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Backgrounder

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Lower Taxes, Focused Spending, Stronger Federation

A Shadow Federal Budget for 2006

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The Backgrounder in Brief

Setting federal finances on a constructive path requires regaining control over burgeoning spending. This Shadow Budget shows how lower federal transfers and operating costs create room for tax relief, in the form of a lower GST and lower income-tax rates. Besides promoting economic growth, tax relief offers provinces room to become more financially self-sustaining, enhancing flexibility and accountability in Canada's federation.

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Since 2000, federal program spending has rocketed ahead at an annual rate of more than 8 percent, a pace far ahead of what was promised in each year's federal budget. Maintaining such a pace — one exceeding the Canadian economy's potential growth rate — would necessitate a relentless rise in federal taxes. The principal challenge addressed by this Shadow Budget is twofold: matching the pace of federal program spending to the needs of the country while lowering federal taxes, and keeping the probability of a deficit low enough that Canadians can be confident that federal finances are sustainable.

For these reasons, this Shadow Budget proposes a major reorientation in federal spending, a reorientation that would reduce transfers in non-core areas and rigorously hold the line on operating costs. It not only lowers the Goods and Services Tax, it enhances Canada's growth prospects by lowering income taxes.

A new Parliament and a government with new priorities create an opportunity to recast federal fiscal planning. Since the federal budget moved out of deficit in 1997/98, padding of the bottom line and unwillingness to plan for significant surpluses have fostered massive unbudgeted increases in spending. The government will hold itself accountable for hitting the spending targets in this budget. As for the future, it proposes a new approach that will let Parliament set plans for taxes and spending that will be better able to cope with the unexpected.

Economic and Fiscal Outlook and Challenges

The economic backdrop for fiscal planning is solid. Growth in Canada's major trading partners has combined with strong domestic demand to support steady expansion of output and employment.

Economic Developments and Outlook

With rising productive capacity underpinned by healthy business investment, the Bank of Canada has kept inflation on target with only modest increases in the overnight interest rate. As the contribution of rising natural resource prices to GDP inflation tapers off, continued stable-inflation expansion should yield an annual average growth in nominal GDP of about 5 percent through the 2006-to-2010 budget planning period, and interest rates should continue to rise gradually toward long-term equilibrium levels (see Table 1).

Fiscal year 2005/06 saw a continuation of a familiar pattern, as revenues came in well above projections. Even with lower income taxes, buoyant tax bases will create additional room for further tax reductions in 2006/2007 and beyond.

Offsetting this good news, unhappily, is another now familiar phenomenon: spending far exceeding what was budgeted in the spring of 2005. In the wake of a stunning $17.7 billion over-run the previous year, current figures suggest that the federal government has overshot the spending increase promised in the spring 2005 budget by another sizeable amount.

We thank Yvan Guillemette and Jack Mintz for comments. Supporting documentation on taxation, federal spending and fiscal federalism are available at www.cdhowe.org.

Table 1: *Key Economic Indicators*

	2005	2006	2007	2008	2009-10
			percent		
Real GDP Growth	2.9	2.9	3.0	3.0	3.0
GDP Inflation	3.1	3.2	1.8	1.9	1.9
Nominal GDP Growth	6.1	6.1	4.8	4.9	4.9
3-Month Treasury Bill Yield	2.7	3.8	4.2	4.2	4.2
Long Government Bond Yield	4.1	4.8	5.4	5.5	5.6

Source: Statistics Canada, CANSIM; Department of Finance (2005); authors' calculations.

The language of recent federal budgets has emphasized fiscal prudence, but to let this most recent overrun raise the base for future spending would not be prudent. Spending increases on that scale would shortly outrun even status-quo projections for revenue, leaving surpluses so small that even the foreseeable setbacks contemplated in the projections by the reserves for contingencies and economic prudence would put the budget back into deficit. Table 2 shows the outlook, which includes the spending and tax changes contained in the November 2005 Economic and Fiscal Update, as well as the changes to the tax treatment of dividend income announced later in the year.

