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Where the Bucks Stop: A Shadow Federal Budget for 2016

Canada's federal budget needs to temper extravagant expectations of federal spending, while boosting growth through targeted infrastructure investments and tax changes, and supporting Canadians seeking education, jobs and retirement security.

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The Study In Brief

The 2016 edition of the C.D. Howe Institute's annual Shadow Federal Budget puts a sustainable financial position and fiscal path at the centre of its plans. Confidence that the country will successfully navigate an environment of slower global growth and population aging is an essential backdrop for government measures to support economic growth in the medium and long term and to promote better opportunities for all Canadians.

This Shadow Budget reflects our view that the new government in Ottawa must temper the sense created by the election campaign and early post-election announcements that there are no limits to what the federal government can spend and borrow.

The commitment during the election campaign to borrow for infrastructure spending can justify only modest deficits: most federal infrastructure projects last a long time, and writing their cost off over long periods adds modest amounts to annual expenditure. Deficits beyond what capital projects justify add to the federal government's net debt, and hurt growth by absorbing saving that would otherwise fund Canadian investment.

Canada needs fiscal measures that will boost productive capacity. This Shadow Budget emphasizes growth-friendly tax policy, openness to trade and competition, and supportive reform of institutions and regulations. It prioritizes spending on federal infrastructure projects while holding the line on the funding already committed for projects under provincial or municipal control.

The Shadow Budget will support financial sustainability by reforming federal employee compensation arrangements, providing a more accurate picture of Ottawa's balance sheet, ensuring federal transfers to the provinces stay on a sustainable course, and limiting exposure to contingent mortgage insurance liabilities.

Looking to the future, a key theme of this Shadow Budget is improving opportunities for Canadians. It proposes new spending in several areas, including federal support for provincial drug programs and on-reserve education, and proposes measures to level the playing field for Canadians saving for retirement.

Reflecting our approach of holding the line in some areas and increasing spending in others, this 2016 Shadow Budget projects modest deficits of $15.3 billion and $12.2 billion over the next two fiscal years, setting the stage for a return to surplus in 2019/20.

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The first budget from a new government is a key statement of economic plans and fiscal intentions.

Overview

The 2016 federal budget must temper and constructively channel some expectations created by an election campaign and early post-election announcements – notably a sense that there are no hard limits to what the federal government can spend and borrow.

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

Accordingly, this 2016 Shadow Budget for the federal government puts a sustainable financial position and fiscal path at the centre of its plans. In their family lives, in their businesses, and in their saving and investing, Canadians need confidence that the country will successfully navigate an environment of slower global growth and population aging. That is an essential backdrop for government measures to support economic growth and job creation in the medium and long term. Measures that will promote better opportunities for all Canadians will be the surest route to widespread prosperity.

Economic Environment and Baseline Projections

Challenging economic conditions are the backdrop for this Shadow Budget. Lower revenues have eliminated the surpluses anticipated this time last year. And slower growth over the long term means neither Ottawa nor the provinces can count on fast-rising future tax revenues to finance spending commitments.

Lower Demand and Productive Capacity

The global environment presents risks and opportunities for Canada. The slowdown in China and other emerging economies has reduced demand for Canadian exports. However, with US demand growing, better export volumes should support Canadian output. With household consumption holding firm, housing investment declining only slightly from recent high levels, and provincial and local governments successfully managing their fiscal stresses, Canada's domestic demand should grow modestly.

Enduring weakness in many commodity prices, notably crude oil, is a major negative for the outlook. At the time of writing, the WTI crude oil price on world markets is around US$38 a barrel – down about one-third from the level

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

Table 1: Forecasts of Real and Nominal GDP Growth (Percent)

	2015		2016		2017	
	Real	Nominal	Real	Nominal	Real	Nominal
Budget 2015	2.1	1.8	2.2	4.9	2.3	4.7
2015 Fall Fiscal Update	1.3	1.0	2.0	4.2	2.2	4.6
February 2016 Backgrounder	1.2	0.7	1.4	2.4	2.2	4.6

Source: Finance Canada.

projected for 2016 in the 2015 Fall Update of Economic and Fiscal Projections. Income from oil production is down sharply and production itself is under pressure. These losses depress demand, with negative effects on business investment and household spending. And with natural resources so critical to Canada's economy, they also represent a major loss of productive capacity. Notwithstanding recent disappointing growth numbers, inflation is close to its 2 percent target, and Canada is running a current account deficit, suggesting limited slack in the Canadian economy.

Overall, real GDP is on a lower path than anticipated in the 2015 budget and nominal GDP even more so. For 2016, the average of economic forecasts used by Finance Canada puts real growth 0.6 percentage points lower than anticipated in the fall fiscal update, while nominal growth is 1.8 percentage points lower (Table 1).

Importantly, the challenge of slow growth is not only short-term. Increases in the population of traditional working age Canadians are slowing, and will soon cease. Absent fresh measures to encourage work, investment and productivity, the resulting slow growth will severely limit Canadians' opportunities to increase their living standards, and governments' ability to fund programs.

A Challenging Baseline

This Shadow Budget uses as its baseline the economic and fiscal projections from the Department of Finance's February 22, 2016 "Backgrounder – Canadian Economic Outlook" (Canada 2016).

The detailed breakdown in Table 2 is from the fall "Update of Economic and Fiscal Projections" (Canada 2015), modified to reflect the February Backgrounder's fiscal adjustments. Revenue is lower by $9.2 billion in 2016/17 and $7.2 billion in 2017/18 to account for lower GDP, revenue shortfalls from the new top personal income tax rate, and other tax measures announced in December 2015. Spending is higher by $2.4 billion in 2016/17 and $2.9 billion in 2017/18, mainly because of higher compensation costs for federal employees due to the reversal of previous reforms to sick-leave provisions and partial recognition of previously unreported costs for employee pensions and other future benefits.

As a matter of fiscal prudence, this Shadow Budget applies for this year and the next a contingency reserve to reduce the risk that downside surprises push the federal fiscal plan off track. The $6 billion contingency reserve in the February Backgrounder was excessive, leaving

too much room for spending outside proper Parliamentary scrutiny. Accordingly, the Shadow Budget returns to the $3 billion figure used in the past.

The resulting base line for planning purposes starts with a $15.6 billion deficit in fiscal year 2016/17, followed by a $12.5 billion deficit the following fiscal year (Table 2). The commitment during the election campaign was to run deficits related to new infrastructure spending before achieving a modest budget surplus of $1 billion in 2019/20. As detailed below, new infrastructure investments of $15 billion over the next two years will mean amortization and maintenance costs of no more than $1 billion per year over the useful life of the projects. Mindful that deficits beyond what infrastructure spending can justify undermine Canada's long-term fiscal health, this Shadow Budget aims to achieve smaller budget deficits than projected in the February update, setting the stage for the promised return to surplus in 2019/20.

Strengthening the Economy

Canada needs fiscal measures that will boost productive capacity as well as spending. This Shadow Budget emphasizes growth-friendly tax policy, modernized public infrastructure, openness to trade and competition, and supportive reform of institutions and regulations.

Making Taxes More Growth-Friendly

Well-structured taxes finance the desired level of public spending without wastefully distorting people's choices. Corporate taxes affect business investment decisions while personal taxes influence individual decisions to work, save, and invest in training and education. Taxes also affect the location of economic activity. The higher the tax rates, the higher the incentive to avoid them.

