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Less Debt, More Growth: A Shadow Federal Budget for 2019

This Shadow Budget ensures the competitiveness and dynamism of the Canadian economy in the near and medium-term, while setting the stage for a return to surpluses during the next Parliament.

William B.P. Robson and Alexandre Laurin

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The Study In Brief

The C.D. Howe Institute's Shadow Federal Budget for 2019 looks past the overspending and deficits the federal government has adopted as its fiscal signature since its election in 2015. Instead, our focus is on ensuring the competitiveness and dynamism of the Canadian economy in the near and medium-term, setting the stage for a return to surpluses during the next Parliament.

This Shadow Budget would improve tax competitiveness in the near term and lay the groundwork for a much-needed modernization of the tax system in the years ahead. It would enhance Canadians' educational, labour-market and retirement prospects. It would facilitate international trade, invest in core federal infrastructure and reduce red tape. And, critically, it would improve fiscal accountability, contain spending and assure Canadians that their federal government is on a return to budget balance.

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Until now, rapid spending growth – virtually across the board – and exceeding revenues has been a signature policy of this government.

Ottawa has embraced red ink and undermined its ability to resist spending demands from its would-be beneficiaries and those who advocate living for today. The 2017/18 fiscal year is a case in point. The 2018 budget, which anticipated five-percent-plus growth in both revenue and expense, underestimated the strength in the economy. Revenue came in $4 billion above projections. The government spent the bulk of this bonus, so the deficit came in almost as projected.

The government's chronic borrowing would be less concerning if accompanied by tax and program changes that enhance Canada's ability to create and retain talent and investment, and to grow in the future. But the rationale for the Liberals' election campaign commitment to run modest deficits – about $10 billion annually – in order to finance infrastructure investment made no sense. No conceivable amount of federal infrastructure spending, let alone the small amount that has actually occurred, could produce a $10 billion addition to annual spending in the near term, because the federal government expenses capital assets over their useful lives, which can be decades.

The commitment to return to budget surplus in 2019/20 also turned out not to be reliable. The government has added considerably more debt than Canadians were led to anticipate during the campaign. The cost of servicing this additional debt means Canadians ultimately will pay more taxes for fewer federal services than they would otherwise have done. This prospect is unwelcome to talented individuals wondering where to live and work and to businesses considering where to invest. Allowing debt to accumulate is also imprudent at this time in the economic cycle. Central banks are getting their policy interest rates back to more neutral levels, asset prices have been volatile, growth has flagged in Europe and Asia, and the US expansion looks vulnerable.

In contrast, this Shadow Budget contains a number of measures to enhance Canada's attractiveness as a place to work and invest, while restraining less productive expenses. Together, they should set the stage for a return to surpluses.

Parallel with the promise to give Canadians confidence in the federal government's fiscal framework and the longer-term prospects for Canada's economy should be a commitment to greater transparency and accountability in the budgeting process. The C.D. Howe Institute's latest fiscal accountability report (Robson and Omran 2018) gave the federal government an A-. Good, but not the top-rank position appropriate to the national government. Obscure presentation of key budget numbers, estimates that do not match the budget projections and late production of the Public Accounts were the defects that kept the government from achieving a top grade.

They are also easy to fix. As detailed below, the Estimates will from now on reconcile straightforwardly with the fiscal plan in the budget.

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Table 1: Near-Term Fiscal Projections with Shadow Budget Initiatives

	2018/19	2019/20	2020/21
		($Billions except as noted)	
Baseline Projections			
Revenues	328.9	339.2	352.1
Expenditures	-344.0	-355.8	-367.2
Budgetary Balance before Initiatives	-15.1	-16.6	-15.1
Shadow Budget Initiatives			
Environmental and Efficient Taxation		*2.3*	*2.3*
Better Opportunities		*-0.5*	*-0.5*
Fostering Growth		*0.9*	*0.6*
Achieving Fiscal Sustainability		*-0.1*	*0.3*
Total		***2.6***	***2.7***
Lower Debt Changes		**0.0**	**0.1**
New Budgetary Balance	**-15.1**	**-14.0**	**-12.3**
Accumulated deficit	687.7	701.7	714.0
as % of GDP	30.9	30.3	29.8

Sources: Tables below; authors' calculations.

The federal government will publish its financial statements before the end of June, matching the best performance among Canada's senior governments. As for straightforward presentation, unlike the 2018 Budget, which buried the key numbers on page 319 in an annex, this Shadow Budget moves the fiscal plan summary to the document's front (Table 1).

Economic and Fiscal Framework

2018 marked the long-awaited closing of the gap between Canada's economic activity and the productive potential of its workforce and capital stock. Inflation came in close to the Bank of Canada's 2 percent target, the unemployment rate hit a record low and business surveys revealed pressures and capacity constraints typical of an economy working flat out. As previously noted, the strong economy yielded higher-than-projected revenues, which the government used mainly to finance higher-than-promised spending.

This Shadow Budget uses as its baseline the economic and fiscal projections from the October 2018 *Fall Economic Statement* (Canada 2018a). The average of private-sector economic forecasts used by Finance Canada puts real growth of gross domestic product (GDP) at 2.0 percent for 2019 and 1.6 percent in 2020. Allowing for inflation, the corresponding figures for nominal GDP growth are 4.1 percent in 2019 and 3.3 percent in 2020. The private sector projections show short-term interest rates rising by 1 percentage point from 2018 to 2020 and long-term interest rates rising by 0.7 percentage points over the same period.

The projections show revenue increasing 7.1 percent in total over the next two fiscal years,

Table 2: Shadow Budget Assumptions and Projections

	2018/19	2019/20	2020/21
		($Billions except as noted)	
Economic Growth (*percent*)			
Real GDP growth	2.0	2.0	1.6
GDP inflation	2.2	2.1	1.7
Nominal GDP growth	4.2	4.1	3.3
Revenues			
Taxes on incomes, payroll, consumption and other transactions	299.1	307.3	318.3
User fees and charges for government services and products	15.6	17.4	19.1
Investment income	14.2	14.5	14.7
Total Revenues	**328.9**	**339.2**	**352.1**
Expenses			
Direct program expenses	149.0	149.6	150.6
Transfers to persons and governments	171.2	178.7	186.7
Gross debt charges	23.8	27.5	29.9
Total Expenses	**344.0**	**355.8**	**367.2**
Summary of Revenue, Expense and Balance			
Taxes, fees, and other charges	314.7	324.7	337.4
Program spending and transfers	-320.2	-328.3	-337.3
Debt charges net of investment income	-9.6	-13.0	-15.2
Budgetary Balance	**-15.1**	**-16.6**	**-15.1**

Notes:
Totals may not add exactly due to rounding.
Investment income projections include interest income, net income from enterprise Crown corporations, foreign exchange revenues and other returns on investment.

Sources: Canada (2018); authors' calculations.

reaching $352.1 billion in 2020/21, and expenses excluding debt charges rising 5.3 percent over the same period, reaching $337.3 billion. Debt charges, however, are expected to rise steeply, by 25.6 percent, over the next two years, reaching almost $30 billion in 2020/21 despite benefiting from a still relatively advantageous effective interest rate. Based on these projections, our Shadow Budget planning baseline starts with a $15.1 billion deficit in 2018/19, followed by a $16.6 billion deficit in 2019/20 and $15.1 billion in 2020/21 (Table 2).

An economy at full capacity can only grow as fast as growth in the workforce, the capital stock and productivity allow. In 2019 and beyond, potential for positive surprises that further buoy federal revenue is limited. While negative surprises are possible, this Shadow Budget uses the economic and revenue projections from the 2018 *Fall Economic Statement* as given. The growth forecasts from the private sector used by Finance Canada in this economic statement have tended to be reliable over the medium term. With no near-term commitment or pressure to achieve a balanced budget, moreover, the long-standing practice of building a contingency reserve – lately termed an "adjustment for risk" – into each year's fiscal plan has little justification. Indeed, these reserves or adjustments increase the real risk of unbudgeted spending when potential downside problems do not materialize (Busby and Robson 2017).

The *Fall Economic Statement* included $3 billion annually for such contingencies. This Shadow Budget ceases this practice and uses the private sector's baseline projections without modification (Table 2).