Challenges and Priorities

Along with headline commitments with immediate fiscal implications — a lower GST rate and a new benefit for all families with young children — this Shadow Budget moves to address the gaps in accountability and impediments to effective delivery when federal programs overlap with provincial responsibilities. A slimmer and more focused federal government will give the provinces more room to raise the revenue they need to meet the wants and needs of their citizens.

Correcting Excessive Spending

That the breakneck pace of program spending for the past five years was fuelled by the availability of money rather than by strategic planning, is clear from the fact that so much of this spending was not mentioned in the annual budgets. Along with serious tax relief and the better planning process outlined below, this budget refocuses federal spending on areas where federal competence and expected payoffs are high.

Reorienting Employment Insurance (EI)

Recent new payments to workers who routinely work less than a full year are undermining a decade-old effort to remake EI as an insurance backstop against unexpected and temporary unemployment. These new payments include "pilot" programs that pay extra weeks of benefits to claimants who would otherwise have exhausted their claims, and basing entitlements on claimants' highest-paid weeks

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

	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
			$ billions			
Taxes and Fees	214.9	224.4	235.3	244.7	254.7	262.1
Investment Income	6.8	6.8	6.8	6.8	6.8	6.8
Total Revenue	*221.7*	*231.2*	*242.1*	*251.5*	*261.5*	*268.9*
Program Spending	184.7	192.6	201.7	211.2	220.9	229.7
Gross Debt Charges	33.3	34.4	34.8	34.6	34.5	34.4
Total Expenditure	*218.0*	*227.0*	*236.5*	*245.8*	*255.4*	*264.1*
Primary Balance	30.2	31.8	33.6	33.4	33.8	32.4
Net Debt Charges	(26.5)	(27.6)	(28.0)	(27.8)	(27.7)	(27.6)
Total Balance	*3.7*	*4.2*	*5.6*	*5.6*	*6.1*	*4.8*
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	*3.7*	*1.2*	*1.6*	*0.6*	*0.1*	*(2.2)*

Note: Calculation of gross debt charges assumes debt paydowns equal to each year's contingency reserve.
Source: Receiver General for Canada (2005); Finance (2005); authors' calculations.

of work, rather than their most recent ones. This Shadow Budget proposes to end these uninformative pilots.

More fundamental EI reform will deliver economic gains and improve accountability and fairness. On the economic front, the elements of EI that truly provide income support for those who lose their jobs through circumstances beyond their control will, after 2006/07, exist as a separate program financed by risk-based premiums that reward employers with a low record of layoffs.

On the accountability and fairness front, other non-insurance elements of the program will be phased out by 2010/11, and the premiums that finance them will also disappear. Like the recent agreement with Quebec, by which premiums collected from Quebec workers fund additional parental and maternity EI benefits in that province, this change will leave provinces room to design supplementary labour-market and social programs as they see fit. Along with rigorous control of administrative costs, these changes will reduce EI premiums and federal EI spending by more than $6 billion between 2006/07 and 2010/11.

Supporting Children

Changes to federal child tax credits in 1992 targeted families with young children for income top-ups. Although subsequent expansions of the credits paid more nontaxable dollars to some families, they often raised the clawbacks on employment income, thereby lowering the net rewards from work. The program also fails to recognize the necessary costs of raising children that are unconnected to a family's income.

This budget therefore launches a new universal child benefit, which will provide a monthly cash payment of $100 per child aged six or under, to help families pay for childcare — whatever kind they choose. These new amounts will be taxable income: families whose income is so low they do not pay any tax will keep all of their new benefits; families with taxable incomes will pay tax at the same marginal rate as before; and higher-income families will give up in taxes a share of their benefits commensurate with their income.

The new benefit will begin July 1, 2006; the existing program of transfers to provinces for institutional daycare will continue for a transition period of one year after that.

Revamping Transfers to Provinces

The provinces' concerns about their capacity to fund programs in areas of their own responsibility often prompt them to call for more federal cash, and in the past five years such calls regularly resulted in increases in federal transfers. This chaotic pattern will change. This Shadow Budget proposes to return the Canada Health and Canada Social Transfers to their 2004/05 level by 2007/08, and to their 2003/04 level by 2008/09.

