Recovery and Stability: A Shadow Federal Budget for 2021

The federal government’s spending and borrowing in response to COVID-19 has left Canada with no plan to restore fiscal stability. This Shadow Budget’s combination of initiatives to support growth and limit debt will help Canada recover and achieve higher living standards, while ensuring federal capacity to deliver services in the future.

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## CONTENTS

**Introduction and Overview** 2

**Fiscal Framework** 3

**The Importance of Lowering the Debt Ratio** 4

**Supporting the Recovery** 9
- Address Existing Pressures on EI Premium Rates 10
- Give Workers a Temporary Bonus 10
- Implement a Childcare Benefit 11
- Provide a General Investment Tax Credit 11
- Improve Tax Treatment of Nondiscretionary Medical Expenses 12
- Facilitate Donations of Private Company Shares and Real Estate 12

**Supporting Long-Term Growth** 12
- Lower the Corporate Income Tax Rate 13
- Incentivize Innovation, Adoption and Commercialization 13
- Reduce Red Tape 13
- Improve Labour Demand-Supply Balance Through Better Labour Market Information 14
- Enhance Benchmarking of Education Results 14

**Fiscal Prudence** 15
- Raise the GST Rate 15
- Transition Federal Employees to Jointly Governed Shared-Risk Pension Plans 15
- Raise the GST Rate on Transportation Fuels 15
- Prioritize Infrastructure under Federal Control 16
- Improve the Budget and Estimates Process 16
- Ensure Competitive Compensation for Federal Employees 17
- Level the Playing Field in the Digital Economy 17
- Close Strike Pay Tax Loophole 17
- Rationalize the Age Credit 17
- Phase Out the Tax Credit for First-Time Homebuyers 18
- Eliminate the Tax Credit for Labour-Sponsored Venture Capital Corporations 18
- Close the Door on Other Possible Expensive Initiatives and Stimulus 18
- Institute a Comprehensive Review of Tax Preferences 18

**Tying it Up** 19

**References** 22

Policy Area: Fiscal and Tax Policy.

Related Topic: Federal Budgets.

The health and economic crises of the past year, and the unprecedented government responses to them, have upended Canada’s fiscal policy framework. The federal government’s fiscal supports cushioned the economic impact, but have left the country without a plan for restoring fiscal stability. As the health crisis abates, Canada faces two related challenges: implementing measures conducive to a strong economic recovery and reducing government debt to levels that are economically sustainable and fair to Canadians in the future. This Shadow Budget addresses those challenges.

The last federal budget, more than two years ago, projected a deficit of almost $17 billion in both the 2019/20 and 2020/21 fiscal years, with gradual declines afterward. Current estimates put the total deficit for those two years at more than $420 billion. Canadian governments’ deficits in fiscal 2020/21 will total about 20 percent of Canadian GDP, the highest among all advanced economies and seven percentage points higher than the average for G20 countries (IMF 2021a).

By 2023, the federal government’s accumulated deficit – a measure of the degree to which it must rely on future taxes to provide services – will be roughly double what was projected before the crisis. Relative to GDP, it will reach 56 percent next year, up 25 percentage points from its pre-pandemic level.

The projections in the federal government’s November 2020 Fall Economic Statement (Canada 2020) foresee continued deficits. Year upon year of expenses exceeding revenues and the resulting deterioration of the federal government’s net worth – in other words, an accumulated deficit that keeps rising – signify an ongoing deterioration in Ottawa’s ability to deliver services to Canadians. Moreover, while that Fall Economic Statement anticipated a federal debt ratio in the 55 percent to 60 percent range for the next five years, our extension of those projections shows that current commitments for new spending and higher interest payments could return the debt ratio to levels last seen during the fiscal crisis of the 1990s when it peaked at 67 percent. The deficit could easily surpass $100 billion 10 years from now.

Meanwhile, combined federal and provincial debt could surpass the 94-percent-of-GDP ratio at which it peaked in the mid-1990s, hitting 100 percent by 2030, and increasing inexorably thereafter. This is a bleak outlook, and if concerns about repayment affect Canadian governments’ borrowing costs, it may not even be possible.

This Shadow Budget proposes a plan to put the federal government – and national finances – on a more sustainable footing. It would take advantage of the coming economic expansion to put the debt ratio on a downward path. By 2025/26, the budget would be balanced. By 2040/41, the debt ratio would be below 30 percent. Through a combination of policies to stimulate the economic recovery and long-run economic growth, along with fiscal prudence, the plan should inspire investor confidence and maintain Canada’s credibility with credit-rating agencies and the public, necessary to avoid spiking interest rates.

Restoring sustainability and generational fairness will require some fiscal restraint. But we should not forget Canada’s weak economic growth prospects before the pandemic, which the pandemic
Commentary 597

has worsened. Even after the recovery, Canada’s longer-term potential growth will suffer from lower investment, lower immigration and workers whose prospects have suffered over the past year. So in addition to supporting the recovery in the short run, Ottawa’s policy framework must support the country’s ability to grow in the years ahead. This Shadow Budget includes measures to boost investment and risk taking in the long run, make Canada attractive to skilled workers and improve the functioning of the labour market.

Table 1 summarizes the existing outlook, the projected impact of our Shadow Budget’s measures and the resulting new trajectories for the bottom line and the federal government’s accumulated deficit. The discipline of a firm target for the debt ratio and the resulting balanced bottom line would ensure that new programs meet a higher value standard in relation to potential alternatives. The improved debt ratio is a clear signal of the plan’s better intergenerational results.

