SUBMISSION

to
The Honourable Jim Flaherty, Minister of Finance for Canada

by

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Introduction

I would like to thank the Honourable Minister of Finance Jim Flaherty for the opportunity to present our recommendations for the 2007 Federal budget. The Conservative government's first budget was a welcome departure from past budgets in that it focused on tax relief and limiting future increases in government spending. Unfortunately, the 2006 budget offered little that addressed two of Canada's most pressing economic issues: the relative decline in average incomes and Canada's lagging productivity. This submission offers solutions to these issues along with a remedy for Canada's fiscal imbalance.

Organization of the submission

The submission is divided into five sections. The first section briefly outlines Canada's lagging productivity and income growth. The second section highlights the impact that Canada's tax system has on the incentives for people to work, save, invest, and act entrepreneurially. The third section provides three recommendations to improve Canada's productivity and prosperity woes. The fourth section outlines a proposal to restore fiscal balance between the federal and provincial governments. The last section outlines other important fiscal issues, such as the disposition of the growing CPP surplus, that the Department of Finance should consider. The submission concludes with a complete list of references.

Summary of our conclusions and recommendations

Canada faces a serious productivity and prosperity challenge. Internationally, Canada ranks 18th among 24 industrialized countries with average labour productivity growth of 1.5% over the past ten years. One of the primary reasons Canada's productivity and prosperity continues to lag is the disincentives for individuals and businesses to engage in productive activities. That is, Canada simply does not have an economic environment that promotes effective work, savings, investment, and risk taking. More specifically, our tax system punishes, rather than promotes, productive behaviour.

This paper recommends that Canada decrease its reliance on the most damaging types of taxes—those on capital and income. To that end, the federal government should:

1. reduce the general corporate income-tax rate from 21.0% to 12.0%, accelerate the elimination of the corporate income surtax from 2008 to 2007, and commit itself to eliminating the capital tax on financial institutions;
2. reduce the personal income-tax rate from 15.5% to 15% for the lowest bracket, eliminate the middle two brackets, and reduce the top rate from 29% to 25% with the goal of moving toward a single-rate personal income tax; and, in addition, index personal income-tax thresholds to wage growth, rather than inflation;
3. eliminate the taxation of capital gains.

While this tax relief represents a significant reduction in tax revenue, the net impact will in all likelihood be much lower once the supply-side impacts of the reductions are taken into consideration. The federal government should also broaden the tax base by eliminating tax rebates, reductions, exemptions, and credits that reduce the tax burden for certain types of activities. Finally, the 2005/06 budget surplus of $13.2 billion (Canada, Dep't of Finance, 2006a), the $1 billion in savings recently found by the Treasury Board, and wasteful spending by the federal government (Clemens et al., 2005) should provide ample fiscal room to fund the suggested tax relief.

Fiscal imbalance

This paper also provides an analysis of the much-discussed fiscal imbalance between the federal and provincial governments. We recommend a three-step reform package as a plan for genuine decentralization. The federal government should:

Step 1 eliminate the Canada Health Transfer and the Canada Social Transfer;
Step 2 reduce the most damaging federal taxes including personal income, business, and capital gains;[1]
Step 3 increase provincial taxes through a GST-based provincial sales tax harmonized with the federal GST.

The proposal to eliminate the federal CHT and CST, coupled with reductions in federal taxes and increases in provincial taxes, would yield a number of benefits including clearer lines of accountability and responsibility, an improved tax system, and reduced costs for businesses and individuals.

Other fiscal issues

CPP surplus

Finally, the federal government must address the growing surplus of assets being built up in the Canadian Pension Plan. Most importantly, Canadian governments must continue to insure that Canadian Pension Plan Investment Board focuses on a single goal: maximize rates of return while balancing risk. In addition, monies above what is required to fund current benefit levels fully and properly in the future should be used to reduce contribution rates.