Responding to the Tax Competitiveness Challenge

Canadians pay relatively high amounts of personal tax due to a combination of relatively high rates and relatively low thresholds at which taxes become payable. Meanwhile, lower corporate income tax rates in other developed countries, and especially in the US, have eroded a long-standing Canadian advantage in corporate income-tax rates. This Shadow Budget address both challenges.

Personal Taxation: Lower Rates, Better Structure

Reducing Punitive Personal Income Tax Rates

Since 2010, provincial governments have raised their tax rates on higher-income earners, and the federal government did the same after 2015. The combined federal/provincial top tax rate is currently close to 50 percent – a threshold typically seen as psychologically, and perhaps economically, important – in the three western provinces and more than 50 percent in the other seven.

In the short term, high-income taxpayers can respond to tax-rate increases by converting their income to different, lower-taxed forms and by realizing that income 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 to reverse a change that would have taken its top marginal tax rate to 60 percent (Laurin 2015). In the long run, tax increases on high earners could depress entrepreneurial activity and private investment. Excessively taxing the talent that fuels a more innovative, creative and successful economy can be counterproductive. 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).

This Shadow Budget would reduce the number of people subject to the highest tax rate by doubling the threshold at which it applies from the current $210,371 to $420,742. The net cost to the federal budget would be around $364 million annually in the short term after accounting for changes in taxpayers' decisions about when and how they report taxable income and higher levels of activity. The positive responses to the lower rates would expand the tax base for both the federal government and for provincial governments. The revenue dividend for provincial governments would be around $767 million – $300 million more than the reduction in federal government revenues.[1]

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

The resulting provincial tax-revenue windfall would provide timely help for provinces and relieve provincial pressures for more federal transfers.

More Generous Tax Treatment of Nondiscretionary Medical Expenses

A key principle in taxing personal incomes is that people who would be equally well off without taxation should be equally well off with it. If people who face unavoidable costs related to, say, children, health status or deductions from employment income, pay tax on the income that covers those costs, they will end up with lower discretionary incomes than people who do not face such costs. For this reason, most personal income tax systems – including Canada's – provide exemptions, deductions or credits related to non-discretionary expenses. Many medical expenses fall into this category: people incur them because they are or may become sick, and the income they need to cover them is not available for enjoyment.

Although Canada's personal income tax does recognize this principle in part – employer-paid premiums for health and dental plans, for example, are exempt from a person's taxable income – in general, its treatment of health-related expenses is overly restrictive. The current medical expense tax credit applies only to expenses exceeding 3 percent of net income, or $2,306, whichever is lower, and is calculated at the bottom tax rate. This Shadow Budget would lower the threshold on such expenses to 1.5 percent of net income, or $1,150, whichever is lower. This change would help people who pay for healthcare directly, or pay health-related insurance premiums not covered by their employers. The fiscal cost of this measure is $400 million per year. Employer-paid health premiums would continue to be untaxed.

Facilitating Donations of Private Company Shares and Real Estate

When philanthropists donate publicly traded shares to registered charities, the determination of their incomes for tax purposes excludes any capital gain on those shares. In contrast, donations of private company shares and non-environmentally sensitive land may leave donors with a capital gains tax liability.

Extending favourable tax treatment to the donation of private company shares and real estate would unblock major new support for Canada's charities. There is no good tax-policy reason to treat the donation of shares of publicly traded securities differently from privately held ones (Aptowitzer 2017). This Shadow Budget proposes to amend the *Income Tax Act* to exempt donations of privately held securities from tax. To maintain the incentive to donate environmentally sensitive land to charities dedicated to its conservation, only a partial exemption would apply to donations of other real estate. The cost of this measure is likely to be small.

More Competitive Business Taxation

The recent reduction in the US federal corporate income tax rate from 35 percent to 21 percent and the provision – albeit temporary – for 100 percent expensing of many capital investments have boosted the attractiveness of the United States for new equity-financed business investment. The United States has also adopted a quasi-territorial system for the taxation of foreign affiliates' profits. These changes have many growth-friendly elements with positive implications for Canada. At the same time, however, they make the United States relatively more attractive as a place for investments in productive facilities intended to serve the North American and world markets, and pose a competitive challenge for Canada.

In Canada, successive reforms during the 2000s lowered the marginal effective tax rate (METR) on new capital investments. The result was a significant METR advantage over the United States. However, Canada's tax burden on new investment has lost its competitive edge over many developed economies in the current decade (Bazel and Mintz 2016), and in particular with the United States following the recent changes (Bazel and Mintz 2017; McKenzie and Smart, forthcoming).

The 2018 *Fall Economic Statement* responded to these pressures by introducing, on a temporary basis, an immediate full tax deduction for some investments in new machinery and equipment – basically replicating a similar US provision – plus a temporary accelerated tax deduction for other forms of capital investments. As a result, Canada's aggregate-industry METR on new capital investment is now down to a level just under that of the United States (McKenzie and Smart, forthcoming). This is a good, although late, temporary first step to improve Canada's competitive position, but still far from fully restoring the advantage Canada enjoyed before the US reforms.

This Shadow Budget responds to these pressures with additional measures to improve the incentives in Canada's business taxation regime. Firstly, it launches a comprehensive tax system review for the best way to remove human and capital investment disincentives while respecting the tax principles of equity, efficiency and adequate revenue yield. On the corporate income tax side, a move to cash-flow taxation would be front and centre (McKenzie and Smart, forthcoming).

Comprehensive reviews take time and consensus is difficult to reach. In the meantime, lower corporate income tax rates would make Canada a more desirable location for capital investment.

Lower Corporate Income Tax Rates

Taxes are a cost of doing business and can influence the location of economic activity and profits of multinational corporations. The large tax-rate differential that existed between the United States and Canada prior to the recent 14 percentage-point US rate reduction likely induced multinational firms to realize more of their profits in Canada than they would have otherwise (McKenzie and Smart, forthcoming). Differences in average effective tax rates (as opposed to METRs) also drive location decisions with respect to new corporate investment, whereas the METR drives the intensity, or quantity, of investments.

This Shadow Budget would reduce the corporate income tax rate by two percentage points, from 15 percent to 13 percent, effective immediately. This change would provide additional locational incentives for investments and profits in Canada, while a more comprehensive review of the tax system is underway.

Unlike a structural reform proposed below, which would apply only to new investments and can be designed to be revenue neutral, a rate reduction would come at a cost, at least in the short-term. Some have argued that this cost is excessive because it rewards "old" capital investments and just not the new investments it is intended to spur. We do not think that this argument should be decisive, any more than concerns about rewarding "old" investments in human capital should discourage lowering personal income tax rates.

Indeed, concerns about rewarding old capital investments were not decisive in the discussion over tax-rate reductions during the 2000s. After those reductions, corporate tax revenues *increased* as a share of profits (McKenzie and Smart, forthcoming). While this experience is consistent with more formal research that shows how positive reactions from investors and business managers can offset the fiscal cost of corporate income-tax rate reductions, it is fiscally prudent to plan for a short-term revenue loss. Based on the Parliamentary Budget Officer's net cost estimate of about $1.6 billion per percentage-point reduction (PBO

2018),[2] the revenue cost of the 2 percentage-point rate reduction would be $3.2 billion per year.

Comprehensive Tax Review: Modernizing Business Taxation

This Shadow Budget calls for a comprehensive review of the tax system with a view to making Canada more attractive to human and capital investments. With respect to business taxation, the review would explore different ways to lower Canada's METR on business investment on a cost-neutral basis. Two promising possibilities are taxing above-normal returns through a cash-flow tax, and providing an allowance for corporate equity (ACE) in calculating taxable profits.

An ACE provides a deduction for shareholders' equity multiplied by an appropriate interest rate. It thus exempts returns equal to the opportunity cost of equity financing from taxation. Such an approach would make Canada more attractive for domestic and foreign investors alike (Milligan 2014, Boadway and Tremblay 2016, Laurin and Robson 2012, IFS and Mirrlees 2011). Eliminating tax on normal profits would greatly reduce or eliminate the METR on new investment. The ACE would also reduce the tax advantages of debt over equity finance.