### Fiscal Framework

The baseline for the Shadow Budget’s fiscal plan is the economic and fiscal outlook from last year’s Fall Economic Statement (Canada 2020). The statement presented multiple economic scenarios, corresponding to different degrees of COVID-19-related restrictions. Uncertainties related to the roll-out of vaccines and infection from coronavirus variants lead us to adopt the extended restrictions scenario, in which many regional and targeted restrictions continue throughout 2021.

That scenario shows real GDP falling 5.5 percent in 2020, rebounding 4.1 percent in 2021 and growing 2.9 percent in 2022. Allowing for inflation, the corresponding figures for nominal GDP...
growth are a fall of 5.2 percent in 2020, growth of 6.0 percent in 2021 and a 5.1 percent increase in 2022. Longer term, nominal GDP growth is projected at 4.4 percent, 4.3 percent and 4 percent for 2023, 2024 and 2025, respectively.

Our baseline outlook for interest rates follows the Fall Statement (we consider an alternative, higher-interest rate scenario later). The statement projects short-term interest rates to stay very low until 2023 and rise to only 1.5 percent in 2025. It projects longer-term interest rates – the 10-year Government of Canada bond yield – to rise gradually, reaching 2.4 percent in 2025. These low interest rates mean that the statement’s projections for federal interest payments are much lower than the government’s recent extensive borrowing might suggest. For fiscal year 2023/24, for example, the statement projects debt charges about one-quarter lower than those projected in Budget 2019, despite federal debt that is about three-quarters higher than projected in that budget.

The projections show revenue jumping 21 percent from 2020/21 to 2021/22, propelled by the economic recovery and investment income recovering after extraordinary losses in 2020 due to premiums paid on the Bank of Canada’s purchases of securities on the secondary market and provisioning for loan losses related to COVID-19 relief measures. Beyond 2021/22, revenues should increase by about 5 percent to 6 percent per year.

Direct program expenses and transfers to persons and governments would decrease by more than $250 billion from 2020/21 to 2022/23 as extraordinary actions, notably income support to households and businesses, wind down. Gross debt charges would increase by $8.6 billion from 2020/21 to 2023/24.

The statement prefigures one-off stimulus spending over the next three years, ranging from $70 billion to $100 billion in total. Our baseline adopts the $100-billion scenario in which the annual spending is: $30 billion in 2021/22, $50 billion in 2022/23 and $20 billion in 2023/24. The statement unaccountably did not build in any interest payments on the additional debt this spending would have required. Our baseline repairs that omission.

The statement omits much else. It does not address the legislative requirement of a balanced Employment Insurance (EI) account. It sets aside no or only partial funds for other items, notably initiatives mentioned in the September 2020 Speech from the Throne (Drummond 2020). For example, the subsequent Fall Statement did not identify funds for reforming the Fiscal Stabilization Program or new pressures on the Canada Health Transfer at a time when the Council of the Federation was asking for another $28 billion per year. Nor did it cost Throne Speech commitments to establish national childcare, national pharmacare, higher Old Age Security payments at age 75, a new Canadian Disability Benefit, a National Training Strategy, or enrichment of EI benefits. These uncosted promises and pressures could increase the size of the annual budget by tens of billions of dollars.

Our status quo scenario assumes that these funding pressures and commitments effectively make a portion of the budgeted stimulus permanent, raising spending by $20 billion in 2024/25, an annual amount that grows with nominal GDP thereafter.

Our Shadow Budget planning baseline starts with a $389 billion deficit in 2020/21, deficits of $158 billion in 2021/22, $105 billion in 2022/23 and continued borrowing through the end of the projection period (Table 2). The net debt-to-GDP ratio rises to 56.2 percent in 2022/23, remains close to that through 2025/26, and then – because of the dynamic of continued borrowing and rising interest payments – begins rising again.

The Importance of Lowering the Debt Ratio

The Jan. 15, 2021, mandate letter to the Minister of Finance specifies the need to present a “plan to regrow the economy” and “a new fiscal anchor to guide this work (Canada 2021).” A useful
Table 2: Shadow Budget Assumptions and Projections

<table>
<thead>
<tr>
<th>Economic Growth (percent)</th>
<th>2020/21</th>
<th>2021/22</th>
<th>2022/23</th>
<th>2023/24</th>
<th>2024/25</th>
<th>2025/26</th>
</tr>
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<tr>
<td>Real GDP growth</td>
<td>-5.5</td>
<td>4.1</td>
<td>2.9</td>
<td>2.3</td>
<td>2.1</td>
<td>1.9</td>
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<td>GDP inflation</td>
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<td>1.8</td>
<td>2.1</td>
<td>2.0</td>
<td>2.1</td>
<td>2.1</td>
</tr>
<tr>
<td>Nominal GDP growth</td>
<td>-5.2</td>
<td>6.0</td>
<td>5.1</td>
<td>4.4</td>
<td>4.3</td>
<td>4.0</td>
</tr>
</tbody>
</table>

Federal Revenues

| Taxes on incomes, payroll, consumption and other transactions | 281.6  | 309.1  | 325.9  | 343.0  | 360.6  | 378.0  |
| User fees and charges for government services and products  | 12.8   | 17.7   | 18.0   | 18.3   | 18.5   | 18.8   |
| Investment income                                           | -8.6   | 17.8   | 22.2   | 24.7   | 28.1   | 29.1   |
| Total Revenues                                              | 285.7  | 344.6  | 366.0  | 386.1  | 407.2  | 426.0  |

Federal Expenditures

| Direct program expenses                                      | 335.8  | 227.0  | 187.4  | 188.8  | 184.4  | 184.5  |
| Transfers to persons and governments                        | 309.0  | 214.7  | 200.3  | 207.4  | 215.7  | 224.2  |
| Stimulus and Commitments                                    | 30.0   | 50.0   | 20.0   | 20.0   | 20.0   | 20.8   |
| Gross debt charges                                          | 29.7   | 30.5   | 33.7   | 38.3   | 43.8   | 47.8   |
| Total Expenditures                                          | 674.4  | 502.2  | 471.4  | 454.5  | 464.0  | 477.3  |

