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Getting Real: A Shadow Federal Budget for 2017

The 2017 federal budget should hold the line on intergovernmental transfers and internal costs to make room for growth-boosting cuts in personal, business and import taxes, while setting a path toward fiscal balance.

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The Study In Brief

The 2017 edition of the C.D. Howe Institute's annual Shadow Federal Budget urges Ottawa to set out a path back toward balance to inspire confidence among savers and investors, accompanied by tax and spending measures to boost economic growth and opportunities.

To reassure Canadians that federal finances are under control, and correct unrealistic expectations about spending encouraged by lack of discipline on the bottom line, this Shadow Budget ensures that, even with cautious economic forecasts and prudence cushions, the ratio of federal debt to gross domestic product will stabilize immediately. Among the measures that produce this result are continued restraint on transfers to other levels of government, and containment of Ottawa's compensation costs.

This Shadow Budget also contributes to fiscal discipline through improved accountability: clearer and more prominent presentation of the key revenue and spending numbers in the budget and the Estimates, and fair-value presentation of the federal government's massive pension obligations.

To boost economic growth and opportunities for Canadians, this Shadow Budget includes a variety of measures.

Changes to the tax system focus on modernization, with recommendations to replace ongoing preferential tax treatment for small businesses with temporary preferential treatment for young businesses, and to tax returns on intellectual property investments at a lower rate to reflect their spillover effects to the broader economy. To enhance Canada's international competitiveness, it proposes to replace aviation fuel taxes and other potential CO2-related levies with a new GST rate on fuels, and proposes to roughly double the threshold for the top personal tax rate. It also proposes to level the playing field for domestic producers of digital services relative to untaxed competitors abroad. It would raise the threshold for sales tax and customs duties levied on imports, and begin the phase-out of all import tariffs. And it would encourage business investment and equity relative to debt finance by establishing an allowance for corporate equity that relieves ordinary returns to capital from corporate income tax.

On the spending side, this Shadow Budget prioritizes infrastructure projects Ottawa can drive on its own. It proposes to dispose of non-core assets and increase private investment in infrastructure by selling selected airport leases. Other measures would improve Canada's job market, and support higher student achievement.

Additional measures to boost Canada's economy include updated mandates for Crown lenders, a backstop for catastrophic insurance, and reforms to help Canadians saving for retirement in RRSPs or target-benefit pension plans, and protect them against outliving their savings.

In summary, this Shadow Budget marks a transition from the rhetoric of campaigning and the hesitations of a new government, to a package of concrete measures that will give Canadians confidence in the future of their country as a place to learn, work, and retire, and as a place to save and invest.

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A new government's first budget often nails down a few platform planks while otherwise marking time. Transforming election promises into a coherent fiscal plan is always a challenge in the transition from campaigning to governing.

The federal Liberal government's imminent second budget needs to rise to that challenge. To prevent endless demands of various stakeholders from driving spending and borrowing beyond responsible limits, Canada badly needs a serious federal budget framework.[1]

This Shadow Budget puts a framework of sustainable finance front and centre. It balances increases in spending with revenue generation and cost-saving measures. It is designed to provide Canadian families and businesses with confidence that the country will successfully meet the challenges of slow growth, lower commodity prices and an aging population. By establishing this trust through prudent fiscal management, Ottawa can support economic growth and job creation, and promote opportunities for all Canadians, thereby improving prosperity.

Parallel with the promise to give Canadians confidence in the federal government's fiscal framework should be a commitment to greater budget transparency. In addition to offering financial reporting improvements and producing estimates that are consistent with the budget, our Shadow Budget moves the fiscal plan summary – buried in an annex on page 234 of the 2016 budget – to the front (See Table 1).[2]

Economic and Fiscal Framework

A confidence-inspiring budgetary framework begins with prudent forecasting. Lower than expected growth in the last year has produced lower than expected revenues and consumed much of the 2016 federal budget's revenue buffer. Continuing low growth, both domestically and internationally, means Canadian governments cannot depend on rising tax revenues to finance spending commitments.

Lower Demand and Productive Capacity

Sluggish global demand, combined with a US growth profile less oriented toward Canadian exports, have made international trade less supportive of economic activity here in Canada than in past expansions. Services are a bright spot

The authors are grateful for ideas and comments on earlier drafts from many contributors and reviewers, notably the members of the C.D. Howe Institute's Fiscal and Tax Competitiveness Council. The authors alone are responsible for the recommendations and views presented here, as well as for any errors.

1 The commitment during the election campaign to borrow for infrastructure spending can justify only modest deficits. Most federal infrastructure projects last a long time, and the government accordingly writes their cost off over long periods, adding relatively modest amounts to annual expenditure. With the partial exception of funds borrowed to support infrastructure spending by other levels of government, deficits beyond what infrastructure can justify are consumption, which adds to the federal government's net debt and hurts national wealth by absorbing savings that would otherwise fund Canadian investment in domestic capital and foreign assets (Robson 2017).

2 This change responds to a critique by the C.D. Howe Institute. Busby and Robson (2016) show that most provinces now provide their consolidated fiscal plans in the first 10 pages of their budget documents where they are much easier for users to find and understand.

Table 1: Fiscal Projections with Shadow Budget Initiatives

	2016/17	2017/18	2018/19
		($ billion)	
Baseline Projections			
Revenues	291.0	303.2	313.2
Expenditures	-316.2	-331.1	-339.1
Adjustment for fiscal prudence	-3.0	-3.0	-3.0
Budgetary Balance before Initiatives	*–28.2*	*–30.9*	*–28.9*
Shadow Budget Initiatives			
Strengthening the economy		2.7	3.6
Sustainable fiscal framework		1.4	2.1
Improving opportunities for Canadians		-0.9	-0.9
Total		*3.2*	*4.8*
New Budgetary Balance	**-28.2**	**-27.7**	**-24.1**
Accumulated deficit	642.0	669.7	693.8
as % of GDP	31.8	31.8	31.8

Sources: Tables below; authors' calculations.

in the export picture, up both relative to goods and in absolute terms.[3] But the rise of protectionist sentiment, notably in the United States, is a key medium-term concern.

Income from oil production is down sharply and production itself has suffered major losses due to the devastating effects of the Alberta wildfires. At the time of writing, crude oil prices were around US$53 per barrel, compared with more than $100 per barrel before their sudden fall in the summer of 2014. With natural resources critical to Canada's economy, these difficulties represent a major loss of productive capacity.

Household spending has continued to support the economy, with income and employment growing in non-energy-intensive regions, particularly in the service sector. However, the broader economic impact of lower real incomes from the commodity-price decline will continue to dampen domestic demand.

3 In the first half of 2016, Canada was on pace to export more than $100 billion in services, almost $25 billion more than five years earlier. Bank of Canada Governor Stephen Poloz last year said that the "continued expansion of our service sector is pointing the way toward full economic recovery and the return of sustained, natural growth (Poloz 2016)."

Table 2: Ottawa's Forecasts of Real and Nominal GDP Growth (Percent)

	2016		2017		2018	
	Real	Nominal	Real	Nominal	Real	Nominal
Budget 2016	1.4	2.4	2.2	4.6	2.2	4.3
2016 Fall Fiscal Statement	1.2	1.8	2.0	4.3	1.8	3.7

Source: Finance Canada.

Most productive-capacity measures, including labour market indicators, suggest continuing slack in the Canadian economy. For instance, youth participation rates are near their post-recession lows and wage growth remains subdued, particularly in goods-producing industries. Looking beyond the temporary weakness associated with the Alberta wildfires, the Bank of Canada judged that the excess capacity in the national economy in the second quarter of 2016 was between 1 percent and 2 percent (Bank of Canada 2016).

Overall, real GDP is currently lower than anticipated in the 2016 budget, and nominal GDP even more so. Looking ahead, the average of economic forecasts used by Finance Canada puts real growth 0.2 percent lower for 2017 and 0.4 percent lower in 2018 than anticipated in the 2016 budget. As for nominal growth, the forecasts anticipate that it will be 0.3 percentage points lower in 2017 and 0.6 points lower in 2018 than the 2016 budget projections (Table 2).

A Challenging Baseline

This Shadow Budget uses as its baseline the economic and fiscal projections from the Department of Finance's October 2016 "Fall Economic Statement" (Canada 2016).[4] As a matter of prudence, our Shadow Budget includes contingency reserves for the 2017/18 and 2018/19 fiscal years to reduce the risk that downside surprises might push the fiscal plan off track. But our reserves are relatively modest. Budget 2016 included a $6 billion annual reserve, which the Fall Statement eliminated entirely – an in-year change so huge that it cast doubt on the integrity of the entire fiscal plan. This Shadow Budget returns to the traditional $3 billion reserve.