Achieving an ACE on a revenue-neutral basis is possible through offsetting changes such as restoring the corporate tax rate to its 15-percent level and broadening the base of investment income subject to personal taxation. In addition, applying the ACE to new capital investments only – a phased-in approach, as Italy did – could lower its initial costs. Alternatively, a cash-flow tax, which provides an immediate deduction for the full cost of all capital investments combined with no interest deductibility, would achieve the same result (McKenzie and Smart, forthcoming). The comprehensive tax review would consider these options among the range of possible reforms.

Rationalizing Taxes and Transfers

Greening Canada's Taxes

Canada has committed to reducing greenhouse gas emissions to 30 percent below 2005 levels by 2030. Many provinces have since put in place systems – cap-and-trade or "carbon taxes" – that discourage carbon-dioxide (CO2) emissions. The federal government has recently set a floor for a national carbon price. For provinces not meeting these standards, namely Ontario, New Brunswick, Manitoba and Saskatchewan, Ottawa will impose a carbon pricing backstop starting this year. For these provinces subject to the backstop, the federal government promises to transfer 90 percent of all revenues from the surcharge on fossil fuels to households in a "climate action incentive payment."

Industrial emitters will not be subject to the carbon price on fuel but instead will pay a carbon charge on the portion of their emissions that are above a limit, which will be determined based on relevant output-based standards (emissions per unit of output). The regulations governing the output-based pricing system are to be finalized later this year.

However, these measures are unlikely to reduce sufficiently the CO2-emissions-intensity to achieve the 2030 targets. The carbon levy will apply at a price that is equivalent to $20 per tonne of CO2 in 2019, increasing annually until it reaches $50 per tonne by 2022. Most studies of the response of households and businesses to higher prices estimate that CO2 emissions will have to become much more expensive to reduce them by amounts sufficient to hit such targets. For example, a recent

2 This cost estimate includes consideration of integration mechanisms between corporate and personal income taxes leading to personal income tax revenue increases. This comes from a decrease in dividend gross up and tax credits to maintain integration (PBO 2018).

study estimated that a carbon tax of about $175 per tonne would be necessary to reduce emissions by about 10 percent in the transport sector (Rivers and Wigle 2018).

The bulk of greenhouse gas emissions are ultimately the result of consumer choices, and most governments have, to date, been reluctant to steer those choices as forcefully as the greenhouse-gas targets require. The federal government's assumption of authority to determine which provinces are meeting its standards is, moreover, certain to be the cause of continuing inter-regional and inter-governmental acrimony.

Instead of putting all of its carbon reduction eggs into one unpredictable basket, this Shadow Budget sets a new course by increasing the Goods and Services Tax (GST) rate applied to transportation fuels. Raising the GST (5 percent) on transportation fuels is preferable to raising existing excise taxes or imposing a new carbon levy because GST is only effectively paid on net value-added when goods and services are purchased by the final consumer. While this feature attenuates the incentive to reduce CO_2 emissions on intermediate activities, it protects Canada's international competitiveness and avoids the distortions that occur when taxes "cascade" on intermediate inputs bought and sold but do not cascade on internal firm transactions. Establishing a new GST rate of 15 percent on motive fuels, starting in the next fiscal year, would provide consumers with a strong price signal to discourage CO_2 emissions and generate about $4 billion in additional revenues that would help finance a return to budget balance in the medium term.

Eliminating Excise Tax on Aviation Gasoline and Jet Fuel

This Shadow Budget would abolish federal aviation fuel excise taxes because they are inferior to value-added taxes such as the GST for several reasons.

By taxing an intermediate input, levies such as the aviation fuel excise tax impose business expenses that have no fiscal offset, raising costs throughout the economy and making Canadian exports less competitive. An aviation fuel excise tax also induces airlines to fuel their aircraft where taxes are lower rather than minimize their fuel use. This response works against the tax's intended impact on fuel consumption, making air transportation less efficient and further damaging the environment.

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 would be less than $100 million per year.

Levelling the Playing Field in the Digital Economy

The Internet is revolutionizing how people access entertainment, order taxis, find accommodations and shop for goods. Consumers can now make many purchases from a supplier located outside Canada just as easily as if the company were domestic.

Domestic providers of digital products and services must charge 5 percent to 15 percent GST/HST on their sales. Foreign providers of like products and services need not collect and remit sales tax if they are not "carrying on business" in Canada. Consumers are responsible for remitting the taxes on these items, but most do not. The impracticality of enforcement means significant amounts of potential tax revenues go uncollected, which gives foreign providers a competitive advantage over domestic competitors in services such as video streaming, digital books, games and myriad fees for digital platform and network services. Requiring suppliers to pay GST/HST based on the location of consumers could help fix this problem.

Provinces have begun addressing these revenue and competition issues. For example, Quebec's 2018 budget created a requirement for non-Quebec suppliers of digital goods and services to register for, collect and remit Quebec Sales Tax, starting

Table 3: Tax Competitiveness: Fiscal Impact of Shadow Budget Initiatives ($Billions)

	2019/20	2020/21
Reducing Punitive Personal Income Tax Rates	0.4	0.4
More Generous Tax Treatment of Nondiscretionary Medical Expenses	0.4	0.5
Facilitating Donations of Private Company Shares and Real Estate	s	s
Lower Corporate Income Tax Rates	3.2	3.2
Comprehensive Tax Review	n/a	n/a
Greening Canada's Taxes	-4.0	-4.0
Eliminating Excise Tax on Aviation Gasoline and Jet Fuel	0.1	0.1
Levelling the Playing Field in the Digital Economy	-0.2	-0.2
Scrutinizing Tax Preferences	-2.2	-2.3
Total	**-2.3**	**-2.3**

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

Sources: Authors' calculations.

in 2019. Already, 76 digital providers including Apple, Google, Netflix, Spotify, Expedia and LinkedIn have registered and started to collect the 9.975 percent provincial sales tax.[3] Saskatchewan has also begun taxing some digital services. Apple is now charging Canadian sales taxes on downloads. Meanwhile, British Columbia has reached an agreement with Airbnb whereby the company will collect the 8-percent provincial sales tax and other taxes that apply to short-term rentals.

This Shadow Budget would amend the Excise Tax Act to apply to all businesses that supply digital goods and services for consumption within Canada, regardless of where the supplier is located, in compliance with the International VAT/GST Guidelines. The main goal of this reform is to level the playing field for domestic and foreign providers of digital products and services. As an added benefit, this measure would increase annual revenue by about $200 million annually.

Scrutinizing Tax Preferences

The federal tax system contains many exemptions, deductions, rebates, deferrals and credits. While some attempt to recognize differing capacity to pay among taxpayers, others are effectively disguised spending programs (Laurin and Robson 2017). A number of these disguised spending programs might not pass muster if accounted for and voted on as federal expenses.

For example, the Age Credit provides a tax subsidy to seniors who already benefit from a number of federal and provincial transfers and in-kind benefits. The amount is clawed back on incomes between $37,790 and $87,750, which

3 *La Presse*. 10 January 2019. « *Taxe Netflix* » *québécoise: 76 entreprises étrangères ont dit oui.*

increases the METR on these seniors. This Shadow Budget contains a number of measures to improve retirement security for Canadians (see next section) by relaxing limits on saving and mandatory drawdown of income. It makes sense to accompany those improvements with a rationalization of the Age Credit subsidy: this Shadow Budget proposes to reduce the base amount for the age credit from $7,494 to $4,000, closer to the amounts most provinces use for their old age tax credits, for a saving of about $1.9 billion annually over the next two years.

Another contentious spending program is the tax credit for first-time homebuyers. This is a problematic subsidy, given the disproportionate amount of Canada's capital investment that flows into residential construction (Robson 2017a) and the evidence that many younger and less well-off Canadians are financially overcommitted. This Shadow Budget proposes to phase it out for a saving of about $100 million annually.

Meanwhile, the federal credit for investment in labour-sponsored venture capital corporations (LSVCC) notoriously distorts saving and investment. In general, venture capital funding spurs innovation, but among the various 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 for a saving of about $200 million annually.

Table 3 summarizes the revenue and expense implications of these measures to improve Canada's tax competitiveness.

