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Backgrounder

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Fiscal Tonic for an Aging Nation

A Shadow Federal Budget for 2007

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The Backgrounder in Brief

Saving and investment are critical to Canada's economy. They underpin today's prosperity, and will be critical to raising living standards in the future. Growth in Canada's workforce is slowing, and a larger population of older Canadians will soon need pensions and social services. Federal fiscal policy must ensure that the environment in which Canadians work, save and invest encourages them to set aside resources for the future, and to invest in ways that will raise living standards for individual families, and for the country as a whole.

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Federal budgets have addressed a series of key challenges since the mid-1990s. The large deficits that formerly added to federal debt at an unsustainable pace ended a decade ago, and gave way to surpluses. Tax rates on individuals and businesses have begun to come down. Periodic attempts to rein in spending have limited Ottawa's claim on national resources.

As a result, an atmosphere of crisis no longer hangs over federal government finances. Canada's economy has grown steadily for a decade, aided by monetary stability arising from successful targeting of 2 percent inflation. Patching fiscal holes and reacting to booms and busts are things of the past. Today's solid fiscal and economic performance instead offers an opportunity to look ahead.

This opportunity is valuable and timely. The major challenges Canada will face in the future will not resemble those that shaped many current policies. In the past, high unemployment rates and idle capacity on a national scale were key challenges. In the future, the most pressing task will not be to take up slack in the economy, but to do better with what we have. Canada needs to expand its capacity to produce, and ensure that increasingly scarce resources are yielding the most we can get from them.

The root of this changed outlook is demographic. Over the next decades, growth of the traditional working-age population will slow and then all but stop. Maintaining and raising living standards will therefore require each potential worker to have access to more and better plant and equipment. Canada needs more investment per worker.

A further key element in the demographic outlook is that the ratio of working age to older Canadians will fall by half over the next 25 years and continue to shrink for another 25 years. To sustain living standards for old and young under those circumstances, Canadians must set resources aside today. So Canada needs saving.

Finally, keeping Canada in the front rank of countries where people will choose to live and work means improving the balance between what we get out of our economy and what we put into it, in the form of work, capital, and environmental stresses. Greater efficiency is the key to higher living standards without the burden of equivalent increases in effort, in plant and equipment, and in pollution. So Canada needs productivity growth.

In short, deploying Canadians' human, physical and environmental wealth to their best advantage requires a policy backdrop in which:

- Employees can work with the latest tools and technology provided by healthy business investment;
- Canadian savers are able to better secure their personal financial security and wellbeing in retirement; and
- Canadian workers apply their skills where their efforts earn the highest rewards, and domestic and foreign savers put their money where each buck earns the biggest bang.

This 2007 federal shadow budget takes important steps toward all these goals.

The authors wish to thank, without implicating them in any remaining errors, Don Drummond and Jack Mintz for their advice and comments.

Table 1: *Key Economic Indicators (actual and estimated)*

	2005	2006	2007	2008	2009-11 average
			percent		
Real GDP Growth	2.9	2.8	2.7	3.0	3.0
GDP Inflation	3.1	2.1	1.9	1.9	1.7
Nominal GDP Growth	6.1	5.0	4.6	4.9	4.7
3-Month Treasury Bill Yield	2.7	4.1	3.9	4.2	4.3
Long Government Bond Yield	4.1	4.3	4.3	4.6	5.0

Source: Statistics Canada, CANSIM; Canada (2006); authors' calculations.

Economic and Fiscal Outlook and Challenges

The Economic Backdrop

Canada's economic prospects are increasingly dependent on the health of economies around the world. Fortunately, global growth seems solid, with emerging powers such as China and India forging ahead, and major trading partners in Europe and Japan moving onto a faster growth track.

Of course, the US economy is the most important determinant for Canada's trading prospects. Here, potential problems from a bursting housing bubble appear to be dissipating, and consumer spending should continue to grow. Steady US growth, further spurred by expanding exports and business investment, will create a congenial environment for Canadian exporters and for the Canadian economy more generally.