Reducing Punitive Personal Income Tax Rates

Both federal and provincial personal income taxes have statutory tax rates that increase with income. The trend since 2010, as provincial governments have sought new revenues and responded to populist pressure, has been to raise the tax rate on higher-income earners. With the recent four-percentage-point federal tax hike to 33 percent on taxable income above $200,000, the combined federal/provincial top tax rate approaches 50 percent in four provinces, and surpasses it in six, including Ontario (54 percent), Quebec (53 percent), and Nova Scotia (54 percent). The rate in New Brunswick is also 53 percent – if not for the province responding to the federal hike by reversing its own previous larger hike on high earners, it would have been almost 60 percent.

In the short term, high-income taxpayers respond to tax-rate increases by realizing their income in different forms, at different times, and in different jurisdictions. These responses shrink the tax base and reduce tax receipts – a key reason for New Brunswick's decision not to maintain its higher rate. Laurin (2015) estimates that the federal government's four-percentage-point tax increase on incomes above $200,000 could reduce taxable income by $7.3 billion in 2016 – a 4.5 percent drop in the tax base. This will reduce incremental receipts from the tax hike to only about $1 billion, rather than the $3.3 billion that would result with no taxpayer reaction. For their part, provincial governments will suffer from lower-than-otherwise personal income tax revenues – a non-negligible shortfall of $1.4 billion in 2016.

Over time, the economic damage of the high-earner tax rate hike will grow. As Alexander and Laurin (2015) remarked, "heavy taxation of high-income Canadians is at odds with the desire for more entrepreneurial activity. Canada is in a competition for talent. Canada needs competitive tax rates for high-income earners, or we run the risk

Table 2: Assumptions and Projections, 2015/16 to 2017/18[a]

	2015/16	2016/17	2017/18
		($ billions except as noted)	
Economic Growth (*percent*)			
Real GDP Growth	1.2	1.4	2.2
GDP Inflation	-0.2	1.0	2.4
Nominal GDP Growth	0.9	2.4	4.6
Federal Revenues			
Taxes on Incomes, Payroll, Consumption and Other Transactions	261.6	264.3	274.6
User Fees and Charges for Government Services and Products[b]	13.0	13.2	13.6
Investment Income[c]	17.6	14.5	16.6
Total Revenues	**292.2**	**292.0**	**304.8**
Federal Expenditures			
Direct Program Expenses	118.5	124.0	128.7
Transfers to Persons and Governments	149.0	154.9	159.4
Gross Debt Charges	25.7	25.7	26.2
Total Expenditures	**293.2**	**304.6**	**314.3**
Fiscal Prudence			
Provision for Prudence	-1.5	-3.0	-3.0
Summary of Federal Revenue, Expenditure and Balance			
Taxes, Fees, and Other Charges	274.6	277.5	288.2
Program Spending and Transfers	-267.5	-278.9	-288.1
Debt Charges Net of Investment Income	-8.1	-11.2	-9.6
Adjustment for Fiscal Prudence	-1.5	-3.0	-3.0
Budgetary Balance Adjusted for Fiscal Prudence	**-2.5**	**-15.6**	**-12.5**

Notes:
(a) Based on Fall Update (Canada 2015), adjusted to reflect February 2016 Backgrounder's updates (Canada 2016).
(b) Estimated figures including earnings of consolidated Crown corporations.
(c) Estimated figures including interest income, net income from enterprise Crown corporations, foreign exchange revenues, and other returns on investment.

Sources: Canada (2015, 2016); authors' calculations.

of a brain drain and the risk of being less able to attract foreign talent. Excessively taxing the talent that fuels a more innovative, creative and successful economy is ultimately self-defeating." Further, the Quebec Taxation Review Committee, in March 2015, recommended that the maximum federal/provincial tax rate should not exceed 50 percent (Quebec 2015).[1]

Recognizing these risks, and motivated by the adverse impact of the rate hike on provinces and its modest boost to federal finances, this Shadow Budget proposes to rescind the increase. The annual cost of this measure is $1 billion. Given the recommendation below to hold the line on federal transfers to provinces, the resulting $1.4 billion provincial tax-revenue windfall will provide timely help to provinces.

Greening Canada's Taxes

The government has committed to environmentally friendly economic policies. But provinces are already implementing their own cap-and-trade systems. The best federal role in this context is as facilitator, seeking to reduce the waste that incompatible systems across the country would produce. A new federal system would add another layer of complexities and arbitrariness that inevitably accompany such systems.

Since the bulk of greenhouse gas emissions results from choices by consumers, the Shadow Budget proposes an increase in the Goods and Services Tax (GST) rate on transportation fuels. Raising the GST is preferable to raising the existing excise taxes because GST is only effectively paid on net value-added when goods and services are purchased by the final consumer. This feature protects Canada's international competitiveness and avoids the distortions when taxes "cascade" on intermediate inputs. Establishing a new GST rate of 10 percent on motive fuels, starting in the next fiscal year, would generate about $2 billion in additional revenues which will help finance the infrastructure investments and reforms to business taxation detailed below. Relatively low world oil prices mean that consumers are more able to afford the GST hike. If prices spike up to levels far beyond medium-term expectations, which would boost federal finances in other ways and discourage demand, the rate could be adjusted downward.

Targeting Business Tax Preferences to New Investments and Young Firms

The economic motivation for lower tax rates on small businesses – and the resulting Small Business Deduction – is to help young and small businesses invest and grow. The large gap between the corporate tax rate and the small business rate may induce some firms to stay small, however. It may also encourage self-employed individuals to incorporate to gain access to the lower tax rate.

Dachis and Lester (2015) point out that a lower tax rate for small businesses has a social cost since the government must compensate with lower spending or higher taxes elsewhere. If the tax burden on large firms is higher as a result, the Small Business Deduction expands the small-business sector at the expense of large businesses. Since small firms, in general, are less productive, this distortion damages overall economic performance.

1 Laurin (2015) estimates that further increases in the top tax rate would generate increasing tax revenues until the rate reaches 38 percent, for only $500 million more. And the erosion of the tax base would mean an even greater provincial government revenue shortfall. The bottom line is that further increasing the top tax rate at the federal level would be an ineffective revenue tool as we have now reached the point where governments extract about as much as they can realistically hope from very high-earners.

A better way to foster growth would be to treat firms equally, independent of their size. At a minimum, the lower tax rate could be better targeted at young firms rather than at all firms that are small, thereby mitigating the growth disincentive effects (Howitt 2015).

This Shadow Budget proposes a task force to design a regime that would distinguish between young, growth-oriented enterprises and small businesses whose owners have limited or no growth ambitions; that is, they are essentially "lifestyle" businesses.[2] The aim would be favourable tax treatment to offset some of the administrative and access-to-capital challenges for young firms, and treatment more akin to the personal income tax for established, no-or-slow-growth firms.

Lowering Taxes on Business Investment

The amount of taxes a business pays depends not only on the applicable statutory corporate tax rate, but on relevant deductions, the firm's capital investment, the income it generates, the speed with which costs may be written off, and prior losses carried forward against current taxable profits. A high statutory tax rate can coexist with low effective taxation if other provisions enable businesses to reduce the amount of profits subject to tax.