Better Opportunities

Enhancing Canada's human capital is a multi-pronged effort. We need to promote high-quality education, improve labour-market performance and ensure that Canadians can prepare for a secure retirement. This Shadow Budget addresses all these areas.

Enhancing Canadian Education

Measuring Results in Elementary and Secondary Education

While the provinces deliver elementary and secondary education services, the federal government plays a key supporting role by supporting the benchmarking of student achievement across the country and internationally. This benchmarking promotes the spread of effective practices and highlights areas that need improvement. This Shadow Budget proposes measures to enhance this federal role.

At the national level, the Pan-Canadian Assessment Program (PCAP) evaluates performance in reading, writing, mathematics and science. Its evaluations currently look at achievements three grades apart, but its value would be far greater if it measured performance at each grade level. Year-by-year measures are better for judging value added, and a shorter cycle would improve the chances of spotting and responding to problems while the students affected are still in school.

At the international level, the Program for International Student Assessment (PISA) benchmarks the performance of Canadian students in math, science and reading against peers abroad. Canada supports over-sampling to also allow comparison among the provinces.

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

Supporting Education for Indigenous Children

Indigenous Canadians, especially on reserve, tend to complete secondary education at much lower rates than other Canadians. In Budget 2016, the federal government proposed spending $2.6 billion over five years to support on-reserve primary and secondary education programs and infrastructure.

Indigenous students on reserves do not benefit from the measures of achievement that benchmark performance and spur improvement in most provincial schools. Therefore, this Shadow Budget proposes to fund the PCAP and PISA assessments for on-reserve schools and offer bonuses for schools whose students participate in sufficient numbers to benchmark their performance. Related spending would amount to some $200 million annually – funds that can help on-reserve Canadians assess whether they receive educations as good as those available to their peers off reserve.

Improving Canada's Labour Markets

Canadian workers and employers will find and engage better with each other if they have access to better information about job opportunities and worker qualifications. They would also benefit from Employment Insurance (EI) reforms that reduce distortions that promote pockets of high unemployment.

Better Labour Market Information

The 2009 report of the Advisory Panel on Labour Market Information identified priority data gaps with respect to vacancy rates, employment figures, Aboriginal peoples, immigrants and education. In the decade since, some advances have occurred. For example, Statistics Canada launched its Job Vacancy and Wage Survey in 2015, providing information on in-demand occupations, job openings, the duration of job vacancies, average pay and educational requirements.

However, data gaps remain. The Labour Force Survey still does not cover the on-reserve Indigenous population. Canada has no consistent data tracking people as they move from formal education to work. A survey asking potential employers about the characteristics they seek would also be useful.

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

Treating Unemployed Canadians More Fairly

Currently, regional differences in the EI program encourage dependency for many workers and discourage migration to areas where job prospects are brighter (Busby, Laurin, and Gray 2009). Shorter qualifying periods and longer benefit periods in areas with higher unemployment subsidize industries and regions where prospects for long-term, stable jobs are poor. This Shadow Budget proposes to phase out EI's regionally differentiated entrance and benefit provisions. Tying the new uniform provisions to the national unemployment rate would preserve a countercyclical income stabilization element in the program.

In the short term, the desirability of accelerating EI access for workers 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 $300 million in 2019/20 and a further $300 million in 2020/21.

Enhanced Security for Canadian Seniors

Revising Tax Rules to Accommodate Target-Benefit Pension Plans

Sharing risks related to retirement income between employers and employees fosters more durable pension plans than traditional defined-benefit (DB) plans. Target-benefit plans (TBP), often known as shared-risk plans, are already common in multi-employer environments. Canadian policymakers and regulators are updating their pension laws and standards to accommodate single-employer TBPs

(Steele et al. 2014), but uncertainty over their tax treatment is impeding progress (Gros et al. 2015).

This Shadow Budget proposes new tax rules to accommodate single-employer TBPs, whether new, or conversions from existing DB or defined-contribution (DC) plans. The default approach would treat TBPs like DB plans. An alternative approach would be more suitable for TBPs that more closely resemble DC plans – for example, plans with fixed or capped contribution rates. Either way, the new rules would reduce uncertainties about tax provisions related to saving and accrual limits, types of benefits and funding requirements. The fiscal impact of this measure would be negligible.

Levelling the Field for Savers in Group RRSPs

Most working Canadians, and the vast majority who work in the private sector, do most of their retirement saving through RRSPs. Many employers support such saving by organizing group RRSPs, and many match at least part of their employees' contributions. Approximately 3.1 million Canadians participated in an employer-sponsored group RRSP in 2018, more than the 2.2 million participants in DC pension plans. In that year, the top 10 suppliers of group RRSPs held $93 billion in assets, only slightly less than the $97 billion in assets held by the top 10 DC plan providers (Benefits Canada 2018).

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 their assets inside the plan. Limits on tax-deferred saving mean these participants cannot contribute to offset these expenses, which means that savers in group RRSPs who have identical work histories and contributions will retire with less than those in DC or pooled registered plans.

This Shadow Budget proposes to let group RRSP sponsors and/or participants deduct some of the administrative expenses currently levied against plan assets from outside income. Since employer contributions to these plans are likelier to be locked in – more like pension plan contributions than employee contributions that might be withdrawn before retirement – this Shadow Budget also proposes to relieve employers' contributions to group RRSPs from payroll tax (Robson 2010).[4] These changes would help put different retirement savers on a more level footing, and would have little effect on federal revenue during the projection period.

Increasing Age Limits for Tax-Deferred Saving

Life expectancy in Canada has risen by more than two years per decade since the 1960s, but current age limits related to retirement plans and benefits do not reflect this new reality. Currently, Canadians (and their employers) 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. This Shadow Budget would increase the age at which contributions to tax-deferred retirement saving schemes must end to 72 on January 1, 2020, and increase it one further month at six-month intervals thereafter. This change would reduce the likelihood that Canadians will outlive their wealth and should encourage older Canadians to stay in the workforce longer. The cost implications are small on an annual basis, and negligible on a present-value basis.

Later Eligibility for Public Pension Benefits

Low fertility rates, rising life expectancy and the aging of the baby boom are pushing up the ratio of retired to working Canadians, creating many fiscal strains. Other countries with aging populations,

4 To address concerns about potential withdrawals of employer contibutions by employees simply seeking to avoid payroll taxes, the government will consider imposing an additional tax penalty on such withdrawals.

including Finland, Sweden, Norway, Poland and the UK, are responding by raising the age of eligibility for social security benefits.

One straightforward way to mitigate the impact of longer life on old-age benefits is to calibrate the age of eligibility for public pension benefits such that the proportion of an average person's adult life spent in retirement stays constant (Brown and Aris 2017). To keep that proportion at its current level of 34 percent, Canada would need to raise the normal age of eligibility for OAS and CPP from 65 at the beginning of 2023 to 66 in 2025. Future changes in the eligibility age would also trigger changes in the range of ages over which people can choose to commence their benefits.

The same actuarial adjustments that penalize or reward early and later commencement of benefits would apply from the new age. This flexibility would ensure that people who cannot work past the current earliest age of commencement can still collect benefits, while further encouraging later receipt by people who wish to work and save for longer. This change would have no implications over the budget-planning horizon.

Increasing Tax-Deferred Saving Limits

Canadian income-tax rules limit the amounts of retirement wealth Canadians can accumulate without paying tax at the time they save. Longer lives and, even more important, low yields on investments suitable for retirement saving have raised the amount of saving needed for every dollar of annual income in retirement. 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 (Robson 2017b).

This Shadow Budget would update the assumptions underlying the equivalency factor – currently a factor of nine – to reflect current demographic and economic realities. This updating would raise the tax-deferred savings limit for capital accumulation plans from 18 percent to 30 percent of income. The tax deferred on additional contributions would be paid when invested funds and income are withdrawn. Since the rate of return on assets in these plans is likely to be equal to, or exceed, the government's cost of borrowing, and since the average effective (inclusive of benefit clawbacks) tax rates affecting people when they save and when they draw down are not very different,[5] the fiscal cost of this measure, on a present-value basis, is small.

