THE CANADIAN CHAMBER OF COMMERCE
LA CHAMBRE DE COMMERCE DU CANADA

Policy Brief

Economic Policy Series – October 2010

Fiscal Policy for a Stronger Tomorrow

Introduction

Canada's economy weathered the financial and economic crisis better than most industrialized countries largely because of the strength of our financial sector and relatively better household and corporate balance sheets. Additionally, highly credible monetary policy and the strongest fiscal position in the G7 enabled Canadian policymakers to take unprecedented actions to swiftly and effectively stimulate the economy.

Canada's economy staged an impressive turnaround fueled by a strong rebound in consumer spending, residential investment and government expenditures. In just four quarters, the economy recouped all the real output and net jobs lost during the recession. No other G8 country can make such a claim.

After bouncing back sharply from the recession, the economy has shifted down a gear. Growth slowed in the second quarter and went into reverse in July, the first monthly decline in almost a year. Buffeted by strong headwinds on both the international and domestic front — a weakening outlook in the U.S. and faltering domestic demand — the economy is expected to settle into a more modest growth this quarter and over the next four quarters.

The Canadian Chamber is committed to fostering a strong, competitive and profitable economic environment that benefits all Canadians. This paper is one of a series of independent research reports covering key public policy issues facing Canada today. We hope this analysis will raise public understanding and help decision-makers make informed choices. The papers are not designed to recommend specific policy solutions, but to stimulate public discussion and debate about the nation's challenges.

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Continued vigilance and leadership are required to secure Canada's recovery and jobs. In its pre-budget submission to the House of Commons Standing Committee on Finance, the Canadian Chamber of Commerce urged the federal government to follow through on delivering existing stimulus plans while working to enhance the operating environment so the private sector can continue to create jobs, invest, innovate and generate wealth.

In its submission, the Canadian Chamber also stressed the importance of returning to budget balance over the medium term. As a first step to budget consolidation, governments should allow temporary stimulus measures to expire as planned. Left unchecked, deficits drive up interest rates and drain national savings. "They pose a corrosive threat to our economic future."[1]

The window of opportunity to bring indebtedness down is rapidly closing as demographic changes — a rapidly aging population and slower growth in the labour force — will exert significant pressures on the public purse. Demand for publicly funded programs, like health care and elderly benefits, will rise significantly, and a smaller number of workers will shoulder a larger share of the tax burden. The rate of potential growth of the Canadian economy "will be closer to 2 per cent going forward than the more than 3 per cent average rate we enjoyed in the first half of the past decade and the latter half of the 1990s".[2]

It is imperative that we boost Canada's potential output growth so we have greater fiscal flexibility to meet the needs of an aging population and tackle areas that are crucial to our long-term competitiveness, including preparing for the jobs of tomorrow and reducing high marginal personal income tax rates. The government's ongoing focus must be on addressing long-standing structural impediments that stifle productivity, hinder growth and negatively affect the operation of markets and the capacity of businesses to operate efficiently. This entails removing all internal barriers to trade and mobility, eliminating burdensome regulatory procedures, minimizing tax administration and compliance costs, reforming Canada's Employment Insurance program, implementing the Competition Policy Review Panel's recommendations with respect to the *Investment Canada Act* and ensuring that national borders do not impede the safe and efficient flow of goods and people.

To summarize, while the government's efforts are rightly focused on tackling the short-term challenges, it must not lose sight of the longer-term picture. The Canadian Chamber's three-pronged strategy — securing the recovery, moving forward with a strong and credible plan to return to budget balance and undertaking structural reforms to bolster the economy's long-term growth potential — will ensure Canada's economy prospers over the long term, stays competitive, dynamic and flexible, and is capable of readily adjusting and adapting to changing circumstances and economic shocks.

1 Treasury Secretary Timothy F. Geithner. Written Testimony before the Senate Committee on Finance. Washington, DC. February 2, 2010.

2 Remarks by Mark Carney, Governor of the Bank of Canada, "The Coming Thaw," to the Winnipeg Chamber of Commerce. Winnipeg: February 4, 2010. Note: Potential output is the rate of growth that can be sustained over time without inflationary or deflationary consequences.