As a small open economy, Canada competes internationally for investments. Higher corporate taxes in Canada than elsewhere would hamper investment, job creation, and growth. On that score, successive reforms since the early 2000s have lowered Canada's marginal effective tax rate on new capital investments slightly below the Organisation for Economic Cooperation and Development (OECD) average and below that of other G7 countries.

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

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

Immediate implementation of a 4 percent ACE without other reforms would likely reduce federal revenues substantially – by as much as $11 billion a year – in the short term. Since raising corporate income tax rates to replace lost revenue would encourage businesses to locate profitable activities outside Canada,[3] broadening the capital tax base would be a better way to offset some of the tax loss. Since higher after-tax returns with an ACE would produce higher dividends and capital gains for Canadian shareholders, adjustments in the capital gains inclusion rate and the dividend tax credit could recoup about $4 billion at the individual level. Broadening the corporate income base by,

2 One option would be a time limit (for example, first 8 years of a firm's existence) coupled with a maximum lifetime amount of Small Business Deduction.

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

for instance, eliminating the Small Business Tax Deduction along with a proportional increase in the corporate capital gains inclusion rate, would offset an additional $5 billion. Eliminating other tax provisions, such as Accelerated Capital Cost Allowances – which would no longer be necessary under an ACE system – would further offset the fiscal cost.

To provide time for the design and implementation of these offsetting measures, the ACE will be phased in gradually starting in fiscal year 2017/18. After taking into account its positive impact on investment and economic activity, the long-term net impact on federal revenues would be negligible.[4] However, the fiscal plan marks revenue down by $500 million during the phase-in.

Scrutinizing Tax Preferences

The federal tax system contains many exemptions, deductions, rebates, deferrals and credits. While some of these preferences attempt to recognize differing capacity to pay among taxpayers, others are effectively spending programs in disguise. Given that the marginal costs of raising a dollar in additional personal or corporate income taxes are much greater than a dollar, compensating for taxes foregone through preferences comes at a high cost (Dahlby and Ferede 2011). Therefore, the overall return to society from preferences ought to be very high.

Many tax preferences might fail such a test. Among them: preferences for activities, such as home buying, volunteering, arts and crafts, traveling by public transit, or fitness, that many recipients would have done anyway; and preferential taxation of employer-paid benefits that would likely be available to employees in amounts almost as large without it.

Other preferences distort saving and investment. A prominent example is the federal credit for investment in labour-sponsored venture capital corporations (LSVCC). Venture capital funding spurs innovation, but among the various types of venture capital funds in Canada, LSVCCs are among the least efficient in this respect (Fancy 2012). Notwithstanding a favourable commitment to this credit during the election campaign, the government has become aware of evidence that LSVCCs have crowded out alternative private venture investments, and favoured portfolios unsuitable for retail investors.[5] For this reason, this Shadow Budget will continue the phase-out of the federal credit for LSVCCs.

Pending a proper review of all tax preferences that resemble spending programs, the government will not proceed with platform commitments related to teachers' expenses, building trades training equipment, and the GST rebate for new rental-housing construction.

Modernizing Taxation of International Transactions

In October 2015, the OECD presented its recommendations for reforms of international tax rules to counter Base Erosion and Profit Shifting (BEPS) – tax planning by multinational enterprises to shift profits to lower tax locations. Canada has concerns in this area, notably the use of hybrid financial instruments which, treated as debt in one country and equity in another, allow

4 Aus dem Moore (2015) evaluates the investment impact from the 2006 introduction of an ACE in the Belgian tax system, finding evidence that small and medium manufacturing enterprises in Belgium expanded their investment activity by 3.0 to 3.7 percent.

5 Both because they tend to concentrate their equity investments in risky assets, and because portions of them must be kept highly liquid to deal with potential withdrawals

income from cross-border investments to escape tax in either country.

At the G20 leaders' summit in November 2015, the leaders endorsed the conclusions of the BEPS project and committed to its implementation with all countries participating on an equal footing. Some recommended measures require changes to bilateral tax treaties, something the government will pursue as part of Canada's treaty negotiations. Other measures require amendments to domestic laws in Canada and abroad.

While Canada will monitor activity elsewhere, discussion of these issues has often blurred the line between tax evasion – breaking the law – and tax avoidance through measures any taxpayer can legally take to reduce tax otherwise owing. The government will avoid any initiatives that treat legitimate transactions as improper and reduce Canada's attractiveness as a place for value-generating businesses to invest and operate. This Shadow Budget anticipates no additional revenues from such measures during the projection period.

Modernizing Public Infrastructure

Infrastructure investment figured strongly in this government's commitments during the election campaign and afterwards. In principle, government spending on public infrastructure can yield economic benefits that outweigh the tax-related costs of financing the project and paying associated interest.

Transportation and telecommunication infrastructure, for example, facilitates such activities as exchanging goods, services and ideas, and finding work. The resulting economic opportunities and welfare gains can surpass the dollar costs of purchasing and debt financing, even allowing for the additional costs that tax distortions impose, if the resulting investments raise productivity.

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

Prioritizing Core Federal Investments

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

On the other hand, federal subsidies to support infrastructure projects under provincial and/or municipal control are grants. The federal government relinquishes all control over the funds and their full value appears in spending and on the bottom line as they occur. Through the Gas Tax Fund, the GST Rebate for Municipalities, the Building Canada Fund and other programs, the federal government has already committed over $5 billion per year in subsidies for such infrastructure projects for fiscal years 2014/15 to 2023/24 – a large increase from the $1 billion annual subsidies that were typical a decade ago.

This Shadow Budget leaves these total commitments unchanged. Enhanced federal support to other levels of government needs appropriate frameworks to ensure economically sound execution, including appropriate pricing of services and participation by non-government

sources of long-term capital such as pension funds. This Shadow Budget instead devotes fresh infrastructure spending to federal projects where the national interest makes federal involvement uniquely appropriate – such as investments in marine, rail, and air transportation infrastructure. Expensed over the useful life of the assets – generally 20 to 40 years for public works and infrastructure – a new annually recurring $1 billion expense can easily support the amortization and maintenance of new capital infrastructure projects whose initial construction costs will exceed $15 billion over the next two fiscal years.

Disposing of Non-Core Assets

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

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

Accordingly, this Shadow Budget will initiate an auction of airport leases, in the order in which the lease terms expire – starting with Vancouver and Calgary in fiscal year 2017/18, followed by Montreal and Edmonton in 2018/19. The resulting revenue is capital, not operating income. While it will not affect annual balances directly, retiring debt with the proceeds will reduce federal interest costs in future years.[6]

Strengthening Canada's Links to World Markets

Clarifying and Streamlining Review of Foreign Direct Investments

Foreign direct investment in Canadian enterprises augments Canadian saving, and can boost Canada's economy and productivity quickly. But Canada's relative attractiveness to foreign investors suffers from a heavy and insufficiently transparent screening process.[7] Vagueness about the calculation of the "net benefit" of a transaction, and the prospect of lengthy negotiations to meet an unspecified standard, can deter investors. As Safarian (2015) points out, no such conditions apply when domestic firms acquire one another, since other laws and regulations exist to control undesirable behaviour.

To improve the prospects for growth- and job-stimulating foreign investment, this Shadow Budget proposes to replace the "net benefit" test applied by

6 The potential proceeds from these four airports have a wide range, between $4 billion and $22 billion during the projection period, depending on investors' discount rate and anticipated profit growth (see Dachis 2014).

