) provide credits at rates unrelated to a taxpayer's marginal tax rate – in which case the credit is arguably a transfer payment in disguise, (iii) favour investments in certain activities or regions or by certain types of enterprises, or (iv) arbitrarily affect the cost of consuming some items as opposed to others. Such preferences make taxation more complex, sometimes facilitating and often encouraging avoidance, raising compliance costs for both taxpayers and tax collectors, and shifting resources away from locations and uses where their overall return to society would be higher (Chen and Mintz 2009).

Among the attractive targets for rationalizing the tax system are preferences for activities, such as home buying, traveling by public transit, or

10 As mentioned at the outset, we do not restate the public accounts in this document to reflect fair-value valuations of pension liabilities. If we did, however, these higher combined employee/employer contributions would be accompanied by a smaller increment in the unfunded liabilities of these plans, therefore reducing growth in the restated net public debt.

fitness, that many recipients would have done anyway, or preferential taxation of employer-paid benefits that would likely be available to employees in almost as large amounts without it. Relatedly, some preferences likely prompt suppliers to increase prices, mitigating their impact on real activity. Others create problematic distortions in investment decisions. A prominent example is the federal credit for investment in labour-sponsored venture capital corporations (LSVCC), which have crowded out alternative private venture investments for the sake of portfolios that are unsuitable for retail investors both because they tend to concentrate their equity investments in risky assets, and because portions of them must be kept highly liquid to deal with potential withdrawals.

Given that the marginal costs of raising a dollar in additional personal or corporate income taxes are much greater than a dollar, compensating for taxes foregone through preferences comes at a high cost. The overall return to society from preferences therefore ought to be very high. Many tax preferences do not meet such a test, and some that do would arguably be better funded through overt spending programs that would need to pass parliamentary scrutiny. This Shadow Budget proposes a panel of independent academics and tax experts to conduct a rigorous review of all tax preferences to identify those failing the tests of economic efficiency and cost effectiveness. Following public consultations on the panel's report, the government should phase out those that do not pass the tests. For example, the complete elimination of tax preferences mentioned above would have yielded more than $3 billion of additional tax revenue in 2010. The overall target for this exercise is $2 billion by 2014/15.

b. Other Initiatives

Prolonging Eligibility for Tax-deferred Saving

The financial crisis has sparked intense interest in potential improvements in Canada's retirement income system. One contrast highlighted by the crisis is between the minority of Canadians who work in the public sector and have relatively rich defined-benefit pension plans, and the majority who participate in defined-contribution pension plans or save in RRSPs – and have much less ability to securely replace work-life income in retirement.

The *Income Tax Act* calibrates its limits on tax-deferred saving relative to *outcomes* for defined-benefit plans but relative to *inputs* for money-purchase arrangements. So when life expectancy increases or rates of return decrease, participants in defined-benefit plans get more contribution room and – since their annuities are paid for life – more access to tax-deferred reinvestment of funds not needed to pay pensions. However, participants in defined-contribution plans and RRSP savers do not. The current rules date from 1992, and are badly out of line with current demographic and economic reality. Two modernizations would help this latter group improve their prospects.

- One would be to extend the age at which contributions to pension plans must cease and withdrawals from Registered Retirement Income Funds (RRIFs) and similar vehicles must begin. The current age of 71 was originally set when life expectancy was much shorter, and the prospect that many people would need or want to work longer seemed less likely. It should rise immediately to 73, and be indexed thereafter to improvements in life expectancy.
- A corollary measure would reduce required RRIF drawdowns to increase the amount of tax-deferred reinvestment available to people who want to mitigate their risk of outliving their assets. The one-time decrease in mandatory withdrawal rates in 2009 was a stop-gap measure that failed to address the longer-term challenges of higher longevity and lower investment returns (Robson 2008). Updating the RRIF drawdowns to reflect the increases in life expectancy and declines in real investment returns since 1992 would bring Canada's retirement saving provisions better into line with current conditions, and reduce the discrepancy in the *Income Tax Act's* effective treatment of people in defined-benefit plans and those in money-purchase arrangements.