The resulting Shadow Budget planning baseline starts with a $28.2 billion deficit in the current 2016/17 fiscal year ending on March 31, followed by a $30.9 billion deficit in 2017/18 and $28.9 billion in 2018/19 (Table 3). During the 2015 election campaign, the Liberals committed to deficits related to new infrastructure spending

4 In keeping with past C.D. Howe Institute Shadow Budgets, we use the average values from Finance Canada's bi-annual survey of private-sector forecasters, which are also inputs for the department's budgetary projections.

Table 3: Shadow Budget Assumptions and Projections (2016/17 to 2018/19)[a]

	2016/17	2017/18	2018/19
	($ billions except as noted)		
Economic Growth (*percent*)			
Real GDP growth	1.2	2.0	1.8
GDP inflation	0.6	2.2	1.8
Nominal GDP growth	1.8	4.3	3.7
Federal Revenues			
Taxes on incomes, payroll, consumption and other transactions	263.9	274.0	282.4
User fees and charges for government services and products[b]	14.2	14.7	15.3
Investment income[c]	12.9	14.5	15.5
Total Revenues	**291.1**	**303.2**	**313.2**
Federal Expenditures			
Direct program expenses	131.6	140.4	142.3
Transfers to persons and governments	159.7	166.1	170.9
Gross debt charges	24.9	24.6	25.9
Total Expenditures	**316.2**	**331.1**	**339.1**
Fiscal Prudence			
Provision for prudence	-3.0	-3.0	-3.0
Summary of Federal Revenue, Expenditure and Balance			
Taxes, fees, and other charges	278.1	288.7	297.7
Program spending and transfers	-291.3	-306.5	-313.2
Debt charges net of investment income	-12.0	-10.1	-10.4
Adjustment for fiscal prudence	-3.0	-3.0	-3.0
Budgetary Balance Adjusted for Fiscal Prudence	**-28.2**	**-30.9**	**-28.9**

Notes: Totals may not add due to rounding.
(a) Based on Fall Update (Canada 2016).
(b) Estimated figures including earnings of consolidated Crown corporations. Excludes the provision for fiscal prudence.
(c) Estimated figures including interest income, net income from enterprise Crown corporations, foreign exchange revenues, and other returns on investment.

Sources: Canada (2016); authors' calculations.

before achieving a modest surplus of $1 billion in 2019/20. Under the new government baseline, this target now appears out of reach.

Inclusive, Innovative Economic Growth

In a challenging economic environment, Canada needs fiscal measures that will boost productive capacity that benefit all Canadians. This Shadow Budget emphasizes growth-friendly tax policies, openness to trade and competition, and supportive reform of institutions and regulations.

Greening Canada's Taxes

Canada has committed to reducing its greenhouse gas emissions to 30 percent below 2005 levels by 2030. This promise reflects the obligations implied by Canada's ratification of the Paris Agreement. Many provinces have since put in place systems – cap-and-trade or carbon tax – that charge producers and other carbon-dioxide emitters for their consumption of high-polluting energy. Meanwhile, the federal government has recently set a price floor for a national carbon price starting in 2018.

However, since the bulk of greenhouse gas emissions results from consumer choices, the Shadow Budget proposes an increase in the Goods and Services Tax (GST) rate applied to transportation fuels. Raising the GST on transportation fuels is preferable to raising existing excise taxes because GST is only effectively paid on net value-added when goods and services are purchased by the final consumer. This feature protects Canada's international competitiveness and avoids the distortions that occur when taxes "cascade" on intermediate inputs bought and sold but not on internal firm transactions. Establishing a new GST rate of 10 percent on motive fuels, starting in the next fiscal year, would generate about $2 billion in additional revenues that would help finance a return to budget balance in the medium term. Relatively low world oil prices mean that consumers would be more able to afford the GST hike. However, if prices spike up to levels far beyond medium-term expectations, which would boost federal finances in other ways and discourage demand, the rate could be adjusted downward.

Bringing Business Taxation into the 21st Century

The amount of tax that a business pays requires consideration of more than just the applicable statutory corporate tax rate. Myriad circumstances affect the tax a firm actually pays, including deductions and expenses, level of capital investment, income and prior losses. When these provisions create high marginal effective tax rates (METRs) on the returns to investment, they discourage capital spending by businesses, hurting job creation, productivity, and growth.

In Canada, successive reforms during the early 2000s lowered the METR on new capital investments, with the 20.1 percent national average METR now slightly below that of most major competitors.[5] However, this advantage has been eroding with Canada's tax burden on new investment rising from 17.5 percent in 2012 to 20.1 percent in 2016 (Bazel and Mintz 2016). Meanwhile, the Organisation for Economic Co-operation and Development average METR has been falling, with countries opting for lower rates to encourage capital investment. Further, the post-Brexit UK has committed to a 3-percent-reduction in its corporate income tax rate, and recent US

5 Canada's national average METR on investment is slightly below the OECD average, and below that of other G7 countries except Italy.

developments suggest that it may be about to reduce its high METRs. This Shadow Budget responds to these pressures with measures to improve the incentives in Canada's business taxation regime and by launching a more thoroughgoing reform that would make Canada more hospitable to capital investment.

Rethinking Research and Innovation Incentives

Canada offers generous research and development incentives in the form of the Scientific Research and Experimental Development (SR&ED) Tax Incentive. The rationale for providing incentives to research activities is to increase investments that provide beneficial spillover effects for society as a whole.[6] Despite the SR&ED tax credit being one of the most generous subsidies of its kind, Canada lags behind its peers in private R&D investment and productivity (Parsons 2011). In fact, Canada's total R&D expenditure as a percentage of GDP has been falling since 2009 and lags behind the US and the OECD average.

R&D expenditures reflect both supply-push and demand-pull drivers. On the supply side, the SR&ED credit decreases the direct cost to firms of initial knowledge creation. On the demand side, however, Canadian companies show a discouragingly low propensity to incorporate such knowledge in their production (STIC 2011). To address this R&D demand-side shortfall, this Shadow Budget proposes to establish a "Patent Box" tax mechanism in which income derived from patents developed through Canadian R&D face a lower corporate tax rate. The revenue cost of this measure will increase gradually to about $1 billion over time. It will be offset by tax revenue generated from the beneficial spillover effects of heightened R&D activity and its adoption through commercial activities.

The rationale for such a mechanism is to encourage Canadian businesses to actively pursue commercialization of innovation. Evidence suggests that firms would undertake R&D in Canada if the returns, or fruits of their efforts, were taxed at a lower rate (Parsons 2011). The Patent Box has the added benefit of incentivizing production related to Canadian patents to remain within our borders, thus capturing much of the beneficial spillover effects.

The measure also seeks to balance the tax benefits of the R&D credit with those related to adopting, commercializing or otherwise employing the new knowledge (Pantaleo, Poschmann and Wilkie 2013). As the OECD (2011) notes: "Neither the supply-side nor demand-side policies are likely to be effective in isolation. Fostering innovation requires addressing the entire innovation chain."

Targeted Incentives, Aiming to Grow Small Businesses

Canada's corporate income tax provides a Small Business Deduction that reduces the effective tax rate on small firms. While the rationale for the deduction – recognizing that younger and smaller firms do not benefit from some economies of scale available to larger firms – is attractive, the lower tax rate discourages businesses from growing past the point where their taxes would increase. At the same time, the Small Business Deduction encourages self-employed individuals to incorporate in order to access the lower tax rate. Dachis and Lester (2015) point out that the government, in effect, finances the lower small business tax rate with lower spending or higher taxes elsewhere. If the tax burden on large firms is higher as a result, the Small Business Deduction is expanding the small-business sector at the expense of large businesses.

6 In the absence of any incentive, private investment in research and development would likely be below optimal levels.

Since small firms, in general, are less productive, and unambitious firms are almost by definition less productive, this distortion damages Canada's overall economic performance.

A better approach would be to provide the Small Business Deduction for young, growth-oriented firms rather than simply all businesses that are small. Targeting such young firms would help mitigate the growth-disincentive tax effect (Howitt 2015). Accordingly, this Shadow Budget proposes to tie the Small Business Deduction to firms' age. The tax benefit would be highest for young businesses with little in taxable capital assets. At five-year intervals the threshold level of capital assets that qualifies for the Small Business Deduction would be raised, and the level of the deduction lowered, regardless of firm size, until the standard corporate tax rate is reached.