7 Canada did not make the top 10 in a recent survey focused on destinations for manufacturing investment (UNCTAD 2015).

Innovation, Science and Economic Development Canada for large acquisitions by foreign investors with a new screening process focusing on national security concerns. This change has no fiscal cost.

Easing Entry of Small Shipments

Free trade agreements help exporters, encourage non-trading firms to access export markets, and let consumers and firms access imports that boost living standards and productivity. But complying with trade agreements' rules of origin (ROOs) can be costly for small- and medium- size firms (SMEs). As Ciuriak (2015) remarked, "the high costs of complying with ROOs have meant that SMEs often find it cheaper and more efficient to pay higher Most-Favored Nation (MFN) tariffs than to fulfill the ROOs' requirements. More problematic, the net effect is to discourage smaller firms from entering into international trade at all."

The current threshold for applying these rules references the value of shipments – typically, rules are waived for shipments with a face value of $1,000 or less. As proposed by Ciuriak (2015), this Shadow Budget proposes to change the threshold to the value of the MFN tariffs payable on shipments instead of the goods' face value. This system would grant easier access to imports with lower MFN tariffs, thus reflecting the priorities behind tariff policy, and improve the incentives for importers to report applicable tariffs accurately. This would be a benefit for SMEs particularly, and simplify administration as well. In view of the simplification of border procedures it would permit, the net cost of this initiative is expected to be small.

Modernizing Rules and Institutions

Upgrading Canada's Payments System

Rapid, secure payments processing is central to the infrastructure of a modern economy. Canada's current system of clearing and settling payments is slower, less robust and more expensive than current technology allows and than other countries have achieved (Dubrovinsky 2014).

A key first step would be digital cheque processing. Associated reorganization and upgrading of the Automated Clearing and Settlement System could produce major efficiency gains and costs savings – for example by providing standardized data for electronic accounting systems (Chant 2015). While much of the cost of modernization can and should fall on private-sector participants and beneficiaries, its benefits will also flow to consumers, businesses and governments more generally. The positive externalities from an improved system justify a federal government investment, and this Shadow Budget allocates $0.1 billion in 2016/17 for the project.

Revising Tax Rules to Accommodate Target-Benefit Pension Plans

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

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

pension arrangements. The fiscal impact of this measure is negligible.

Improving Labour Market Information

Good labour market information can help people preparing to enter the labour market and people already in it to connect with employers who want their skills. Since the 2009 report of the Advisory Panel on Labour Market Information, established by the Forum of Labour Market Ministers, some advances have occurred.

Statistics Canada launched the Job Vacancy and Wage Survey in 2015, which provides valuable information on in-demand occupations, job openings, the duration of job vacancies, average pay, and educational requirements. Last summer, provincial labour ministers agreed to create a Labour Market Information Council and a national Stakeholder Advisory Panel to develop better labour market information. This Shadow Budget will provide an additional $50 million to support this work and further implementation of the Advisory Panel's recommendations.

Updating Crown Lenders' Mandates

Three federal Crown corporations operate in the financial sector: the Business Development Bank of Canada, Export Development Canada and Farm Credit Canada. Government lending can make sense when private lenders cannot price properly or diversify against certain risks. Crown lenders receive no ongoing financial subsidies; they pay a dividend to the government, their owner. Their sovereign backing allows them to access capital at lower costs than private lenders taking similar risks would pay. Moreover, they pay no corporate income tax.

The inevitable tension between underwriting extraordinary risks with government backing and operating along commercial lines, potentially competing with private institutions, requires a careful balance (Bergevin and Poschmann 2013). This balance does not currently exist in the case of Farm Credit Canada, which has no legislative requirement to complement private lenders, and, in practice, competes straightforwardly with them. The government will amend the *Farm Credit Canada Act* to ensure that Farm Credit Canada complements private lenders, and ensure that the *Act* undergoes the same five-year review that applies to the other financial Crowns. Moreover, all Crown financial corporations will henceforth 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.

Eliminating Excise Tax on Aviation Gasoline and Jet Fuel

Aviation fuel taxes create a number of problems relative to value-added taxes such as the GST. By taxing an intermediate input, these levies impose costs on businesses that have no fiscal offset, raising costs throughout the economy and making Canadian exports less competitive.

They also induce airlines to fuel their aircraft where taxes are lower rather than to minimize their use of fuel, which results in less efficient air transportation and environmental damage from excess fuel consumption.

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

Supporting Quality Elementary and Secondary Education

While elementary and secondary education in Canada is largely a provincial responsibility, the federal government plays an important role in supporting the benchmarking of student achievement across the country and internationally

– an activity that promotes better curricula and delivery across Canada. This Shadow Budget proposes measures to enhance these federal roles.

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

At the international level, the Programme for International Student Assessment (PISA) benchmarks the performance of Canadian students against their peers abroad. Canada has gained additional insights into the performance of provincial education systems by supporting the participation of enough students to allow comparison between provinces and with other countries – which showed, for example, which provinces were particularly responsible for declines in Canadian students' mathematics scores over the decade to 2012.

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

Achieving Fiscal Sustainability

The Shadow Budget will support financial sustainability by reforming federal employee compensation arrangements, providing a more accurate picture of the government's financial position, ensuring federal transfers to the provinces stay on a sustainable course, and limiting exposure to contingent mortgage insurance liabilities.

Managing Federal Employment Costs

To bring federal deficits in the short run close to what infrastructure investments justify, and to ensure return to a budget surplus by 2019/20, this Shadow Budget contains new measures to manage the federal government's operating costs.

About two-thirds of federal program spending – that is, excluding interest payments – is money transferred to individuals and other levels of government. More than half the remainder – some $44 billion annually – relates to employee compensation – a share larger than a decade ago.[8] While fiscal restraint curbed compensation growth in the past two years, this effort mainly affected total numbers of employees. Compensation per employee continued to grow, continuing a notable trend.

Containing Current Compensation Expense Growth

Since 1997, federal compensation per hour of work – cash plus employer contributions to health, dental, disability and pension plans – has outpaced private-sector compensation for similar employees. In 1997, average total compensation in the private sector was $23 per hour for professional, scientific and technical services jobs, and $25 per hour for finance and insurance jobs compared to $33 per hour for government services jobs. A 2006 Treasury Board Secretariat review of federal compensation found that, especially after allowing for pensions and other non-cash benefits (discussed further in the next section), it exceeded private-sector benchmarks