On a present-value basis, the cost of these measures is small, since they affect the timing rather than the magnitude of federal revenue. We estimate that they would reduce revenues by marginal amounts – some $200 million annually – over the projection period.

Initiating a Phase-out of Agricultural Supply Management

Two barriers to Canada's prosperity are, first, impediments to flows of goods and services across our borders and, second, artificial costs or restrictions on the inputs Canadian producers need to satisfy customers at home and participate in world supply chains and markets. Canada's supply management system for dairy, poultry and egg farmers creates both. In place since the 1970s, supply management restricts Canada's ability to negotiate multilateral trade agreements and possibly stands in the way of important negotiations for the Trans-Pacific Strategic Economic Partnership – a free trade agreement for the Asia-Pacific region, including New Zealand, Chile, Singapore, and Brunei; soon to be joined by Australia, Vietnam, Peru, and perhaps the US. It also raises prices for Canadian consumers, and drives food processing abroad or out of business.

Because the capital value of the rights to produce these products – production quotas – is now some $30 billion, producers and their financers will need time to adjust to the eventual termination of the cartels that support them. Signaling in advance a plan to gradually unwind the system over a 20-year period, coupled with annual issuances of production quotas, would prepare domestic producers for change and help attenuate the impact of reforms on producers (Robson and Busby 2010). A complementary move that can begin immediately is a phased reduction of the tariffs that block foreign imports of these products. Because these tariffs are deliberately set at levels that suppress the trade they tax, reducing them would produce increases in customs revenue. This Shadow Budget proposes that the bulk of these revenues be devoted to the retirement of production quotas to mute the impact that higher imports and the auctioning of new quotas would have on the affected farmers' balance sheets, and therefore shows marginal impact on the federal government's bottom line.

Better Debt Management

The joint commitment by Parliament and the Bank of Canada to hold consumer price index inflation at 2 percent, which has successfully delivered low and stable inflation since the mid-1990s, creates an opportunity to reduce Ottawa's interest costs in the short term and protect them from increases in the longer term. Alongside its ordinary debt securities, Ottawa issues real-return bonds – which, as mentioned earlier, have principal repayments that are indexed to inflation. This protection means that their current yield is lower than the yield on ordinary bonds, yet the difference between the two yields is larger than the 2 percentage points that the Bank of Canada's 2 percent inflation target would imply. It averaged 2.36 percent from 2001 to 2007, and after dipping during the crisis, widened to 2.41 percent at the end of 2010.

One frequently cited reason for the spread being wider than 2 percent is that the limited supply of real-return bonds raises their price and depresses their yields. These bonds are an excellent investment for pension funds and retirement savers generally, and the roughly $37 billion of them currently outstanding are mostly in the hands of these long-term investors. Provided that the Bank of Canada continues to produce 2 percent inflation, issuing more of these securities would let Ottawa fund its debt more cheaply than through issuing nominal-return bonds with yields that are more than 2 percent higher.

Another plausible reason for the spread being wider than 2 percent is that investors may doubt that the Bank will actually produce 2 percent inflation, and that those who buy ordinary nominal-return bonds may therefore demand an insurance premium in the form of extra yield against the possibility that inflation ends up being higher. Such a premium presents an additional opportunity. Ottawa could make its commitment

to lower inflation more credible by issuing more real-return bonds: debt that it cannot debase through surprise inflation. That more credible commitment could, in turn, reduce the interest rate on its nominal-return bonds.

In each of the past three years, Ottawa issued $2.2 billion in real-return bonds. This Shadow Budget proposes to increase this issue to $10 billion annually in each of the next five years. Along with the anticipated reduction in overall borrowing, that pace of issue would markedly raise the share of these bonds in total federal debt.