These changes would not include previously claimed Small Business Deductions. Going forward, mature small businesses would be evaluated on the same terms as new firms at the outset of the changes. This measure would allow mature small businesses time to adapt.

Safeguards to ensure that businesses cannot roll over their assets to a new company at regular intervals, and to limit fragmentation of business activities or other artificial arrangements using subsidiary or agent companies, will accompany this change.

Levelling the Playing Field in the Digital Economy

The Internet is revolutionizing how people access entertainment, order taxis, find accommodations and shop for goods. In many cases, consumers can make purchases directly from a supplier located outside Canada just as easily as if the company were domestic. This development raises concerns about government revenue and competition for Canadian producers.

Domestic providers of digital products and services must charge 5 percent to 15 percent GST/HST on their sales. But foreign providers of like products and services are not obliged to collect and remit sales tax if they are not "carrying on business" in Canada. Instead, the consumers of the service are expected to account for and remit the taxes that should be paid on those items. But most consumers do not do this, and the impracticality of enforcement means significant amounts of potential tax revenues go uncollected. Since the sales tax is not getting paid, foreign digital providers have a competitive advantage over domestic companies.

This imbalance affects a wide range of services, including video streaming, digital books, games and myriad fees for using digital platform and network services. At the issue's core is what, exactly, is meant by "carrying on business." If a non-resident person operates a business in Canada that is sufficiently large and supplies taxable goods, services or other intangibles, then it must register for GST/HST purposes. However, if a non-resident does not "carry on business" in Canada, then any supplies made in Canada by the non-resident are deemed to be made outside Canada and, consequently, they generally do not remit GST/HST.

To address both problems, this Shadow Budget recommends amending the *Excise Tax Act* to reflect international VAT/GST guidelines for determining the place of taxation for cross-border services and intangibles. The main goal of the reform is to level the playing field for domestic and foreign providers of digital products and services in Canada by requiring that foreign sellers remit tax on sales in the jurisdiction where the final consumer is located. This measure is expected to increase annual revenue by about $200 million annually.

Raising the de minimis Threshold on Imports

The *de minimis* threshold (DMT) is the maximum value of an imported good sent to a person by mail or courier that is exempt from HST/GST or custom duties. Canada's DMT of $20 has not been changed in decades, even to account for inflation, and is lower than any other industrialized country.

While raising the DMT has revenue-loss implications, it has far greater associated cost savings from a reduction in brokerage fees, import delays and in administrative costs for government, consumers and businesses. The effects of increasing the DMT are positive for consumers and businesses, particularly small- and medium-sized businesses, because the cost savings for smaller entities is disproportionately large (McDaniel, Schropp and Latipov 2016).

Accordingly, this Shadow Budget proposes to increase the DMT from $20 to $100. This increase would save the federal government $190 million in administrative costs. The revenue impact of this measure would be limited to the GST portion, or about $20 million, because this Shadow Budget also proposes to eliminate all tariffs (see next section). It therefore would yield a $170-million net improvement in the federal budget balance.

Allowance for Corporate Equity

Canada's tax system would be more attractive for domestic and foreign investors if it provided an allowance for corporate equity (ACE) in computing taxable profits (Milligan 2014; Boadway and Tremblay 2014; Laurin and Robson 2012; Mirrlees et al. 2011). The purpose of an ACE – calculated by multiplying shareholders' equity by an appropriate nominal interest rate – is to exempt returns equal to the opportunity cost of equity financing from taxation, so that only profits above that rate of return attract tax.

Eliminating tax on normal profits would greatly reduce the METR on new business investment, making capital investment in Canada more attractive relative to alternatives such as lending the money to government or investing abroad. In addition, the ACE would reduce the asymmetry between the preferential tax treatment of debt-financed over equity-financed investments.

Immediate implementation of a 4 percent ACE without other reforms would likely reduce federal revenues substantially – by as much as $12 billion a year – in the short term. Since raising corporate income tax rates to replace lost revenue would encourage businesses to locate profitable activities outside Canada,[7] broadening the capital tax base would be a better way to offset some of the tax loss. Since higher after-tax returns with an ACE would produce higher dividends and capital gains for Canadian shareholders, adjustments in the capital-gains inclusion rate and the dividend tax credit could recoup about $4 billion at the individual level.

Broadening the corporate income base by, for instance, reforming the small business tax deduction along with a proportional increase in the corporate capital-gains inclusion rate, would offset an additional $6 billion. Eliminating other tax provisions, such as accelerated capital cost allowances, which would no longer be necessary under an ACE system, would further offset the $12 billion fiscal cost.

To provide time for the design and implementation of these offsetting measures, we propose to phase the ACE in gradually, starting in 2017/18. After taking into account its positive impact on investment and economic activity, the long-term net impact on federal revenues would be negligible.[8] Nevertheless, our fiscal plan marks down revenue by $500 million during the phase-in period.

Scrutinizing Tax Preferences

The federal tax system contains many exemptions, deductions, rebates, deferrals and credits. Some of

7 Absent other measures, replacing the revenue would require increasing the corporate tax rate from the current 15 percent to about 21 percent, with a proportional rise in the small business tax rate.

8 Aus dem Moore (2015) evaluates the investment impact in Belgium from its 2006 introduction of an ACE, finding evidence that manufacturing SMEs expanded their investment activity by 3 percent to 3.7 percent.

these preferences attempt to recognize differing capacity to pay among taxpayers; others are effectively spending programs in disguise (Laurin and Robson 2017). One item that frequently features in discussions of tax preferences – the non-taxation of employer-paid premiums for health and dental plans – falls in the former category. Many medical expenses are non-discretionary: people incur them because they are sick, and the income they need to cover them is not available for enjoyment. When it comes to health-related expenses, Canada's personal income tax is not generous enough: the current medical expense tax credit only applies to expenses exceeding 3 percent of net income, or $2,237, whichever is lower, and is calculated at the bottom tax rate.

As a down payment on further reform, this Shadow Budget would lower the threshold for a tax break on such expenses to 1.5 percent of net income, or $1,120, whichever is lower. This change would help people buying healthcare directly, or paying high health-related insurance premiums not covered by their employers. Employer-paid health premiums would continue not to be taxed.

Among the items that fall in the category of spending programs in disguise are several that would struggle to pass muster if accounted for and voted on as part of annual spending programs because they subsidize activities that have small social benefits[9] and/or already receive other types of fiscal support, or they distort investment. For example, the age credit provides a tax subsidy to seniors who already benefit from a number of social transfers and in-kind benefits. The amount is already clawed back on incomes between about $36,000 and $83,000, which increases the marginal effective tax rates on these seniors. This Shadow Budget proposes to reduce the base amount for age credit to $4,000, which is analogous to the amounts in most provinces.

This Shadow Budget would also eliminate the tax credits for children's art and fitness programs, consistent with current plans, and for teachers' supplies, since these provisions support activities that already receive various kinds of public support.

The tax credit for first-time home buyers is another problematic subsidy, given the disproportionate amount of Canada's capital investment that is flowing into residential construction (Robson 2017) and the evidence that many younger and less well-off Canadians are financially overcommitted. This Shadow Budget proposes to phase it out.

The public transit tax credit also subsidizes an activity that already receives substantial tax support and, thanks to the ramping up of federal support for infrastructure, will soon receive more. This Shadow Budget proposes to eliminate it, starting in the 2019 tax year.

Another preference that distorts saving and investment is the federal credit for investment in labour-sponsored venture capital corporations (LSVCC). Venture capital funding spurs innovation, but among the various types of venture capital funds in Canada, LSVCCs are among the least efficient in this respect (Fancy 2012). In addition, LSVCCs crowd out alternative private-venture investments and favour portfolios unsuitable for retail investors. For this reason, this Shadow Budget would eliminate the LSVCC federal credit.

9 The marginal costs of raising a dollar in additional personal or corporate income taxes are much greater than one dollar (Dahlby and Ferede 2011). This means that tax preferences, which for a given amount of revenue raised require higher tax rates, must yield a large social benefit.

Eliminating Excise Tax on Aviation Gasoline and Jet Fuel

Aviation fuel taxes create a number of problems relative to value-added taxes such as the GST. By taxing an intermediate input, these levies impose business expenses that have no fiscal offset, raising costs throughout the economy and making Canadian exports less competitive. They also induce airlines to fuel their aircraft where taxes are lower rather than minimize their fuel usage, which results in less efficient air transportation and environmental damage from excess fuel consumption.