The counterpart of this change is lower federal taxes, which will allow the provinces to assume more control of these programs and more responsibility for financing them. By 2010/11, the measures outlined in the next major section of this Shadow Budget will reduce federal revenues by some $38 billion annually compared to the status-quo outlook. This is a sizeable ceding of fiscal room by the federal government, and until the provinces have taken advantage of it, what has become a more-than-annual trip to Ottawa to ask for more should stop.

Getting Equalization Back on Track

A program to lower federal tax rates and create room for more provincial revenue-raising must respond to the constitutional principle that provinces should be able to provide similar services at similar tax rates. But not all tax bases across the country are equally rich; the federal equalization program is intended to mitigate these disparities.

Recent ad hoc changes, however, have divorced equalization from this principle, setting it on a path to continued expansion regardless of provincial disparities. Pending the forthcoming recommendations of the Expert Panel on Equalization, this Shadow Budget maintains the total funding levels envisioned in the ad hoc arrangements through to 2010. The allocation of those funds is, however, subject to change in the event that the panel recommends a new formula that is sensitive to variations in provincial fiscal capacity. Any growth in the program after that date will depend on the revenue needs of provinces whose taxing capacity is below the national average.

Curbing Operating Spending

The federal government's recent expansion of grants to municipalities has created a web of entanglements as Ottawa has become involved in myriad decisions about

Table 3: *Impact of Spending Measures*

	2006/07	2007/08	2008/09	2009/10	2010/11
			$ billions		
Phase-out of non-insurance EI benefits	(0.4)	(0.7)	(4.5)	(6.6)	(8.8)
New Child Benefit	1.5	2.0	2.0	2.0	2.0
Changes in transfers to other levels of government	(0.5)	(3.8)	(10.2)	(13.0)	(14.5)
Restraint of subsidies and crown corp. expenditures	(6.5)	(8.6)	(10.7)	(12.3)	(14.5)
Savings in non-defence operations	(1.7)	(3.5)	(5.3)	(6.7)	(8.7)
Enhancement of armed forces' capacity	0.5	1.0	2.5	3.0	2.5
Impact of GST relief on indexation	s	(0.2)	(0.6)	(0.5)	(0.7)
Net Change in Program Spending	*(7.1)*	*(13.8)*	*(26.7)*	*(34.0)*	*(42.7)*

Note: s = small.
Source: Authors' calculations.

roads, water and sewage, transit, and other matters where it has little expertise or accountability. These programs will start to be phased out in 2006/07 and will end in 2007/08. The lowering of federal taxes will create room for provinces that wish to replace the federal funds with their own grants or let municipalities levy their own charges.

In only two years miscellaneous transfers to individuals, business and other groups have ballooned by more than one-fifth. This Shadow Budget will roll those transfers back to their 2004/05 levels in 2007/08, and will then freeze them. Subsidies to Crown corporations will receive the same treatment. In addition, other operating expenditures of government, which have also increased by more than one-fifth over the past two years, will show no nominal increase over the budget period.

Aside from further additions to the defence budget to rebuild the size of the Armed Forces and modernize their equipment, these changes will produce a marginal decline in program spending net of major transfers to persons and other levels of government over the budget period.

The total impact of these spending changes appears in Table 3. The table also shows the effect of GST on the transfer payments that protect their recipients from inflation, protection that will be less necessary when the GST is lowered.

Meaningful Tax Relief

The counterpart of these measures to reduce and refocus federal spending is lower federal taxes that will support economic growth and create fiscal room so that other levels of government can raise more of the revenue they need, rather than relying on federal transfers.

The GST

In the January 2006 election, a plurality of Canadians voted for a party that had promised to lower the GST. While a given amount of tax relief delivered through lower personal and corporate income taxes can, in principle, boost economic growth more than a cut in consumption taxes, GST relief also increases the net reward to work, and constitutes a major ceding of tax room by the federal government. This Shadow Budget proposes to lower the GST rate from 7 to 6 percent on July 1, 2006, and to 5 percent on July 1, 2011. These changes would lower GST revenue by nearly $12 billion by 2010/11.

Personal Income Tax Rates and Thresholds

The economic fortunes of Canadians depend on their ability to earn and save. For this reason, balanced tax relief should also lower the burden that taxes place on earning and saving.