We estimate two types of interest saving from an enhanced issue of real-return bonds.

a) To begin with, it straightforwardly lowers the cost of servicing new debt. At the recent spread of 2.41 between the two types of bonds, the saving from lower interest payments would exceed the cost of indexing the principal of the real-return bonds by some $160 million in the final year of the projection period.

b) Estimating the potential saving from the credibility boost this larger float of real-return bonds would give the 2 percent inflation target is necessarily more speculative. We expect the immediate impact on nominal bond yields would be marginal. Over time, however, especially to the degree that concerns about sovereign debt provoke fears of inflation, we anticipate that the impact on nominal bond yields would grow. Our projections allow for a yield benefit to the government, evident on all nominal-return bonds, of five basis points in the first year, increasing by five additional basis points each year until it amounts to 25 basis points (one-quarter of one percent) by 2015. Because new debt issuance to finance projected deficits and the stock of bonds maturing every year is relatively large, the interest saving even from this modest effect would be substantial.

If this second effect were to occur, the net impact of the lower yield on real-return bonds relative to their nominal counterparts would be less. Our projections therefore show the net interest saving from more aggressive real-return bond issuance.

Modernizing Canada's International Taxation

Canada's taxation of business operating abroad has been in a state of constant review and flux for many years. As part of a general commitment to reducing uncertainty and complexity, this Shadow Budget proposes to simplify treatment of foreign affiliates of Canadian corporations.

Foreign affiliates can currently repatriate active business income on a tax-exempt basis if the affiliates are resident in jurisdictions with which Canada has a tax treaty or, since 2008, in jurisdictions with which negotiations to establish a Tax Information Exchange Agreement have been announced. To facilitate the reinvestment of earnings at home and abroad, this Shadow Budget proposes to provide exempt treatment to all active business income of controlled foreign affiliates in any jurisdiction. The net domestic revenue impact of such an approach would be small.

Improving Fuel Tax Accountability

Ottawa currently distributes a portion of federal fuel taxes to municipalities in support of infrastructure spending.[11] Notwithstanding the desirability of broader, more diverse revenue bases for municipalities, this transfer disconnects the flow of funds from political accountability for setting tax rates – all the more so because of the complexity of the formula that determines the grants. Matching revenue raising authority and spending responsibility is vital to responsive, accountable government. As a step toward the goal of closer matching, this Shadow Budget proposes to lower the federal fuel tax in provinces that agree to design their own mechanisms for delivering fuel tax revenues to the jurisdictions in which they were raised. This measure would be cost-neutral.

11 In 2009/10, the federal government collected $4.1 billion in gasoline excise tax at a rate of 10 cents per litre, and transferred $1.9 billion to the Gas Tax Fund in support of municipal infrastructure investment.

Federal-Provincial Fiscal Relations Post-2013

Current legislation sets the value of federal transfers to provinces and territories in support of health and social programs through 2013/14: transfers for health will grow 6 percent annually until then, while transfers intended for social programs will grow 3 percent annually. The projections in the Fall Update continue these growth rates after 2013/14, but this is a technical assumption: the Update reiterates previous warnings that these growth rates have not been legislated and are subject to change.

For the reasons just laid out in connection with transfers funded by federal fuel taxes, such transfers are problematic – all the more so when they are on such a colossal scale.[12] This overlap complicates the task of identifying which government is responsible when taxes exceed, or programs fall short of, voters' expectations – and in the vital case of healthcare, seriously checks the innovations needed to ensure that the mounting costs of publicly funded healthcare deliver commensurate benefits in well-being. Since a key corollary of transfers – arguably both a cause and an effect of their size – is the fact that the federal government currently occupies tax room that would otherwise be available to the provinces to fund these programs directly, an essential step toward disentanglement is for the federal government to decrease its fiscal footprint relative to the current projections from 2014/15 forward.

The differences in the marginal cost of raising a dollar in revenue through various taxes alluded to earlier mean that if the federal government were to cede tax room from 2014/15 on, it would create an opportunity to further reduce its most damaging tax: the corporate income tax. But with this opportunity comes a risk. The marginal cost of raising a dollar in revenue is generally higher at the provincial level, as Table 3, which reproduces calculations from Dahlby and Ferede (2011 forthcoming), illustrates. To take the most problematic example, if the federal government were to cede tax room by reducing the GST, as it has already done twice in the past five years, with the provinces reacting to the equivalent reduction in federal transfers by raising their corporate income taxes, Canadians would be collectively much worse off. A tax that does relatively small additional damage per dollar raised would be replaced by taxes that typically impose economic costs that are several times larger than the revenue they raise.