Introduce experience rating in the Employment Insurance program

Changes made to the Canadian EI system in the early 1970s introduced very generous benefits at low levels of weeks worked (especially in high unemployment regions) and encouraged repeated use of the program. These changes caused unemployment rates in Canada to rise and the federal government should, therefore, introduce experience rating for the Employment Insurance program.

1 The reduction of federal taxes in this three-step reform package is in addition to the tax relief proposed above.

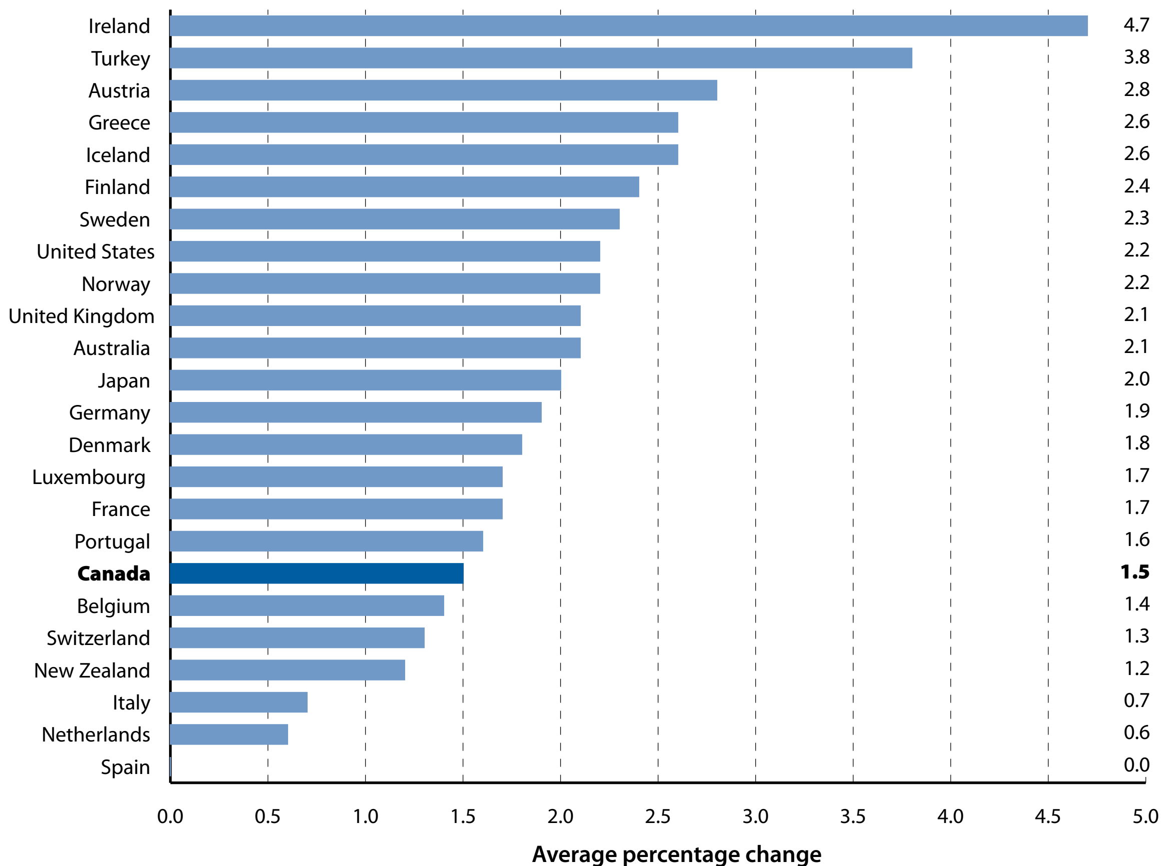
1 Canada's productivity and standard of living

The following section provides a brief analysis of labour productivity in Canada. While particular attention is paid to Canada's performance relative to that of the United States, comparisons to other industrialized nations are included. A more in-depth analysis can be found in *Productivity, Prosperity, and Business Taxes* (Veldhuis and Clemens, 2006), published earlier this year by The Fraser Institute.