Strong global demand for commodities should continue to support prices for Canadian resource industries. Despite recent weakness in energy prices, the same demand forces, combined with limited short-run supply, will likely continue to provide a strong economic platform for transformative fiscal policy.

Accordingly, this budget is framed around an outlook of stable real GDP growth and inflation (Table 1).

Fiscal Prospects

The fiscal year that ends March 31, 2007, was a good one for federal finances. A growing economy continued to support federal revenues. The government's focus on economy in its own operations yielded further gains, such that program spending growth is now expected to come in fully 1 percentage point below the levels projected in the fall update. This progress ensures that the government can meet its commitment to pay down federal debt in the short run, which will increase the interest savings available for personal tax relief on a continuing basis. The baseline outlook for the federal government's fiscal situation is illustrated in Table 2.

Table 2: *Summary Statement of Transactions: Outlook with Unchanged Policy*

	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
			$ billions			
Taxes and Fees	220.1	229.4	236.6	244.9	255.2	267.1
Investment Income	9.3	9.6	9.8	10.0	10.4	10.8
Total Revenue	*229.4*	*238.9*	*246.4*	*254.9*	*265.6*	*277.9*
Program Spending	187.6	196.1	204.4	213.1	220.7	228.6
Gross Debt Charges	34.6	34.7	34.6	34.7	34.6	34.6
Total Expenditure	*222.2*	*230.8*	*239.0*	*247.8*	*255.3*	*263.2*
Primary Balance	32.5	33.3	32.2	31.8	34.5	37.4
Net Debt Charges	-25.3	-25.1	-24.8	-24.7	-24.2	-23.8
Total Balance	7.2	8.1	7.4	7.1	10.3	14.7
Planned Debt Reduction	3.0	3.0	3.0	3.0	3.0	3.0
Total Balance after Planned Debt Reduction	*4.2*	*5.1*	*4.4*	*4.1*	*7.3*	*11.7*

Sources: Canada 2006; Authors' calculations.

Making Room for New Measures

In the face of ongoing pressures, particularly related to funding defence operations and rebuilding, the government must build on recent savings in some program areas to bolster its room for fiscal maneuver. To this end, fiscal restraint in 2007/08 will again deliver a spending growth rate 1 percent less than projected in the fall update. Specific measures include:

- Federal operating costs have continued to grow more rapidly than appears reasonable, either against the benchmark of economic growth generally, or against a measure of the services provided directly to Canadians. This budget therefore commits to holding growth in non-defence operating costs constant in real terms through the projection period.
- Federal spending in areas of provincial jurisdiction, including regional infrastructure, has likewise grown rapidly. Holding the line on such spending, so that inflation and population growth return spending levels to the real per capita amounts of 2003/04, would generate significant savings, pending a negotiated arrangement with the provinces on the trajectory of federal/provincial transfers versus tax room.

Equipping Workers

Canada urgently needs to improve its performance in adding to the capital stock which will help Canadian workers raise their incomes and secure future prosperity. A decade ago, the average Canadian worker got about the same new

private-sector plant and equipment annually as her or his counterpart elsewhere in the OECD (Goldfarb and Robson 2006). Last year, for every dollar of new plant and equipment enjoyed by the average OECD worker, the average Canadian worker got about 87 cents. For every dollar of new plant and equipment the average US worker got a decade ago, his or her Canadian counterpart got 90 cents. Last year, the figure was 75 cents. These corrosive trends bode ill for Canadians' ability to raise their living standards in line with improvements abroad, and will not support the kind of income growth they need in the future.

Business Tax Measures

A key contributor to recent poor investment performance is an uncongenial tax environment. The C.D. Howe Institute's 2006 survey of effective tax rates on capital investment calculated Canadian governments' take of the representative marginal dollar invested to be 36.6 percent (Mintz 2006). That marginal effective tax rate (METR) put Canada eighth from the top in a field of 81 countries, and second-highest in the G7. High business tax rates promote business structures that avoid multiple layers of tax, as the rise of income trusts illustrated in spectacular fashion, and push taxable income into more welcoming jurisdictions. The system also departs significantly from tax neutrality, as different industry sectors face very different marginal effective tax rates on investment. Tax design also discourages businesses from growing beyond the threshold at which small business concessions cease or new taxes — such as capital taxes — take effect (Hendricks et al. 1997). This deprives Canada of the dynamism and innovation that growing small and medium enterprises bring to an economy. Steps to streamline regulatory compliance requirements, such as those applying to the credit for scientific research and experimental development, will improve small businesses' access to these benefits and lower barriers to business growth.

