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BACKGROUND

FISCAL AND TAX COMPETITIVENESS

Back to Balance:

A Shadow Federal Budget for 2010

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In this issue...

How Ottawa can avoid taxing Canadians more.

THE STUDY IN BRIEF

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The 2008/09 recession in Canada hammered government revenues and precipitated extraordinary fiscal measures in response. Together, these forces caused the federal bottom line to fall into massive deficits, breaking from a recent history of black ink. Future additions to federal debt will erase the gains made from surpluses since 1996/97. Restoring this balance will be critical to the prospects of all Canadians and should be the focus of fiscal policy going forward.

In this year's Shadow Budget we urge Ottawa to return to budgetary balance by fiscal year 2014/15. To ensure Canada's international tax competitiveness position remains strong – making Canada a more attractive place to invest when compared to its peers – this goal can be achieved by reining in spending growth rather than increasing taxes. Sensible, fair, and efficient measures for expenditure reduction include raising the employee share of federal pension contributions from 32 to 50 percent, limiting growth in federal transfers to the provinces beginning in 2014, and reducing subsidies to Crown corporations.

Prudence, moreover, means seriously tackling deficits now, to avoid repeating the experience of the 1980s and early 1990s, when compounding debt absorbed incremental revenues, and kept the budget deep in the red. The 2010 Shadow Budget therefore offers areas for spending reduction within a feasible short- and medium-term economic forecast, while developing an environment for investment and innovation that positions our economy to better confront the challenges of an aging population.

ABOUT THE INSTITUTE

The *C.D. Howe Institute* is a leading independent, economic and social policy research institution. The Institute promotes sound policies in these fields for all Canadians through its research and communications. Its nationwide activities include regular policy roundtables and presentations by policy staff in major regional centres, as well as before parliamentary committees. The Institute's individual and corporate members are drawn from business, universities and the professions across the country.

INDEPENDENT • REASONED • RELEVANT

Canada's recession from late 2008 to mid-2009, and the federal government's fiscal responses to it, have delivered a massive setback to Ottawa's bottom line. The latest fiscal update (Canada 2009a) projects a \$56 billion deficit for fiscal year 2009/10, followed by a \$45 billion deficit in 2010/11.

By adding more than \$100 billion to net federal debt, these deficits alone will effectively erase the results of budget surpluses since 1996/97, and the update's projections show the debt rising by more than \$165 billion by 2014/15.¹ This Shadow Budget demonstrates how to limit the rise in federal debt, by prudently reining in spending growth rather than raising taxes, so that past and pending improvements to the nation's tax competitiveness are not also erased.

Federal finances respond to ups and downs in the Canadian economy, and even minor differences between economic projections and actual events can mean significant differences in fiscal outcomes. The latest recession is no exception: the weaker than expected economy means federal tax revenues will likely fall short of expectations by nearly \$20 billion in 2009/10² – a gap equivalent to nearly four percentage points in Goods and Services Tax (GST) revenue. On the spending side, extraordinary fiscal stimulus has come on top of an acceleration of outlays, essentially across the board. The bottom-line result is so burdensome that it is reasonable to fear that later this decade, as demographically driven spending pressures mount, Canada will risk falling back into the compounding debt trap of the 1980s and early 1990s.

In this year's Shadow Budget, we address two key questions: How quickly should Ottawa return to

budgetary balance? Can this objective be met by constraining spending rather than tax increases and, if so, how?

Our answer to the first question is emphatic: the federal government needs a clear and achievable plan to balance the budget in five years, by 2014/15. Several considerations reinforce this conclusion.

This year, 2010, is the year in which the share of Canada's population in the traditional working-age category – 18 to 64 – will peak. The move by more of the population from working and saving to retirement and drawing down wealth will subdue growth in government revenue from payroll and income taxes, while governments will face increasing demand for seniors' benefits and publicly funded healthcare. Robson (2009) has estimated that the discounted value of the increase in taxes needed to meet demographically driven obligations over the next half-century is \$1.5 trillion.

Prudence, moreover, means seriously tackling deficits now, to avoid repeating the experience of the 1980s and early 1990s, when compounding debt absorbed incremental revenues, and kept the budget deep in the red. The economic crisis has driven interest rates to extraordinary lows. As monetary policy tightens, short-term interest rates will rise toward historic norms. At least as important, government debt – which in the depths of the crisis was in tremendous demand from safe-haven investors – is burgeoning. The sobering fiscal situations of many governments, most notably the United States, will raise fears of inflation, or even default in some cases, among investors. For these reasons, long-term interest rates are also likely to rise – perhaps sharply – in the next few years. An interest rate rise of one percentage point above the government's baseline fiscal projections in 2011 would add about \$9 billion to federal debt charges by 2015. The sooner Ottawa stops borrowing and starts repaying, the better it can weather bad news on that front.

The authors wish to thank the members of the C.D. Howe Institute's Fiscal and Tax Competitiveness Council for their useful comments.

- 1 For the sake of presenting numbers consistent with those in official documents, we do not restate Ottawa's financial results here, but we do note that fair value accounting for federal pension obligations (Laurin and Robson 2009) would add almost \$60 billion to the net debt as of March 31, 2009, and would have revealed deficits in many years during the past decade.
- 2 Difference between federal tax revenues projection in the 2009 fiscal update to that of the 2008 federal budget, adjusted to take into account tax measures announced in the 2009 federal budget.