Canada's labour productivity has decreased significantly relative to the United States over the past 20 years. In 1985, Canada's gross domestic product (GDP) per hour worked was 89.9% of that found in the United States. Unfortunately, the gap has increased substantially: by 2004 Canada's productivity had fallen to 82.8% of that in the US. Particularly worrying is the dramatic widening of the gap in the past five years. From 2001 to 2004, Canada's labour productivity relative to the US decreased by six full percentage points.

The growth of labour productivity in Canada is equally disappointing when compared to that of other countries. Figure 1 presents the average year-over-year change in

Figure 1: Average growth in labour productivity, 1995–2004

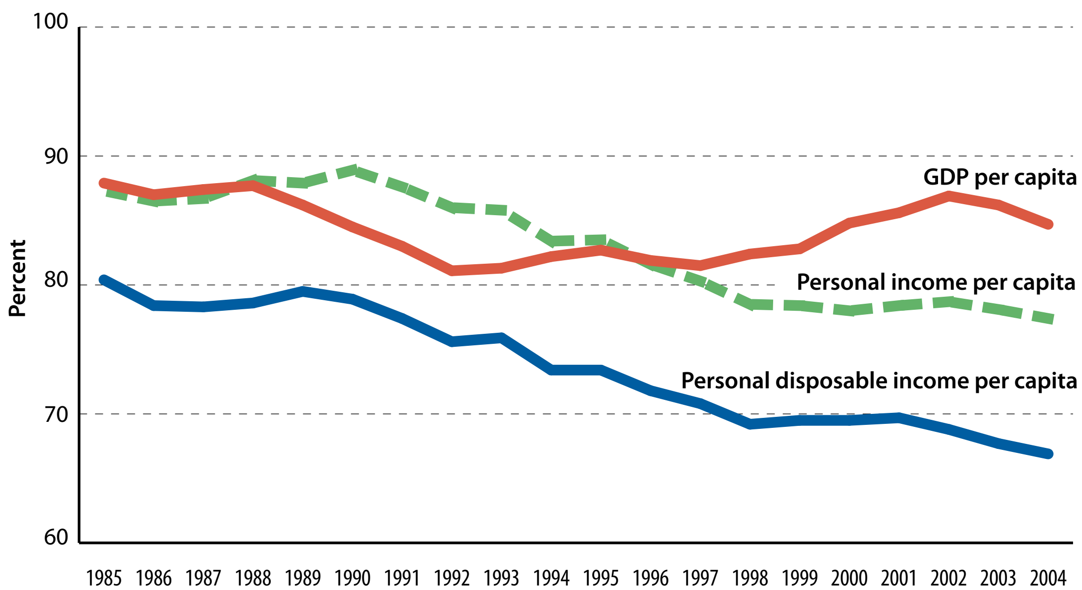


Note: Labour productivity is measured as gross domestic product per hour worked. Purchasing power parity exchange rates are used to convert figures into US dollars.
Source: Veldhuis and Clemens, 2006.

GDP per hour worker from 1995 to 2004. From 1995 to 2004, Canada ranked 18th among 24 industrialized countries on average labour productivity growth. Ireland, which ranked first, had an average labour productivity growth rate that was three times that of Canada.

Productivity growth is essential for sustained increases in living standards. Over the past 20 years (1985 to 2004), Canada's GDP per capita adjusted for inflation, a most commonly used measure of standard of living, has increased by an average rate of 1.7% a year. More narrow measures of income reveal less robust increases in living standards. Specifically, average personal incomes have grown by an average of 0.9% a year from 1985 to 2004 and personal disposable income increased by an average of just 0.6%.[2] Even more worrying is the fact that average incomes, regardless of the measures used, have decreased substantially relative to average incomes in our southern neighbour and main trading partner (Figure 2).

Figure 2: Standard of living in Canada relative to that in the United States, 1985–2004



Note: Purchasing power parity exchange rates are used to convert US figures into Canadian dollars.
Source: Veldhuis and Clemens, 2006.