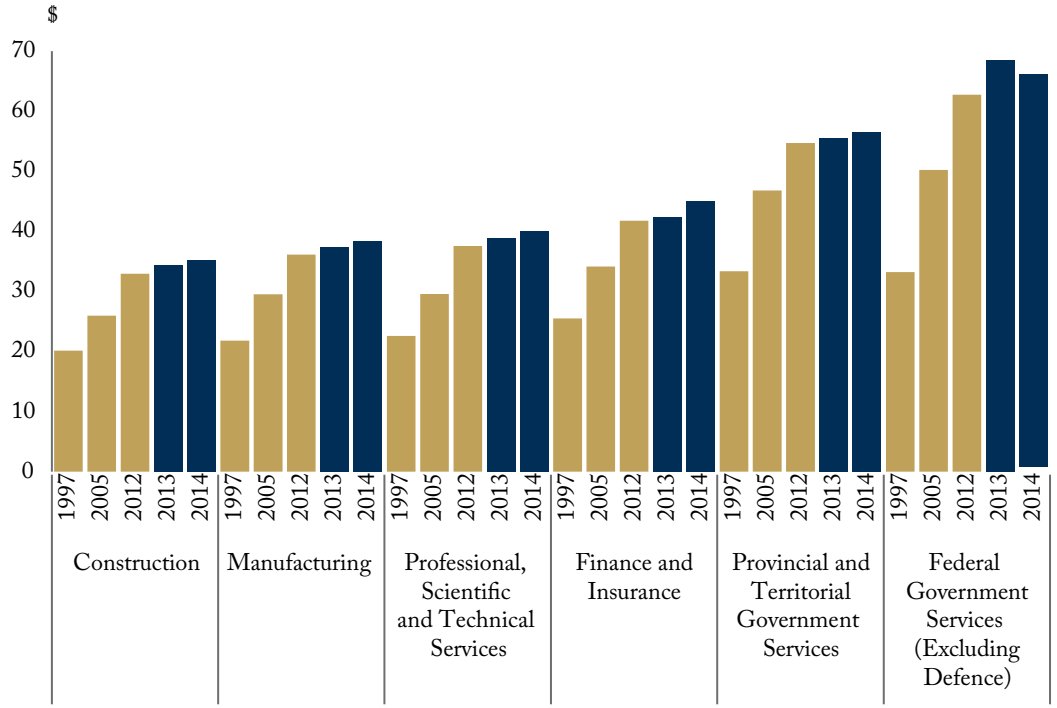
8 Eleven years ago, employee compensation made up less than half of Ottawa's direct program expenses. Since then, compensation costs have risen by $19.5 billion, while other direct program expenses have risen by just $9.5 billion.

Table 3: Strengthening the Economy: Summary of Initiatives and Impact on Budget Balance 2016/17 and 2017/18

Initiatives	2016/17	2017/18
	($ billions)	
Making Taxes More Growth-Friendly		
Reducing Punitive Personal Income Tax Rates	-1.0	-1.0
Environmentally-Friendly Fuel Tax	2.0	2.0
Small Business Targeted Preferences for Younger Firms	n/a	n/a
Lowering Taxes on Business Investment	-0.5	-0.5
Scrutinizing All Tax Preferences	0.3	0.3
Modernizing Taxation of International Transactions	s	s
Modernizing Public Infrastructure		
Prioritizing Core Federal Infrastructure	-1.0	-1.0
Disposing of Non-Core Assets	s	s
Strengthening Canada's Links to World Markets		
Clarifying and Streamlining Review of Foreign Direct Investment	n/a	n/a
Easing Entry of Small Shipments	s	s
Modernizing Rules and Institutions		
Upgrading Canada's Payments System	0.1	
Revising Canadian Tax Rules to Accommodate TB Pension Plans	s	s
Improving Labour Market Information	-0.1	-0.1
Updating Crown Lenders' Mandates	n/a	n/a
Eliminating Excise Tax on Aviation Gasoline and Jet Fuel	-0.1	-0.1
Supporting Quality Elementary and Secondary Education	s	s
Total	**-0.5**	**-0.4**

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

Figure 1: Average Reported Employee Compensation per Hour of Work



Source: Statistics Canada, CANSIM database, table 383-0031.

(Hamilton 2014a).[9] Nevertheless, the gap has widened further. By 2014, average compensation in these fields had grown to $40 and $45 per hour in private-sector professional and finance jobs, and $57 and $64 per hour at the provincial and federal governments. While some federal occupations require relatively advanced qualifications, a 60-percent-plus margin in compensation per hour over private professional, scientific and technical service providers is startling (Figure 1).

This Shadow Budget therefore proposes to freeze per-employee wage and salary increases over the projection period. Should discussions with federal employees and their representatives not yield the

9 Although some observers note that the wage premium for federal employees is larger at lower and mid-level positions, and warn that narrowing the premium overall would hurt Ottawa's ability to retain talent at higher levels, we note that the federal government's pension plan – which, as we explore in the following paragraphs, is more generous than commonly understood – is a final-salary scheme that compensates senior positions very generously. We see no evidence that the federal government has a retention problem for senior employees – until they reach the age at which they are eligible for their full pensions, when they usually leave. A better compensation structure would neither incent people so strongly to stay before pension eligibility nor incent them so strongly to leave after it.

required restraint, reductions in staffing levels will make up the difference. This measure will reduce planned expenditures by about $0.6 billion in 2016/17 and $1.3 billion in 2017/18.[10]

Containing Employee Pension Expenses

The federal government's contributions toward the cost of pension and other post-retirement benefits represented about 22 percent of wages and salaries paid in 2014/15. Adding contributions for other benefits, such as health, dental and disability, amounting to about 5 percent of payroll,[11] puts the recorded cost of employee benefits at some 28 percent of wages and salaries.

These amounts, however, do not capture the full cost to the government – and therefore to taxpayers – of federal employees' pensions and benefits. If employer and employee contributions and any investments they fund cannot cover these obligations when they come due, taxpayers are on the hook. Past contributions do not cover benefits earned to date – indeed, all these plans were unfunded until 2000, and the major pension plans have been only partially funded since then. With yields on high-quality investments suitable to back such commitments as low as they are now, these plans are promising benefits much larger than current contributions can cover.

In 2014/15, the differences between expected and actual investment returns, on one hand, and liability values, on the other, represented an additional 15 percent of federal wages and salaries, raising the total cost of these benefits to 43 percent of payroll. Allowing for these additional amounts further widens the margin of hourly compensation for federal over comparable private-sector employees (Figure 1).[12] Effective containment of compensation costs therefore requires special attention to these benefits.

Recent changes to federal employee pensions – a gradual rise in employee contributions and a higher normal retirement age for new hires – alleviate some of the pressure. The unfunded liabilities that have already accrued, however, and ongoing accruals, are much larger than these improvements. Because the federal government guarantees its employees' pensions unconditionally, those obligations resemble other federal debt, and because the benefits are indexed to inflation, the appropriate comparator is the federal real-return bond (RRB).[13] The yield on RRBs is currently around 0.6, yet federal accounting discounts its future obligations at a real rate of 4.1 percent.[14] If accruing benefits in federal employee pension plans resulted, not in book-keeping entries assuming high returns, but in issues of actual RRBs, the costs for the Public Service (PS), Canadian Forces (CF) and

10 Estimated assuming wages and salaries otherwise planned to rise with inflation, and holding constant the number and composition of federal employees.

11 Rough estimate from data provided in the Expenditure Review of Federal Public Sector Compensation Policy and Comparability, 2006.

12 The adjustments arising from differences between expected and actual experience are amortized over the remaining service of the employees involved. A fair-value approach to federal pension-related assets and liabilities would show all such changes in the annual statement of operations and the net debt immediately.

13 As Robson and Laurin (2015a) and Robson (2012) have documented, someone not in a federal pension plan who wanted a similar retirement – or, alternatively, wanted to offset the liability federal pensions create for her or him as a taxpayer – would appropriately invest in RRBs.

14 As Hamilton (2014b) points out, taxpayers are effectively guaranteeing federal pension plan participants a 4.1 percent long-term real rate of return, and the difference between this assumed rate and the actual yield on RRBs makes this guarantee very valuable. The cost of this guarantee does not appear in the federal government's financial statements, however, and few taxpayers know it exists.