This Shadow Budget would abolish federal aviation fuel excise taxes. Aviation fuel would be subject to the same higher GST rate that applies to other motive fuels, with rebates through the same invoice-credit system that relieves intermediate users of tax. The revenue cost of this change is about $0.1 billion per year.

Canada: Open for Business

Overwhelming reliance on US trade exposes Canada to the ups and downs of American economic conditions and trade policies. There is a trade-off between the specialization gains derived from deep integration with a massive economy and the volatility that results from the lack of market diversification.

Emerging Markets for New Partnerships

Canada is at a crossroad in international trade policy. After 25 years of increased market integration through the 1987 Canada-US Free Trade Agreement and the 1991 North American Free Trade Agreement (NAFTA), Canadian and US production have become more closely integrated than at any time in history. Thus, it is crucial that Canada maintain open US borders, despite the recent protectionist turn of American policy, as exemplified by the Trump administration's intent to renegotiate NAFTA.

It would be better for Canadians if the integrity of a trilateral NAFTA could be maintained, supplemented by bilateral agreements with the United States as warranted in certain areas such as public-sector procurement. There is no question, however, that Canada should do everything it can to maintain barrier-free bilateral economic relationships, including – if push comes to shove – reverting to the bilateral 1987 Canada-US agreement.

Future Canadian export growth also depends significantly on markets beyond the United States. In this regard, we regret the American withdrawal from the 12-country Trans-Pacific Partnership. However, there are other bodies and pending bilateral negotiations that can take up the mantle, notably in the Asia-Pacific Economic Cooperation forum – where both the US and China are active – and in a potential bilateral trade agreement with China.

Mindful of the importance of commercial services as a generator of good jobs for Canadians, the government will continue multilateral negotiations for the proposed international Trade in Services Agreement and to seek promising markets in Asia through bilateral agreements. Meanwhile, the United Kingdom remains an important market for Canada for services as well as goods, and Canada will open negotiations for a bilateral trade agreement.

Eliminating Tariffs

Tariffs on imports increase costs to Canadian consumers and businesses. Since tariffs are not applied evenly to countries or goods, they distort purchasing decisions. When a Canadian buyer chooses a good from a preferentially treated trade partner over a superior product affected by a tariff, Canadian businesses and consumers suffer. Rankings of Canada's openness to foreign products place us below counterparts such as the Scandinavian countries, Germany and the

UK (World Economic Forum, 2016 – pillar 6 Competiveness index).

At the moment, Canada pursues preferential treatment for our exports through bilateral negotiations. The benefits of this route are clear: we obtain lower tariffs for Canadian products abroad, in addition to lower costs for our businesses and consumers, by reducing our own tariffs in exchange.

However, there is also potential for unilateral action that would result in economic benefits. Research shows that if Canada eliminated all tariffs, it would spur output gains of about 1 percent of GDP. Furthermore, tariff elimination would have a greater effect on output growth than any other major preferential trade agreement would have (Ciuriak and Xiao 2014). Accordingly, this Shadow Budget envisages the gradual elimination of all tariffs. Over time, the unilateral elimination of import tariffs represents $4 billion annually in forgone revenue but is offset by administrative cost savings and revenue associated with output gains of approximately 1 percent of GDP for a net fiscal cost of about $2 billion, or less if we are able to achieve this tariff reduction mutually with our trading partners.

A New Framework for Infrastructure Investment

Infrastructure investment has figured strongly in this government's commitments. In principle, government spending on public infrastructure can yield economic benefits that outweigh the tax-related costs of financing the project and paying associated interest. Transportation and telecommunication infrastructure, for example, facilitates such activities as exchanging goods, services and ideas, along with finding work. The resulting economic opportunities and welfare gains can surpass the dollar costs of purchasing and debt financing, even allowing for the additional costs that tax distortions impose, if the resulting investments raise productivity.

In the short run, infrastructure investment can also boost demand and stimulate output. The overall uncertain economic outlook has created pressure to accelerate projects. However, large greenfield projects require extensive planning and assessment of their economic and environmental benefits and costs. These considerations are especially prone to delay projects that require coordination with other levels of government, which have their own requirements, including accountability for the public money they raise and spend.

Accordingly, this Shadow Budget prioritizes direct funding for projects that fall under federal government control and can move relatively quickly. New projects that fall under provincial and municipal jurisdiction should be funded through a new framework for infrastructure investment involving substantial private or institutional participation.

Multi-jurisdictional Projects

Federal subsidies to support infrastructure projects under provincial and/or municipal control are grants. With subsidies, the federal government relinquishes all control over the funds, and their full value appears in spending and on the bottom line. Through the Gas Tax Fund, the Goods and Services Tax Rebate for Municipalities, the Building Canada Fund and Phase 1 infrastructure funding committed in Budget 2016, Ottawa has already promised $10 billion plus per year in infrastructure subsidies for fiscal years 2016/17 to 2018/19. Such spending then falls gradually to about $4 billion annually by 2027/28. This is a large increase from the $1 billion in annual infrastructure subsidies that were typical a decade ago. While the federal government will accelerate the delivery of some of these supports, this Shadow Budget leaves total spending commitments unchanged.

In addition to these Phase 1 promises, there is Phase 2 infrastructure funding – planned to commence in the 2017/2018 fiscal year – that is expected to deliver $700 million initially, $4 billion in 2018/19 and gradually rise to $11 billion in 2027/28. Such enhanced federal infrastructure support for other levels of government needs appropriate frameworks to ensure economically sound execution, including appropriate pricing and participation by non-government sources of long-term capital such as pension funds. In this respect, the proposed Canada Infrastructure Bank can play a bigger role by channeling more of the Phase 2 spending through the bank in the form of equity participation in projects funded in cooperation with institutional or private investors. Our Shadow Budget would require that equity participation comprises more than half of Phase 2 annual funding commitments. That would reduce planned federal spending by at least $40 billion in the next 11 years, of which $0.4 billion would be saved in 2017/18 and $2 billion in 2018/19.

Prioritizing Core Federal Investments

Even when they are debt-financed, investments in capital assets owned and operated by the federal government – for example, infrastructure on reserves, ports, harbours, ferries, park lands, office buildings, federal bridges and roads – do not create large annual spending. The value of new or improved infrastructure is an asset, offsetting the associated debt. Amortizing the costs of such projects over the period they yield their services adds annual spending that is equal only to the amount written off each year.

This Shadow Budget would devote fresh infrastructure spending to federal projects where the national interest makes government involvement uniquely appropriate – such as investments in marine, rail and air-transportation infrastructure. Expensed over the useful life of such assets – generally 20 years to 40 years – a new annually recurring $0.2 billion expense can easily support the amortization and maintenance of new capital infrastructure projects whose initial construction costs would exceed $4 billion over the next two fiscal years.

Disposing of Non-Core Assets

A key complement to investment in new assets is regular examination of old assets that may not make sense to keep under federal government ownership – for example, airport authorities.

During the 1990s and early 2000s, the federal government transferred the operation of airports designated nationally significant to non-profit, non-share-capital corporations. In return for receiving these assets, the authorities pay rent on ground leases. Although requiring travellers to pay costs related to airport operation makes sense, the structure of these rents – related to total revenues rather than profits – discourages airports from developing other sources of income such as retail. Also, the airport authorities' non-share-capital structure impedes their ability to operate and finance new infrastructure. Because airport authorities often enter into multi-decade agreements with tenants and bondholders, the looming ends of leases require the federal government to address the future of these airports.

Accordingly, this Shadow Budget would initiate an auction of airport leases, in the order in which the lease terms expire – starting with Vancouver and Calgary in 2017/18, followed by Montreal and Edmonton in 2018/19. The resulting revenue would be capital, not operating income. While it would not affect annual balances directly, retiring debt with the proceeds would reduce federal interest costs in future years.[10]

10 The estimated potential proceeds from selling equity stakes in airports (after accounting for debt repayment) are between $7.2 billion and $16.6 billion (Robins 2017).

Modernizing Rules and Institutions

Improving Labour Market Information

Reliable labour market information helps job seekers as well as people already employed to connect with employers who want their skills. Since the 2009 report of the Advisory Panel on Labour Market Information, established by the Forum of Labour Market Ministers, some advances have occurred. A high priority identified by the panel was addressing obvious data gaps with respect to vacancy rates, employment figures, Aboriginal peoples, immigrants and educational data.