Clearly, the preferable course would be for the federal government to lower its corporate income tax rates while the provinces increase their sales taxes. Since sales tax increases are politically awkward, the overall reduction in federal transfers contemplated in this reform would require transitional payments akin to those recently provided to Ontario and British Columbia for sales tax harmonization to facilitate the change. It is in Ottawa's interest to make such payments, because the economic damage done by hikes in provincial personal, and especially corporate, income taxes adversely affects Ottawa's own tax base. Since calibrating these transfer payments would require further study of these interactions, we do not break down the specific changes in federal taxes or federal-provincial transfers that may be required. We do judge, however, that it is fair for Ottawa to see some benefit to its bottom line from the change. The provinces shared in the benefit when federal finances were buoyant; they have no reason to complain when they share the cost when federal finances are weak. Lower interest costs, moreover, will help the federal government reduce its fiscal footprint, helping create the room the provinces will need. The overall projections therefore show a flat line in transfers at their 2013/14 level, with a reduction in federal taxes equal to the 90 percent of the difference between the Fall Update projections and the flatlined amount from 2014/15 on, which yields a benefit to the federal bottom line of $430 million in 2015/16.

12 At more than $37 billion in 2010/11, these transfers mean that federal taxes fund about a quarter of the provincial/territorial cost of delivering the related services. Notwithstanding the current federal government's reticence about intruding on provincial jurisdiction, such dependence on federal transfers inevitably erodes provincial autonomy in delivering these services, and with it provincial accountability to their own voters.

Table 2: Summary of Measures and Fiscal Projections ($ billion)

	Actual	Projection					
	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Revenues (Table 1)							
Taxation Revenues	180.2	189.2	201.0	212.1	225.6	238.3	248.7
EI Premiums	16.8	17.5	18.8	20.6	22.6	24.6	25.9
Other Revenues	21.7	25.7	26.5	28.6	29.5	30.3	31.2
Net Adjustment for Fiscal Prudence		-0.2	0.0	0.0	-0.9	-2.2	-2.2
Total Revenues for Planning Purposes	**218.5**	**232.2**	**246.3**	**261.3**	**276.8**	**291**	**303.6**
Expenses Based on Latest Fiscal Update							
Direct Program Expenses	119.2	122.9	117.3	116.3	117.2	117.7	120.5
EI Benefits	21.6	21.1	19.4	18.8	18.5	18.6	18.9
Other Major Transfers to Persons	47	49.2	51.5	53.8	56.2	58.4	60.6
Transfers to Other Levels of Government	57.0	53.3	54.5	57.1	59.8	62.4	65.4
Gross Debt Charges	29.4	31.3	33.4	36.4	37.5	37.9	38.0
Total Expenditures	**274.2**	**277.8**	**276.1**	**282.4**	**289.2**	**295.0**	**303.4**
Budgetary Balance before Initiatives	**-55.6**	**-45.6**	**-29.8**	**-21.1**	**-12.4**	**-4.0**	**0.2**
Spending Restraint Initiatives							
Letting Unspent Stimulus Money Lapse			0.1	n/a	n/a	n/a	n/a
Restraining Federal Public Service Employment			0.6	1.2	1.9	2.5	2.6
Containing the Growth in Compensation per Employee			0.1	0.2	0.4	0.7	0.9
Tackling the Cost of Ottawa's Employee Pension Plans			0.1	0.1	0.2	0.3	0.3
Financial Assistance to Crown Corporations			0.7	0.7	0.7	0.7	0.7
Review of Tax Expenditures			0.0	1.0	1.5	2.0	2.0
Other Initiatives:							
Prolonging Eligibility for Tax-deferred Saving			-0.2	-0.2	-0.2	-0.2	-0.2
Phase Out of Agricultural Supply Management			0.1	0.1	0.1	0.1	0.1
Better Debt Management			0.1	0.2	0.3	0.5	0.5
Modernizing Canada's System of International Taxation			neg.	neg.	neg.	neg.	neg.
Improving Fuel Tax Accountability			0.0	0.0	0.0	0.0	0.0
Transfer Payments Freeze / Partial Offsetting Tax Reduction			n/a	n/a	n/a	0.2	0.4
Change to Debt Charges				0.1	0.3	0.7	1.1
New Budgetary Balance	**-55.6**	**-45.6**	**-28.2**	**-17.7**	**-7.2**	**3.5**	**8.6**
Accumulated Deficit	519.1	564.7	592.9	610.6	617.8	614.4	605.8
as a % of GDP	*34.0*	*34.9*	*35.2*	*34.5*	*33.2*	*31.5*	*29.8*