2 Personal income per capita measures the sum of all sources of income received per person (including wages, salaries, interest income, dividends, government transfers, etc). Personal disposable income measures the amount left over from personal income after the payment of direct personal taxes such as income taxes and contributions to social insurance plans.

2 Canada's uncompetitive tax system

One of the primary reasons that Canada's productivity and prosperity continues to lag is the disincentives for individuals and businesses to engage in productive activities. That is, Canada simply does not have an economic environment that promotes effective work, savings, investment, and risk taking. More specifically, our tax system punishes, rather than promotes, productive behaviour. A plethora of independent economic research has found that taxes have a significant impact on economic growth, capital formation, labour supply, and entrepreneurship. Extensive literature reviews can be found in *Productivity, Prosperity and Business Taxes* (Veldhuis and Clemens, 2006) and "Do Tax Rates Matter?" (Karabegović et al., 2004).

A number of economic studies have also documented the economic costs of different types of taxes.[3] That is, the studies estimate what is known as the marginal efficiency cost (MEC) of taxes, the cost to the economy of raising an additional dollar of revenue from a particular tax. Findings consistently show that business taxes impose significantly higher economic costs than sales taxes, payroll taxes, and personal income taxes. Estimates of the MEC for Canadian taxes have been calculated by the federal Department of Finance:[4] corporate income taxes were shown to impose much higher costs ($1.55) than other, more efficient, types of taxes such as sales ($0.17) and payroll ($0.27) taxes.

The federal Department of Finance recently undertook a study to evaluate the benefits to Canadian society from different tax reductions (Baylor and Beauséjour, 2004). The Department of Finance calculated the long-term economic costs imposed by the main taxes used in Canada to gain a better understanding of the benefits of reducing different taxes.[5] Decreasing personal income taxes on capital (dividends, capital gains, and interest income) by $1 and increasing lump-sum tax revenues by $1 were shown to result in an increase in society's well being of $1.30. At the other end of the scale, the smallest benefit ($0.10) is received from a reduction in consumption taxes.

Canada's tax mix

Data from the OECD indicates that Canada, when compared to other nations, is among the most reliant on the most economically damaging types of taxes. A cross-country analysis of how much revenue, as a percentage of the total, is collected from five different groups of taxes (income and profit, social security, payroll, property, goods and services, and

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3 See Veldhuis and Clemens, 2006, pp. 16–19 for a detailed review of these studies.

4 These cost estimates do not include the cost of compliance.

5 Benefits of different types of tax cuts were calculated by assuming that any revenue loss was off-set by a non-distortionary "lump-sum" tax increase. In other words, tax changes are revenue neutral. The lump-sum tax does not distort individual and firm behaviour by altering the incentives to work, save, invest, or undertake risk.

other taxes) reveals that Canada is one of the highest users (28th out of 31) of income and profit taxes. Specifically, governments in Canada collected 46.0% of their total revenue in income and profit taxes in 2003, compared to an average of 34.4% among the 31 OECD countries (Table 1).

Table 1: Revenue, as a percentage of the total, collected from different taxes (2003)