RCMP plans would range, not from the reported 20 to 24 percent of pensionable pay, but from 52 to 56 percent of pensionable pay.[15]

This Shadow Budget proposes to limit taxpayers' exposure to pension shortfalls, and cease subsidizing accruals of tax-deferred pension wealth that are so much larger than savers in Registered Retirement Savings Plans (RRSPs) and DC pension plans can put aside. It introduces measures to cap Ottawa's contributions as an employer at 50 percent of the maximum tax-deferred limit available to Canadians saving in RRSPs or DC plans, or 9 percent of pensionable earnings, whichever is larger. The rest of the amount needed to fund the plans at their actual cost will come from employees. These changes will hold total taxpayer contributions to these plans to about $3.3 billion per year, an annual saving of about $0.7 billion in 2016/17 and $0.6 billion in 2017/18.[16]

This shift in funding risk will give plan participants a greater stake in the sustainability of federal pension plans and in potential future changes – for example, further increases in the retirement age. The federal government therefore will open discussions about how to create a shared governance structure that builds on the positive experiences of jointly governed plans elsewhere in Canada's public sector.

Containing Federal Sick Leave Expenses

The government has tabled legislation to undo recent changes to sick-leave management and short-term disability, leading to an additional annual expense in its latest economic update. Notwithstanding the new government's desire to proceed in this area with a greater degree of collaboration with government employees and their representatives, the twin goals of bringing workplace absences in the federal public service into better alignment with counterparts in the private sector, and giving taxpayers better value for money, remain valid. This Shadow Budget therefore anticipates annual savings of $0.9 billion in 2016/17, and $0.2 billion relative to the status quo starting in 2017/18. Should negotiations with the affected parties not achieve this objective, the savings will be achieved by increasing employee contributions to the plans.

Providing a Fuller Picture of the Federal Government's Financial Position

The federal debt is a key figure for federal fiscal policy. It is a main indicator of financial health for credit rating agencies, and successive federal governments have set long-term goals for its level as a percent of GDP.

Other than market-traded debt securities and some financial assets, however, the values of all other balance sheet components are best estimates subject to accounting standards. Two of these are understated: the value of Ottawa's obligations for employee pensions, and the current value of Ottawa's financial assets in the form of future tax receivable.

More Meaningful Reporting of Employee Pension Obligations

As elaborated above with respect to federal pensions, low yields and correspondingly low

15 Taxpayers are themselves struggling with low rates of return as they save for their own retirements, and are hampered by limits under the *Income Tax Act* on their own tax-deferred saving – 18 percent of pensionable earnings up to $25,370. So it is troubling that the actual commitment taxpayers are making to the future pensions of federal employees is far greater than reported.

16 Taxpayer contributions to the PS, CF and RCMP pension plans are expected to be 10.7, 14.3 and 12.6 percent of pay, respectively, in fiscal year 2016/17, and 10.2, 13.7 and 12.5 percent of pay, respectively, in 2018/19.

discount rates on liabilities make a given future payment more expensive to fund. The Public Accounts show Ottawa's obligation for employee pensions – net of the assets that have accumulated since these plans began operating on a partially funded basis in 2000 – at $151 billion at the end of fiscal year 2014/15. But, a market-based valuation yields a deficit of $269 billion at that date.[17] This restatement increases the total value of federal liabilities – and the federal debt – by $118 billion.

Reporting the Value of Deferred Taxes on Registered Saving

Canadians hold much of their retirement savings in tax-deferred forms, notably RRSPs and registered pension plans. No tax is payable on contributions to these plans, or on investment returns within them. Distributions, however, are subject to personal income taxes, and trigger income-tested clawbacks of benefits such as the Guaranteed Income Supplement (GIS). This deferral of taxes means that federal and provincial governments have an implicit asset: the future stream of revenues that withdrawals of funds accumulated in RRSPs and pension plans will generate (Robbins and Veall 2002).

Statistics Canada's 2012 Survey of Financial Security estimated the market value of tax-deferred assets at around $2.83 trillion. Although the liabilities in defined-benefit pension plans, representing the payments they will make, are the relevant measure for calculating the future revenues governments would collect on those payments, we use the value of assets as the basis for a conservative estimate. If the average federal tax rate on distributions from these plans will be 20 percent, a more complete federal balance sheet would show a deferred-income-tax asset of $566 billion (Robson and Laurin 2015b).

Supplementary Reporting

Both the $118 billion additional pension liability and the $566 billion potential tax asset are useful supplements to existing information about the federal government's position. The former gives a fuller measure of the value of federal pensions to their recipients and their cost to taxpayers. The latter reflects the reality that taxes deferred are still owed.

Holding the Line on Intergovernmental Transfers

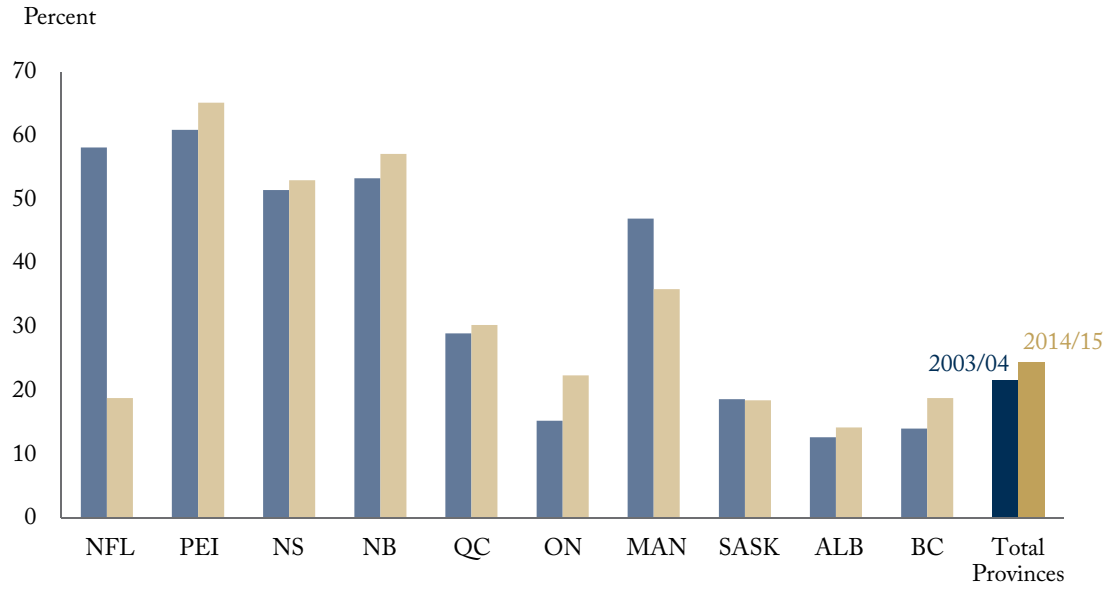
Federal transfers to provincial, territorial, and local governments have grown faster than the economy and faster than the revenues of either the federal or other governments over the last 10 years. The growing importance of federal transfers in most provincial budgets (Figure 2) reinforces a tendency for provinces to see Ottawa as the answer to their fiscal challenges.

Provincial governments, however, have access to essentially the same revenue sources that Ottawa does. The more federal transfers respond to provincial demands, the weaker the incentives for effective fiscal management by provinces, and the stronger the incentives for them to blame Ottawa for shortcomings in their programs – and to divert time and energy from improving services toward lobbying for bigger federal transfers (Robson and Laurin 2015c).