Source: Canada (2010a); authors' calculations.
Notes: Columns may not sum exactly due to rounding.
Signs on initiatives indicate impact on bottom line – positive means moves balance toward surplus.

Table 3: The Marginal Cost of Public Funds for the Provincial and Federal Governments in 2006 ($)

	Corporate Income Tax	Personal Income Tax	General Sales Tax
BC	11.64	1.83	1.13
AB	40.83	1.45	1.00
SK	***	1.86	1.13
MAN	2.25	2.16	1.13
ONT	***	2.16	1.15
QUE	2.57	3.85	1.15
NB	4.30	2.22	1.15
NS	***	2.46	1.15
PEI	***	2.31	1.21
NL	30.31	2.54	1.15
Federal Government	1.71	1.17	1.11

Note: *** indicates that a small CIT rate reduction would increase the present value of the government's total tax revenues. The MCF is undefined in such cases because there would be social welfare gain from a reduction in the CIT rate.

Source: Dahlby and Ferede (2011 forthcoming).

Future Priorities

The focus of this Shadow Budget is on prudence, accelerating the path to surpluses and buffering it against potential dips in the tax base. The initiatives proposed above are, in total, beneficial to Ottawa's bottom line. The surplus at the end of the projection period will protect Canada from adverse debt-market shocks, prepare the federal balance sheet for potential improvements in the reporting and funding of federal-employee pensions, and ultimately create fiscal room for new measures – either further tax relief or program enrichments. In this final section, we preview some of the potential payoffs from successful execution of this plan.

Moving to Comprehensive Corporate Group Taxation

Canada's current restrictive approach to corporate group taxation creates many problems, including administrative and transaction costs, unfairness among different types of corporations, uncertainty, and weakened international competitiveness. The web of intragroup transactions and structural changes needed to achieve some degree of tax consolidation adds complexity to the tax system, and when the costs of achieving consolidation outweigh the benefits, tax considerations may drive business decisions about where and whether to operate. Allowing the transfer of profits and losses among domestic members of a corporate group for federal and provincial tax purposes would address these problems.

An outline for such a system would see each eligible subsidiary of a group determine its own tax base separately, including taxable profits, current-year non-capital tax losses and federal credits. These amounts would then be transferred, on paper, from the subsidiaries to the parent company, which would then pay federal taxes for the entire group based on the aggregated transferred amounts and its own tax situation. Provincial taxes payable could be computed based on the existing interprovincial allocation formula (Laurin 2009).

Consultations about this reform are now under way: the fiscal framework in this Shadow Budget would ensure favourable circumstances for its implementation.

Extending the Basic Personal Amount to all Individual Investors

While Canadian individual investors benefit from a basic personal exemption that shields income below $10,527 from taxation, individual foreign investors receive no such benefit. For partnerships and other ventures that pool contributions from large numbers of individual investors, some of whom may own quite small stakes, the need to trace even tiny amounts is a disincentive to invest in Canada.

Other countries such as the United States and the United Kingdom do exempt income below a low threshold from taxation. In a few years, as fiscal room grows, future budgets should extend the basic personal amount to all individual investors.

More Generous Treatment of Returning Travelers

Canadians returning from abroad must pay tax and duty on purchases above limits that are low, whether considered in comparison to provisions in other countries, or in the light of Canadian and international moves toward free trade. The $50, $400 and $750 limits for travelers who have been abroad more than 24 hours, 48 hours and 7 days, respectively, are nuisance values, compounded by the fact that alcohol and tobacco products have separate quantitative limits.