Summary of Federal Revenue, Expenditure and Balance

| Taxes, fees, and other charges                              | 294.4  | 326.8  | 343.9  | 361.3  | 379.2  | 396.8  |
| Program spending and transfers                             | -644.8 | -471.7 | -437.7 | -416.2 | -420.1 | -429.5 |
| Debt charges net of investment income                       | -38.3  | -12.7  | -11.5  | -13.5  | -15.8  | -18.7  |
| Budgetary Balance                                          | -388.7 | -157.6 | -105.3 | -68.5  | -56.7  | -51.4  |

Federal Debt

| Net Debt (Accumulated Deficits)                            | 1,107  | 1,265  | 1,370  | 1,439  | 1,496  | 1,548  |
| Percent of GDP                                             | 50.6   | 54.5   | 56.2   | 56.6   | 56.6   | 56.3   |

Notes:

Totals may not add due to rounding. Investment income projections include expected return on average market-related value of pension plans' investments, interest income, net income from enterprise Crown corporations, foreign exchange revenues, and other returns on investment. User fees and charges include miscellaneous penalties and interests. Gross debt charges are shown gross of investment income on pension investments, contrary to budget figures.

Sources: Canada (2020); authors' calculations.
fiscal anchor creates the framework for future sustainability (FTWG 2020a) – which among other things means it must promote fiscal discipline and inspire the confidence of Canada’s creditors.

The government has appeared satisfied in the past to defend its fiscal policy with reference to a stable debt-to-GDP ratio. Yet, just as predicted debt ratios proved to be unreliable in the run-up to the mid-1990s fiscal crisis, the 30-percent-plus-or-minus ratios referenced in the government’s pre-pandemic policy statements have not forced fiscal discipline. By sanctioning ongoing borrowing, a stable debt-to-GDP ratio relieves spending advocates of the obligation to justify their preferences relative to alternative uses for each dollar. The inspiration for the Public Sector Accounting Standards that underlie federal budgets is a bottom line that represents a government’s capacity to deliver services: when the bottom line is negative, the government’s capacity is falling.

Furthermore, a debt-to-GDP ratio target makes the budget a function of the economy in an unfortunately asymmetrical way: when the economy grows quickly, deficits can be larger; when the economy grows more slowly or shrinks, the government abandons the target, which tends to ratchet the ratio higher with each downturn – as now threatens to happen. As John Lester noted in a recent C.D. Howe Institute report, “Generations not yet born receive little or no benefit from cushioning the downturn but will pay a cost as long as the debt is rolled over. The increase in debt should therefore be paid down before the next generation starts working and paying taxes (Lester 2021).”

Laying out a fiscal path with a persistently higher debt ratio is akin to saying that the income support costs triggered by the pandemic should and will be borne, not by the Canadians who received the transfers, but by future cohorts. This burden on future generations would be in addition to the pre-existing fiscal liability they face due to population aging and the escalating costs of healthcare (Mahboubi 2019).

On a practical plane, a responsible fiscal plan needs to protect government finances and Canadians from a reversal of the current environment of interest rates lower than growth rates. The roots of Canada’s 1990s’ problems lay in the large deficits the federal government started running in the 1970s when the average interest rate on new federal borrowing was lower than GDP growth for an extended period. New programs looked cheap relative to taxes paid until the 1980s when the growth/interest rate differential shifted, the debt-to-GDP ratio began to rise and interest payments grew as a share of the federal budget. As a result, the Mulroney and Chrétien governments had to raise taxes and cut spending by multiple GDP points: between 1987/88 and 2007/08, Canadians on average paid 16.8 percent of GDP in federal taxes and received back programs valued at only 13.9 percent of GDP.

Our long-term projection scenarios adopt two perspectives for a future probable rise in interest rates. In the optimistic scenario, Ottawa’s effective interest rate gradually rises from its current record low of less than 1.5 percent to about 3 percent over the next 20 years, ending the period below the 3.6 percent rate of economic growth. In the pessimistic scenario, the effective interest rate gradually rises to 4.1 percent over the next 20 years, ending the period above the 3.6 percent rate of economic growth (Figure 1).

However different it may be from recent experience, the pessimistic scenario is a serious possibility. Interest rates have often been higher than growth rates (Smart 2020, Kronick 2020). They were in the 1990s, when the relentless rise in federal debt and interest costs prompted Paul Martin’s austerity budgets, and they were in 2020 when COVID-19 hammered the economy. Debt binges by governments can push rates up – especially if bloating central bank balance sheets spark inflation fears and lenders begin to fear repayment in depreciated currency, or worse. Canada is not the only country borrowing
unsustainably, and long-term bond yields are already reacting.\(^1\)

Another risk that needs mitigating is further adverse events. COVID-19’s economic impact, while relatively severe, is just the latest in a series of shocks Canada has experienced at a rate of about one per decade since the 1960s. Governments will need fiscal room to deal with the next one. Stimulus spending tends to be less effective for governments entering a recession already in bad fiscal shape (Huidrom et al. 2020).

Easier to predict is the relentless pressure of population aging on provincial healthcare spending and finances (Robson et al. 2017). Absent any new measures or shocks, provincial debt-to-GDP ratios will more than double over the next 30 years. This provincial debt accumulation will affect the federal budget. It will create pressures for Ottawa to increase provincial transfers or vacate some fiscal room the provinces will need to tax.