	Income and profit	Social security	Payroll	Property	Goods and services	Other
Poland	18.2	41.4	0.6	4.0	35.8	—
Slovak Republic	22.3	39.6	—	1.8	36.2	0.0
France	23.2	37.7	2.5	7.3	25.5	3.6
Greece	23.3	36.1	—	4.5	35.8	0.0
Turkey	23.7	20.8	—	3.2	49.5	2.9
Portugal	24.5	31.7	—	4.1	36.7	2.8
Hungary	24.8	30.5	2.5	2.2	39.4	0.7
Czech Republic	25.3	43.6	—	1.4	29.7	0.0
Netherlands	25.5	36.3	—	5.2	31.8	0.5
Mexico	26.5	16.9	1.8	1.6	52.5	0.7
Germany	27.4	40.5	—	2.4	29.4	0.0
Korea	28.0	19.5	0.2	11.8	37.1	3.3
Spain	28.2	35.3	—	7.5	28.2	0.5
Austria	29.7	33.7	6.2	1.3	28.2	0.7
Japan	30.6	38.5	—	10.3	20.3	0.3
Italy	30.9	29.5	—	8.0	25.7	6.0
OECD average	34.4	26.1	0.9	5.6	32.1	0.8
Luxembourg	36.3	27.9	—	7.5	28.1	0.1
Sweden	36.3	29.1	4.9	3.1	26.3	0.3
United Kingdom	36.5	18.5	—	11.8	32.7	—
Finland	38.7	26.7	—	2.3	32.0	0.1
Belgium	39.0	31.8	—	3.3	24.6	0.1
Ireland	39.3	14.8	0.6	6.5	38.4	—
Switzerland	42.9	25.5	—	8.3	23.3	—
United States	43.3	26.4	—	12.1	18.2	—
Norway	43.3	22.9	—	2.5	31.2	—
Iceland	44.3	8.6	—	5.9	41.0	0.2
Canada	**46.0**	**15.4**	**2.1**	**10.0**	**26.1**	**0.4**
Australia	55.2	—	5.6	9.5	29.7	—
New Zealand	59.6	—	—	5.2	35.2	—
Denmark	59.9	2.5	0.4	3.8	33.0	0.0

Note: Categories may not add to 100.0 due to rounding.
Source: Veldhuis and Clemens, 2006.

3 Reducing economically damaging taxes

Canada's relatively high use of income and profit taxes, along with the empirical studies that find that these taxes are the most damaging types of taxes, provides Canada with a clear picture of how to improve its economic and productivity performance. That is, moving away from the most damaging types of taxes will result in higher rates of economic and productivity growth through improved incentives for individuals and businesses to save, invest, undertake risk, and work effectively.

To that end, three courses of action should be taken: Canada should (1) dramatically reduce business income taxes; (2) reduce middle and upper personal income-tax rates and increase the thresholds at which they apply; and (3) eliminate the taxation of capital gains.

1 Business tax relief

One of the most effective means of increasing productivity lies in creating an environment that is conducive to the accumulation of capital. To that end, the federal government should enact a five-year plan to make its business taxes more competitive. Specifically, the federal government should reduce the general corporate income-tax rate from 21.0% to 12.0%, the preferential rate levied on small businesses.[6] Reducing the general corporate income-tax rate to 12.0% will significantly lower Canada's effective tax rate on capital investments and will eliminate the barrier, or disincentive, for small businesses to grow and expand beyond $300,000 (the threshold for the preferential 12% rate).[7] In addition, the federal government should accelerate its plan to eliminate the corporate income surtax from 2008 to 2007.[8]

While the federal government has completely phased-out the general corporate capital tax, a sector-specific capital tax remains on financial institutions. These capital taxes artificially penalize firms in the financial services sector and raise costs for anyone using financial services. The federal government should commit itself to eliminating the capital tax on financial institutions.[9] It is a counter-productive public policy to maintain

6 In order for small businesses to be eligible for the reduced or preferential tax rate, they must be qualifying Canadian Controlled Private Corporations (CCPC) with assets below $15 million. In addition, only a certain portion of their income is eligible for the preferential rate. The threshold for income eligibility at the federal level is $300,000.

7 For information on the tax barrier to growth of small businesses, see Clemens and Veldhuis, 2005.

8 The corporate income surtax is currently 4%. Eliminating the surtax is equivalent to a 1.12 percentage-point reduction in corporate income-tax rates.

9 Unfortunately, the federal government does not provide revenue estimates for capital taxes. However, data from the Canadian Bankers Association (CBA) indicate that the revenue generated from the capital tax on financial institutions is minimal. The CBA estimates that the six big Canadian banks paid $22 million in capital taxes in 2004. Thus, the federal government should not experience a significant revenue loss from the elimination of the capital tax.

this tax distortion on an industry that is a large employer of Canadians and in an area with very mobile capital resources.