Except for a new grant supporting provincial drug programs, detailed below, this Shadow Budget therefore proposes no further increases in federal-provincial 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

17 Based on the RRB rate of 0.19 percent as of the end of 2014/15. More details on the methods used can be found in Robson and Laurin (2015).

Figure 2: Federal Major Cash Transfers as Share of Own-Source Revenue



Source: Finance Canada's Fiscal Reference Tables.

Transfer will continue rising at the greater of GDP growth or 3 percent, rather than returning to the previous, unsustainable, 6 percent rate of growth (Clark and DeVries 2016).

Addressing Risks in Mortgage Insurance

Many Canadians have mortgage debt that may be hard to manage: the share of mortgage-indebted households with primary mortgage debt more than five times their disposable incomes climbed from 3 percent in 1999 to 11 percent in 2012 (Alexander and Jacobson 2015). The increase is more evident for lower-income groups, younger households, and buyers in booming housing markets. If house prices fell significantly, many of these households would be unable to service their debts. In addition to hardship for the families concerned, failures to service mortgage debt could damage Canada's banking system, with repercussions for the economy, and for taxpayers.

The federal government currently guarantees mortgages insured by the Canada Mortgage and Housing Corporation (CMHC) as well by private mortgage insurers. A recent analysis by Koeppl and MacGee (2015) indicates that a low-probability housing crisis could cost the federal government up to $9 billion to recapitalize mortgage insurers.

This Shadow Budget would create a standalone fund – available only for the residential ownership market – accumulating reserves to insure against a severe housing downturn up to a target level and with capacity to borrow against future revenue if needed. The Financial Institutions Supervisory Committee would oversee the backstop fund's pricing and reserve policies. The backstop would

Table 4: A Sustainable Fiscal Framework: Summary of Initiatives and Impact on Budget Balance 2016/17 and 2017/18

Initiatives	2016/17	2017/18
	($ billions)	
Managing Federal Employment Costs		
Containing Current Compensation Expense Growth	0.6	1.3
Containing Federal Employee Pension Expenses	0.7	0.6
Containing Federal Sick Leave Expenses	0.9	0.2
Providing a Fuller Picture of the Federal Balance Sheet	n/a	n/a
Holding the Line on Intergovernmental Transfers	n/a	n/a
Address Tail Risks in Mortgage Insurance Backstopping	s	s
Total	**2.2**	**2.1**

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

be primarily funded by market participants, so the direct cost for the federal government would be negligible.

Improving Opportunities for Canadians

The Shadow Budget will promote equality of opportunities by lowering the upfront cost of post-secondary education for students of lower-income families, better funding for on-reserve education, equalizing regional access to employment insurance benefits, ensuring basic pharmaceuticals for all Canadians, and improving opportunities for retirement saving and drawdown.

Reforming Tuition and Education Tax Credits

Post-secondary educational achievement boosts individual capacity and earnings, contributing to a more prosperous economy (Boothby and Drewes 2010; Moussaly-Sergieh and Vaillancourt 2009). Completion of post-secondary education among children of low-income parents also improves social mobility.

Tuition and education/textbook tax credits channel some $1.6 billion annually in federal support toward postsecondary education. These credits benefit students who have tax payable, and unused amounts can carry forward to future years or be transferred to a parent, grandparent or spouse. The credits do not work as well for students from lower-income families, who can only use them once they have enough taxable income to claim them (Neill 2013). This Shadow Budget therefore proposes to transform the tuition and education/textbook tax credits into refundable benefits paid to students immediately after they file their tax returns.

This change will alter the timing of benefits paid and their fiscal cost: credits currently carried forward will be paid immediately. The ongoing cost of the initiative will be small, even accounting for positive effects on student enrolment.

Funding for On-Reserve Education

Indigenous Canadians, especially those on reserve, tend to complete secondary education at much lower rates than other Canadians. In 2012/13, Ottawa provided $1.6 billion to support First Nations elementary and secondary education, and $0.2 billion for construction and maintenance of education facilities on reserves. This Shadow Budget proposes substantial increases in funding for on-reserve schools that meet basic requirements.

When it comes to what they learn while in school, indigenous students on reserves don't benefit from the rigorous achievement measurement that monitors and prompts improvements in educational quality in many provincial schools. Therefore, this Shadow Budget also proposes additional bonuses for on-reserve schools whose students participate in the PCAP and PISA assessments in sufficient numbers to benchmark their performance. Related spending will come to $0.5 billion annually – a major investment in ensuring that on-reserve Canadians receive educations as good as those available to their peers off-reserve, and their counterparts abroad.

Eliminating Regional Differences in Employment Insurance

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

This Shadow Budget proposes to phase out EI's regionally differentiated entrance requirements and benefit periods. Varying the resulting coast-to-coast uniform requirements with the national unemployment rate will add a countercyclical income stabilization element to the program. In the short-term, the desirability of accelerating EI access for workers displaced by the energy slump – who are typically in regions where recent low unemployment rates impede access – justifies easing the stringent requirements ahead of tightening the looser ones. To cover these transitional costs, the Shadow Budget includes $0.5 billion in fiscal year 2016/17 and $0.5 billion in 2017/18.

Federal Support for Provincial Drug Programs

Prescription drugs are increasingly valuable in maintaining Canadians' health and quality of life. These benefits come at a cost: the share of drugs in health expenditures in Canada rose from 6.3 percent in 1975 to 13.4 percent in 2014. Some Canadians may be failing to fill prescriptions because they lack access to a drug plan and/or do not have the financial means. Just as the federal government helped provincial governments introduce universal doctor and hospital insurance in earlier years, the federal government can help them fill what is becoming an important gap in Canadian medicare.

This Shadow Budget proposes a new grant that would cover a share of drug expenditures for all provinces that (i) protect families from paying more than specified shares of their incomes on prescription drugs, (ii) handle rebates and payments through personal income tax, and (iii) relieve patients of out-of-pocket payments when a prescription is filled (Blomqvist and Busby 2015). The federal government will also seek improved cooperation in drug pricing, formulary design, and in creating a drug strategy for rare and high-cost diseases.

The estimated annual cost of this initiative is $2.8 billion (Blomqvist and Busby 2015).

Simultaneously subjecting employer-paid health and dental benefits to ordinary income tax, as recommended in the 2015 report of the federal Advisory Council on Healthcare Innovation – would bring in some $2.2 billion annually.[18] The net cost of these changes is therefore $0.6 billion. Because it will take time to design these programs, and employers and employees will want time to adapt to a new tax regime on employer-paid health benefits, this Shadow Budget anticipates implementing this initiative in 2019/20, when the federal government has returned to a budget surplus.

Leveling the Field for Savers in Group RRSPs

The majority of Canadians, and the vast majority who work in the private sector, do most of their retirement saving in RRSPs. Many employers support this saving by organizing group RRSPs, and many match at least part of their employees' contributions. Approximately 1.5 million Canadians participate in an employer-sponsored group RRSP.

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

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

Increasing Age Limits for Tax-Deferred Saving

Life expectancy in Canada has been rising more than two years per decade since the 1960s, but current age limits related to retirement do not reflect this change. Canadians (and their employers) now must stop contributing to tax-deferred retirement saving vehicles at age 71, which is also the age at which users of these vehicles must start drawing down their wealth. The Shadow Budget will increase the age at which contributions to tax-deferred retirement saving vehicles must end to 72 on January 1, 2017, and begin increasing it at a rate of one month per six-month interval after that. Among other advantages, this change should encourage older Canadians to stay in the workforce longer.