Figure 2 extends our Table 2 fiscal framework by 15 years and includes provincial governments

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1 The size of the debt burden, itself, influences interest-rate movements. High-debt countries experience larger interest-rate increases in response to unexpected changes in economic conditions and volatility (Lian et al. 2020). A reasonable estimate of the relationship is that every percentage-point increase in the debt-to-GDP ratio above 60 percent raises interest rates on the debt by two to four basis points (Lester 2021).
to create national consolidated federal/provincial status quo debt and deficit projections. Interest rates follow the pessimistic path illustrated in Figure 1, reflecting the view that fast-rising deficits and national debt burdens exert upward pressure on interest rates.

We project that the federal debt-to-GDP ratio will rise from 31 percent in 2018/19, prior to the pandemic, to a temporary plateau in the 50-percent-plus range through this decade, and then climb again. Nationally, taking provincial debts and deficits into account, the consolidated federal/provincial debt-to-GDP ratio surpasses 100 percent in about a decade and rises faster thereafter. This dynamic would force a wrenching adjustment. For example, arresting the climb in the federal debt-to-GDP ratio in 2036 would require raising the GST rate by almost four percentage points or cutting spending by an equivalent amount, about $55 billion.

Turning the debt dynamic around earlier would be better. One compelling benchmark for success is to return the federal debt ratio to 30 percent over the next 20 years. Doing that would keep interest payments to within 8 percent to 9 percent of revenues, limiting the wedge they drive between taxes and programs. As we know from experience, a debt-to-GDP ratio of 30 percent allowed flexibility to respond to an economic shock. A gradual return of the ratio to 30 percent would also signal, in a rough and ready way, that the Canadians who benefited from the fiscal response to the pandemic are “paying back” rather than bequeathing a permanent impairment of the federal government’s service capacity to future Canadians. Importantly,
a 20-year path to a 30 percent debt-to-GDP ratio is consistent with a return to budget balance in 2025/26, with the benefits that balance provides when it comes to disciplined fiscal decisions, ending the current erosion of the federal government’s service capacity.

The measures in this Shadow Budget would achieve these goals. The resulting fiscal trajectory would limit upward pressure on interest rates and payments. Figure 3, which assumes the optimistic interest-rate trajectory as depicted in Figure 1, shows the resulting long-term profile of government bottom lines and net debt figures.

The benefits of our package are evident in this figure. The budget is balanced by 2025/26: the federal government’s capacity to deliver services stops deteriorating. The federal debt-to-GDP ratio declines to about 40 percent by 2030/31 and to less than 30 percent by 2040/41. And the consolidated federal/provincial debt-to-GDP ratio is under control, protecting the country’s borrowing position.

**Supporting the Recovery**

The lingering effects of COVID-19 will keep Canada’s economy below its previous growth path for the foreseeable future. This prospect is prompting calls for more spending and borrowing to bolster demand. But two considerations militate against this approach.

One is that the government has already provided massive support—considerably greater than the income losses from the pandemic. The IMF noted recently that Canadian governments had already
spent almost $250 billion, or 12 percent of GDP, in direct aid to households and firms: one of the largest aid packages of all advanced economies (IMF 2021b). With consumption hurt by the partial or complete cessation of many kinds of activity, this income support has produced a sharp increase in private-sector savings. Noting the upsurge in personal and corporate deposits at financial institutions, one analysis concluded that, “COVID-19 has triggered the largest cash accumulation in recorded history” (Tal and Judge 2020). As the economy reopens, much of this liquidity will be spent. It is, in the words of the C.D. Howe Institute’s Fiscal and Tax Working Group “preloaded stimulus.”

The other consideration is that this lockdown-induced recession reflected not so much a fall-off in demand as a cessation of activity on both the economy’s demand and supply sides. Productive capacity effectively shrank to zero in some areas such as seated restaurant meals, cinemas and live entertainment venues, personal care and travel. Capacity in many other areas is still impaired. Demand will return – people are anxious to resume their pre-COVID-19 lives, and many have the financial resources to do so. It is the supply side of Canada’s economy that needs help most.

Therefore, any further federal spending should focus on restoring and boosting supply: i.e., increasing productivity, increasing labour-force participation, raising immigration, strengthening the foundation of the business sector and boosting business investment. In this Shadow Budget, accordingly, we leave unspent about two-thirds of the Fall Economic Statement’s $70 billion–$100 billion pencilled-in fiscal stimulus. We re-direct the rest of it to address unfunded fiscal pressures and support initiatives to increase Canada’s productive capacity.

Address Existing Pressures on EI Premium Rates

A notable unfunded fiscal pressure comes from the Employment Insurance (EI) program. EI contribution rates are set such that the EI operating account breaks even over a seven-year period. On Sept. 14, 2020, Ottawa froze the 2021 and 2022 EI premium rates at the 2020 level (for employees, $1.58 per $100 in insurable earnings). That implies substantial hikes in EI premiums as of 2023, which will come on top of scheduled increases in Q/CPP premiums. Recent evidence suggests that higher premiums could lead to less employment, dampening job growth in the middle of the economic recovery (Veall 2020).

This Shadow Budget proposes to credit $6 billion to the EI operating account in 2021 to cover the cost of freezing EI contribution rates at their existing level beyond 2022. Since premium hikes required by law were already planned in the fiscal framework, this crediting will be expensed annually over the projection period as the premium shortfall adds to the annual deficit. Preventing a sharp rise in EI premiums will enable employers to retain and hire more workers – a boost that will particularly benefit small businesses for whom payroll taxes constitute a sizable share of operating costs.

Give Workers a Temporary Bonus

Major income support programs such as the Canada Emergency Wage Subsidy and the Canada Recovery Benefit are set to expire at end of June
and September 2021, respectively. To promote a smooth winding down of this support and to promote the recovery by incentivizing and rewarding work, this Shadow Budget would create a temporary working bonus (Laurin and Dachis 2020).