In 2015, Statistics Canada launched its Job Vacancy and Wage Survey. It provides valuable information on in-demand occupations, job openings, the duration of job vacancies, as well as on average pay and educational requirements. However, other data gaps remain as large, if not larger, than they were when the Advisory Panel wrote its report. To improve labour market information about Aboriginal communities, for one, the labour force survey should be expanded to sample on reserves.

Statistics Canada should also expand the information related to the transition from school to work by expanding the linkage between graduates' information and administrative databases to allow researchers to better establish the determinants of successful transitions into the labour market. There should also be a survey asking potential employers about the characteristics they seek in new employees.

This Shadow Budget proposes an additional $25 million annually to support the implementation of the Advisory Panel's recommendations to address continuing gaps in labour market information and expand existing surveys where necessary.

Updating Crown Lenders' Mandates

Three federal Crown corporations operate in the financial sector: the Business Development Bank of Canada, Export Development Canada and Farm Credit Canada. They all engage in government lending, which makes sense when private lenders cannot price properly or diversify against certain risks. Crown lenders receive no ongoing financial subsidies; they pay a dividend to the government, their owner. Their ability to turn to taxpayers allows them to access capital at lower costs than private lenders. Moreover, they pay no corporate income tax.

The inevitable tension between underwriting extraordinary risks with government backing and operating along commercial lines, potentially competing with private institutions, requires a careful balance (Bergevin and Poschmann 2013). This balance does not currently exist in the case of Farm Credit Canada, which has no legislative requirement to complement private lenders, and, in practice, competes straightforwardly with them. Under our Shadow Budget, the government will amend the *Farm Credit Canada Act* to ensure that the Crown corporation complements private lenders, and ensure that the *Act* undergoes the same five-year review that applies to the other financial Crowns. Moreover, all Crown financial corporations will henceforth be required to provide a clear statement of their complementary role to private institutions in their annual reports, including comparisons of interest rates on current lending with those of private loans such as the prime rate.

Supporting Quality Elementary and Secondary Education

While elementary and secondary education in Canada is largely a provincial responsibility, the federal government plays an important role in supporting the benchmarking of student achievement across the country and internationally – an activity that promotes better curriculum and delivery. This Shadow Budget proposes measures to enhance these federal roles.

At the national level, the Pan-Canadian Assessment Program evaluates performance in reading, writing, mathematics and science across the country. Its value in assessing progress, grade by grade, would be greater, however, if it measured performance at each grade level, rather than, as currently, at levels three grades apart. Annual assessments would also shorten the cycle for special emphasis on specific areas, improving Canadians' ability to spot changes and respond to them.

At the international level, the Program for International Student Assessment benchmarks the performance of Canadian students against their peers abroad. Canada supports additional participation in this program to allow for inter-provincial evaluation, in addition to comparison to other countries. This expansion has yielded insights into education performance at the provincial level that, for example, pointed to those provinces particularly responsible for the declines in Canada's mathematics scores since 2003. It also showed which provinces' lagging performance were hidden by the stability of countrywide reading and science scores over time.

The Shadow Budget would augment funding for the above two student performance assessment programs over the next five fiscal years. The estimated cost of this measure is small.

Achieving Fiscal Sustainability

The Shadow Budget also supports fiscal sustainability through prudent restriction of federal expenses, the exploration of new revenue streams and improving accountability of government finances. Federal costs can be contained by ensuring federal transfers to the provinces remain sustainable and by reforming federal employee-compensation arrangements. Sustainability can be ensured by providing a more accurate picture of the government's financial position, introducing new revenue tools and limiting exposure to contingent mortgage-insurance liabilities.

Joint Federal-Provincial Marijuana Regulation

One area requiring more attention is federal marijuana policy. Current policy has been, at best, ineffective. Marijuana is the most commonly used illegal drug in Canada with more than 40 percent of Canadian adults reporting they have used cannabis (Centre for Addiction and Mental Health 2012). Furthermore, current policy has left distribution in the black market, with no health and safety standards of any kind. The lack of successful enforcement exposes the public to medical and other risks.

To address this situation, this Shadow Budget allocates $100 million to Health Canada to develop licensing regulations for the production and supply of marijuana, in conjunction with the Departments of Justice and Public Safety, in anticipation of pending legalization for recreational consumption. Health Canada would set labelling requirements and be responsible for setting and enforcing health-related safety regulations such as acceptable pesticide use, testing for contaminants, along with levels of psychoactive ingredients.

The federal government intends initially to levy GST on the sale of both unprocessed product and at the consumer retail level. In the interest of black market minimization, and expecting that provinces would impose their own excise taxes, the Shadow Budget proposes no federal excise taxes on marijuana.[11]

11 As the marijuana market matures and production volumes lower the cost per unit of output, the government should reassess excise taxes as both a revenue generation tool and also as a means of protecting public health. According to a recent study (Sen 2016), recreational marijuana taxation could be a significant future revenue stream that could be used to offset public costs related to the market.

Table 4: Strengthening the Economy – Summary of Shadow Budget Initiatives' Impact on Budget Balance (2017/18 and 2018/19)

Initiatives	2017/18	2018/19
	($ billions)	
Environmentally-friendly fuel tax	2.0	2.0
Targeting small business tax incentives to young firm	s	s
Implementing international VAT/GST guidelines	0.2	0.2
Establishing a Patent Box	-0.2	-0.4
Raising the *de minimus* threshold	0.2	0.2
Allowance for coporate equity	-0.5	-0.5
Scrutinizing tax preferences	1.4	1.4
Eliminating excise tax on aviation fuel	-0.1	-0.1
Eliminating tariffs	-0.5	-1.0
New funding framework for Phase 2 infrastructure spending	0.4	2.0
Prioritizing core federal infrastucture	-0.2	-0.2
Disposing of non-core assets	n/a	n/a
Improving labour market information	s	s
Updating Crown lender's mandates	n/a	n/a
Supporting quality elementary and secondary education	s	s
Total	**2.7**	**3.6**

Notes: n/a = not applicable; s = cost is small or negligible.

Sources: Authors' calculations.

Under this scheme, the taxation of recreational marijuana is projected to yield $1.5 billion in annual federal revenue, starting in 2017/18.

Containing Federal Employment Costs

While transfer payments and interest on debt together make up the bulk of federal spending, about one-third of federal program expenses are the government's own operations. Of that amount, about 60 percent – $50.2 billion – is in employee compensation. That price tag has two parts. One is what people usually think of as compensation: wages and salaries, health and dental benefits, pension and social security contributions. The other is less front-of-mind, but has been rising dramatically over time: non-payroll expenses for the value of future payments and benefits earned in a given year and accumulating as unfunded liabilities.

Wages, Salaries and Other Payroll Contributions

A Treasury Board Secretariat review of federal government compensation released in November 2006 found that federal employee compensation was higher than private-sector benchmarks when pension benefits are considered. In a subsequent article, the author of the Treasury Board review, while acknowledging the difficulties of making effective comparisons between federal public-sector and private-sector jobs, noted that a total compensation premium in the order of 15 percent to 20 percent on average seemed reasonable (Lahey 2011).

What has happened in the decade since the study? One approach is to compare total compensation per hour worked in federal government service jobs (excluding defense) and private-sector service jobs in fields requiring relatively advanced qualifications. Today, at $64 per hour, average total compensation, including pensions and benefits, in the federal government is still higher than in private-sector professional, scientific and technical service jobs ($40 per hour) or in finance and insurance jobs ($46 per hour) – a margin about the same as that prevailing at the time of the Treasury Board review. On that basis, if federal public-sector compensation was ahead of its private-sector benchmarks in the early 2000s, it would still be.

Unfunded Future Benefits

Such comparisons do not include non-payroll items related to the cost of unfunded future benefits offered to employees, including disability plans for veterans and police officers, future health and dental care for federal employees, provisions for severance and sick leave accumulation and the gradual recognition of the rising value of accrued pension and other future benefits. These costs have proved much harder to control and have increased dramatically since 2005/06.

A key driver of this increase is declining rates of investment return, which make a given future payment more expensive to fund. The per-employee cost of non-pension future benefits more than tripled in the decade from 2005/06 to 2015/16, as the expected federal long-term bond rate used to determine their value dropped from 5.1 percent to 2.4 percent.