This proposed five-year, federal business tax-relief initiative amounts to $28.8 billion.[10] While this represents a significant tax reduction in revenue, the net impact will in all likelihood be much lower than is currently estimated. That is, the current revenue-loss estimate is rather conservative given that the supply-side impacts of the reductions in have not been taken into consideration.[11]

The federal government should also broaden the tax base through the elimination of tax rebates, reductions, exemptions, and credits that reduce the tax burden for certain types of business investments. For example, the federal government provides tax credits for investments in activities ranging from Canadian film and video production, mineral exploration, and credit unions, to investment in Atlantic Canada. The federal government's corporate tax expenditures amount to $3.0 billion in 2005/06 or an estimated $17.3 billion from 2006/07 to 2010/11. As a result, the federal government could offset more than one-half of the revenue losses expected from reducing business tax rates through the elimination of the tax expenditures for business investment. More specifically, the cost of the proposed federal tax cut is reduced from $28.8 billion to $11.5 billion. Finally, the 2005/06 budget surplus of $13.2 billion (Canada, Dep't of Finance, 2006a), the $1 billion in savings recently found by the Treasury Board and wasteful spending by the federal government (Clemens et al., 2005) should provide ample fiscal room to fund the business tax relief and other initiatives listed below.

In conclusion, the proposed multi-year initiative to reduce business taxes will make Canadian tax policy much more conducive to capital investment, improve Canada's productivity performance vastly, and lead to a higher standard of living for Canadians.

2 Personal income tax relief

After business taxes, the revenue base next most in need of marked tax reduction is personal income. Personal income-tax rates in Canada are generally high and the incomes at which they are applied are relatively low. Substantial cuts in middle- and upper-bracket personal income-tax rates would harness the productive energies of workers, business owners, and entrepreneurs across the country.

A proposal worthy of consideration was put forth by Fraser Institute Senior Fellows Mike Harris and Preston Manning in *A Canada Strong and Free* (Harris and Manning, 2005a). They recommended reducing the personal income-tax rate from 16% to 15% for the lowest bracket, eliminating the middle two brackets, and reducing the top rate from 29% to

10 See Veldhuis and Clemens, 2006 for a detailed explanation of cost figures.

11 Mankiw and Weinzierl (2006) provide evidence of the extent to which tax cuts are self financing. The authors estimate the effects of changes in taxes on capital and labour income and find that approximately 50% of a capital tax cut pays for itself.

25%. In other words, incomes between the basic personal exemption ($8,639) and $150,000 would be taxed at 15% and income over $150,000 would be taxed at 25%.

The Harris/Manning personal income-tax proposal amounts to $20.9 billion in 2007/08 or 18% of federal personal income-tax revenues. Again, while this represents a significant tax reduction in revenue, the net impact will in all likelihood be much lower once the dynamic effects of such reductions are included.

Regardless of the specific proposal, the federal government's aim should be to follow the Government of Alberta's lead by moving toward a single-rate personal income tax. Reducing the progressivity in the personal income-tax system would help remove the disincentives for work, saving, investment, and entrepreneurship and will encourage productive activity and make the Canadian economy more efficient.

In addition, the federal government should move to index personal income tax thresholds to wage growth, rather than inflation as is currently done. Given that wages typically increase faster than prices, Canada's personal income-tax thresholds are decreasing relative to income. The proportion of Canadians being taxed at upper rates is increasing over time and this will materially impact the economic incentives faced by Canadians.

3 Eliminate the Capital Gains Tax

The capital gains tax is one of the most damaging taxes in Canada in that it encourages the owners of capital to hold on to their investments and prevents them from taking advantage of more profitable investment opportunities—a practice known as the "lock-in effect." Given that capital gains taxation reduces the amount of money received from the sale of an asset, any new potential investment must have a rate of return high enough for the investor to recoup the taxes paid plus yield a reasonable rate of return.