The bonus would target low-wage workers and would run from July to December of 2021. It would pay a maximum of $500 per month per worker. To be eligible, workers would need to earn at least $1,000 per month from employment or self-employment. It would phase in at a rate of 50 cents per dollar of earnings, reaching its maximum when the worker’s monthly earnings reached $2,000 and phase out at a rate of 25 cents per dollar of earnings when the worker’s monthly earnings passed $2,500.

Because the working bonus would increase for those at the lower end of the income spectrum, it would encourage these workers to work more, supporting the economy during the period when vaccination becomes widespread enough for effective reopening across the board. The cost for this temporary six-month bonus program would be about $6 billion. It would support not only workers, but employers as well, especially small businesses, as it would incentivize workers to seek employment.

Implement a Childcare Benefit

The September 2020 Speech from the Throne promises a national childcare program. Since childcare is an area of provincial jurisdiction, the federal government would need provincial cooperation and agreements, greatly complicating implementation, which could take many years. A new federal childcare benefit, administered through the tax system, would be a faster, more flexible approach.

Replacing the federal childcare expense deduction with an income-tested benefit would provide more support at the low end of the income spectrum and could encourage many stay-at-home parents to take on paid work and remain employed over the long term (Laurin and Milligan 2017).

Our Shadow Budget would implement a benefit that reimburses up to 75 percent of childcare expenses for low-income families, with the size of the benefit declining as income rises. The boost to employment would generate extra tax revenues for both federal and provincial governments. Based on the existing Quebec childcare program and tax credit, Laurin and Milligan (2017) estimate the federal net cost of a national benefit to be $700 million annually in the short term and just $100 million annually in the long term, since mothers’ employment gains continue after their children have left childcare. Adding possible compensation for the province of Quebec, we budget the initial net cost of the program at $1 billion per year.

Provide a General Investment Tax Credit

Business investment is critical to Canada’s recovery in the short and long runs. Canada’s stock of machinery and equipment and intellectual property products has been growing more slowly than the labour force for years (Robson and Wu 2021), undermining wages and productivity growth. The collapse of business investment in 2020 has caused forecasters, including the Bank of Canada, to mark down their projections of long-term growth. The need to ensure safety for workers and customers, repair disrupted supply chains and produce more goods and services closer to home will place additional demands on private-sector investment in 2021 and 2022.

To help businesses meet this demand, and offset reluctance to invest on the part of businesses uncertain about the economic and policy outlook, this Shadow Budget would implement a temporary general investment tax credit. The credit would apply to all investments in depreciable assets, including intangibles, at a uniform rate of 5 percent. It would come into effect on July 1, 2021, and run until July 1, 2023. Its temporary nature will encourage early investment. This measure also has the advantage of being relatively neutral – letting...
businesses themselves decide what types of capital they need and what types of activities they will pursue. Its net cost over the projection period will be some $20 billion – part of the stimulus pencilled into the Fall Economic Statement.

**Improve 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 pay tax on income they need for nondiscretionary costs related to, say, children, health or deductions from employment income, they have lower after-tax discretionary incomes than people without such costs. Most personal income tax systems – including Canada’s – provide exemptions, deductions or credits related to non-discretionary expenses. Many medical expenses are like this: 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 – 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 $2,421, whichever is lower, and is calculated at the bottom tax rate.

The health impacts of the pandemic make this over-restrictiveness especially problematic. Our Shadow Budget would lower the threshold on such expenses to 1.5 percent of net income, or $1,210, whichever is lower. This change would help people who cover medical costs directly or through health-related insurance premiums. The estimated fiscal cost of this measure is $400 million per year. Employer-paid health premiums would continue to be untaxed.

**Facilitate Donations of Private Company Shares and Real Estate**

Canadian charities have suffered a decline in donations, even as demands on them – particularly for health and social services, and also for cultural activities hurt by the pandemic – have increased. This is a good time to re-evaluate Canadian tax rules that unnecessarily limit charitable donations.

Philanthropists who donate publicly traded shares to charities pay no capital gains tax on those shares. However, philanthropists who donate private company shares and non-environmentally sensitive land that has appreciated in value must pay capital gains tax. There is no good reason for this difference in treatment – a requirement for the charity to sell the donation to establish market value addresses concerns about correct valuation (Aptowitzer 2017). Relieving shares and real estate donated to charities from capital gains tax would unblock major new support for Canada’s charities.

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. Although the impact of this measure on charitable donations will likely be large, new donations of this kind occur at present, making the fiscal cost of this measure small.

**Supporting Long-Term Growth**

Federal fiscal policy over the past five years has been all about redistribution. We need a fresh focus on growth, addressing areas in which the economy’s productive capacity has suffered. The pandemic and associated recession have hurt Canada’s workforce. Even before COVID-19, Canada’s business investment per potential worker had been declining relative to investment in the United States and other developed countries since the middle of the
last decade (Robson and Wu 2021). Canadians need measures to foster jobs, investment and productivity growth to ensure future prosperity and underwrite the tax revenues that will support federal programs and a return to a sustainable fiscal position.

**Lower the Corporate Income Tax Rate**

Canada improved its tax environment for business investment during the early 2000s, and its relative performance in investment per worker responded, narrowing the gap with the United States and other OECD countries. More recently, however, Canada has lost its competitive edge. Other countries have been lowering their corporate income tax rates, and changes in the United States – dropping its corporate income tax rate in 2018 from 35 percent to 21 percent and providing immediate write-offs for many capital investments – dramatically boosted its attractiveness for new equity-financed business investment (Bazel and Mintz 2017, McKenzie and Smart 2019).