Another consideration is political and event risk. Over a planning period of six years, economic and other surprises are likely to trigger new program spending increases or revenue cuts. For example, net Employment Insurance (EI) program revenues make a major contribution to the baseline projections of the federal budget balance. Under existing rules, the Canadian Employment Insurance Financing Board must increase EI premiums to eliminate any excess of EI benefits over premiums accumulated since 2009.³ Yet the annual EI surpluses Ottawa is counting on to bolster its bottom line will more than replenish the recent accumulation of excess benefits over premiums, at which time the government will face considerable pressure to let premiums decline. Such considerations make desirable a measure of prudence in the projections of EI surpluses.

On the expenditure side, the federal government expects nearly \$20 billion of stimulus spending to expire within the next two years, and also expects that underlying program spending will grow more slowly than the economy and more slowly than in recent history. Such firm control over program spending over such a long period cannot be taken for granted.

Finally, fiscal planning for the next decade must recognize, as previous budgets have not, that economic expansions wax and wane. A reasonable objective, given the size of the deficit, would be to resume paying down the debt before the next slowdown. The average business cycle length – less than six years⁴ – takes us to fiscal year 2014/15.

Turning to the second question of choosing spending restraint or tax increases, deficit elimination should not compromise Canada's emerging position as a country with growth-friendly and internationally competitive tax rates. Governments in previous budgets have shown a continuous commitment to lower Canadians' tax

burden through various rate reductions (see Figure 1). Some of those reductions, such as the decline in the general corporate income tax rate to 15 percent by 2012, promise major gains in economic performance. This shadow budget aims to keep taxes low and internationally competitive.

Returning to balanced budgets will require rigorous spending restraint on the part of the government. It can be done, however: the pages that follow identify expenditure reduction measures whose attractiveness is based on cost, effectiveness, and equity considerations.

The Size of the Challenge Ahead: Outlook for Program Spending

With the economy now in recovery, stimulus spending must give way to containing expenditure growth. In this section, we estimate the size of the challenge ahead based on reasonable long-term economic assumptions.

1. Prudent Economic and Revenue Projections

The baseline forecast for this budget assumes that the economy will expand at a pace consistent with historical average labour productivity growth, demographic projections and GDP inflation running at 2 percent per year (Table 1). Because aging significantly depresses the share of the economically active population in our model,⁵ our forecasts for economic growth rates are lower than those from the Parliamentary Budget Office and the Department of Finance's most recent survey of private forecasters, notably toward the end of the planning period.⁶ Allowing for the down as well as the up phase of the business cycle, we believe our approach is consistent with fiscal prudence in the medium and longer term.

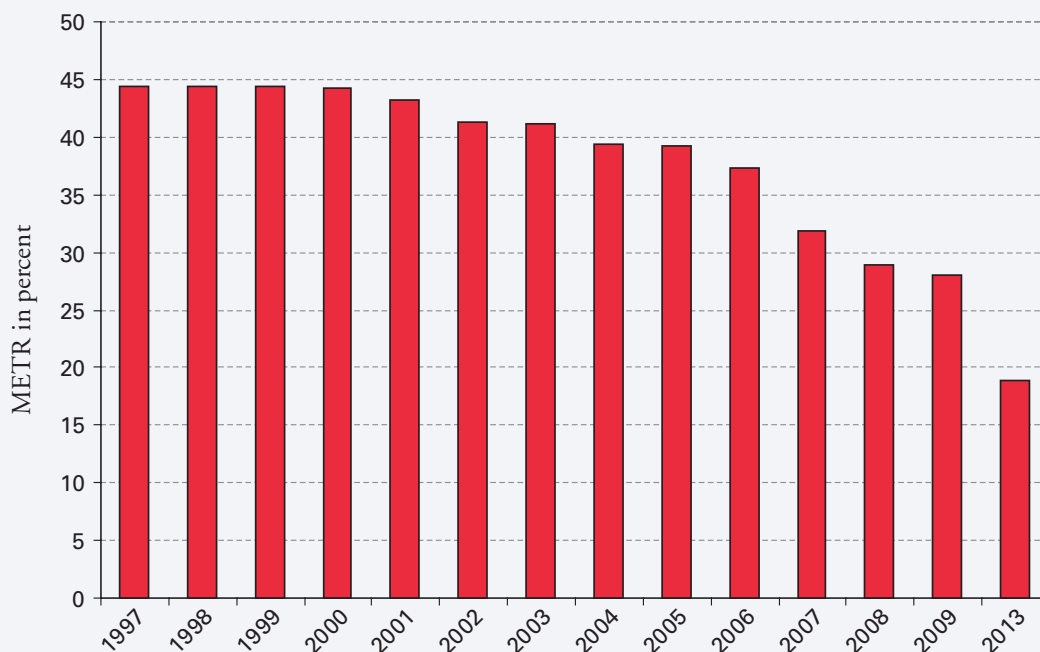
3 Excluding \$2.9 billion of benefit enhancements announced in Budget 2009 that Ottawa has committed not to count among the funds to be replenished in future years.

4 As measured by the average length of the last 11 US business cycles (National Bureau of Economic Research 2009). Cross (1996) shows Canadian business cycles roughly mimicking US cycles.

5 With total fertility rates fixed at 2007 levels throughout the projection period, our demographic model assumes that trends in life expectancy and international migration continue at recent six-year historical averages. Under these assumptions, our model predicts that the expansion of the workforce will rely more heavily on immigration than in the past as baby boomers begin to exit the labour force over the next decade.

6 We assume the economy will reach its long term potential growth by 2015, at which point the economy will have caught up to its potential level of output.

Figure 1: Declining Marginal Effective Tax Rates on Capital Canada, Industry Aggregate



Source: Chen and Mintz (2006, 2009).