Most important, high METRs discourage the capital formation that is indispensable for future economic growth. Federal fiscal policy includes numerous tools for improving the business investment environment,[1] the project at the heart of building future prosperity. Priorities for this budget include:

Lower general corporate income tax rates: Past government plans delayed the target date for achieving the modest goal of 19 percent for the federal general CIT rate until 2010. Canada can do better. This budget proposes staged reductions to bring the rate to 15 percent by 2012. Achieving the target will help keep the business investment METR in a range competitive with jurisdictions such as Ireland and Belgium, where tax reform has formed part of more comprehensive market liberalization programs. The federal share of the proposed tax on income-trust distributions will also be 15 percent, reflecting the lower corporate income-tax rate that it matches, improving the after-tax yield on income-trust holdings.

Phased-out minimum tax on financial institutions: The federal government has aggressively accelerated capital tax relief for most Canadian businesses. Financial

1 Potent tools, such as sales tax reform, remain in the provincial realm, as illustrated in Mintz et al. (2005, p. 9).

Table 3: *Impact of Spending Measures*

	2007/08	2008/09	2009/10	2010/11	2011/12
			$ billions		
Universal Child Benefit increases	1.0	1.1	1.1	1.9	2.8
Changes in transfers to other levels of government	-0.9	-2.2	-4.7	-5.9	-7.2
Constrained non-defence operating spending	-2.3	-4.0	-4.9	-5.5	-6.2
Net Change in Program Spending	*-2.1*	*-5.2*	*-8.5*	*-9.6*	*-10.6*

Source: Authors' calculations.

institutions, however, have as yet seen less relief. Budget 2006 raised the financial institutions capital tax threshold to $1 billion, above which the minimum tax is set at 1.25 percent of taxable capital employed in Canada. This budget proposes to lower that rate to zero in 25-basis-point annual increments.

LIFO Accounting: Rising energy and commodity prices in recent years have confronted businesses with challenging cost pressures. Inventory accounting for Canadian tax purposes, however, requires first-in, first-out costing, which tends to make profits calculated for tax purposes higher than actual economic profits. This budget therefore proposes transition measures that would lead to last-in, first-out cost accounting for inventories. This change will lower METRs on business investment, especially for businesses with significant inventories and volatile input prices.

Capital cost allowance rate increases: Past budgets revised tax depreciation rates to better reflect the economic lives of selected physical assets. The capital cost allowance (CCA) rates applying to plant and structures employed in manufacturing remain below levels that would reflect obsolescence. Rather than granting fast-paced writeoffs to specific industry sectors, this budget proposes to continue the process of revising CCA rates to match economic depreciation, so that more productive and environmentally sound equipment may readily replace obsolete capital stock.

Unblocking foreign investment: Foreign investments in Canada not only offer Canadians more saving than they themselves generate, but also bring growth-enhancing benefits such as innovative ideas, managerial expertise, and market knowledge. A number of tax policies, however, inhibit such investment, while yielding revenues for Canadian governments that are small or — where they discourage investment entirely — even zero. Canadian and US venture-backed companies compete directly with each other in the North American markets, yet Canadian companies enjoy a smaller capital base (less than one-third of their US counterparts). The difficulty Canadian operating companies have in obtaining capital and its attendant benefits may mean that many are sold before they attain market leadership, keeping Canadian firms smaller and less productive than they might otherwise be.