Eliminating Mandatory Drawdowns from RRIFs

Tax rules should not prevent retirees enjoying the lifelong security they are striving to achieve. The 2015 federal budget's reduction of mandatory minimum withdrawal amounts from registered retirement income funds (RRIF) and similar tax-deferred accounts reduced the risk that many Canadians would outlive their savings. Yet, with longevity increasing and yields on safe investments as low as they now are, the risk is still material (Robson and Laurin 2015a). The calculations of the new RRIF mandatory minimum withdrawal schedule's impact in the 2015 budget assumed real

5 Total personal income contributed to registered retirement plans in 2017 reduced current federal income tax receipts by about 22.0 percent of contributions in aggregate, and increased federal income-tested benefit payments by about 2 percent of contributions – for an aggregate effective rate of 24 percent on registered contributions. Total personal income paid out of tax-deferred registered plans in 2017 – pensions, RRIF withdrawals, or RRSP withdrawals – garnered new income taxes representing about 15 percent of that income federally, while reductions in benefit entitlements, such as GIS benefits, GST credit, or OAS clawbacks, represented about 8 percent of total income paid out of tax-deferred registered plans – for an aggregate effective rate of 23 percent on registered retirement income. These estimates were computed by the authors using Statistics Canada's Social Policy Simulation Database and Model (SPSD/M), v.26.0.

Table 4: Better Opportunities – Fiscal Impact of Shadow Budget Initiatives ($Billions)

	2019/20	2020/21
Measuring Results in Elementary and Secondary Education	s	s
Supporting Education for Indigenous Children	0.2	0.2
Better Labour Market Information	s	s
Treating Unemployed Canadians More Fairly	0.3	0.3
Revising Tax Rules to Accommodate Target-Benefit Pension Plans	s	s
Levelling the Field for Savers in Group RRSPs	s	s
Increasing Age Limits for Tax-Deferred Saving	s	s
Later Eligibility for Public Pension Benefits	n/a	n/a
Increasing Tax-Deferred Saving Limits	n/a	n/a
Eliminating Mandatory Drawdowns from RRIFs	n/a	n/a
Promoting Longevity Insurance	n/a	n/a
Broadening Access to Pension Credit and Income Splitting	s	s
Total	**0.5**	**0.5**

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

Sources: Authors' calculations.

investment returns of 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 – which increases the likelihood of future seniors depending on government benefits because they depleted their own resources.

This Shadow Budget would launch a consultation on two options: regular adjustments to keep the minimum withdrawals aligned with returns and longevity; or eliminating the mandatory minimums. The new regime would be in place for the 2020 taxation year.

Promoting Longevity Insurance

Increasing numbers of Canadians who have accumulated retirement wealth in capital accumulation plans are nearing retirement or have already retired. Many of them would benefit from new opportunities to obtain secure incomes for life – the kind of incomes longevity insurance can provide. However, Canadian insurers do not currently offer pure longevity insurance on a standalone basis. Among the reasons for this are the income tax rules just discussed that require minimum distributions from registered funds after age 71 and a requirement that owners of permanent life insurance pay tax on returns above a specified level, even when the insurance company has not paid them the money (Ezra 2018).

This Shadow Budget would change the tax rules to ensure, so long as RRIF minimum withdrawals exist, that single-premium, standalone deferred annuities are exempt from the drawdown requirement. It would also relax current age limits to make deferred annuities available later in life. And it would require tax to be paid when, and only when, the individual receives an annuity payment.

The government would initiate consultations to encourage capital accumulation plans like DC pension plans to offer partial standalone longevity insurance for voluntary member purchase at retirement. It would also work with insurance regulators to ensure that solvency rules for standalone, single-premium longevity insurance contracts are adequate to protect both consumers and the industry.

Broadening Access to Pension Credit and Income Splitting

The Pension Income Tax Credit and pension income splitting are currently 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 and split income only at age 65. This Shadow Budget would make these tax provisions available to all recipients of income from retirement saving.

Table 4 summarizes the fiscal impact of these measures to improve opportunities for Canadians.

Fostering Growth

The 2019 Shadow Budget puts forward measures that would enhance Canada's international trade performance, rationalize and modernize infrastructure, and improve regulation in key sectors.

Improving Canada's International Trade Performance

Notwithstanding the conclusion of the Canada-US-Mexico Agreement (CUSMA), protectionist threats put countries with smaller internal markets at a disadvantage when businesses are considering where to produce. This Shadow Budget introduces several initiatives to reduce friction at the border and enhance Canada's ability to expand domestic production to serve markets at home and abroad.

Rationalizing Tariffs and Sales Taxes on Small-Value Imports

The de minimis threshold (DMT) is the maximum value of a product imported by mail or courier that is exempt from HST/GST or custom duties. Canada's DMT is currently $20. The administrative costs and frictions at the border created by attempting to charge taxes and duties on small shipments above the $20 level exceed the value of the revenue collected. As well, the fixed costs of dealing with these taxes and duties loom particularly large for small- and medium-sized Canadian businesses using imported inputs, whose shipments tend to be smaller (McDaniel, Schropp and Latipov 2016). The CUSMA will raise the DMT that applies to shipments by private courier from the United States and Mexico to $40 with respect to HST/GST and $150 for customs duties.

This change will reduce some administrative costs and border frictions. Extending this treatment to cover imports from all trading partners would reduce them further. This Shadow Budget would, therefore, apply the same DMT to all shipments by private courier from abroad. Especially in view of the accompanying proposed phase-out of import tariffs (see below), the revenue impact of this measure is negligible. Since imports near the lower limit produce most of the administrative costs and border frictions, the Shadow Budget also announces the beginning of consultations with the provinces and other stakeholders about raising the threshold for HST/GST to match the threshold for custom duties.

Simplifying International Trade for Small Businesses

Rules of Origin are a key component of any free-trade agreement, because they determine which goods and services qualify for lower or no customs duties. But compliance can be onerous, and small and medium-sized firms – whose shipments will typically be smaller relative to the fixed costs of compliance –

often prefer to pay customs duties at Most Favoured Nation (MFN) rates. Their decision to pay the MFN duties clearly indicates that these frictions raise the costs of those who do trade internationally and it is straightforward to infer that they reduce the gains from trade liberalization by deterring some firms from trading internationally at all.

Very small shipments – typically with values of $1,000 or less – are exempt from these MFN rules. An elegant way to mitigate the bias against smaller firms would be to calculate the exemption not with respect to the value of the shipment, but to the value of the MFN duty (Ciuriak 2015). This approach would be consistent with the trend by customs agencies to move to risk-based enforcement and would require minimal changes to the wording of existing free trade agreements. Canada would seek to make this change in its current trade agreements and add it to its objectives in negotiating new ones.

This proposal has no fiscal implications over the budget-planning horizon.

Eliminating Tariffs

Import tariffs increase costs to Canadian consumers and businesses. Since they vary by countries and product, they distort purchasing decisions. When a Canadian buyer chooses a product 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 Competitiveness index).

While lowering our tariffs through negotiations that induce trading partners to lower their tariffs also has straightforward benefits, it takes time – and at the moment, the momentum of trade liberalization is weak. Under these circumstances, Canada can benefit from unilateral action. Eliminating all import tariffs would add about 1 percent to Canadian GDP – a larger effect than any preferential trade agreement available (Ciuriak and Xiao 2014).

This Shadow Budget would phase out all remaining import tariffs. On its own, this reduction would eventually reduce federal revenue by more than $5 billion annually. The offset in lower administrative costs and additional tax revenue from a higher GDP, however, reduces the net fiscal cost to about $2 billion once the phase-out is complete.

A New Framework for Infrastructure Investment

Although infrastructure investment figured strongly in the current federal government's 2015 election platform, follow-through has been disappointing. The Parliamentary Budget Officer (PBO 2018b) observed that about 60 percent of committed Phase 1 infrastructure money in the 2016 *Fall Economic Statement* was not spent as planned by the end of 2017/18. Large greenfield projects require extensive planning and assessment of their economic and environmental benefits and costs, much of which occurs at the provincial and local level, and is therefore out of the federal government's control – and the federal government's prospective *Impact Assessment Act* will add further delay and uncertainty to major projects. Moreover, many proposed projects require coordination with other levels of government, a further obstacle to completion since they have their own responsibilities for use of funds, to users of infrastructure and for environmental and other impacts.