Table 1: Economic Assumptions and Revenue Projections

	2009	2010 to 2015					
Underlying Assumptions	Department of Finance Canada, Update of Economic and Fiscal Projections, September 2009, Tables 2 and 5.	Productivity growth per hours of work continuing at its 20-year historical average; labour supply per capita decreasing according to demographic projections but adjusted to reflect a rebound of employment; GDP inflation assumed at 2 percent per year. Federal tax revenues and EI premium revenues are derived from Department of Finance's projected revenues as a share of GDP. Other federal revenues are as projected in the Update of Economic and Fiscal Projections					
	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
Economic Growth (%)							
Real GDP growth	-2.3	2.8	3.1	3.1	2.5	2.4	2.0
GDP inflation	-2.3	2.0	2.0	2.0	2.0	2.0	2.0
Nominal GDP growth	-4.6	4.8	5.1	5.1	4.5	4.4	4.0
Federal Revenue Projections (\$ billion)							
Taxation Revenues	176.5	190.4	202.5	213.8	224.9	236.4	245.9
EI Premiums	16.4	17.3	19.5	22.0	24.5	25.8	24.4
Other Federal Revenues	23.9	26.9	30.1	33.0	33.5	32.7	33.0
Total Revenues	216.8	234.6	252.1	268.8	282.9	294.8	303.3

Sources: Canada (2009a) and authors' calculations.

Table 2: Path of Direct Program Spending Required to Bring the Federal Budget Back to Surplus by 2015/16

	2009/10	2015/16
Direct Program Expenses (\$billion)	120.7	114.9
Minus temporary stimulus expenses	-18.7	-0.6
Underlying Expenses	102.0	114.3
Projected Required Annual Average Growth Rate (%) of Underlying Direct Program Expenses (2009/10 to 2015/16)		
	<i>Nominal</i>	1.9
	<i>Per capita</i>	1.0
	<i>Inflation-adjusted per capita</i>	-1.0

Source: Authors' calculations as described in text.

Table 3: Real Per Capita Direct Program Expenses Past and Projected

	Average Growth Rate (%)	End-of-Cycle Level (2008 constant \$)
Projected Required Path 2009/10* to 2015/16	-1.0	2,927
Shadow Budget Proposed Path 2009/10* to 2015/16	-0.5	3,023
Previous Business Cycles		
2001/02 to 2009/10*	3.3	3,104
1992/93 to 2001/02	-1.0	2,397
1983/84 to 1992/93	-1.2	2,615

*Excluding temporary stimulus spending
Source: Authors' calculations as described in text.

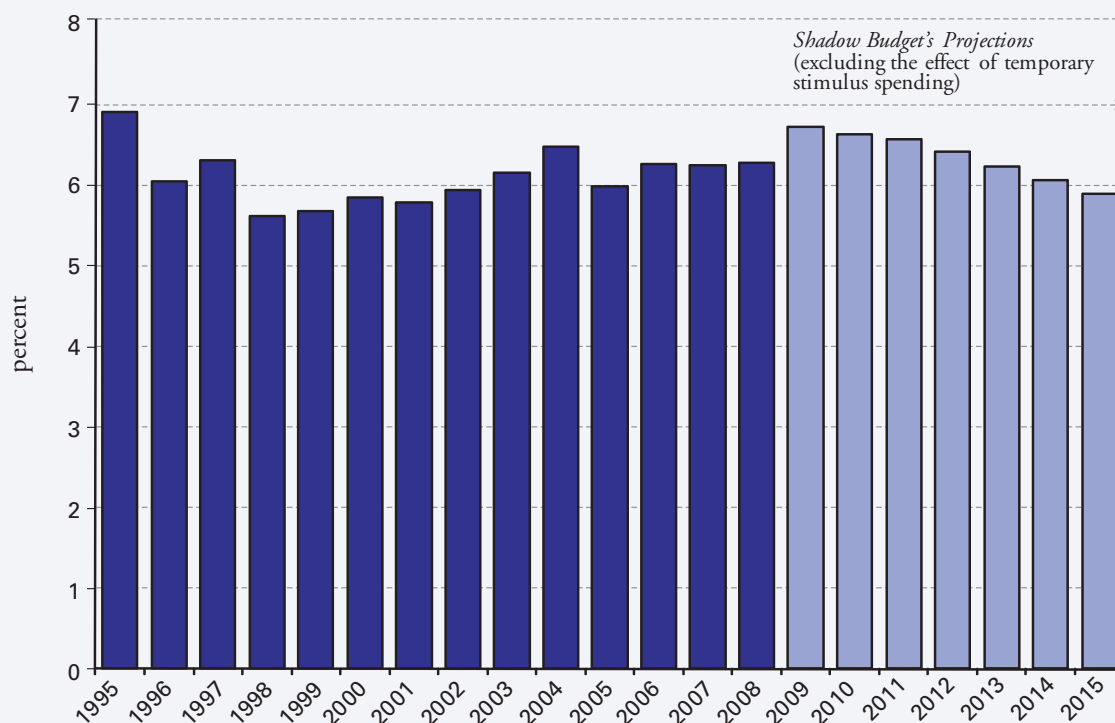
Presuming no change to the tax structure, budgetary revenues would stand at about \$303 billion by 2015/16, or 15.2 percent of GDP (Table 1). Notwithstanding our reservations expressed above, EI premium revenues are assumed to grow at a healthy pace, following federal projections and consistent with premium rate hikes legislatively mandated.

2. Revenue Implications for Program Spending

Given this path for revenue – and assuming transfers to provinces, territories and persons grow as projected in the fiscal update – what path for program spending would yield balance in 2014/15 and surplus in 2015/16? Direct program expenses⁷ – excluding temporary stimulus spending – would need to grow by only 1.9 percent per year on average for the next six years (Table 2).