Worse, the cost of employee pension benefits earned in a given year, as shown by the federal government in its financial statements, understates the true value of these commitments as well as their true cost to taxpayers. Ottawa's pension guarantees for its employees are part of the federal government's debt – indeed, they closely resemble federal real-return (inflation-indexed) bonds (RRBs). Someone not in a federal pension plan would need to fund a similar retirement – or, alternatively, to hedge against his or her liability for federal pensions as a taxpayer – by investing in the federal government's RRBs (Laurin and Robson 2016). At the end of 2015/16, the yield on these bonds was 0.49 percent, reflecting the extraordinarily low yields lenders are willing to accept for relatively high-quality credit.

Yet, unlike private-sector pension plan sponsors, the federal government values its accrued pension obligations by using arbitrary discount rates that average around 2.7 percent in real terms. As Hamilton (2014) points out, this means that taxpayers are guaranteeing plan participants long-term real rates of return of around 3 percent – a guarantee that has enormous value, yet does not appear in the federal government's statement of operations or debt. Valued at the RRB rate, the per-employee cost recorded for government pension contributions in 2015/16 would be more than triple what appears in the Public Accounts.

Ensuring Competitive Employee Compensation

The standard argument for providing generous pension benefits to federal employees is that public pressure constrains what Ottawa can pay in wages and salaries and, therefore, it must use non-wage benefits to prevent its employees leaving for the private sector. This argument is open to two objections.

First, the federal government suffers insignificant attrition – the typical career path of a federal employee is to stay until (comparatively early) retirement. If total federal compensation, including pension plans, were aligned to a competitive labour market, we would expect to see some departures for the private sector. In that event, the government would respond to particular pressures in particular areas with targeted compensation adjustments, rather than maintaining across-the-board premiums.

Second, the right response to public pressure to keep employee compensation down is not to provide additional compensation that is effectively hidden from view – it is to make a public case for good compensation for valuable employees. The argument that Canada needs able people doing important federal government jobs is not hard to make; the case that federal employees across the board should receive benefits far richer than most taxpayers enjoy, and that taxpayers cannot see, is very hard to make.

The recommendations flowing from this investigation are straightforward. First, the federal government should recognize the full value of its employees' deferred benefits using actual, not invented, discount rates. Second, it should ensure that the total value of its compensation is competitive with outside alternatives, understanding that some employees will depart even if they have the "right" level of compensation. In doing so, imposing prolonged periods of departmental operating budget freezes, as occurred in the early 2010s, is one of the most likely methods to succeed at restoring the overall balance between federal public and private-sector compensation with the least possible disruptions of essential public services (Lahey 2011). Implementing this measure results in expected cost savings of $0.6 billion in 2018/19.

Finally, in managing total compensation costs, the government should transition its pension plans to shared-risk plans in which taxpayers do not bear all the risks related to the future cost of these benefits and in which a joint governance structure gives employee representatives a stake in the long-term sustainability of the plans.

Improving Long-Term Sustainability and Transparency in Federal Finances

The challenge of slow economic growth will persist beyond the short-term. The increase in the traditional working-age population is slowing and will soon cease. Absent fresh measures to encourage work, investment and productivity, the resulting lagging economic growth will severely limit Canadians' opportunities to increase their living standards and governments' ability to fund programs and repay debts. This Shadow Budget would commit to a realistic timetable for a balanced budget, hold the line on provincial transfers, improve transparency with respect to future employee pension liabilities and minimize financial risks in the catastrophic and mortgage insurance industries.

A Clear Timeline for Balancing the Budget

In the continuing environment of low growth, both domestically and internationally, governments cannot depend on quickly increasing future tax revenue to finance spending commitments. To ensure balance between needed program spending and long-term fiscal sustainability, this Shadow Budget establishes a clear fiscal anchor: a firm commitment to balance the books by the end of 2023.

An anchor provides very clear parameters to frame the government's priorities, and it gives the public the ability to hold Ottawa to account. Targeting a steady debt-to-GDP ratio does not do this: GDP is not something the government can control, so the number will drift on its own, making it an ineffective bulwark against demands for increased spending. In the medium term, a clear timetable for balancing the budget would give businesses and households greater confidence in the larger picture. This assurance should also improve the response to fiscal stimulus, since it would mitigate potential fears of higher future taxes and borrowing costs (Scarth 2014). A lack of trust in the fiscal framework may hurt business confidence and, thus, curtail private investments more than encouraging them.

More Meaningful Reporting of Employee Pension Obligations

The federal debt is a key figure for assessing federal fiscal policy. It is a main indicator of financial health for credit rating agencies, and successive federal governments have set long-term goals for its level as a percentage of GDP. Other than market-traded debt securities, however, the values of all other liability components are only best estimates subject to accounting standards. One of those critical best estimates is the present value of Ottawa's future obligations for employee pensions.

As elaborated above with respect to federal pensions, low yields and correspondingly low discount rates on liabilities make a given future payment more expensive to fund. The Public Accounts show Ottawa's obligation for employee pensions – net of the assets that have accumulated since these plans began operating on a partially funded basis in 2000 – at $151 billion at the end of fiscal 2015/16. But a market-based valuation yields a deficit of $264 billion at that date.[12] This restatement increases the total value of federal liabilities – and the federal debt – by $113 billion, a significant amount.

Clearly, accurately reporting the fair value of federal pensions to their recipients and their cost to taxpayers in the Public Accounts would provide a useful supplement to existing information about the federal government's financial position.

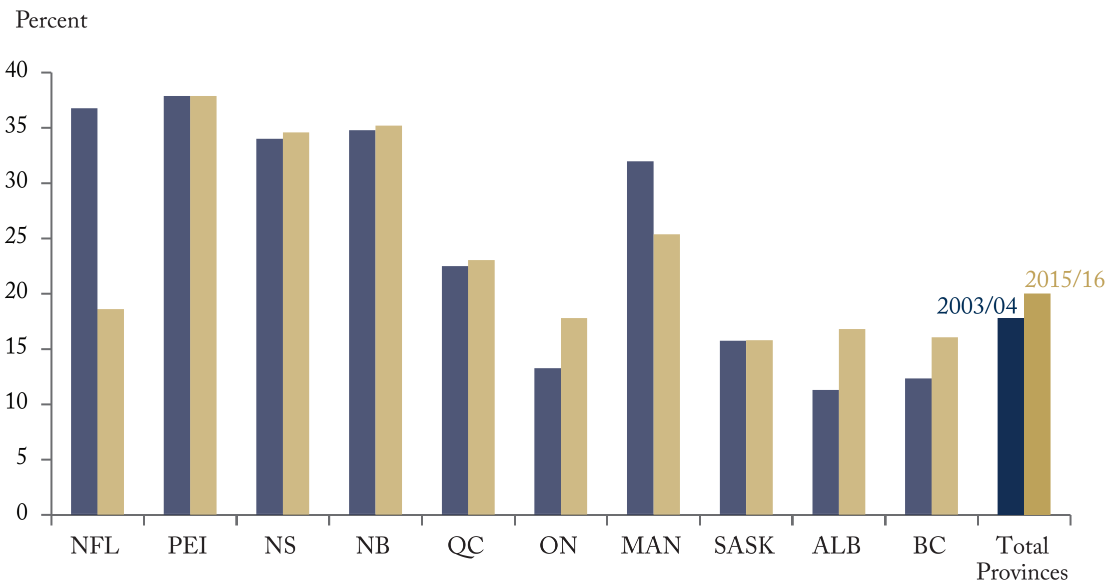
Holding the Line on Provincial Transfers

Over the past 10 years, federal transfers to provincial, territorial and local governments have grown faster than the economy as well as faster than the revenues of either the federal or other governments. The growing reliance of most provincial budgets on federal transfers (Figure 1) reinforces a dangerous tendency for provinces to see Ottawa as the answer to their fiscal challenges.

Provincial governments, however, have access to essentially the same revenue sources as Ottawa. The more federal transfers respond to provincial demands, the weaker their incentives for effective fiscal management and the stronger their incentives to blame Ottawa for shortcomings in their programs. Furthermore, this reliance on federal financial support diverts provincial time and energy from improving services toward lobbying for even larger transfers (Robson and Laurin 2015).

12 This calculation is based on the 0.49 percent RRB rate at the end of 2015/16. More details on the calculation methods can be found in Robson and Laurin (2016) and prior annual updates in this series.

Figure 1: Federal Major Cash Transfers as Share of Total Revenue



Source: Finance Canada's Fiscal Reference Tables.

This Shadow Budget, therefore, proposes that federal-provincial transfers increase only in line with economic growth and federal revenues. Canadians need each level of government to steward its own finances well, rather than budgeting less rigorously in the hope of a bailout from another level. One positive example of holding the line is the Canada Health Transfer. It will continue rising at the greater of GDP growth or 3 percent – notwithstanding already signed bilateral health agreements with four provinces for home care and mental health – rather than returning to the previous, unsustainable 6 percent growth rate (Clark and DeVries 2016).