Our Shadow Budget would reduce the corporate income tax rate by two percentage points, from 15 percent to 13 percent, starting in 2024 after the temporary investment tax credit outlined in the previous section expires. A lower corporate income tax rate would provide additional locational incentives for investments and profits in Canada. It would also create favourable conditions for wage increases, since corporate income taxes in a small open economy like Canada’s mainly lower workers’ wages (Boadway and Tremblay 2016). On a static basis, this change initially would reduce federal revenues by $3.9 billion annually. However, as investors and business managers responded positively, the tax base would expand, reducing the net impact on tax revenues over time and boost provincial revenues from corporate income taxes.

**Incentivize Innovation, Adoption and Commercialization**

Research and development (R&D) expenditures reflect both supply-push and demand-pull drivers. On the supply side, the Scientific Research and Experimental Development tax credit decreases the direct cost of initial knowledge creation. On the demand side, however, Canadian companies show a discouragingly low propensity to incorporate such knowledge in their production.

To address this R&D demand-side shortfall, this Shadow Budget would establish a “patent box” tax mechanism in which income derived from patents developed through Canadian R&D face a lower corporate tax rate – a mechanism similar to that adopted by Saskatchewan and Quebec in recent years. The rationale for such a mechanism is to encourage Canadian businesses to actively pursue commercialization of innovation. Evidence suggests that firms would undertake more R&D in Canada if the returns, or fruits of their efforts, were taxed at a lower rate (Parsons 2011). Our patent box has the added benefit of incentivizing Canadian-patent-related production to remain within our borders, thus capturing much of the beneficial commercialization spillover effects. This 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). The cost to the federal budget would initially be around $500 million annually.

**Reduce Red Tape**

Our Shadow Budget would renew the federal government’s commitment to ensuring that regulations achieve their objectives at the lowest practical cost to Canadians and Canadian
businesses. Excessive red tape – regulatory costs beyond those necessary to achieve a given benefit to health, safety or consumer protection – hurts consumers and makes businesses uncompetitive. The 2015 federal Red Tape Reduction Act required offsets for any new or amended regulation that increased the administrative burden on business. Our Shadow Budget would build on this progress, mandating annual reductions, including for regulations related to taxes or tax administration, that are currently exempt. The mandated reductions in estimated administrative burdens for calendar years 2021 and 2022 would be $25 million each. During that period, the government should review 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 with less fragmentation of Canada’s internal market. This proposal has no fiscal implications over the budget-planning horizon.

**Improve Labour Demand-Supply Balance through Better Labour Market Information**

The imbalances between labour demand and supply are being exacerbated by the pandemic. The sudden changes in the economy and production techniques are making it hard for some employers to get workers with the right skills. At the same time, some workers will find the skill set they were employing prior to the pandemic is no longer in demand. Canada does not have a good system to identify the skill requirements of jobs, a gap that is particularly lamentable during times of rapid change.

The federal government, working with provincial and territorial governments, can help by providing better information on the labour market. Our Shadow Budget would allocate new funding in support of the federal effort. The 2009 report of the Advisory Panel on Labour Market Information identified data gaps with respect to vacancy rates, employment figures, skill requirements, Indigenous people, immigrants and education. Progress has occurred since – notably, the launch of Statistics Canada’s Job Vacancy and Wage Survey in 2015 – yet gaps remain, especially in the Labour Force Survey’s information regarding the on-reserve Indigenous population and data tracking the transition from formal education to work. Information on job openings has improved through Statistic Canada’s Job Bank and other means, but more should be done, especially to have a broader representation of occupations. New funding to improve labour-market information, building on the Advisory Panel’s recommendations and modified by the needs identified through the pandemic, would amount to $25 million annually.

**Enhance Benchmarking of Education Results**

This Shadow Budget would provide new funding to enhance our understanding of how well Canadian students are learning. Although the provinces deliver elementary and secondary education services, the federal government helps support the benchmarking of student achievement across the country and internationally. This benchmarking promotes the spread of effective practices and highlights areas that need improvement. At the national level, the Pan-Canadian Assessment Program (PCAP) evaluates performance in reading, writing, mathematics and science. 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.

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4 The World Bank’s Ease of Doing Business Index – which captures a hypothetical firm’s cost of doing business in a nation’s business capital – has Toronto at an uncompetitive ranking of 23rd among business capitals around the world. See: https://www.doingbusiness.org/en/rankings
Federal support helps include enough students across the country to allow comparisons among the provinces and of provinces against other countries. Currently, Indigenous students on-reserve do not benefit from these benchmarking measures. The Shadow Budget would augment funding for these student assessment programs over the next five years, including support for PCAP and PISA assessments of students in on-reserve schools. This new support would amount to $200 million annually.

**Fiscal Prudence**

Ensuring that the budget returns to balance and that federal debt grows more slowly than the economy require important adjustments to major tax and spending programs. This Shadow Budget would initiate changes to achieve those results.

**Raise the GST Rate**

Consumption taxes are the least distortive to economic growth and, considering Canada’s relatively low reliance on them among OECD countries, are a superior way to raise needed revenues (FTWG 2020b). In comparison with other revenue sources, consumption taxes such as the GST do less harm to investment and growth than taxes on capital and personal income and are a more stable and reliable source of revenues. Because the GST base is more resilient to rate increases, heavier reliance on the GST by the federal government does less damage to provincial revenues. To help pay for the massive pandemic-related financial aid to Canadians, this Shadow Budget would raise the GST rate by two points in 2023. This increase will restore the GST rate to its level before July 2006.\(^5\)

**Transition Federal Employees to Jointly Governed Shared-Risk Pension Plans**

This Shadow Budget would initiate a plan to transition federal employees’ 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 would give 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. This change would have the important long-term benefit of subjecting public servants and MPs to annual contribution limits more like those that apply to other Canadians – and would therefore, over time, foster more generous limits for the majority of the population that currently has overly limited opportunity to save for retirement. It has no fiscal cost over the projection horizon.