⁷ Direct program expenditures are expenses associated with programs directly delivered by the federal government. More than 60 percent of direct spending is composed of the operating expenses of the federal government – such as the cost of public servant's compensation, national defence, food inspection, the Coast Guard, the federal court system, the operation of health facilities for natives and veterans, and the national parks system – more than 30 percent is made up of various grants and contributions administered by departments, and less than 10 percent is made up of amounts appropriated to Crown corporations (proportions based on fiscal year 2008/09).

Figure 2: Direct Federal Program Expenses as a Percentage of GDP



Sources: Canada (2009a) and authors' calculations.

From one perspective, this is not a tremendously ambitious goal: similar declines have occurred before. The level of spending required by 2015/16 would, after adjustment for inflation and population growth, still exceed the marks set at the end of two of the last three business cycles (Table 3), and would be roughly equivalent to its 2008/09 level. From another perspective, however, it is a challenge: it means real per capita direct program spending decreasing 1.0 percent a year on average from its current level.

The recommendations in this Shadow Budget would take real per capita direct spending down by about half of the required amount, leaving direct program expenses at the same share of GDP they represented in 2002 (Figure 2). The bulk of the remaining required savings comes from cuts in tax expenditures and provincial/territorial transfers. A shift in debt management that reduces expected debt charges rounds out the recommended improvements to the budget balance.

Priorities for the 2010 Federal Budget

As noted at the outset, a planning period of six years is long enough that a measure of prudence seems sensible to allow for events that may trigger new spending or lower revenues. For this reason, we aim for a budgetary surplus of nearly \$5 billion at the end of the period and a debt-to-GDP ratio of 30 percent – five percentage points above the pre-recession target of 25 percent, but down from its peak of 35 percent in 2010/11 (Table 4 on page 14).

1. Measures to Restrict Direct Spending

EXPENDITURE REVIEW AND REALLOCATION: The spending restraint of the mid-1990s, so critical in restoring federal fiscal health, required careful prioritizing. The reviews scaled back federal obligations, not only in high-profile areas such as EI and transfers to the provinces, but also in areas such as Crown corporation subsidies and the government's own operating expenditures.

Estimated Annual Cost Savings (\$ million)						
	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
Expenditure review and reallocation	250	500	750	1,000	1,250	1,500

A similar expenditure review and reallocation, of all aspects of government expenditures, operating and capital outlays alike, is now needed. Government programs, grants and contributions need scrutiny against a set of familiar questions:⁸

- Is there a legitimate and necessary role for government in this program area or activity, or could the private and voluntary sectors play a greater role?
- Does the initiative give Canadians value for their tax dollars? Have options for achieving lower delivery costs – through, for example, technology, public-private partnership or third-party delivery – been properly exploited?
- Is the federal government acting within its well-known constitutional responsibilities? Is there overlap and duplication with another order of government, and is the program a candidate for realignment with the provinces?

A rigorous evaluation of federal activity, according to the above criteria, can restrain growth in program spending.⁹ It is important, however, to be realistic about the available gains. While expenditure reviews in 2005 and 2006 identified nearly \$12 billion of cumulative savings over five years, most of these were to be realized through efficiency gains, which are difficult to calculate and verify, and overall, federal spending accelerated

during this period. Recognizing that expenditure reviews tend to be implemented incompletely, we target savings that grow incrementally from about 0.25 percent of overall direct spending in the first year to reach about 1.2 percent in the sixth year (see above).

RESTRAINING FEDERAL PUBLIC SERVICE EMPLOYMENT:

The number of federal public servants has grown rapidly in the last 10 years. Growth of federal employment,¹⁰ excluding military personnel, exceeded general population growth by nearly 3 percent a year on average from 1999 to 2008.

The federal government should scale back employment by about 0.7 percent per year for the next six years, which would return it, relative to total population, to its average level of the last 10 years. Ideally, this would be accomplished by merit-based considerations. Because federal workforce management is currently seriously constrained by practices that reflect its non-market setting, however, attrition will inevitably be the principal means for realizing this reduction. We note that data from the Public Service pension plan suggests that nearly 20 percent of current plan contributors are nearing retirement.¹¹ If the government were simply to eliminate one of every five positions that become open through retirement, it would achieve the reduction we recommend (see below).

Estimated Annual Cost Savings (\$ million)						
	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
Containing federal government employment	237	489	755	1,036	1,333	1,647

⁸ See, for example, the federal spending review announced in December 2003 with the creation of an Expenditure Review Committee.

⁹ Parliament, which reviews and annually authorizes about one third of federal (non-statutory) spending plans, has a complementary oversight role in prioritizing spending.

¹⁰ Federal employees common to Treasury Board of Canada Secretariat, Public Service Commission of Canada and Statistics Canada statistical universes.

¹¹ About 17 percent of federal Public Service pension plan contributors have more than 25 years of service.

REDUCING THE CURRENT SERVICE COST OF

DEFERRED COMPENSATION ARRANGEMENTS: The federal government has many deferred compensation arrangements for its employees, including health and pension benefits. On the pension front, the largest obligations are for the Public Service (PS), Canadian Forces (CF) and Royal Canadian Mounted Police (RCMP) pension plans. At their inception decades ago, these plans were completely unfunded; since 2000, employees' and government contributions have been invested and managed independently by the Public Sector Pension Investment Board. In the early 2000s, government (employer) contributions covered nearly 75 percent of the current service cost of new benefit accruals. With employee contributions growing more rapidly than government contributions, this ratio is now reduced to about 68 percent, and the latest triennial actuarial reports for the PS, CF, and RCMP pension plans together are expecting that this ratio will continue to decline to about 64 percent in 2015 due to planned legislated employee contribution rate increases.