Addressing Risks in the Insurance Industry

Ensuring Insurers Can Withstand Catastrophic Disaster

Since the 2008 financial crisis, policymakers have focused on addressing areas of systemic risk in financial and economic systems. However, these interventions have generally overlooked property and casualty insurers, focusing instead on the banking system. While the systemic risk posed by general property and casualty insurers is generally low, a catastrophic event in which insurable losses exceed $30 billion would overload the industry and exceed the Property and Casualty Insurance Compensation Corporation's (PACICC) ability to meet policyholder claims (Kelly and Stodolak, 2013). In such a case, PACICC must assess surviving insurance companies to fill consumer claims, adding to the strain on already strained companies and exacerbating the systemic risk.

This Shadow Budget proposes to implement a federal emergency backstop arrangement for property and casualty insurers to minimize the systemic impact that a catastrophic natural disaster would have on the economy. This last-resort guarantee would kick in beyond an industry-wide trigger of expected losses. For example, it would protect against those high-risk events, such as a one-in-500-year catastrophic earthquake, which would result in damages currently estimated at $30 billion to $35 billion.

As part of such a reform package, PACICC would be bolstered to deal with potential insurance industry failures while reducing the likelihood that a federal financial commitment would be required and, if triggered, reduce its costs (Le Pan 2016). Accordingly, the Shadow Budget would allocate appropriate funds to the Office of the Superintendent of Financial Institutions, in collaboration with PACICC, to determine the proper risk-sharing arrangement that balances mitigation of risk with addressing moral hazard issues. The cost of this initiative is small.

Minimizing Risks in Mortgage Insurance

The federal government currently guarantees mortgages insured by the Canada Mortgage and Housing Corporation as well as by private mortgage insurers. A recent analysis by Koeppl and MacGee (2015) indicates that a low-probability housing crisis could cost the federal government up to $9 billion to recapitalize mortgage insurers. In October 2016, the federal government launched consultations on a new proposed risk-sharing framework for mortgage losses between lenders and mortgage insurers.

This Shadow Budget, instead of establishing new loss-sharing arrangements, would create a standalone fund – available only for the residential ownership market – to insure against a severe housing downturn up to a target level and with the capacity to borrow against future revenue if needed, as proposed by Koeppl and MacGee (2015). The Financial Institutions Supervisory Committee, which oversees all federally regulated financial institutions, would oversee the emergency fund's pricing and reserve policies. This backstop would be primarily financed by market participants, so the direct cost to Ottawa would be negligible.

Improving Opportunities for Canadians

The Shadow Budget would promote mobility of workers in two ways, internationally by improving our capacity to attract and retain top talents and domestically through equalizing regional access to employment insurance benefits. It would also create the conditions for greater financial stability for our seniors, now and in the future.

Ensuring that Skills get to Where They are Needed

Canada competes for labour talent on an international stage, and it is crucial that employers are able to attract and retain the best and brightest. Domestically, the right conditions must be in place to encourage workers to move to where they are needed and job prospects are brighter. There are several measures governments can take to help make this happen.

Reducing Punitive Personal Income Tax Rates

Since 2010, provincial governments have tended to raise the tax rate on higher-income earners as they seek new revenues and respond to populist pressure. Currently, with the recent four-percentage-point federal hike on taxable income above $200,000, the combined federal/provincial top tax rate in 2017 approaches 50 percent in the three western provinces and surpasses it in the other seven, including Ontario (54 percent), Quebec (53 percent) and Nova Scotia (54 percent). The rate in New Brunswick is also 53 percent, but would have been almost 60 percent if the province had not reversed a previous larger hike on high earners.

Table 5: Achieving Fiscal Sustainability – Summary of Shadow Budget Initiatives' Impact on Budget Balance (2017/18 and 2018/19)

Initiatives	2017/18	2018/19
	($ billions)	
Joint federal-provincial marijuana regulation	-0.1	
Taxation of recreational marijuana	1.5	1.5
Ensuring competitive employee compensation		0.6
A clear commitment to balance the budget in the medium-term	n/a	n/a
More meaningful reporting of employee pension obligations	n/a	n/a
Holding the line on provincial transfers	n/a	n/a
Bolstering insurers capacity to withstand catastrophic disasters	s	s
Creation of a mortgage insurance backstop fund	s	s
Total	**1.4**	**2.1**

Notes: n/a = not applicable; s = cost is small or negligible.

In the short term, high-income taxpayers respond to tax-rate increases by trying to realize their income in different forms, at different times and in different jurisdictions. These responses shrink the tax base and reduce tax receipts – a key reason for New Brunswick's decision not to maintain its higher rate (Laurin 2015). In the long run, as well, the economic damage of the high-earner tax rate hike will be felt through less entrepreneurial activity and private investment.

The prospect of lower US personal tax rates in the coming years heightens the urgency of competitive Canadian rates. Excessively taxing the talent that fuels a more innovative, creative and successful economy is ultimately self-defeating (Alexander and Laurin 2015). Responding to these concerns, the Quebec Taxation Review Committee in March 2015 recommended that the maximum federal/provincial tax rate should not exceed 50 percent (Quebec 2015).[13]

13 Laurin (2015) estimates that further increases in the top tax rate would generate increasing tax revenues until the rate reaches 38 percent, but would only generate $500 million more in revenues at that point. But the resulting erosion of the taxable revenue base would produce a provincial government revenue shortfall. The bottom line is that further increasing the top tax rate at the federal level would be economically ineffective since we have now reached the point where governments extract about as much as they can realistically hope from very high earners.

Also recognizing these risks, this Shadow Budget proposes to reduce the number of people subject to the highest tax rate by raising the threshold at which it applies from the current $202,800 to $402,800. The net cost to the federal budget would be around $363 million annually in the short-term after accounting for taxpayers' behavioural response and positive economic impacts, while such positive impacts would expand the taxable revenue base yielding a tax-revenue dividend for provincial governments of around $654 million – greater than the federal cost by around $300 million.[14] While helping Canada to remain competitive and fiscally attractive for the world's best talents, the resulting provincial tax-revenue windfall would provide timely help for provinces.

Equalizing Labour Support across the Country

Currently, regional differences in the employment insurance (EI) program encourage dependency for many workers and discourage migration to areas where job prospects are brighter (Busby, Laurin and Gray 2009). Longer benefit payout periods in areas with higher unemployment hurt the economy by subsidizing industries and regions where the prospects for long-term, stable jobs are relatively poor.

This Shadow Budget proposes to phase out EI's regionally differentiated entrance requirements and benefit periods. The resulting coast-to-coast uniform requirements would be tied to the national unemployment rate, providing a countercyclical income stabilization element to the program. In the short term, the desirability of accelerating EI access for workers displaced by the energy slump – who are typically in regions where past low unemployment rates impede access – justifies easing the stringent requirements ahead of tightening the looser ones. To cover these transitional costs, the Shadow Budget includes $0.5 billion in fiscal 2017/18 and $0.5 billion in 2018/19.

Ensuring Financial Stability for Seniors, Now and In The Future

Revising Tax Rules to Accommodate Target-Benefit Pension Plans

Policymakers' interest in target-benefit plans (TBPs) has increased with the recognition that sharing risks related to retirement income between employers and employees fosters more durable pension plans than requiring either side to bear disproportionate burdens in plans whose benefit commitments depend, at least to some degree, on their funded status. Such TBPs are already common in a multi-employer environment, and Canadian policymakers and regulators are updating their pension laws and standards to accommodate single-employer TBPs (Steele et al. 2014). It is time for federal tax rules to do the same.

This Shadow Budget proposes new tax rules to accommodate single-employer TBPs, whether new or conversions from existing defined-benefit (DB) and defined-contribution (DC) plans. The tax rules for TBPs would provide a default approach for TBPs functioning more like DB plans, while an alternative approach would accommodate TBPs functioning more like DC plans (Gros et al. 2015). These adjustments would provide valuable certainty for employers and employees seeking more durable pension arrangements. The fiscal impact of this measure is negligible.

Levelling the Field for Savers in Group RRSPs

The majority of Canadians, and the vast majority who work in the private sector, do most of their

14 This estimate uses the same methods as described in Laurin (2015); i.e., the median taxpayer response-elasticity coefficient of 0.62.

retirement saving in RRSPs. Many employers support this saving by organizing group RRSPs, and many match at least part of their employees' contributions. Approximately 1.5 million Canadians participate in an employer-sponsored group RRSP.