Prioritizing Infrastructure under Federal Control

Accordingly, this Shadow Budget prioritizes direct funding for projects that fall under federal government control and can move relatively quickly. 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. Such a re-profiling of already budgeted Phase 2 infrastructure funding – originally purported to deliver grants of almost $5 billion in 2019/20, rising to an extraordinarily ambitious $11 billion in 2027/28 – could support federal capital investments and reduce by about one-quarter the amounts budgeted for infrastructure funding over the projection period.

Disposing of Non-Core Assets

A key complement to investment in new assets is regular winnowing of the federal government's portfolio of existing assets, some of which may no longer make sense to keep. Airport authorities are a key example.

During the 1990s and early 2000s, the federal government transferred the operation of designated airports to non-profit, non-share-capital corporations, which pay the government rent. While requiring travellers to support the cost of airports makes sense, the base for these rents is total airport revenues rather than profits or revenue from flights, discouraging airports from developing other sources of income such as retail.

In addition, 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 are a unique opportunity for the federal government to address these airports' futures.

Accordingly, this Shadow Budget initiates an auction of airport leases, in the order in which the lease terms expire – starting with Vancouver and Calgary in 2019/20, followed by Montreal and Edmonton in 2020/21.The resulting revenue would be considered 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. 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).

Harnessing Private Capital to Modernize Canada's Ports

Various Canada Port Authorities (CPA) oversee our largest ports. Owned by the federal government, the authorities operate at arm's length, managing the leases of different terminal operators, providing safety and navigation services and approving new construction. The CPAs are valuable and could easily attract capital from institutional investors who want exposure to Canadian infrastructure.

Henceforth, the Shadow Budget would oblige CPAs to rely on private capital, rather than federal funding as is now the case, to finance expansion. This would result in initially small but rising savings in the years ahead. Competition among ports and from other modes of transportation, with appropriate regulatory oversight, would ensure that port users see only beneficial changes in pricing and customer experience.

Modernizing Regulation

The extraordinary growth of product and conduct regulation in recent decades suggests that there are many opportunities to rationalize, maintaining equivalent protections in areas such as the environment, health and safety at a lower cost.

Red Tape Reduction

Compliance with laws and government regulations create an administrative burden on affected businesses. Excessive red tape costs the economy resources that are better put to productive use. Sometimes, as demonstrated above with respect to rules of origin, businesses do not even claim a regulatory exemption or an advantage simply because the administrative cost is higher than the prospective benefits of compliance. Other times, businesses need to comply with government standards from multiple jurisdictions that are equivalent or only slightly different in application, creating wasteful duplication and use of business resources. Endless examples of red tape exist in private and public reports on the subjects.

Following the 2011 report of its Red Tape Reduction Commission, Ottawa established that each increased administrative burden imposed by regulations must be offset with a corresponding decrease, one for one. This one-for-one rule was enshrined in the *Red Tape Reduction Act* of 2015, which stipulates that when a new or amended regulation increases the administrative burden on business, other changes must offset the cost.

This is a useful first step. It mandates Ottawa to evaluate and monetize the administrative burden imposed on business from new regulations. Since its introduction, the one-for-one rule has resulted in approximately $30 million in annual cumulative administrative burden relief to all businesses (Canada 2018b).

This Shadow Budget would build on this progress to expand the *Red Tape Reduction Act* and mandate yearly reduction targets. The amended Act would cover more than the currently specified regulations, embracing all laws and regulations related to tax or tax administration, which are currently exempt. This Shadow Budget would mandate a red tape net reduction target of $25 million per year for the first two years. During that period, the government will undertake a review of its framework for regulation, with a view to employing “negative list”, mutual recognition and equivalent-outcome approaches to achieve health, safety, and consumer-protection goals at less cost to efficiency and innovation

Updating Crown Lender Mandates

Three federal Crown corporations extend credit: the Business Development Bank of Canada, Export Development Canada and Farm Credit Canada. While these Crown lenders receive no ongoing financial subsidies and pay dividends to the government, their ability to tap taxpayers for losses without compensating them for the associated risks and their immunity from corporate income tax make their cost of funds artificially low (Bergevin and Poschmann 2013).

All Crown financial corporations would 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. Government lending that does not clearly address market failures subsidizes inefficient activity and exposes taxpayers to losses.

Farm Credit Canada is unique: unlike the other two Crown financial corporations, it has no legislative requirement to complement private lenders and, in practice, competes straightforwardly with them. This Shadow Budget proposes legislation to amend the *Farm Credit Canada Act* to ensure that Farm Credit Canada complements private lenders and subject this Act to the same five-year review cycles that apply to the acts governing its counterparts.

Reform of Mortgage Insurance and the CMHC

The Canada Mortgage and Housing Corporation (CMHC) serves two different purposes: backstopping mortgage lending and spending directly on affordable housing.

Its activities in, and influence on, Canada’s mortgage market expose taxpayers to major risks in the event of a slump in the housing market. In October 2016, the federal government launched consultations on a new proposed risk-sharing framework for mortgage losses between lenders and mortgage insurers. A promising mechanism to ensure that private lenders exercise appropriate care in extending credit is risk-based premiums for mortgage coverage.

Table 5: Fostering Growth – Fiscal Impact of Shadow Budget Initiatives ($Billions)

	2019/20	2020/21
Rationalizing Tariffs and Sales Taxes on Small-Value Imports	s	s
Simplifying International Trade for Small Businesses	s	s
Eliminating Tariffs	0.5	1.0
Prioritizing Federal Infrastructure/Reprofiling of Funding	-1.2	-1.4
Disposing of Non-Core Assets	-0.2	-0.2
Harnessing Private Capital to Modernize Canada's Ports	s	s
Red Tape Reduction	n/a	n/a
Updating Crown Lender Mandates	n/a	n/a
Reform of Mortgage Insurance and the CMHC	n/a	n/a
Removing Obstacles to Fintech Investment	n/a	n/a
Ensuring Insurers Can Withstand Catastrophes	s	s
Total	**-0.9**	**-0.6**

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

Sources: Authors' calculations.

This Shadow Budget proposes a standalone fund – available only for the residential ownership market – to insure against a severe housing downturn. The fund would be available up to a target level and have 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 this emergency fund's pricing and reserve policies. This backstop would be financed primarily by market participants through risk-adjusted premiums. Its establishment would have no significant fiscal implications.

Channelling funding for affordable housing through the same Crown corporation that backstops mortgage lending makes little sense. The complicated fiduciary duties facing the board and management of such a dual-purpose entity are problematic for governance. As well, the CMHC's role as a conduit for taxpayer money dilutes accountability for the effectiveness of affordable housing programs.

Accordingly, the government will introduce legislation to create a separate Canada Mortgage Corporation, with appropriations to subsidize housing directly flowing through a new federal Department of Housing. This change would have no fiscal implications.

Removing Obstacles to Fintech Investment

Innovation is providing faster and more convenient financial services and has the potential to enhance economy-wide productivity growth with high-value-added jobs. Canada lags in this area: a 2017 study showed that as of 2016 the UK fintech market was more than $10 billion and New York State alone had a market in excess of $9 billion, whereas Canada's fintech startups had secured just over $1 billion in financing since 2010 (Deloitte 2017).

A hurdle to faster development of larger-scale Canadian fintech is a prohibition on banks and insurance companies investing in fintech firms that undertake activities outside the financial services space (Kronick 2018). The government tabled legislation following Budget 2018 to remove this obstacle, but determining whether a given activity is or is not allowed is still challenging. This Shadow Budget proposes revisions to the *Bank Act* and the *Insurance Companies Act* that would facilitate investments by major existing players and help scale up some of Canada's more innovative firms.

Ensuring Insurers Can Withstand Catastrophes

Since the 2008 financial crisis, policymakers have focused on systemic financial risk in banking. However, major risks also face property and casualty insurers: a catastrophic event such as an earthquake producing insurable losses greater than $30 billion would exceed the ability of the Property and Casualty Insurance Compensation Corporation (PACICC) to meet policyholder claims (Kelly and Stodolak 2013). If PACICC assessed surviving insurance companies to fill the gap, further failures might ensue.