In view of these changes in life expectancy, the government will maintain the currently scheduled increase in the standard age of receipt for the Old Age Security (OAS), and will consult over further changes to key ages related to retirement as Canadians continue to live longer and healthier lives.

Boosting the Guaranteed Income Supplement

The government's election platform committed to increasing the Guaranteed Income Supplement (GIS) for single, low-income seniors. This Shadow Budget proposes to fulfil that pledge once the budget has returned to surplus.

The platform also included a commitment to calculate a seniors' price index, and to index seniors' benefits to whichever of it or the Consumer

18 After accounting for a possible 18 percent drop in coverage (Finkelstein 2002) as a result of the removal of the non-taxation provision of employee group benefits.

Table 5: Improving Opportunities for Canadians: Summary of Initiatives and Impact on Budget Balance 2016/17 and 2017/18

Initiatives	2016/17	2017/18
	($ billions)	
Reforming Tuition and Education Tax Credits	-0.3	-0.3
Funding for On-Reserve Education	-0.5	-0.5
Eliminating Regional Differences in Unemployment Insurance	-0.5	-0.5
Expanded Federal Role in Access to Provincial Drug Plans	c	c
Leveling the Field for Savers in Group RRSPs	s	s
Increasing Age Limits for Tax-Deferred Saving	s	s
Boosting the GIS	c	c
Consultations on Eliminating Mandatory Drawdowns from RRIFs	n/a	n/a
Extending Pre-Age-65 Pension Credit and Income Splitting	-0.1	-0.1
Total	**-1.4**	**-1.4**

Notes: n/a = not applicable; s = cost is small or negligible; c = implementation is conditional on budget balance.

Price Index increases more in a given period. But following through on the latter part of the commitment would be unfair, since indexation should reflect particular circumstances, not an opportunistic linking to whatever number produces a more advantageous result. And it is unwise, potentially setting a precedent for other groups who would ask for similarly "heads I win, tails you lose" treatment. The government will not proceed with this idea.

Reducing Mandatory Drawdowns from RRIFs

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

Table 6: Fiscal Projections with Shadow Budget Initiatives

	2015/16	2016/17	2017/18
		($ billions)	
Baseline Projections (Table 2)			
Projected Revenues	292.2	292.0	304.8
Projected Expenditures	-293.2	-304.6	-314.3
Adjustment for Fiscal Prudence	-1.5	-3.0	-3.0
Budgetary Balance before Initiatives	**-2.5**	**-15.6**	**-12.5**
Shadow Budget Initiatives			
Strengthening the Economy (Table 3)		-0.5	-0.4
A Sustainable Fiscal Framework (Table 4)		2.2	2.1
Improving Opportunities for Canadians (Table 5)		-1.4	-1.4
Total		**0.3**	**0.3**
New Budgetary Balance	**-2.5**	**-15.3**	**-12.2**
Accumulated Deficit	616.2	631.5	643.7
as % of GDP	*31.0*	*31.0*	*30.2*

Sources: Tables above; authors' calculations.

The calculations of the new mandatory minimum schedule's impact in the 2015 budget assumed real 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. The 2015 changes should be a step toward further liberalization. Therefore, the government will launch consultations on two options: more regular adjustments to keep the withdrawals aligned with returns and longevity; or eliminating minimum withdrawals entirely. One way or another, tax rules should not prevent retirees enjoying the lifelong security they are striving to achieve.

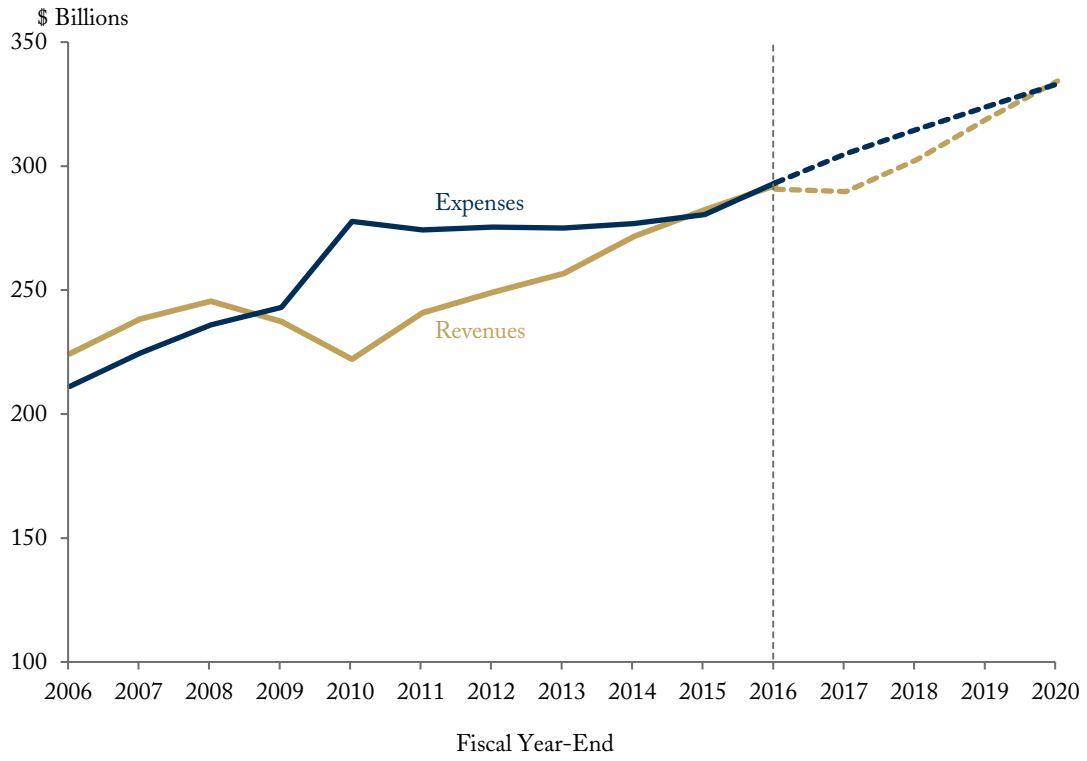
Extending Pre-Age-65 Eligibility for Pension Credit and Income Splitting

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

Combining It All

These plans for supporting long-term growth, achieving a sustainable fiscal framework, and

Figure 3: Actual and Projected Federal Revenues and Expenditures, 2005/06 to 2019/20



Notes: Projections for 2018/19 and 2019/20 assume revenues from taxes, fees, and other charges growing with the economy, program expenses growing with inflation and population growth, and debt charges estimated at the average effective net interest rate projected in the latest fiscal update (Canada 2016).

Sources: Public Accounts of Canada; authors' calculations.

improving Canadians' opportunities, leave the federal budget balance on a better path than outlined in Finance Canada's February 2016 economic update (Table 6). Prudent management of public finance will prevent a rise in the ratio of federal debt to GDP and ease the path back to surpluses as the economy accelerates (Figure 3).

Thus, this Shadow Budget assures that Canadians can pursue their lives, and can work, save and invest with confidence. They can know that the federal government is dealing successfully with the country's economic and demographic challenges, is supporting economic growth, and promoting opportunities that will help all Canadians prosper.

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