Locked in capital hinders a well functioning and efficient capital market by impeding the reallocation of money to alternative, potentially more profitable, investment opportunities. This, in turn, reduces the efficiency of the economy and lowers the economic performance and wealth-generating ability of Canadians.[12]

In addition, capital-gains taxation has a material impact on entrepreneurship by reducing the return that entrepreneurs, venture capitalists, and wealthy investors receive from risk-taking, innovation, and effort. The end result is a lower level of entrepreneurship, lower levels of financing to potentially profitable projects, and less innovation than would otherwise exist with no, or at least less, capital gains taxation.[13]

12 See Grubel, 2000 for a detailed analysis of the lock-in effect and other issues surrounding the taxation of capital gains.

13 See Bruce and Mohsin, 2003, Keuschnigg and Nielsen, 2004, Poterba, 1989, Gompers et al., 1998, and Da Rin et al., 2006.

Perhaps not surprisingly, this highly damaging form of taxation raises little revenue for the federal government. Specifically, federal capital-gains tax revenue totalled $2.2 billion or approximately 1.0% of federal revenues (total $220.0 billion) in 2005/06.

Capital gains taxation is an inefficient way to raise revenues for government and creates serious negative implications for the economy. For these reasons, the federal government should move to eliminate the taxation of capital gains and look to other international jurisdictions such as Hong Kong and Switzerland for their experience without capital gains taxes (Grubel, 2001b).

4 Rebalancing Canada

Much has been made over the last few years of fiscal imbalance. A recent Fraser Institute study, *Fiscal Balance, the GST, and Decentralization* (Clemens et al., 2006), examines the existence of a fiscal imbalance and outlines a plan for reform. The following section reviews the main findings of the study and presents the three-step reform package.

Is there a fiscal imbalance?

Although the term "fiscal imbalance" has multiple meanings, most of the discussion has surrounded the large surpluses enjoyed by Ottawa at the same time that many provinces are struggling to finance programs such as health and education.[14] Both the federal and provincial governments have experienced strong revenue growth since 1990/91. In fact, provincial governments have enjoyed stronger average revenue growth (2.5%) than the federal government (1.8%). The provincial governments, however, have had much larger spending increases, in part due to pressures in three of the largest programs provided by the provinces: health, education, and social assistance.

The nature of federal spending has also changed dramatically over the last ten years. The federal government has tended to neglect core areas of federal responsibility, such as defence and transportation, while increasingly involving itself in provincial areas of responsibility such as health, education, and social assistance.

Are increased transfers the solution?

Those who believe that the "fiscal imbalance" is a serious problem that must be addressed commonly propose that the federal government increase its transfer payments to the provinces, particularly, the Canada Health Transfer (CHT) and the Canada Social Transfer (CST).[15] Simply increasing the CHT and CST would, however, retain the federal government's role in these provincial areas of responsibility. The recent federal document, *Restoring Fiscal Balance in Canada* (Canada, Department of Finance, 2006c), clearly acknowledged that K-12 education, health, municipalities, social assistance, and social services were exclusive areas of provincial jurisdiction. This is an important recognition by the federal government and offers a genuine opportunity for reform.

14 The federal government outlined these problems in its *Budget Plan 2006* as well as the supplementary document, *Restoring Fiscal Balance in Canada: Focusing on Priorities*. See Canada, Dep't of Finance, 2006b, 2006c.

15 The high-profile expert panel appointed by the Council of the Federation—a provincial body—recommended large-scale increases in both equalization as well as the CHT/CST. See Council of the Federation, 2006.

A far more accountable system is to remove the federal government from these activities in order to have one level of government responsible for both the raising of revenues (taxes) and the accordant provision of programs and services. This improves accountability since there is no longer confusion or ambiguity about responsibilities. The provinces would be required to raise necessary revenues and then provide high-value services.[16]

An additional benefit would be that the provinces would be freer to experiment in how best to provide demanded goods and services to their citizens than is currently the case due to conditions imposed by the federal government. Welfare and K-12 education are two excellent examples of the benefits of provincial autonomy and experimentation.[17]

A 3-step plan for reform

A plan for genuine decentralization requires that the federal government reduce its taxes so that provinces can simultaneously increase their taxes with no net increase for taxpayers. Such a reform means that provinces raise more of their revenues from their own sources and rely less on the federal government for transfers. A critical decision is what type of taxes the federal government should reduce and what types of taxes the provinces should increase.