This budget proposes changes in a number of areas that would make the border less of an impediment to people with the funds and ideas that could help Canada grow:

- To make Canadian venture firm investments more attractive to nonresidents, this budget proposes to streamline the clearance process for obtaining tax treaty benefits for foreign investors who file notice of claim for treaty benefits (Hurwitz and Marett, 2007).
- US limited-liability corporations that are partnerships under US tax law are not considered to be either US "residents" for purposes of the Canada-US income tax treaty, or eligible for tax relief from double taxation under that treaty. This budget proposes that Canada clarify, through a Canada-US protocol, that — subject to certain safeguards — US limited-liability companies will enjoy the same tax status under the Canada-US treaty as US corporations when selling shares of a private Canadian company (Hurwitz and Marett 2007).
- Canada levies a 15 percent withholding tax on dividends to residents of the United States and other tax treaty nations (5 percent where US recipients own 10 percent or more of a Canadian company's voting shares). It also levies a 10 percent withholding tax on interest paid to arm's-length creditors on debt of less than five years' term. This budget proposes to eliminate the withholding tax on arm's-length interest payments. The government will finalize tax treaty changes to eliminate the Canada-U.S. withholding tax on non-arm's length interest payments and ultimately to eliminate dividend and interest withholding taxes.
- While Canadian individual investors benefit from a basic personal amount that shields income below about $9,200 from taxation, individual foreign investors receive no such benefit. Other countries such as the United States and the United Kingdom do exempt income below a low threshold from taxation, which makes partnership and other ventures for international investors more attractive, and spares a good deal of administrative expense. This budget proposes to extend the basic personal amount to all individual investors.

Promoting Saving

Canada's tax system hurts Canadians' capacity to save in a number of ways. This budget addresses three key problems: limits on contributions to pension plans and RRSPs, double-taxation of retirement saving, and distorting taxes on reinvested capital gains.

I*mproving RRSP and RPP room*: Policies that permit only limited tax relief on contributions to pension plans impede saving. Limits related to income — limits on RRSP contributions and formulas restricting the size of defined-benefit pensions — prevent many individuals from providing adequately for retirement. And the prohibition on contributions to pension plans that have assets equal to more than 110 percent of their liabilities stops plan sponsors from preparing during good times for the deficits that will normally occur when times are harder.

A long-standing benchmark has it that individuals should aim to replace 70 percent of their pre-retirement income. Based on current annuity rates and a 5

percent nominal growth rate of earned income over 35 years, the current RRSP and pension plan contribution limit of 18 percent of earned income is too low to achieve that objective. Individuals who withdraw from their RRSPs, moreover, do not get their contribution room back, which puts people with fluctuating incomes and large temporary needs such as home purchases at an additional disadvantage. This budget therefore proposes to increase the earned income limit to 25 percent immediately, and to deliver a substantial improvement to the currently scheduled increase in annual contribution limits: from $22,000 in 2010 to $32,000 by 2015, with lockstep increments in the value of defined-benefit pension plan contribution room. In addition, withdrawals from RRSPs will henceforth restore contribution room. While these changes will still leave Canada's treatment of pension plan contributions less generous than those in countries, such as the United States and the United Kingdom, they will improve the situation of skilled workers at income levels that are close to, or above, maximum pensionable earnings eligible for pension or RRSP treatment, and will therefore improve Canada's attractiveness to such workers.

As for pension-plan funding, this budget proposes to raise the threshold below which sponsors of defined-benefit pension plans may make tax-deductible contributions to 125 percent of liabilities, effective immediately, and will commence consultations about the advisability of removing such limits altogether.

Pension splitting: Owing to graduated personal income taxes, pensioner couples who (i) did not benefit during their full working lifetimes from the range of savings options available now and in future, and (ii) have markedly uneven pension income, are exposed to greater future taxation than younger families or those whose partners have more similar incomes. This budget proposes to extend, to all families, pension-income splitting options, so that private and public pension income received by one marriage partner may be taxed as if divided across both, effective in the 2009 tax year.

Improving savings options: Tax-Prepaid Saving Plans (Kesselman and Poschmann 2001) will help Canadians better manage their lifetime savings. TPSPs would permit individuals to earn income within the plan exempt from tax, with contributions to the plan triggering no deduction from taxable income, and distributions from the plan attracting no tax on withdrawal. (As is the case with RRSPs, interest on funds borrowed to invest in TPSPs would not be deductible.)