We think that the federal share of the current service cost of new pension accruals should shrink further. Contributions to most public-sector pension plans, including in Ontario, Québec, and Alberta, are shared more evenly, with about 50 percent from the employer and 50 percent from employees. 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 55 percent of the cost of contributions. The Ontario Teachers' Pension Plan and the Ontario Municipal Employees Retirement System (OMERS) both have equally shared contributions.

One method to increase the portion of the cost borne by employees would be simply to further raise their contribution rates. Another method, which might be more acceptable to the employees if it reduced the contributions they would otherwise have to pay, would be to lower the total cost of these plans by amending their benefits, which offer federal employees far richer retirements than their private-sector counterparts.¹²

In particular, these plans contain early retirement provisions resulting in members spending, on average, more time in retirement than working and contributing to the plan. Over the past three years, members of the PS pension plan – the largest of all – retired from the public service at age 58 on average. After contributing for 26 years, they are expected to draw on their pensions for another 27 years – or a few years longer, factoring in survivors' benefits. Members of the RCMP and CF pension plans retired at 54 and 48 on average with, respectively, 31 years of service for 32 in retirement, and 25 years of service for 39 in retirement. Any change contributing to a greater average length of *service* would have a significant impact on the financial position of these plans.

Another alternative would be to adopt some hybrid pension-plan features, resulting in a different risk-sharing formula between the employer and employees. Whatever the route chosen, the objective is to gradually even out the employer and employee portions of the current-service cost of federal pension plans, resulting in a contribution ratio of about 50/50, similar to that of most other public-service pension plans in Canada (see below).

Estimated Annual Cost Savings (\$ million)						
	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
Gradually equalizing employer/employee cost sharing of PS, RCMP and CF pension plans	103	208	312	486	676	882

12 A fair-value approach to these plans puts the value of benefits accrued in 2008/09 at some 34 percent of covered pay for the Public Service Plan, and about 41 percent of pay for the RCMP and Canadian Forces Plans (Laurin and Robson 2009). By contrast, in the case of individuals saving on their own, the *Income Tax Act* prevents them from putting more than 18 percent of earnings or \$22,000 into an RRSP, whichever is the lowest.

Estimated Annual Cost Savings (\$ million)						
	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
Military spending grows in line with its current real per capita level	492	966	1,363	1,504	1,567	1,633

STABILIZING THE GROWTH OF NATIONAL DEFENCE SPENDING: Since 2000, spending on Canada's military has grown by about 8 percent annually, or nearly three percentage points faster than other direct government spending. These rapid increases were necessary to arrest the decline in Canada's military capability, and to better equip our armed forces for their role in an unstable world.

Efficiencies are available in this area. The extensive use of reservists, for example, has allowed the Canadian Forces to leverage core resources. As Busby (2010) has shown, a modest investment of \$8 million annually could make Canada's reliance on reservists more robust, by supporting their employment in civilian life.

Importantly, the end of Canada's military presence in Afghanistan, planned for 2011, will generate sizable cost savings to be reallocated to other military purposes. The Parliamentary Budget Officer estimated the annual operating cost of Canada's armed forces in Afghanistan at about \$1.5 billion (PBO 2008).¹³

The reallocation of cost savings from the withdrawal of our troops from Afghanistan creates an opportunity to limit the expansion of spending on National Defence without lowering our military capacity. Therefore, growth in military spending should be constrained to a rate not exceeding inflation plus population growth for the next six years (see above).

SUBSIDIES TO CROWN CORPORATIONS: Subsidies to Crown corporations have grown rapidly in recent

years, spurred more recently by measures to cushion the recession. Yet the distinguishing feature of Crown corporations as opposed to government departments is that they operate in a commercial environment, which should imply consistent attention to the bottom line. This shadow budget therefore proposes to gradually reduce subsidies to Crown corporations from their currently planned level by 5 percent in the first year to reach 10 percent in five years (see below).

2. Review of Tax Expenditures

The tax system is used by the federal and provincial governments to attain various economic and social objectives. These objectives are achieved through a number of tax measures – such as exemptions, deductions, rebates, deferrals or credits – that are generally referred to as tax expenditures, because they represent a cost to the treasury by reducing government revenues. In the Finance Canada assessment of tax expenditures, more than 170 federal tax measures are listed, with the amount of foregone revenues ostensibly exceeding more than a third of the total value of all taxes collected (Canada 2009b).

Using the tax system in this way is fraught with problems that distort taxpayer choices and compromise its core revenue-raising function. Tax preferences make the system more complex, sometimes facilitating and often encouraging tax avoidance, and raising compliance costs for both taxpayers and tax collectors. Preferences directed at particular sectors, industries or activities – such as

Estimated Annual Cost Savings (\$ million)						
	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
Reducing subsidies to crown corporations	380	456	532	608	684	760

¹³ For fiscal year 2007/08.

Estimated Annual Cost Savings (\$ million)						
	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
Review of tax expenditures	600	900	1,200	1,200	1,200	1,500

accelerated depreciation for manufacturing and processing, the Atlantic Investment Tax Credit or the small business tax deduction – shift resources away from more efficient uses and locations (Chen and Mintz 2009).

On the personal side, tax preferences designed to encourage activities deemed socially desirable – examples include the First-Time Home Buyers' Tax Credit, the Home Renovation Tax Credit, the Public Transit Tax Credit, or the Children's Fitness Tax Credit – inevitably subsidize people who would do these things anyway. Narrowly targeted tax incentives may also result in price increases from suppliers, thereby reducing the benefit of the tax incentive for those to whom it was directed and undermining its effectiveness (Chen and Mintz 2009).