The Canadian Chamber's Three-Pronged Strategy

1. Securing the Economic Recovery and Jobs

To help secure the recovery, it is essential that federal and provincial / territorial governments follow through on delivering the $29.0 billion in stimulus that has been committed for fiscal 2010–11. "The steady fiscal course is essential to reinforce consumers' and investors' confidence, and thus to turn the emerging but still gradual recovery into a period of sustainable growth and job creation."[3]

Securing the recovery and sustaining growth also necessitates that governments work to enhance the operating environment so Canada's businesses prosper and create jobs.

- Canada must adopt an ambitious, comprehensive and forward-looking strategy to boost our country's trade and investment ties with other nations. Signing the proposed Comprehensive Economic and Trade Agreement with the European Union would send a resounding message to the rest of the world that, instead of turning inwards, Canada has a confident view of the role it can play in the global economy.

- While progress continues to be slow, a successful and ambitious conclusion to the World Trade Organization's (WTO) Doha Round of multilateral trade negotiations would bring much needed stability and predictability to Canadian companies conducting business internationally, give added impetus to the recovery and spur long-term economic growth and prosperity.

- Continued vigilance against protectionism is imperative, particularly when so much of Canada's fortunes depend upon trade. Protectionist sentiments around the globe are likely to increase with low growth, persistent unemployment and mounting pressures on government finances. The impulse for protectionism may be understandable; however beggar-thy-neighbour policies can derail the recovery, drag down future growth and undercut the ability to increase incomes. Canada must collaborate through multilateral institutions and work with other international partners to stop protectionism and promote rules-based trade liberalization.

- Better management of the Canada-U.S. border would boost the competitiveness of Canadian businesses and strengthen economic growth by facilitating the movement of legitimate people and goods. Since 2001 there has been an increase in the number of fees and inspections at the border, growing penalties for minor infringements, increased complexity of regulatory requirements, uncertain wait times and infrastructure constraints. The thickening of the border is also coming at a time when North America's main competitors are looking for ways to streamline border procedures.

- There is compelling evidence that innovation is an important driver of strong and sustainable growth. Canada must continuously strive to build the most skilled and entrepreneurial workforce in the world, significantly enhance its scientific and technological capacities, improve its ability to move research breakthroughs out of the laboratory to the marketplace, and champion a strong intellectual property rights regime.

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3 Rehn, Olli. "Reinforcing economic confidence in Europe." Speech to the ECON Committee – European Parliament. Strasbourg. July 5, 2010.

- Finally, we must ensure that businesses continue to have access to affordable credit, particularly when governments are looking to the private sector to increase investment and create jobs. Access to affordable capital is also important to entrepreneurs who are looking to transform their ideas into successful ventures and to families looking to finance their homes and their children's education. While priority must be given to ensuring adequate capital and liquidity standards as part of an international financial reform agenda, "we must be careful not to tighten the requirements too quickly, in ways that might restrict private-sector access to credit."[4]

2. Moving Forward with a Strong and Credible Plan to Return to Budget Balance

The strongest consensus that emerged at the June G20 Business Summit in Toronto was that addressing deficits effectively is essential to restoring confidence and to driving business investment and economic growth — in other words, a precursor to a sustainable recovery. Failure to do so "is now the biggest risk to global economic recovery."[5]

Many advanced economies emerged from the recession with the highest deficit- and debt-to-GDP ratios since the Second World War. The International Monetary Fund (IMF) projects that in 2014, government debt in advanced G20 economies will hit 118.4 percent of GDP, on average, up from an estimated 106.7 percent in 2010, and substantially higher than the pre-crisis (2007) level of 78.2 percent.[6]

In the United States, debt is projected to nearly double from 61.9 per cent of GDP in 2007 to 108.2 per cent in 2014, while Japan's debt burden is expected to rise to over 245 per cent.

Canada is in a relatively better fiscal position compared to most industrialized countries. Gross debt is projected to fall to 68.9 per cent of GDP in 2014 from an estimated 79.3 per cent in 2010.

"While other industrialized nations wallow in their fiscal mud, Canada should leverage its fiscal advantage to build its competitiveness."[7] This is particularly important since emerging-market countries came out of the recession with stronger economies and much better balance sheets than most industrialized nations.[8]

4 Notes for remarks by the Honourable John Manley, Chair, G-20 Business Summit. "Report to G-20 Ministers of Finance." Toronto: G20 Business Summit. June 26, 2010

5 Ibid.

6 Horton, Mark, and Philip Gerson (2009). "The State of Public Finances Cross-Country Fiscal Monitor: November 2009." *IMF Staff Position Note*. Washington: International Monetary Fund. November 3.