**Raise the GST Rate on Transportation Fuels**

The Government of Canada has committed to increase the carbon tax from the $50 level planned for 2022 to $170 by 2030. This increase requires addressing competitiveness issues, possible border adjustments, and consultation and coordination with the provinces.

This Shadow Budget suggests that in the meantime, and at least until the carbon price gets to a more significant level, an increase in the GST rate applied to transportation fuels would provide a powerful means of controlling carbon dioxide emissions. Using the GST in this way would avoid some competitiveness problems, as the tax effectively would be paid only on the net value added when goods and services are purchased by

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\(^5\) The GST rate cuts in 2006 and 2008 were not accompanied by any reduction in the GST credit. Accordingly, our proposed increase is not accompanied by any increase in the GST credit.
the final consumer. While this approach would attenuate the incentive to reduce CO2 emissions on intermediate activities, it avoids the distortions that occur when taxes cascade on intermediate inputs bought and sold, but not on internal firm transactions. Increasing the GST on transportation fuels by 10 points, starting in 2023/24, would give consumers a strong price signal to discourage CO2 emissions. By helping Canada achieve its emission targets at less cost to investment and jobs than a regulatory approach and financing the federal government through a relatively growth-friendly tax, this change supports both the environment and the economy. This measure would generate about $7.5 billion in additional revenues in the first year. These amounts would gradually shrink over time as demand adjusts.

Prioritize Infrastructure under Federal Control

This Shadow Budget would prioritize direct funding for infrastructure projects that the federal government, on its own, can implement expeditiously. New funds would be devoted to projects where the national interest makes government involvement uniquely appropriate, such as investments in capacity and added security for marine, rail and air transportation. Unlike transfers that appear as expenses in the short run, these investments would be amortized over the period – typically 20 to 30 years – during which the asset in question would be expected to deliver its services.

The second phase of the Invest in Canada Plan, which began in fiscal year 2018/19, envisioned about $6.5 billion in federal grants in support of provincial and local infrastructure projects in 2021/22, rising to an extraordinarily ambitious $11 billion in 2027/28. Replacing about one-quarter of the amounts budgeted for Phase 2 infrastructure transfers over the projection period with direct investments under federal control and thus amortized over a long period, would reduce planned expenses by an average of about $2 billion annually over the period.

Improve the Budget and Estimates Process

The failure of the federal government to present a budget in 2020 was an unprecedented accountability lapse. Spending public money without authorization by elected representatives is an affront to democracy, and a budget is a unique and irreplaceable opportunity for members of Parliament to review the government’s revenue and expense plans. The legislation to implement this Shadow Budget will include provisions to require future federal budgets no later than February 14 – one month and a half before the start of the fiscal year.

An essential element of government accountability to elected representatives, and of elected representatives to voters, is that approval of specific spending items takes place amid an understanding of how they fit into the broader fiscal plan. In the past, MPs received estimates after the budget had been presented, often after the fiscal year had begun, and those estimates did not follow the Public Sector Accounting Standards that underlie the federal government’s financial statements and budgets, making it needlessly hard for MPs to reconcile the sums they are being asked to vote on with past results and with the fiscal plan. In the 2016 Fall Economic Update (Canada 2016, 36), the government committed to providing better estimates, but its attempt to do so in 2019 prompted concerns that the reconciliation between the estimates and the budget required Parliament to approve far too much unexamined spending.

This Shadow Budget re-commits the government to presenting spending estimates that parliamentarians can reconcile with budget projections. Our Shadow Budget’s fiscal year 2021/22 Main Estimates would follow Public Sector Accounting Standards and appear before the start of that fiscal year, after appropriate vetting by the Treasury Board. The 2022/23 Main Estimates would appear simultaneously with the 2022 federal budget by mid-February of that year, with more detail about the items making up the reconciliation amount.
Ensure Competitive Compensation for Federal Employees

This Shadow Budget would freeze for five years departmental operating budgets for wages and salaries at their 2020 level, 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 $1 billion in fiscal year 2021/22 growing to $5.4 billion in the last year of the freeze.

Level the Playing Field in the Digital Economy

This Shadow Budget would amend the Excise Tax Act to apply GST to businesses that supply digital services for consumption within Canada, regardless of where the company is located, in compliance with international value-added tax/GST guidelines. At present, foreign providers of digital products and services over the Internet need not collect and remit sales tax if they are not “carrying on business” in Canada (Wyonch 2017). Requiring all suppliers to pay GST/HST based on the location of consumers could help level the playing field for both domestic and foreign providers of such products. Bill C-10 is a step in the right direction in this particular respect.6

Some provinces have already begun addressing these revenue and competition issues. For example, and following the initiatives of many OECD countries, Quebec and Saskatchewan since 2019 have required foreign suppliers of digital goods and services to register for, collect and remit sales tax. The federal government should follow suit. This measure would increase annual revenue by about $200 million annually.

Close Strike Pay Tax Loophole

This Shadow Budget would fix an anomalous feature of Canada’s tax system that allows some income to escape income tax and subsidizes strikes. Union dues paid by employees are deductible from their taxable income; any returns on those funds invested by the unions escape tax and amounts paid out in strike pay are not taxable. This tax-free treatment is unusual. It contrasts strongly with the treatment of ordinary compensation, which would attract tax when it was paid, and if not consumed would yield taxable investment returns. It also contrasts with the treatment of most tax-recognized saving, which may avoid taxation up-front, as in an RRSP, or on distribution, as in a TFSA, but does get taxed at least once. Providing a tax preference to income earned when on strike, this tax-free treatment subsidizes activity that harms the Canadian economy (Kesselman 1999, Alarie and Sudak 2006). This Shadow Budget introduces legislation to make strike pay taxable as ordinary income. The revenue impact of this measure would vary depending on the number and compensation of employees involved in work stoppages. It would usually be less than $10 million annually.