An incentive with well-documented flaws is the federal credit for investment in labour-sponsored venture capital corporations (LSVCC). This tax subsidy has lured retail investors' money into numerous ventures across Canada, resulting in individuals with relatively modest wealth and small investment portfolios investing a portion of their retirement funds in very risky securities. Also, outside Quebec and providing that a minimum holding period has been met, these venture capital funds are as liquid as many mutual funds, compelling LSVCCs to retain a relatively sizable portion of their investments in more liquid instruments to meet expected withdrawals. LSVCCs have become a dominant source of venture capital in Canada, likely crowding out private venture investment (Cumming 2007). The fact that they would likely not survive in the absence of the tax credits is evidence that these resources are likely not routed to their best uses.

Because governments can use either tax measures or program spending to achieve their public policy goals, the cost of tax measures should be assessed in light of the cost of alternative programs that might achieve the same objective. For example, the complete elimination of tax expenditures mentioned above would have yielded more than

\$4 billion of additional tax revenue in 2009. This shadow budget urges a rigorous and ambitious review of all tax expenditures to identify and rapidly phase out those failing the tests of economic efficiency and cost effectiveness (see above).

3. Limiting Growth in Federal Transfers to Provincial/Territorial Governments

In 2008/09, major federal transfers to the provinces and territories in support of health and social programs exceeded \$33 billion: federal taxes thus funded about a quarter of the provincial/territorial cost of delivering the services these transfers are intended to help finance. This overlap creates confusion over who is responsible for funding and delivering public services, making it difficult to identify which government is responsible when taxes exceed, or programs fall short of, voters' expectations. Stress within the federation would be reduced, and political accountability for public-service delivery increased, if Canadians paid more of their taxes to the level of government that spends them on delivering the services voters want and need (Poschmann and Tapp 2005). The simplest way to do so is for the federal government to tax voters less and transfer less to the other jurisdictions.

A previous federal budget lowered the GST by two percentage points, creating room for provinces to raise the taxes of their choosing to suit regional preferences and spending needs. Such change at the provincial level should entail a shift to consumption-based, value-added taxes such as the HST, and away from antiquated retail sales taxes, with transitional financial support from Ottawa. Three Atlantic provinces have made this shift, and Ontario and British Columbia plan to do so by mid-2010. However, as provinces take on more responsibility for financing activities in areas that are their constitutional responsibility, federal transfers should shrink in relative terms.

Estimated Annual Cost Savings (\$ million)						
	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
Limiting growth in federal transfers to provinces and territories	0	0	0	0	1,146	2,369

Federal transfers to the provinces and territories in support of health and social programs are set in current federal legislation through 2013/14, following federal-provincial negotiations. This shadow budget therefore proposes to freeze major federal-provincial transfers in support of health and social programs at their 2013/14 levels for five years, after federal-provincial accords and current legislation expire. This will provide the federal government more fiscal room for tax relief, explicitly leaving tax room available for provincial/territorial governments to occupy (see above).

4. 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 important opportunity to reduce the federal government'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 (RRBs), which promise repayment of their principal with adjustment for increases in the price index. Because these bonds protect investors from inflation, their yield is lower than the yield on ordinary bonds, which do not. Yet the difference between the yield on RRBs and the higher yield on nominal-return bonds, which would be close to 2 percent if the markets for the two bonds were similar and commitment to the inflation target were fully credible, is typically larger than that. It averaged 2.36 percent from 2001 to 2007, and after dipping during the crisis, widened to 2.55 percent at the end of 2009.

One frequently cited reason for the spread being wider than 2 percent is that the yield on RRBs is low because their supply is so small relative to the demand for them. RRBs are an excellent investment for pension funds and retirement savers generally, and the roughly \$34 billion of them that are outstanding are mostly in the hands of these

long-term investors. By satisfying more of this demand, Ottawa could save on interest costs, thereby funding its debt more cheaply than through issuing higher-yield nominal-return bonds.

Another critical reason for the spread being wider than 2 percent is that the commitment to 2 percent inflation is not perfectly credible. Investors in ordinary nominal-return bonds demand more than just compensation for the 2 percent inflation that the government and the Bank of Canada have promised. They also want an extra premium for insurance against the possibility that inflation ends up being higher than 2 percent. This premium presents an additional opportunity for a government truly committed to containing inflation. Ottawa could make its commitment to lower inflation more credible by issuing more debt that it cannot debase through surprise inflation. In so doing, it could reduce the interest rate it would otherwise have to pay on nominal-return bonds.

AN EXPANDED RRB PROGRAM: ESTIMATING THE INTEREST SAVINGS: In each of the past two years, Ottawa issued \$2.2 billion in RRBs. This Shadow Budget proposes an aggressive expansion of this program, increasing the issue of RRBs to \$10 billion annually in each of the next six years – a pace sufficient to ensure that the share of RRBs in total bonds outstanding grows, despite the massive amount of borrowing Ottawa will undertake in the near term. We estimate two types of interest saving from an enhanced issue of RRBs:

- (i) To begin with, it straightforwardly lowers the cost of servicing new debt. At the recent spread of 2.55 between the two types of bonds, the saving from lower interest payments would exceed the cost of indexing the principal of the RRBs by an amount averaging some \$200 million in the latter half of the projection period.
- (ii) The second source of saving arises from the additional credibility for the inflation target this aggressive program of RRB issuance would provide – the government is, in effect, putting its

Estimated Annual Cost Savings (\$ million)						
	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
Better debt management	74	179	293	400	499	578

money where its mouth is. Our estimates here are necessarily more speculative: in the short run, the impact on nominal bond yields of enhanced credibility for the government's inflation target would probably be marginal. However, over time – especially as fears that the United States will monetize its unsustainable public debts push bond yields up south of the border – we anticipate that the impact would grow. In our projections, we allow for a yield benefit to the government, evident on all nominal-return bonds, of five basis points in the first year, increasing five basis points per year until it amounts to 30 basis points (over 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 RRBs themselves relative to their nominal counterparts would be smaller. The combined interest saving from the more aggressive RRB issuance program, after netting out the relevant interest saving from replacing nominal-return bonds with RRBs, is shown above.