7 Mintz, Jack M. (2010). "Leading the way." *FP Comment*. Financial Post. January 27.

8 The IMF projects the debt burden in emerging G20 economies will fall to 36.2 percent of GDP in 2014 from 39.6 percent at present.

G20 leaders committed to at least halve deficits by 2013 and stabilize or reduce government debt-to-GDP ratios by 2016. This was a win for Canada who had been leading the push for targets, primarily because these targets appear well within our reach. In Budget 2010, the federal government predicted a deficit of $53.8 in fiscal 2009–10, and its forecasts indicate the deficit will decline by almost half over the next two years.

The more difficult challenge is moving from the intermediate targets to a zero deficit. Federal government projections imply the deficit will be eliminated in 2015. From 2012 to 2015, nominal GDP growth (a good proxy for government tax revenue) is projected to average about 4.3 percent while debt service costs are projected to rise steadily.[9] Balancing the books by 2015 rests on limiting program spending growth to historical low levels (at, or below two per cent per year on average post 2011). "On the surface, this period of restraint many not appear draconian. But it would represent a dramatic shift of gear."[10] Federal program spending increased around six per cent per year from fiscal 2000–01 to fiscal 2008–09.

"History points to a number of things that don't work well. Across-the-board slashing of programs without putting in place underlying structural reform has generated little in the way of sustained savings. The federal Program Review of the mid-1990s resulted in significant short-term savings, but once these savings were secured and surpluses emerged, the machinery was abandoned. Close scrutiny of spending must be an ongoing process."[11]

At the Canadian Chamber's Annual General Meeting in Gatineau, Quebec (September 25-28, 2010), delegates passed a resolution calling on the federal government to regularly evaluate all its programs and activities by asking the following questions:

- Does the program or area of activity continue to serve the public interest?
- Is there a legitimate and necessary role for government in this program area or activity, or could the private / voluntary sectors play a greater role in whole or in part?
- Are Canadians getting value for their tax dollars?
- If the program or activity continues, how could its efficiency and effectiveness be improved? For example, can delivery costs be lowered through intelligent use of technology, public-private partnerships or third-party delivery?
- Is the federal government acting within its well-known constitutional responsibilities, or is the program a candidate for realignment with the provinces / territories?

Fiscal discipline — reining in spending and improving efficiencies — is imperative to eliminate deficits over the medium term and pay down debt over the longer term so the federal government has the fiscal flexibility to respond to changing circumstances.

Going forward, Canada will be confronted with two daunting challenges — a rapid rise in the share of seniors in the population (by 2019, individuals 65 years of age and over are expected to account for more than a quarter of the population and, by 2029, for more than a third) and much slower

9 Public debt charges are projected to reach over $40 billion by fiscal 2013–14 (up from $33.3 billion in fiscal 2007–08), absorbing about 15 cents of each dollar of revenue collected by the federal government. To put this into perspective, $40 billion is roughly what the federal government collected in corporate income taxes in fiscal 2007–08.

10 Burleton, Derek and Don Drummond. (2009). "New era of restraint." *FP Comment*. Financial Post. October 20.

11 Ibid.

growth of the labour force. The fiscal consequences are significant. First, the share of government revenue (and GDP) devoted to publicly-funded programs, like health care and elderly benefits, will rise significantly. Second, a smaller number of workers will carry a larger share of the personal income tax burden.

Canada must modernize its tax system to reduce its heavy dependence on personal income taxes that hit the working population, a diminishing group expected to fund public programs for a retiring population, the hardest. Additionally, Canada's success will depend very much on maintaining, attracting and developing one of the most skilled and productive workforces in the world. We must ensure Canada's personal income tax system is competitive.

Raising corporate income taxes or reneging on promised corporate tax rate reductions to generate additional revenue is not the answer. Businesses have a critical role to play in sustaining economic growth by initiating new investments and hiring to expand productive capacity. "The economic cost of giving up the three-point reduction in the federal corporate income tax rate planned by 2013 would be a long-run loss of $47 billion in capital investment and 233,000 jobs."[12] This illustrates that business taxes are one of the most economically destructive mechanisms for raising revenue.

That is why most OECD countries rely less, than Canada does, on income and profit taxes and more on less economically-damaging consumption taxes like the GST. Switching the tax mix towards consumption-based taxes would encourage both work and capital formation and, thus, stimulate productivity and economic growth.