Rationalize the Age Credit

The income tax regime’s age credit provides a subsidy to seniors who already benefit from a number of federal and provincial transfers and in-kind benefits. As a redistribution measure, the age credit is poorly targeted: at a given income level, a younger person may have needs as great as, or greater than, those of an older person. The increase

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6 By expanding the definition of broadcasting to include streaming, and giving the CRTC the power to require registration of streamers, Bill C-10 could result in providers such as Netflix becoming subject to the GST.
of the medical expense tax credit proposed in this Shadow Budget further lowers the necessity of an age credit. Furthermore, the amount is clawed back on incomes between $38,893 and $90,313, which increases the marginal effective tax rate for such seniors. It makes sense to reduce the base amount of the age credit from $7,713 to $4,000, which is closer to the amounts most provinces use for their old age tax credits. This measure would produce a saving of more than $2 billion annually.

**Phase Out the Tax Credit for First-Time Homebuyers**

This Shadow Budget would phase out the tax credit for first-time homebuyers. Government measures that increase demand for housing are problematic, increasing price pressures in markets where housing supply is constrained and inducing households to take on debt that many will have trouble servicing in the event of an economic downturn or an increase in interest rates. Phasing out this credit would generate a saving of about $100 million annually.

**Eliminate the Tax Credit for Labour-Sponsored Venture Capital Corporations**

This Shadow Budget proposes to end the tax credit for labour-sponsored venture capital corporations (LSVCCs), which 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. Eliminating the LSVCC credit would improve the federal government’s bottom line by about $200 million annually.

**Close the Door on Other Possible Expensive Initiatives and Stimulus**

Even if all the measures discussed above were implemented, fiscal stability would still be jeopardized by the prospect of other expensive initiatives recently floated by the federal government. This Shadow Budget leaves unspent most of the $70 billion–$100 billion of temporary stimulus penciled into the Fall Economic Statement. It also makes no provision for major permanent new programs.

In particular, the government should not pursue a national pharmacare program. The enhanced medical expense deduction proposed in this Shadow Budget would alleviate some pressures Canadians experience from healthcare costs. Governments can enhance drug coverage and affordability through more strategic and less costly initiatives (Wyonch and Robson 2019).

The government should also not introduce a basic income, nor should it further enhance Old Age Security and the Guaranteed Annual Income. Nor should it loosen the eligibility requirements for EI or increase the share of earnings that EI covers. Such measures would be inconsistent with containing the growth of federal debt and transfer payments that discourage workforce participation are inappropriate when demography and the lingering effects of COVID-19 will be drags on economic growth.

**Institute a Comprehensive Review of Tax Preferences**

The measures put out in this Shadow Budget would put the country’s public finances on a stable and sustainable long-term trajectory. But the immediate pressures from Canadians and the election cycle for expensive initiatives or lower taxes will not stop. The government will need to clear some additional fiscal room to finance potential new initiatives in the
coming years. This Shadow Budget would start this process by launching a comprehensive review of tax preferences.

The federal tax system contains hundreds of exemptions, deductions, rebates, deferrals and credits. While some attempt to recognize differing taxpayer capacities to pay, 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. This Shadow Budget already identifies several, notably the credits for age, for LSVCCs and for first-time homebuyers. It would initiate a comprehensive review of the remaining tax preferences with a view to broadening the personal, business and consumption tax bases. Such a review would lead to the elimination of a number of tax preferences that would support across-the-board tax rate reductions or future spending initiatives. The exercise will be revenue neutral before accounting for positive impacts on growth.

A proper review of tax expenditures will require a number of procedural changes. The capacity for review must be enhanced, as only a few are typically analyzed each year. There should be a broader perspective on the tax preferences since the reviewers are now closely associated with the tax specialists who crafted the measure. Parliament should also have greater involvement, just as this Shadow Budget urges on the spending side. The tax expenditure review could also be tasked to an independent panel of experts under a structure similar to that of the 1990s Technical Committee on Business Taxation.

**Tying it Up**

Supporting the recovery from COVID-19 and re-establishing a coherent fiscal framework for the federal government are fundamentally important and complementary tasks. This Shadow Budget addresses both with measures that would support economic growth immediately and in the longer term and with measures that will end the deterioration of the federal government’s service capacity, ensuring that public debt is sustainable and fair to future generations.

The 2020 Fall Economic Statement contained little to enhance Canada’s growth prospects and much to raise anxiety about mounting debt and exposure to adverse events, notably rising interest rates. By contrast, this Shadow Budget would enhance opportunities for Canadian households and spur business investment. It would put the federal government on a path to budget balance within five years and restore its debt-to-GDP ratio to its pre-pandemic level. Table 3 shows the impact of these Shadow Budget measures. While the projections in Table 3 do not include any boost to growth from these measures, they do reflect the optimistic interest rates in the Fall Statement since this framework will reassure lenders that Canada is on a sustainable fiscal path.

This Shadow Budget’s combination of growth-supporting and debt-limiting initiatives will help Canada recover from the COVID-19-induced recession, support higher living standards in the future and ensure public services at reasonable cost. It is the federal budget Canada needs in 2021.
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Sources: Authors’ calculations. More details in the main text.
### Table 3: Continued

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Source: Authors’ calculations. More details in the main text.
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