5. Tax Initiatives

CHANGES TO THE REGULATORY ENVIRONMENT FOR PENSION PLANS: A scan of recent governmental reviews, the 2009 federal discussion paper (Canada 2009c), and recent pension-related initiatives reveals the large extent to which defined-benefit (DB) pension plans preoccupy policymakers. Their decline in the private sector is an area of concern for many, and their recent troubles have prompted accommodation in funding requirements and some outright bailouts. Policy toward defined-contribution (DC) plans or Registered Retirement Savings Plans (RRSPs) has been less supportive, worsening their problems and inhibiting their improvement. We need to improve the policy

environment around DC/RRSP savings to facilitate the private-sector development of new employer/employee risk-sharing formulas that help to solve challenges faced by both DC and DB plans.

This budget proposes to adopt key changes to the *Income Tax Act* with respect to DC/RRSP arrangements found in Robson (2010). Among the list of recommendations would be to provide more tax-deferral room for DC/RRSP savers. Using the federal Public Service Plan as a benchmark would suggest that the maximum percentage of income should be 34 percent (Laurin and Robson 2009, 3); a proportional rise in the dollar limit would bring it to \$42,000. Also, the age at which people lose access to tax-deferred saving and must start decumulating should rise from 71 – say to 73. Further, once savers have moved into the decumulation phase, with Registered Retirement Income funds (RRIFs) or Life Income Funds (LIFs) the pension credit should apply regardless of age. They should also have the same spousal income-splitting opportunities as registered plan members. Another step would be to alleviate the tax disadvantages of group RRSPs by (i) letting sponsors and/or participants deduct some administrative expenses currently levied against plan assets from outside income, and (ii) removing federal payroll taxes from employer contributions. As for mandatory rapid drawdowns from RRIFs and LIFs, current rules can force people to deplete their assets too quickly, which points to the need to revisit the current formula or simply abolish these rules.

Of all of these initiatives, raising the annual tax-deferred contribution limit would be the most costly. However, on a present value basis, the cost of this measure is small: it mainly affects the timing of federal revenue. Overall, the cost of these measures is small, and can be phased in or out at different rates.

REFORMING CORPORATE GROUP TAXATION:

Canada's approach to corporate group taxation gives rise to a number of problems, including higher administrative and transaction costs,

unfairness among different types of corporations, uncertainty, and weakened international competitiveness. Also, the web of intragroup transactions and structural changes needed to achieve some degree of tax consolidation adds complexity and artificiality to the tax system and the business environment since the sole purpose for these business activities is to gain a tax advantage. These concerns point to the need for the introduction of a comprehensive federal-provincial statutory framework allowing for the transfer of profits and losses among domestic members of a corporate group for federal and provincial tax purposes (Laurin 2009). This proposed group-taxation regime would increase the ability of firms to use tax losses and use them more quickly, thereby reducing the economic costs associated with partial loss refundability. This budget proposes a study of potential group taxation regimes which, if implemented, would bring the Canadian tax base in line with international norms.

MODERNIZING CANADA'S SYSTEM OF INTERNATIONAL TAXATION: Canada's approach to taxing active business income of foreign affiliates of Canadian corporations allows those affiliates to repatriate earnings on a tax-exempt basis if the foreign affiliate is resident in a jurisdiction with which Canada has a tax treaty or, since 2008, if Canada and the host jurisdiction have announced negotiations to establish a Tax Information Exchange Agreement (TIEA). However, many Canadian corporations invest in foreign affiliates that earn active business income in jurisdictions with which Canada has no tax treaty, nor negotiations respecting a TIEA, nor any reasonable prospect of doing so in the near future. Earnings of Canadian corporations could be more readily reinvested at home and abroad, if the exemption system were extended to cover all active business income of controlled foreign affiliates, irrespective of the existence of a tax treaty or negotiations to establish a TIEA. The domestic revenue impact of such an approach would be small.

IMPROVING FUEL TAX ACCOUNTABILITY: There exists an elaborate mechanism for distributing federal fuel taxes to municipalities in support of infrastructure spending. While municipalities

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. This measure will be cost neutral.

OTHER TAX INITIATIVES SHOULD THEY BECOME AFFORDABLE: As economic outcomes improve, debt repayment may be accelerated, and tax initiatives that would otherwise await the development of larger surpluses could be brought forward. Revenue changes that promise important economic gains appear in Box 1.

Pulling It Together

This shadow budget has proposed a suite of expenditure reduction measures aimed at restraining government spending growth and balancing the budget within five years, at a pace consistent with Canadians' long-term capacity to pay taxes at internationally competitive rates. Given the longer-term horizon of budget planning, these proposals are enacted against a relatively prudent fiscal framework. The focus of this shadow budget has been to restore federal fiscal sustainability; however, a surplus will emerge by the end of the fiscal projection period, enabling the federal debt-to-GDP ratio to fall back to its 2008/09 level (Table 4). As fiscal room grows, future budgets will contemplate reducing federal debt and enacting other initiatives, such as those proposed in Box 1.

This Shadow Budget will bring the federal budget framework into line with the needs of an economy challenged by population aging as a shrinking labour force is asked to pay for the services of a growing portion of the population. Restoring fiscal health will provide the flexibility necessary to enable Canadian competitiveness to thrive, and help Canadians save and invest for future prosperity.