This Shadow Budget proposes a federal emergency backstop arrangement for property and casualty insurers to mitigate the economic impact of a natural disaster. This last-resort guarantee would kick in beyond an industry-wide trigger of expected losses (Le Pan 2016). This Shadow Budget would allocate appropriate funds to the Office of the Superintendent of Financial Institutions to collaborate with the PACICC on a risk-sharing arrangement that protects insurers and taxpayers. The cost of this initiative would be small.

Table 5 summarizes the fiscal impact of these measures to foster economic growth.

Achieving Fiscal Sustainability

Eliminating new net borrowing during the next Parliament requires a number of measures to rein in spending and encourage better stewardship of public funds through more meaningful presentations of government activities.

The Seniors Price Index: A Bad Idea Dropped

The Liberal 2015 election campaign featured a promise to create a Seniors Price Index geared to the cost of goods typically purchased by seniors. The Liberals promised they would use either this new index or the Consumer Price Index (CPI), whichever increased more in a given period, as a basis for increasing seniors' benefits. This change would tilt the redistributive playing field in a way that is entirely arbitrary and unfair. Over time, changes in the purchasing power of a dollar throughout the economy are very similar – but indexing transfers to whichever of two measures of price changes happens to rise more in a given month or quarter will ratchet up the real value of those benefits, even if the longer-term trend in the two measures is identical.[6]

There is no rationale, moreover, for giving such favourable treatment to seniors, as opposed to any other identifiable group such as homeowners, residents of particular types of communities or regions, or public servants. Such unfairness would

6 Suppose, 40 years ago, a government seeking votes from homeowners had announced a new homeowner's benefit, to increase by whichever of the "owned accommodation" subindex of the CPI or the total CPI rose more each month. Since 1978, the owned accommodation subindex has risen, on average, 3.23 percent annually – almost identical to the 3.26 annual increase in the total CPI. Nevertheless, a benefit geared to whichever index rose more each month would have risen 5.38 percent annually and more than doubled in real value over the period.

set a terrible precedent. The government has decided not to proceed with this idea.

Better Fiscal Accountability with an Improved Estimates Process

Parliamentary scrutiny and control of the federal government's spending is weaker than it could be. Many provincial governments present the estimates that legislators vote to authorize specific spending simultaneously with their budgets, and do so using accounting that lets legislators see how their votes match – or not – the budget's fiscal plan. The federal government does neither of these things. Ottawa typically presents its estimates after the budget, often after the fiscal year has begun. These spending estimates focus on cash, rather than the accrual accounting that underlies the budget, and do not sum the figures to allow comparison with the fiscal plan. The government committed to better estimates in the 2016 Fall Economic Update (Canada 2016, p. 36), but has not yet done so.

The Shadow Budget, therefore, commits to presenting its 2019/20 Main Estimates before the start of the fiscal year, using Public Sector Accounting Standards. It further commits to releasing its 2020/21 Main Estimates simultaneously with the 2020 federal budget in February of that year.

More Meaningful Reporting of Employee Pension Obligations

The federal government provides its employees with pensions that are far more generous than those found in other sectors. The obligation to pay these pensions is a major component of the federal government's debt, and the annual accrual of pension benefits is a major component of the government's operating costs. Economically meaningful measurement of these obligations is crucial to assessing the government's overall fiscal position and ability to meet its commitments.

As noted above with respect to saving for retirement in RRSPs and DC pension plans, low yields make a given future payment more expensive to fund and, therefore, more valuable to the recipient. However, the federal government's Public Accounts do not reveal the full cost and value of its employee pensions. Although it discounts some of its future payments at a rate based on government bond yields – a reasonable proxy for this kind of obligation – it discounts the greatest part of them using an assumed rate of return on plan assets.

The most recent Public Accounts restated the value of federal pension obligations incurred before 2000, using a bond-yield-based discount rate that added $20 billion to the federal debt immediately and will add another $14 billion over time. This partial recognition of the liability is inadequate: all federal pension obligations are alike, and the Public Accounts should show the entire obligation on a consistent basis.

The Shadow Budget would complete this process, which would add about $93.5 billion to the federal government's accumulated deficit and, depending on the future path of the government bond yield, may add or help the bottom line in any given year. The estimated impact of this change is a hit of $1 billion per year to the bottom line for the next two years.

Containing Federal Employment Costs

Operating costs are almost one-third of federal program expenses, and most of that amount – more than $60 billion annually – is compensation of federal employees. 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 deferred compensation such as pensions – the value of future payments, plus new benefits earned during the year – which accumulate as unfunded liabilities.

Table 6: Achieving Sustainability – Fiscal Impact of Shadow Budget Initiatives ($Billions)

	2019/20	2020/21
The Seniors Price Index: A Bad Idea Dropped	n/a	n/a
Better Fiscal Accountability with an Improved Estimates Process	n/a	n/a
More Meaningful Reporting of Employee Pension Obligations	1.0	1.0
Containing Federal Employment Costs	-0.9	-1.9
Creating Fiscal Room for Provincial Pharmacare	n/a	0.6
Total	**0.1**	**-0.3**

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

Sources: Authors' calculations.

Wages, Salaries and Other Payroll Contributions

A Treasury Board Secretariat review of federal government compensation released in November 2006 found that federal employee compensation, including pension benefits, exceeded private-sector benchmarks. The author of that review later stated that the total premium of federal compensation was 15 percent to 20 percent (Lahey 2011).

Our comparison of compensation per hour in federal government service jobs (excluding defence) with private-sector service jobs in fields requiring relatively advanced qualifications shows that federal compensation ($66 per hour) exceeds private-sector professional, scientific and technical service jobs ($41 per hour) as well as finance and insurance jobs ($51 per hour).[7] This margin has shrunk somewhat since the time of the Treasury Board review, by four percentage points when federal compensation is compared to professional, scientific and technical service jobs and by 10 points when compared to finance and insurance jobs. But the margin still exists: if compensation of federal employees was ahead of its private-sector benchmarks in the early 2000s, it still is.

Unfunded Future Benefits

Such comparisons do not include the cost of unfunded future benefits, 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 increased dramatically since the mid-2000s – in large part because, as already discussed, low yields make a given future payment more valuable.

Ensuring Competitive Employee Compensation

The standard argument for generous federal pensions is that optics constrain salaries in the public service, so the federal government must provide outsize deferred compensation to retain its employees. But the federal government suffers negligible attrition – until pension eligibility induces its employees to retire considerably earlier than their private-sector counterparts! If total federal compensation were aligned to a competitive labour market, we would expect to see

7 Statistics Canada. Table 36-10-0489-01. *Labour statistics consistent with the System of National Accounts (SNA), by job category and industry.*

Table 7: Medium-Term Fiscal Path Including Shadow Budget Initiatives ($Billions)

	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24
Baseline Projections						
Revenues	328.9	339.2	352.1	367.9	382.1	396.7
Expenditures	-344.0	-355.8	-367.2	380.0	391.7	405.1
Budgetary Balance before Initiatives	-15.1	-16.6	-15.1	-12.1	-9.6	-8.4
Shadow Budget Initiatives						
Environmental and Efficient Taxation						
Reducing Punitive Personal Income Tax Rates		-0.4	-0.4	-0.4	-0.4	-0.4
More Generous Tax Treatment of Nondiscretionary Medical Expenses		-0.4	-0.5	-0.5	-0.5	-0.5
Facilitating Donations of Private Company Shares and Real Estate		s	s	s	s	s
Lower Corporate Income Tax Rates		-3.2	-3.2	-3.0	-2.9	-2.7
Comprehensive Tax Review		n/a	n/a	n/a	n/a	n/a
Greening Canada's Taxes		4.0	4.0	4.0	4.0	4.0
Eliminating Excise Tax on Aviation Gasoline and Jet Fuel		-0.1	-0.1	-0.1	-0.1	-0.1
Levelling the Playing Field in the Digital Economy		0.2	0.2	0.2	0.3	0.4
Scrutinizing Tax Preferences		2.2	2.3	2.4	2.5	2.6
Total		***2.3***	***2.3***	***2.6***	***2.9***	***3.3***
Better Opportunities						
Measuring Results in Elementary and Secondary Education		s	s	s	s	s
Supporting Education for Indigenous Children		-0.2	-0.2	-0.1	s	s
Better Labour Market Information		s	s	s	s	s
Treating Unemployed Canadians More Fairly		-0.3	-0.3	n/a	n/a	n/a
Revising Tax Rules to Accommodate Target-Benefit Pension Plans		s	s	s	s	s
Levelling the Field for Savers in Group RRSPs		s	s	s	s	s
Increasing Age Limits for Tax-Deferred Saving		s	s	s	s	s
Later Eligibility for Public Pension Benefits		n/a	n/a	n/a	n/a	n/a
Increasing Tax-Deferred Saving Limits		n/a	n/a	n/a	n/a	n/a
Eliminating Mandatory Drawdowns from RRIFs		n/a	n/a	n/a	n/a	n/a

Notes: N/A = not applicable. S = small. For simplicity and ease of comparison, our change to the reporting of pension obligations is not reflected in the accumulated deficit.
Sources: Tables above and authors' calculations.