DC pension plans and pooled registered pension plans help their participants prepare for retirement by allowing sponsors to deduct some administrative expenses from outside income. By contrast, participants in group RRSPs pay these expenses from plan assets, which reduces their ability to accumulate tax-deferred retirement wealth. This Shadow Budget proposes to let group RRSP sponsors and/or participants deduct some administrative expenses, currently levied against plan assets, from outside income. Since employers' contributions to employees' accounts are more likely to be locked in, and are more like pension-plan contributions than money employees might withdraw before retirement, the Shadow Budget also proposes to relieve employers' contributions to group RRSPs from payroll tax (Robson 2010).

These changes would have little effect on federal revenue during the projection period.

Increasing Age Limits for Tax-Deferred Saving

Life expectancy in Canada has been rising more than two years per decade since the 1960s, but current age limits related to retirement do not reflect this change. Canadians (and their employers) now must stop contributing to tax-deferred retirement saving plans at age 71, which is also the age at which contributors must start drawing down their wealth. The Shadow Budget would increase the age at which contributions to tax-deferred retirement saving schemes must end to 72 on January 1, 2018. For every six months after that date, we propose adjusting the contribution time frame by one month. Among other advantages, this change should encourage older Canadians to stay in the workforce longer.

In view of these life-expectancy changes, the government should start consultations to assess whether automatic actuarially based adjustments to the eligibility age for the Old Age Security and the Canada Pension Plan is warranted, as Canadians continue to live longer and healthier lives.

Increase Tax-Deferred Saving Limits

Canadian income-tax rules limit the amounts of retirement wealth Canadians can accumulate on a tax-preferred basis. Because people are living longer and, even more important, yields on investments suitable for retirement saving are now very low, the cost of obtaining a given level of retirement income has risen. The current rules for calculating equivalency between DB and DC pension plans or limits for RRSPs are badly out of date, putting people with DC plans and/or RRSPs at a major disadvantage relative to those in DB plans.

Accordingly, this Shadow Budget updates the assumptions underlying the equivalency factor (Factor of Nine) to reflect current economic and demographic realities. As a result, the tax-deferred savings limit for capital accumulation plans would increase from its current 18-percent-of-income-level to 30 percent. Since tax owing on higher contributions is deferred to be paid when invested funds and income are withdrawn, the tax deferral is effectively a current asset to governments – making the fiscal cost of this measure small on a present-value basis.

Eliminating Mandatory Drawdowns from RRIFs

The 2015 federal budget's reduction of mandatory minimum withdrawals from registered retirement income funds (RRIFs) and similar tax-deferred accounts reduced the risk that many Canadians would outlive their savings. Yet with yields on safe investments as low as they now are, and longevity increasing, the risk is still material (Robson and Laurin 2015d).

The calculations of the new RRIF mandatory minimum withdrawal schedule's impact in the 2015 budget assumed real investment returns of

Table 6: Increasing Opportunity – Summary of Shadow Budget Initiatives' Impact on Budget Balance (2017/18 and 2018/19)

Initiatives	2017/18	2018/19
	($ billions)	
Reducing punitive personal income tax rates	-0.3	-0.3
Eliminating regional differences in unemployment insurance	-0.5	-0.5
Revising tax rules to accommodate target-benefit pension plans	n/a	n/a
Leveling the field for savers in group RRSPs	s	s
Increasing age limits for tax-deferred saving	s	s
Increasing tax-deferred saving limits	s	s
Consultations on eliminating mandatory drawdowns from RRIF	n/a	n/a
Extending pre-age-65 pension credit and income splitting	-0.1	-0.1
Total	**-0.9**	**-0.9**

Notes: n/a = not applicable; s = cost is small or negligible

Sources: Authors' calculations.

3 percent. Re-running those projections with real returns on safe investments closer to current levels suggests that most seniors still face a material risk of outliving their tax-deferred savings. In our view, the 2015 changes should be only one step toward further liberalization. Therefore, the government should consider two further options: more regular adjustments to keep the withdrawals aligned with returns and longevity; or eliminating minimum withdrawals entirely. One way or another, tax rules should not prevent retirees enjoying the lifelong security they are striving to achieve.

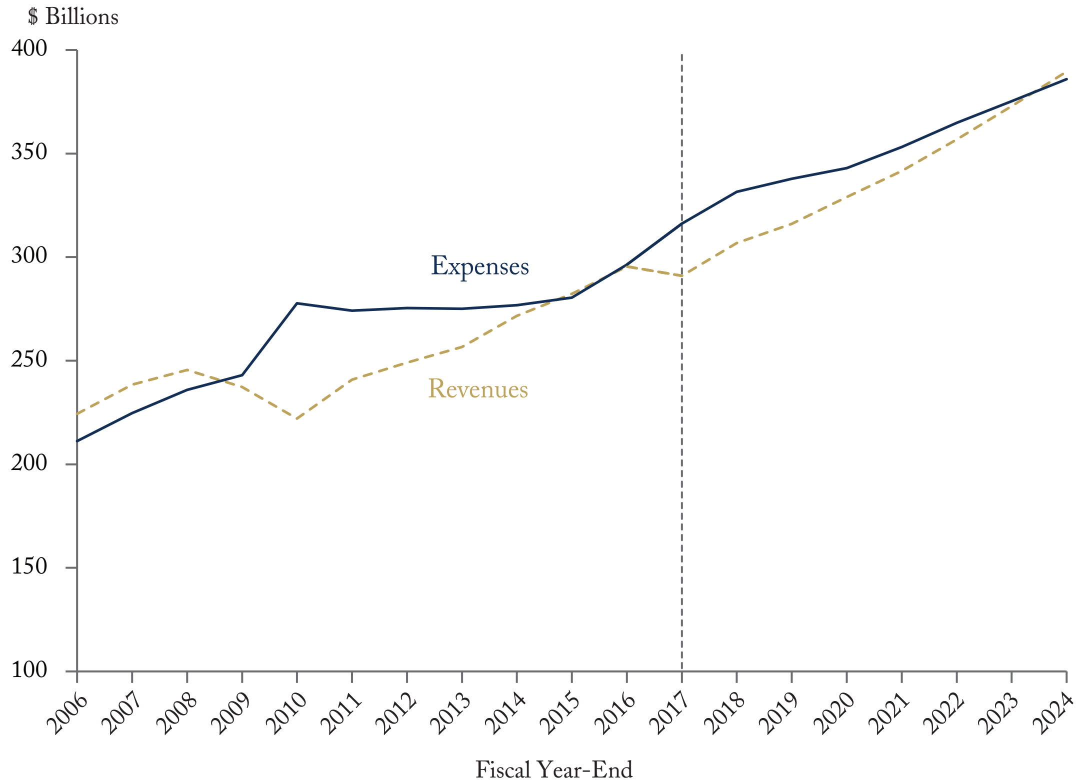
Extending Pre-Age-65 Eligibility for Pension Credit and Income Splitting

Currently, the Pension Income Tax Credit and pension income splitting are available to pension annuity recipients before age 65. However, recipients of funds from other retirement saving vehicles, such as life-income funds, RRIFs and RRSPs, can use the credit or income splitting only at age 65. This Shadow Budget would make these tax provisions available to all such income, regardless of the recipient's age.

COMBINING IT ALL

These Shadow Budget plans for strengthening the economy, achieving a sustainable fiscal framework and improving Canadians' opportunities leave a large federal budget deficit in the short term (Table 1). However, the continuation of these initiatives and prudent management of public

Figure 2: Actual and Projected Federal Revenues and Expenditures, 2005/06 to 2023/24



Notes: Projections are adjusted for Shadow Budget initiatives but do not include fiscal prudence. Base revenues and expenditures before adjustments are from the Fiscal Update (Canada 2016) for 2019/20 and 2020/21. For 2021/22 to 2023/24, base revenues are assumed to grow with the economy and base expenses to grow with inflation and population growth.

Sources: Public Accounts of Canada; authors' calculations.

finance would ease the path back to surpluses in the medium term (Figure 2).

Therefore, this Shadow Budget provides a sound fiscal framework at the federal level, assuring Canadians that they can pursue their lives and work, save and invest with confidence. It promotes economic growth with tax changes for businesses, people and imports. And it enhances opportunities for Canadians working and preparing for their retirement. Whatever the world brings in 2017, this Shadow Budget would help all Canadians prosper now and in the future.

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