"To the extent that our tax system over-relies on high-cost sources of tax revenue, the Canadian economy grows at a lower rate than might be possible with a more efficient tax system".[13] As long as we have taxes, we need to ensure that their mix and structure are as efficient as possible.

The aging of Canada's population will also exert significant upward pressure on government expenditures stemming from increased demand for health care services (those over 65 generally consume much more health care than other segments of the population) and elderly benefits (Old Age Security, the Guaranteed Income Supplement and the Spousal Allowance).

Health care-related expenditures are already consuming a significant portion of government budgets. According to the Fraser Institute, in Ontario and New Brunswick, health care expenditures are on pace to consume half of provincial revenues by 2014 or earlier. Prince Edward Island will likely reach 50 percent within 10 years, Nova Scotia in 15 years, Manitoba in 17 years, and Quebec in 25 years.[14]

The federal government's main health care-related expenditure is the Canada Health Transfer (CHT), through which it finances approximately 20 percent of provincial/territorial government health expenditures, or about $24.0 billion in fiscal 2009–10.[15] Incorporating annual increases

12 Chen, Duanjie, and Jack Mintz. (2010). "Canada's Tax Competitiveness After A Decade of Reforms: Still An Unfinished Plan." *SPP Briefing Papers*. Vol. 3, Issue 5. Calgary: University of Calgary. May.

13 Clemens, Jason, Niels Veldhuis, and Milagros Palacios. (2007). "Tax Efficiency: Not all Taxes are Created Equal." *Studies in Economic Prosperity*. No. 4. Vancouver: The Fraser Institute. January.

14 Skinner, Brett J., and Mark Rovere. (2009). "Paying More, Getting Less: Measuring the Sustainability of Government Health Spending in Canada, 2009 Report." *Studies in Health Care Policy*. Vancouver: Fraser Institute. November 30.

15 The federal government is also directly responsible for the delivery and funding of health care services to special groups, namely members of the First Nations living on reserves, members of the military and veterans, as well as the funding for health research, promotion and protection. These categories accounted for a total of $6.6 billion in federal direct health care spending in 2009.

of six percent per year as stipulated in the 2004 First Ministers' Agreement, *The 10-Year Plan to Strengthen Health Care*, the CHT will reach $30.3 billion in fiscal 2013–14. Continued escalation in the CHT at six percent annually would result in the CHT reaching $86.5 billion in 2031–32. CHT funding is also provided through tax transfers[16] that amounted to roughly $13.9 billion in fiscal 2009–10 and will continue to grow in line with the economy.

"Meeting the demographic and fiscal challenges requires bringing down trend growth in public health spending significantly, lest other public spending is squeezed and / or taxes rise."[17]

Elderly benefits — comprised of Old Age Security, the Guaranteed Income Supplement, and the Spousal Allowance — will also put an increasing strain on federal finances. These benefits are the federal government's largest transfer to individuals ($33.4 billion in 2008-09). The Parliamentary Budget Officer (PBO) projects elderly benefits will rise from 2.3 per cent of GDP in 2013–14 to 3.3 per cent of GDP by 2031–32. To provide perspective, a one percentage-point increase in GDP represents an added tax burden of $16 billion per year, relative to today's economy.

"The upward pressure on the costs of these programs will only be partially offset by reduced spending (as a share of GDP) on programs with benefits largely focused on younger age groups, such as education and social services."[18]

3. Undertaking Structural Reforms to Bolster the Economy's Long-Term Growth Potential

Population aging presents a significant challenge to the continued improvement of living standards and to the sustainability of social programs in Canada in the decades to come.

To deal effectively with emerging demographic pressures, Canada must bolster its economic base. In other words, if we want a bigger-sized pie to divide among the elderly and non-elderly in the future, we must grow Canada's economy.

"The evidence is overwhelming that economic growth is strongly related to the openness and competitiveness of a country's markets and that competition is a key driver of innovation, productivity and prosperity."[19]

As such, Canada has much to gain by addressing long-standing structural impediments to growth, including internal barriers to trade and mobility, foreign investment restrictions, overlapping federal / provincial / territorial rules and regulations, an excessive tax-compliance burden and work disincentives in the income-support system (like Employment Insurance).