In November 2005, the previous government announced that, for eligible dividends paid after 2005, the federal dividend gross-up rate would rise from 25 to 45 percent and the dividend tax credit rate from 13 1/3 to 19 percent. This Shadow Budget maintains that change.

The previous government also proposed a retroactive increase in the basic personal amount and a one-percentage-point lowering of the bottom personal income tax rate. For a great many Canadians, these changes would have made scant difference to the rewards from additional work or saving. This Shadow Budget proposes changes that will do more to support growth.

Effective July 1, 2006, the bottom federal rate will drop to 15 percent, and the second rate to 21 percent. Effective January 1, 2007, the second rate will drop to 20 percent and the third rate from 26 to 25 percent. Effective January 1, 2008, the second rate will drop to 18 percent and the third rate from 25 to 24 percent.

Increases to the personal amount will follow the timetable announced in the 2005 Budget, with the basic personal amount reaching $10,000 in 2009; and, effective January 1, 2009, the threshold for the top (29 percent) rate will rise to $200,000. As of January 1, 2010, the first and second rates will converge at 15 percent, income between $79,000 and $200,000 will be taxed at 24 percent, and income above $200,000 at 28 percent. By 2010/11, these changes will lower personal income taxes paid to Ottawa by more than $18 billion annually.

Taxes and Savings (and Capital Gains)

The 2006 Conservative election campaign promised relief from the burden of capital gains tax when the proceeds of a disposition are reinvested. This budget proposes a consultation period on the best way of freeing savers from tax on portfolio adjustments that can improve their returns and support productive investment. This budget proposes three models for discussion:

- *Tax-Prepaid Savings Plans (TPSPs)*. Savers could put after-tax income from any source into registered TPSP accounts, within which income, including capital gains, would accrue without being taxed. Since taxes have already been paid on income when it entered the accounts, withdrawals — unlike withdrawals from Registered Retirement Savings Plans — would also be untaxed. Holders of TPSPs would be free to reallocate their investments without having to pay tax on dispositions.

- *Capital Gains Deferral Accounts (CGDAs)*. This option would permit contributors to purchase securities within a registered CGDA. While those securities were held within the account, capital gains on them would not be included in their beneficiaries' incomes. Withdrawals, including net capital gains, would be taxed, with the cost base of the assets being deducted on a pro-rated basis for the calculation of taxable proceeds.

- *Additional Capital Gains Contribution Room for RRSPs*. A third option to facilitate reinvestment is deferral: taxpayers would calculate a year's taxable gains as they do now and add a corresponding amount to their available RRSP contribution room for the year (perhaps up to a dollar limit). They would be able to reinvest capital gains proceeds in an RRSP in the first 60 days of a calendar year, the same limit that applies to other post-year-end contributions. Any assets that are currently permitted in RRSPs would be eligible. Investors who took their gains into current income would be liable for the usual capital gains tax in the year the gains were recognized.

These options vary in the extent to which they offer deferral treatment for unrealized capital gains. None of them requires fundamental changes to the existing capital gains tax mechanisms, or new valuation dates or income-inclusion rates.

Labour-Sponsored Investment Funds (LSIFs)

The federal credit available for investments in Labour-Sponsored Investment Funds has outlived its usefulness. The credit has tended to subsidize high-risk investments, and the corporate structure prescribed by legislation has not produced rewards that offset those risks. An end to the credit will bring in $200 million in annual federal revenue.

Corporation Income and Capital Taxes

The 2005 budget and the November 2005 fiscal update proposed quick elimination of the federal capital tax and staged reductions of the basic corporate income tax rate to 19 percent in 2010. Authorizing legislation for this economically important relief accompanies this Shadow Budget.