Reinvesting capital gains: The current capital gains tax discourages savers from reallocating assets as economic circumstances change. Letting savers defer tax when they sell investment assets and reinvest the capital would prevent "lock-in" that inhibits portfolio adjustments. This budget proposes a provision whereby taxpayers would calculate a year's taxable gains as they do now, but would receive a matching increase in the dollar limits to their RRSP contributions, unbound by current percent-of-earned-income limits. Instead of paying capital gains tax, which applies to 50 percent of gains, individuals would be able to reinvest, subject to annual dollar limits, up to half their net capital gains in an RRSP in the first 60 days of a calendar year, as with other post-year-end contributions. Investors who took their gains into current income would be liable for the usual capital gains tax in the year the gains were recognized. Improved

capital market performance, arising from unlocking accrued gains, will generate economic activity (and federal revenue) offsetting part of the cost to federal revenue that arises from postponing taxation of the capital gain.

Refundable dividend tax credits for dividends paid to RSPs: The recent growth of income trusts in Canada arose from a key failure of integration between business and personal taxes. In principle, income earned at the business level and paid to shareholders should be taxed at the business level or the individual level, but not both. At present, the dividend tax credit relieves investors who hold dividend-paying shares of tax paid at the business level prior to dividend distribution. But no equivalent relief from double taxation exists for investors who hold shares through pension or retirement savings plans. Providing a refundable dividend tax credit to RRSPs and RPPs will resolve this issue. The fiscal plan for this budget makes provision for such payments by allocating $2 billion in tax relief in fiscal year 2008/09 and beyond.[2] In the interim, the government will launch consultations on the best way of ensuring that these payments are made only in respect of dividends paid by tax-paying corporations.

Promoting Productivity

Personal taxes/transfers

Federal support for families delivered through income-tax and transfer mechanisms is weakened by clawbacks that subject modest-income working families to benefit reductions that stack on top of ordinary taxes, producing very high marginal tax rates. This budget therefore proposes in 2007 to expand the universal child care benefit, and to double it by 2011, so that it will play a larger role in helping families finance their child-care choices (shown in Table 3). Because this benefit is taxable at ordinary income-tax rates, its expansion will not exacerbate the clawbacks affecting these families. This government will also work with the provinces to improve the design of federal and provincial income-tested child benefits, so that provincial working-income supplement programs do not interact with federal benefits in ways that raise the effective tax rate on incremental income to unreasonable levels.

The Federal Labour Funds Credit: The federal credit for investment in labour-sponsored venture capital corporations has encouraged the pooling of small investors' seed money in support of numerous ventures across Canada. However, as evidence mounts that alternative vehicles may better suit the current marketplace, and as domestic and foreign investors find effective routes for matching their investment capital to promising projects, the federal credit emerges as a hindrance, rather than a spur, to steering resources to their best uses

2 Trusteed Pension Funds received some $3.7 billion in dividend payments in FY2005. Assuming an average corporate tax rate of 20 percent on the earnings from which these dividends were paid, a credit to the pension plans concerned would have cost $0.9 billion. The total here assumes that RRSPs would be entitled to similar credits and that the cost would be proportional to the ratio of RRSP to RPP assets, which stood at 30:63 as of 2005. Providing similar treatment to dividends received by the C/QPP yields a total cost of under $1.8 billion.

Table 4: *Impact of Revenue Measures*

	2007/08	2008/09	2009/10	2010/11	2011/12
			$ billions		
CIT relief	-1.8	-2.8	-4.0	-4.4	-7.0
Increased earned income limits, RPP/RRSP contribution room	-0.9	-1.9	-2.0	-3.3	-4.7
Pension income splitting	0.0	-0.3	-0.8	-0.9	-1.0
LSIF credit phaseout	0.0	0.1	0.1	0.2	0.2
Reinvesting capital gains	-0.3	-0.5	-0.6	-0.8	-0.9
Refundable dividend credit for pensions	-0.4	-1.8	-1.9	-2.0	-2.1
Total Revenue Measures	*-3.4*	*-7.2*	*-9.3*	*-11.2*	*-15.5*

Source: Authors' calculations.