"The government would be smart to look at proposals to reduce the complexity of regulations that stall projects for inordinate times. For example, taking on a major resource or power plant investment requires several years of approvals from various levels of government. Better regulation could reduce federal expenditures if the process is made more efficient."[20]

16 A federal tax transfer involves the federal government transferring some of its "tax room" to provincial and territorial governments.

17 Organisation for Economic Co-Operation and Development (OECD). (2010). *OECD Economic Surveys: Canada*. Vol. 2010 / 14. Paris: September.

18 Office of the Parliamentary Budget Officer. (2010). "Fiscal Sustainability Report." Ottawa. February 18.

19 The Commissioner of Competition. (2008). "Submission to the Competition Policy Review Panel." Ottawa: January 11.

20 Mintz, Jack M. (2010). "Opinion: Ottawa's budget must walk the fiscal tightrope." Canadian Business magazine. March 15.

Improvements to Canada's tax system can also yield significant benefits. Canada's tax system should be simple, transparent and easy to understand and comply with. In a nationwide survey of more than 8,200 Canadian businesses, the Canadian Federation of Independent Business (CFIB) estimates it costs businesses $12.6 billion annually to comply with their tax obligations, the lion's share of the burden ($11.4 billion) carried by small- and medium-sized businesses (SMEs).[21] "Where tax compliance imposes heavy burdens of cost and time, it can create a disincentive to investment and encourage informality."[22] Reducing the tax compliance burden for businesses, particularly for SMEs, can make a significant difference to their bottom line, productivity and competiveness setting the stage for more solid economic growth.

Staying on the theme of taxes, it is essential that the federal government develop a formal system of loss transfer or consolidated reporting for groups of related companies (i.e. those under common ownership and control). This would improve the functioning of the tax system, significantly ease compliance and strengthen international competitiveness. More than two-thirds of OECD member-countries offer group taxation. Canada is the only country within the G7 with no tax consolidation regime.

The government must also redouble its efforts to persuade the remaining provinces (Saskatchewan, Manitoba and Prince Edward Island) that currently levy retail sales taxes to switch to a harmonized sales tax, similar to what Ontario and British Columbia recently implemented. This would significantly reduce marginal effective tax rates on new business investment and would significantly bolster the competitiveness of Canadian businesses both in the domestic and international markets.

Improvements can also be made to Canada's Employment Insurance program. Eligibility and benefits vary according to regional labour-market conditions. Where benefits are less accessible, Canadians who lose their jobs are unfairly treated. Where they are more accessible, they discourage labour market adjustment (i.e. upgrading of one's skills and relocating to where the jobs may be). The misallocation of labour reduces overall economic output and hampers productivity.

It is imperative that the government not lose sight of these issues.

21 Canadian Federation of Independent Business. (2008). "The Hidden Tax Burden: A Business Perspective on the Cost of Complying with Taxes." *CFIB Tax Research Series*. Report 1. Toronto: August.

22 PricewaterhouseCoopers and the World Bank Group. (2010). "Paying Taxes 2010: The Global Picture." February.

Conclusion

Canada's economy is at a sensitive point in the economic cycle where it is transitioning from a period of sharp recovery to a period of slower growth. Through the recession and up to now, government investments have supported growth, but "private demand needs to replace policy stimulus as the source of recovery in order to be self-sustaining."[23]

To pave the way for sustainable economic growth led by the private sector and to bolster the economy's long-term growth potential, the government must deliver on all fronts: pursue growth-friendly fiscal consolidation while advancing structural reforms.

Time is of the essence. The demographic shift has far-reaching implications for our public finances. The Auditor General of Canada stated: "The demographic die is cast: there is little we can do to reverse or even slow the ag(e)ing of Canada's population over the coming decades. But it is certainly within our power to plan better for it."[24]

We must act now with a clear sense of purpose to address both the immediate and longer-term economic and budgetary challenges. What is at stake is nothing less than the future prosperity of every Canadian.

23 Remarks by Angel Gurría, Secretary-General of the Organisation for Economic Co-Operation and Development (OECD). "G20: Global economic conditions and short-term prospects for recovery." Toronto: G20 Business Summit. June 26, 2010.

24 The Standing Senate Committee on Banking, Trade and Commerce. (2003). "The Demographic Time Bomb: Mitigating the Effects of Demographic Change in Canada." Ottawa. June 6.

For further information, please contact:
Tina Kremmidas, Chief Economist | tkremmidas@chamber.ca | 416.868.6415 ext 222