A Prudent Path

The net impact of these spending and revenue changes is threefold. Ottawa will focus its activities more on areas where it has clear responsibility to act and will reduce its claims on the nation's resources in areas, such as internal operations, that do not provide public services in proportion to the cost. A reduction in federal taxes will foster a better climate for jobs and investment and will create room for the provinces to raise the revenues they need to act in areas where they have clear

Table 4: *Impact of Revenue Measures*

	2006/07	2007/08	2008/09	2009/10	2010/11
			$ billions		
GST Relief	(4.1)	(5.8)	(6.1)	(6.4)	(11.7)
Personal Income Tax Relief	(3.5)	(7.1)	(10.4)	(13.1)	(18.1)
LSIF phaseout	0.0	0.1	0.2	0.2	0.2
Lower EI Premiums	(0.3)	(0.5)	(4.2)	(6.3)	(8.4)
Total Revenue Measures	*(7.9)*	*(13.2)*	*(20.5)*	*(25.6)*	*(38.1)*

Source: Authors' calculations.

pre-eminence rather than engaging in an annual begging trip to Ottawa. And this Shadow Budget clearly plans a series of budget surpluses at a time in Canada's economic and demographic history when debt paydown is appropriate — surpluses that will be big enough to withstand setbacks (see Table 5) and that are straightforward targets rather than a trigger for in-year spending.

A New Framework

In every year since 1997/98, the total revenues and amount of interest saved by the federal government has exceeded the amount projected in that year's budget. The cumulative discrepancy comes to $67 billion — an average of $7.4 billion per year. At the same time, program spending overshot projections in every year but the no-budget year 2001/02. The cumulative spending discrepancy was $51 billion, or $5.7 billion annually.

In the light of that performance, Canadians would be justified in wondering how much stock they should put in the projections just outlined. Such skepticism is inevitable. Parliamentarians must respond by holding the government to account for the budget they pass and the spending they approve at the beginning of the year.

For the fiscal year 2007/08 and beyond, a better framework is needed. The government recently introduced legislation that would create a Parliamentary Budget Officer within the Library of Parliament. Among other duties, the Parliamentary Budget Officer will prepare, with the aid of outside forecasters and experts, an economic and fiscal backdrop that models ways in which uncertainties — such as fluctuations in economic activity, the yield of various taxes and interest rates — might affect federal finances. This exercise will help planners understand the probability that deviations larger than a given amount from the most likely outcome will occur.

This process will establish a range of variation that can reasonably be expected, just as the one-percentage-point band on either side of the Bank of Canada's 2 percent target does in the case of inflation control. It can help the public be confident that surprises on a predictable scale will not cause abrupt changes in the government's plans — and in particular will not trigger the sort of end-of-year splurges that have undone so many budget projections in recent years.

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

	2006/07	2007/08	2008/09	2009/10	2010/11
			$ billions		
Non-Interest Revenue					
Status Quo Projection	224.4	235.3	244.7	254.7	262.1
Impact of Revenue Measures	(7.9)	(13.2)	(20.5)	(25.6)	(38.1)
Outlook after Revenue Measures	*216.5*	*222.1*	*224.2*	*229.1*	*224.0*
Program Spending					
Status Quo Projection	192.6	201.7	211.2	220.9	229.7
Impact of Restraint and Reallocation	(7.1)	(13.8)	(26.7)	(34.0)	(42.7)
Outlook after Restraint and Reallocation	*185.5*	*188.0*	*184.5*	*186.9*	*187.0*
Primary Balance					
Status Quo Projection	31.8	33.6	33.4	33.8	32.4
Impact of Budget Measures	(0.8)	0.5	6.2	8.4	4.6
Outlook after Budget Measures	*30.9*	*34.1*	*39.7*	*42.2*	*37.0*
Net Debt Charges					
Status Quo Projection	27.6	28.0	27.8	27.7	27.6
Impact of Budget Measures	0.0	0.0	0.0	0.0	0.0
Outlook after Budget Measures	*27.6*	*28.0*	*27.8*	*27.7*	*27.6*
Total Balance					
Status Quo Projection	4.2	5.6	5.6	6.1	4.8
Impact of Budget Measures	(0.8)	0.5	6.2	8.4	4.6
Outlook after Budget Measures	*3.3*	*6.1*	*11.9*	*14.5*	*9.4*
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	*0.3*	*2.1*	*6.9*	*8.5*	*2.4*

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

Conclusion: Fiscal Policy for a Confident Economy and a Strong Federation

Canadians' future prosperity depends on a strong and growing economy and on a rebalancing of the nation's finances that puts more responsibility for raising revenue in the hands of the governments that need it. A steady hand on spending will promise better odds of healthy finances for the federal government and for all Canadians.

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