Box 1: A Short List of Tax Initiatives Should They Become Affordable

Extending the basic personal amount to all individual investors: While Canadian individual investors benefit from a basic personal exemption that shields income below \$10,382 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.

Elimination of withholding taxes on cross-border dividend payments: Canada generally levies a withholding tax on cross-border dividend payments. A 15 percent withholding tax apply on portfolio investments paid to residents of the United States and other tax treaty nations and a 5 percent rate applies on 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 made to US investors and on arm's length interest payments made to all investors, regardless of their country of residence. New US tax treaty agreements signed with its main trading partners provide that cross-border dividends paid by a subsidiary to its parent company are completely exempt from withholding taxes, while rates on portfolio dividends have been reduced (Laurin 2007). This budget proposes to initiate treaty negotiations with the United States to provide for the reciprocal elimination of withholding taxes on all cross-border dividend payments. The elimination of withholding taxes on dividends and interest would result in an increase in capital investment in Canada of approximately \$28 billion, and an increase in income of more than \$7.5 billion annually (Mintz 2001).

Extending the Dividend Tax Credit: Many current or soon-to-be retirees have suffered from the financial crisis, and sponsors of defined-benefit pensions face pressure to fund their plans with cash they could otherwise use to pay workers and suppliers, and make capital investments. The existing dividend tax credit (DTC) provides relief for taxable investors receiving dividends when the business has paid tax prior to distribution, but dividends paid into retirement saving plans get no equivalent relief. Extending the DTC to retirement savings plans receiving dividends from tax-paying businesses will alleviate some need for new saving by individuals and plan sponsors in the short run, and remove a distortion in Canada's tax system in the long run.

Eliminating Regionally Extended Employment Insurance Benefits: The EI program is built around a multitude of policy objectives. Regional income support goals are blended into the regular benefit program, significantly weakening the program's ability to perform its original function: insurance against involuntary, temporary and unanticipated loss of income. Adopting uniform entrance requirements and uniform benefit durations would eliminate the unfairness inherent in the provision of benefits based on regional unemployment rates (Busby et al. 2009). Reforms must also not encourage the further development of seasonal employment patterns that tend to couple with EI benefits. Modulating the new, universal benefit standards with the national unemployment rate should help remedy this problem. Regionally extended benefits, intended to supplement the income of workers in regions affected by structural unemployment, reinforce the persistence of unemployment and reduce economic incentives to adjust to labour-market conditions. They should be left outside of the EI program, and dealt with by other means, such as federal or provincial transfers funded by general revenue.

Table 4: Summary of Measures and Fiscal Projections

	2008/09 actual	2009/10	2010/11	2011/12	2012/13 projections	2013/14	2014/15	2015/16
<i>(\$billion)</i>								
Projected Revenues								
Taxation Revenues	191.6	176.5	190.4	202.5	213.8	224.9	236.4	245.9
EI premiums	16.9	16.4	17.3	19.5	22.0	24.5	25.8	24.4
Other revenues	24.6	23.9	26.9	30.1	33.0	33.5	32.7	33.0
Total Revenues	233.1	216.8	234.6	252.1	268.8	282.9	294.8	303.3
Projected Expenses based on Latest Fiscal Update								
Direct program expenses	99.7	120.7	117.2	113.5	117.4	120.0	122.3	124.6
Transfers to persons	61.6	69.5	71.4	71.0	72.5	74.3	76.8	79.1
EI benefits	16.3	22.1	22.0	19.2	18.4	17.6	17.9	17.9
Other personal benefits	45.3	47.4	49.4	51.8	54.1	56.7	58.9	61.2
Transfers to other levels	46.5	51.8	56.0	56.1	56.9	59.7	62.3	65.0
Gross debt charges	31.0	30.7	33.7	37.6	41.0	41.9	41.9	42.5
Total expenditures	238.8	272.7	278.3	278.2	287.8	295.9	303.3	311.2
Budgetary Balance								
before Initiatives	-5.8	-55.9	-43.7	-26.0	-19.0	-13.0	-8.4	-7.9
Initiatives:								
Expenditure review and reallocation			-0.3	-0.5	-0.8	-1	-1.3	-1.5
Containing federal government employment			-0.2	-0.5	-0.8	-1.0	-1.3	-1.6
Gradually equalizing employer/employee cost sharing of PS, RCMP and CF pension plans			-0.1	-0.2	-0.3	-0.5	-0.7	-0.9
Military spending grows in line with its current real per capita level			-0.5	-1.0	-1.4	-1.5	-1.6	-1.6
Reducing subsidies to crown corporations			-0.4	-0.5	-0.5	-0.6	-0.7	-0.8
Review of tax expenditures			-0.6	-0.9	-1.2	-1.2	-1.2	-1.5
Better debt management			-0.1	-0.2	-0.3	-0.4	-0.5	-0.6
Limiting growth in federal transfers to provinces and territories							-1.1	-2.4
Change to debt charges				-0.1	-0.4	-0.8	-1.3	-1.9
New Budgetary Balance	-5.8	-55.9	-41.5	-22.2	-13.4	-5.9	1.2	4.8
<i>Accumulated Deficit</i>	<i>463.7</i>	<i>519.6</i>	<i>561.1</i>	<i>583.3</i>	<i>596.7</i>	<i>602.6</i>	<i>601.5</i>	<i>596.6</i>
<i>Debt-to-GDP Ratio (percent)</i>	<i>29</i>	<i>34</i>	<i>35</i>	<i>35</i>	<i>34</i>	<i>33</i>	<i>31</i>	<i>30</i>
Sources: Canada (2009a) and authors' calculations.								

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