Raising these limits – US travelers are entitled to bring $200 or $800 worth of goods tax and duty free for cross-border trips of less or more than 48 hours, respectively – and rationalizing them to include the value of alcohol and tobacco in the dollar limits and eliminating separate quantitative provisions would make international travel easier and more pleasant. While these changes would marginally affect provincial sales taxes collected at the border, the provinces would share in a key additional important benefit: reduced delay and administration at the border, which would facilitate commerce and tourism by helping unclog major crossings, ports and airports, and allow greater attention to policing the border for threats to Canadians' life and property.

Elimination of Withholding Taxes on Canada-US Cross-border Dividend Payments

Canada generally levies a withholding tax on cross-border dividend payments. A 15 percent withholding tax applies to income from portfolio investments to residents of the United States and other tax treaty nations, and a 5 percent rate applies to income from foreign direct investments where foreign dividend recipients own 10 percent or more of a Canadian company's voting shares. Recent amendments to the *Income Tax Act* and the Canada-US Income Tax Convention effectively eliminated withholding taxes on all interest payments to US investors and on arm's-length interest payments to all investors, regardless of country of residence. New US tax treaty agreements with its main trading partners exempt cross-border dividends from a subsidiary to its parent from withholding taxes, and reduce rates on portfolio dividends (Laurin 2007).

Future treaty negotiations with the United States should contemplate reciprocal elimination of withholding taxes on all cross-border dividends. Eliminating withholding taxes on cross-border investment income would boost capital investment in Canada, resulting in productivity improvements, job creation and greater economic prosperity (Mintz 2001).

Extending the Dividend Tax Credit

Now that changes to federal tax rules have shut down Canada's once-thriving business income trusts, equity investors in tax-deferred vehicles such as RRSPs and Registered Retirement Income Funds have limited options to escape over-taxation on corporate income received as dividends. Investors in Tax Free Savings Accounts (TFSAs) face the same problem. The dividend tax credit (DTC) provides relief for taxable investors receiving dividends when the business has paid tax

prior to distribution, but dividends paid into tax-deferred vehicles or TFSAs get no equivalent relief. This distortion affects portfolio decisions, an effect that will become more important as pension-fund and individual retirement assets grow, and as the quantitative limits that inhibit pension funds controlling productive assets directly become less binding or disappear.

Extending the DTC to tax-deferred vehicles and TFSAs will alleviate some need for new saving by individuals and pension-plan sponsors in the short run, and reduce the incentives for savers in these vehicles to own, and in some instances promote the creation of, assets that do not pay dividends. Announcing such a change ahead of implementation and/or phasing it in slowly will be beneficial, since anticipation of the end of this over-taxation will forestall some measures the affected investors may otherwise take to avoid it.

Eliminating Regionally Extended Employment Insurance Benefits

The EI program has many objectives. Mixing regional income supports with regular benefits vitiates its ability to insure most Canadians against involuntary, temporary and unanticipated loss of income. Uniform entrance requirements and benefit durations would eliminate the unfairness of benefits based on regional unemployment rates (Busby et al. 2009) and mitigate the development of employment patterns timed to trigger EI benefits. Since the program, as currently designed, has encouraged such patterns and discouraged migration of potential workers to areas where the labour market is healthier, making EI fairer will be easier if transitional payments are available – another important reward from ambitious fiscal consolidation.

Pulling It Together

This Shadow Budget proposes a package of cost-cutting measures aimed at restraining government spending growth and balancing the budget within four years without raising taxes. Budget surpluses at the end of the projection period will bring the federal debt-to-GDP ratio as currently reported in the public accounts back close to its pre-recession level. By lowering interest costs and protecting Canadians from sovereign-debt concerns and other potential adverse events abroad, this strategy will create room for initiatives that can further boost income growth, and ensure that demographic and other supply-side constraints do not impede Canadians’ quest for prosperity in the decades ahead.

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