Table 7: Continued

	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24
Promoting Longevity Insurance		n/a	n/a	n/a	n/a	n/a
Broadening Access to Pension Credit and Income Splitting		s	s	s	s	s
Total		***-0.5***	***-0.5***	***-0.2***	***-0.1***	***-0.1***
Fostering Growth						
Rationalizing Tariffs and Sales Taxes on Small-Value Imports		s	s	s	s	s
Simplifying International Trade for Small Businesses		s	s	s	s	s
Eliminating Tariffs		-0.5	-1.0	-1.5	-2.0	-2.0
Prioritizing Federal Infrasructure/ Reprofiling of Funding		1.2	1.4	1.5	2.0	2.2
Disposing of Non-Core Assets		0.2	0.2	0.3	0.3	0.3
Harnessing Private Capital to Modernize Canada's Ports		s	s	s	s	s
Red Tape Reduction		n/a	n/a	n/a	n/a	n/a
Updating Crown Lender Mandates		n/a	n/a	n/a	n/a	n/a
Reform of Mortgage Insurance and the CMHC		n/a	n/a	n/a	n/a	n/a
Removing Obstacles to Fintech Investment		n/a	n/a	n/a	n/a	n/a
Ensuring Insurers Can Withstand Catastrophes		s	s	s	s	s
Total		***0.9***	***0.6***	***0.3***	***0.3***	***0.5***
Achieving Fiscal Sustainability						
The Seniors Price Index: A Bad Idea Dropped		n/a	n/a	n/a	n/a	n/a
Better Fiscal Accountability with an Improved Estimates Process		n/a	n/a	n/a	n/a	n/a
More Meaningful Reporting of Employee Pension Obligations		-1.0	-1.0	s	s	s
Containing Federal Employment Costs		0.9	1.9	2.8	3.8	4.8
Creating Fiscal Room for Provincial Pharmacare		n/a	-0.6	-0.6	-0.6	-0.6
Total		***-0.1***	***0.3***	***2.2***	***3.2***	***4.2***
Total Initiatives		**2.6**	**2.7**	**4.9**	**6.3**	**7.9**
Lower Debt Charges		**0.0**	**0.1**	**0.2**	**0.3**	**0.5**
New Budgetary Balance	**-15.1**	**-14.0**	**-12.3**	**-7.0**	**-3.0**	**0.1**
Accumulated deficit	687.7	701.7	714.0	720.9	723.9	723.9
as % of GDP	30.9	30.3	29.8	29.0	28.1	27.0

Notes: N/A = not applicable. S = small. For simplicity and ease of comparison, our change to the reporting of pension obligations is not reflected in the accumulated deficit.
Sources: Tables above and authors' calculations.

some departures for the private sector – which the government could address as needed, rather than maintaining across-the-board premiums.

Furthermore, the right response to political pressure for low employee compensation is not to hide part of the total package, but to make a public case for the value of good employees. The argument for able people doing important jobs is easy to make. The argument that federal employees across the board receive hidden benefits richer than most taxpayers enjoy does not hold up.

This Shadow Budget would freeze departmental operating budgets, giving managers latitude to adjust compensation to better reward higher performers and reduce the number of less valuable positions. This approach could help achieve a better balance between federal public and private sector compensation with a low risk of disruption to public services (Lahey 2011). The freeze would reduce federal spending by at least $900 million in 2019/20 and $1.9 billion in 2020/21.

This Shadow Budget also initiates a plan to 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 where a joint governance structure gives employee representatives a voice in the long-term sustainability of the plans. The plan for federal MPs, which is completely unfunded and offers retirement benefits far richer than any other plan, would be at the top of the list for this transition.

Creating Fiscal Room for Pharmacare

Provincial governments have access to essentially the same revenue sources as Ottawa. Yet they rely on these sources less than they could, while the federal government over-relies on them to fund transfers to the provinces. The federal government now transfers about one-quarter of the taxes it collects to the provinces – a level of support that might make sense in a country where subnational governments were too fiscally weak to perform essential functions, but is hard to justify in a mature federation such as Canada's. Overreliance on federal financial support diverts provincial time and energy from improving services toward lobbying for even larger transfers (Robson and Laurin 2015b). The more federal transfers respond to provincial demands, the weaker the incentives for provinces to manage their expenses effectively and the stronger their incentives to blame Ottawa for shortcomings in their programs.

Provincial governments desire to expand their coverage of drug costs to better integrate drug treatments with the hospital and doctor services covered by medicare, and protect their citizens from catastrophic drug-related expenses. The federal government supports this objective, noting that expanded provincial programs will be better integrated and responsive to different circumstances across the country than a federal program.

This Shadow Budget maintains increases in existing federal-provincial transfers to no more than economic growth. Reductions in federal income-tax rates, outlined below, would reverse the recent vicious circle whereby tax increases by one level of government shrink the tax base and, therefore, revenues for the other: as the lower federal rates foster increases in provincial tax bases, provinces would see their own revenues rise, reducing their need for federal transfers. 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.

The Canada Health Transfer will continue rising at the greater of GDP growth or 3 percent. The federal government will initiate discussions with the provinces about the fiscal costs anticipated from expanding drug coverage, in preparation for a formal transfer of tax room to better equip the provinces to finance their pharmacare programs. Anticipating that more comprehensive protection from catastrophic drug expenses will require a net transfer of fiscal resources from the federal government to provincial governments, this Shadow

Budget shows expenses of $600 million in 2020/21 and thereafter.

Table 6 summarizes the impact of these measures to achieve fiscal sustainability.

The 2019 Shadow Budget's Bottom Line

As Table 1 indicated, these Shadow Budget proposals for responding to various challenges: tax competitiveness; providing better opportunities; fostering growth and achieving fiscal sustainability would leave a large federal budget deficit in the short term.

With the Canadian economy at capacity and signs of flagging growth abroad, the government cannot depend on more upside revenue surprises. An economy at capacity and the potential for a downturn in the next few years also argues for a clear path back to budget surpluses. Governments can only respond effectively to a slump if households and businesses trust the longer-term fiscal framework and do not respond to fears of higher interest payments and taxes by reducing their own spending (Scarth 2014). A target for the annual bottom line provides discipline in budgeting and promotes accountability, something the often-cited alternative targets based on the ratio of accumulated debt to GDP cannot. GDP is outside the government's control, so the debt-to-GDP ratio would move independent of government action. A clear timetable for balancing the budget gives Canadians greater confidence in the larger picture.

This Shadow Budget, therefore, combines near-term initiatives to improve Canada's competitiveness with measures that would set a path toward budget balance by the end of a four-year term for the next Parliament. As Table 7 details, the smaller debt resulting from these initiatives lowers interest costs as time goes by. The combined result of the initiatives and lower interest costs is a modest budget surplus in 2023/24.

This Shadow Budget would improve tax competitiveness in the near term and lay the groundwork for a much-needed modernization of the tax system in the medium term. It would enhance educational, labour market and retirement opportunities for Canadians. It would foster economic growth by facilitating international trade, investing in core federal infrastructure, and by removing regulatory obstacles and red tape. And, critically, it would improve fiscal accountability, contain spending and restore fiscal sustainability. It is the fiscal leadership Canadians need in 2019 and beyond.

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