(Cumming, forthcoming). This budget therefore proposes to follow Ontario's lead in phasing out the existing credit, with the phase-out period allowing existing funds to reorganize themselves as unsubsidized venture funds.

Consumption taxes

Facilitating provincial sales tax reform: The retail sales taxes that still exist in British Columbia, Saskatchewan, Manitoba, Ontario and Prince Edward Island are point-of-sale taxes that may apply at many points along the production chain to a final finished good, including business investment in intermediate capital goods and services. This "cascading" effect is also a major contributor to the high METRs on investment in Canada. The federal government has already eliminated its equivalent tax, and four other provinces have followed that lead, moving to consumption-based, value-added taxes that impose no such burden on investment. The second percentage-point reduction in the GST scheduled for 2011 will provide an opportunity for reform of retail sales taxes in the provinces that still have them. The federal government will consult with the provinces on reforms to federal provincial taxes and transfers that could assist this process, so that GST-compatible VATs can replace all remaining retail sales taxes in 2011.

Fuel tax accountability: The previous government established an elaborate mechanism for distributing federal fuel taxes to municipalities in support of infrastructure spending. While municipalities would benefit from access to a broader range of revenue sources (Kitchen 2006), this mechanism disconnects the flow of funds from political accountability for setting tax rates. Matching revenue-raising authority and spending responsibility is at the core of responsible governance and accountable government. This goal will be better achieved by lowering 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.

The combined impact of these measures is shown in Table 4.

Table 5: *Summary Statement of Transactions: Impact of Budget Measures*

	2007/08	2008/09	2009/10	2010/11	2011/12
			$ billions		
Non-Interest Revenue					
Status Quo Projection	229.4	236.6	244.9	255.2	267.1
Impact of Revenue Measures	-3.4	-7.2	-9.3	-11.2	-15.5
Outlook after Revenue Measures	*226.0*	*229.4*	*235.6*	*244.0*	*251.6*
Program Spending					
Status Quo Projection	196.1	204.4	213.1	220.7	228.6
Impact of Restraint and Reallocation	-2.1	-5.2	-8.5	-9.6	-10.6
Outlook after Restraint and Reallocation	*194.0*	*199.2*	*204.6*	*211.1*	*218.0*
Primary Balance					
Status Quo Projection	33.3	32.2	31.8	34.5	38.5
Impact of Budget Measures	-1.2	-1.9	-0.8	-1.6	-4.9
Outlook after Budget Measures	*32.0*	*30.3*	*31.0*	*32.9*	*33.5*
Net Debt Charges					
Status Quo Projection	-25.1	-24.8	-24.7	-24.2	-23.8
Impact of Budget Measures	0.0	0.0	0.0	0.0	0.0
Outlook after Budget Measures	*-25.1*	*-24.8*	*-24.7*	*-24.2*	*-23.8*
Total Balance					
Status Quo Projection	8.1	7.4	7.1	10.3	14.7
Impact of Budget Measures	-1.2	-1.9	-0.8	-1.6	-4.9
Outlook after Budget Measures	*6.9*	*5.4*	*6.3*	*8.7*	*9.7*
Reserves and Prudence Factors					
Contingency Reserve	3.0	3.0	3.0	3.0	3.0
Economic Prudence		1.0	2.0	3.0	4.0
Total Balance after Reserves and Prudence	*3.9*	*1.4*	*1.3*	*2.7*	*2.7*

Note: As in baseline, calculator of gross debt charges assumes debt paydown equal to each year's contingency reserve only.

Source: Authors' calculations.

Pulling it Together

Past fiscal efforts and economic success have put Canada in an enviable short-run position. The challenge now is to build on current strength to ensure that Canadians continue to enjoy rising living standards in the years ahead, when workforce growth is much slower, and when the need to make more efficient use of all resources — human, capital and environmental — is much greater.

As Table 5 shows, near-term fiscal changes to address this challenge are possible within a prudent framework.

As Canada's population ages and growth of the workforce slows, creating a savings and investment environment that supports an extremely productive economy becomes increasingly urgent. This budget addresses that challenge with policies that will help Canadians save and invest for future prosperity.

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