Section 2 above clearly points to the benefits of using consumption taxes like the GST more, and distortionary and high-cost taxes, such as capital-based taxes, less. With the federal government committed to decreasing the GST to 5%, the challenge then is how Canada as a federation can use the GST.

The confluence of the federal government's decision to reduce the GST, the need for decentralization, and greater reliance on consumption taxes offers the country a unique opportunity to achieve all three goals simultaneously.

Step 1 Eliminate health and social transfers

The federal government should eliminate the Canada Health Transfer ($22.5 billion) and the Canada Social Transfer ($8.8 billion) to the provinces and territories as of the next fiscal year (2007/08). This would decrease federal spending by $31.3 billion in 2007/08.

Step 2 Reduce federal taxes

The federal government should concurrently reduce taxes. In addition, the taxes selected for reduction should be based largely on improving the country's tax system. Specifically, the federal government should focus the tax relief on improving the economic incentives

16 Please note that "provide" does not necessary mean provision of services by the public sector. Rather, it refers to a general provision through financing, regulating, contracting, or direct provision of goods and services to citizens.

17 For more on welfare and K-12 education reform, please see Faguet and Sanchez, 2006; Harris and Manning, 2005b; Hepburn and Robson, 2002; Schafer et al., 2001; Hepburn, 2001; Richards and Poschmann, 2000; Karlsen, 1999; Richards, 1997; and Boessenkool, 1997.

to work, save, invest, and act entrepreneurially (see section 2 above). Examples of these types of tax-relief measures would include reductions in middle- and upper-income personal income-tax rates and business taxes. The reduction of federal taxes is in addition to the tax relief proposed in Section 3. In other words, if the decentralization plan were implemented, the federal government should reduce business and personal income taxes beyond the decreases suggested in Section 3.

Step 3 Increase provincial taxes

The final step is for the provinces to increase their own taxes to compensate for the loss of revenues from the elimination of the CHT and CST cash transfers. The provinces should increase, or adopt, the least costly (most efficient) tax available, which is a GST-based provincial sales tax. The GST rates required to replace the revenues received from federal CHT and CST payments range from a low of 4.2% in Alberta to a little over 7.1% in Newfoundland and Labrador (Table 2). This would result in greater use of the GST in aggregate but with no net tax increase for the country as a whole.

In addition, provinces with independent provincial sales taxes (PST) should harmonize their PST with the federal GST. Harmonization would mean one sales-tax system for the country even though revenues would flow to two levels of government.

Major benefits for Canadians from rebalancing

The proposal to eliminate the federal CHT and CST, coupled with reductions in federal taxes and increases in provincial taxes, would yield a number of benefits. First, and perhaps most importantly, it would re-establish clear lines of accountability and responsibility for critical areas such as health, education, and social assistance broadly defined. Second, it would markedly improve the country's tax system by increasing our reliance on efficient, low-cost, consumption taxes while reducing our use of less efficient, more costly, capital-based taxes. Third, it would reduce costs for businesses and individuals that file sales taxes since the number of reporting and administrative requirements would be cut in half. This proposal is a watershed rebalancing and improvement in the functioning of the Canadian federation.

Table 2: Expected provincial GST rates required to compensate for the loss of CHT and CST revenues

	Provincial GST Rate		Provincial GST Rate
British Columbia	6.0%	**Quebec**	6.4%
Alberta	4.2%	**New Brunswick**	7.0%
Saskatchewan	7.0%	**Nova Scotia**	6.7%
Manitoba	6.9%	**Prince Edward Island**	6.7%
Ontario	5.6%	**Newfoundland**	7.1%

Note: The rates included in this table are in addition to the existing provincial sales tax rates.

Source: Clemens, Veldhuis, and Palacios, 2006.

5 Other fiscal issues

Disposition of the growing CPP surplus

In 1998, the government introduced major changes to the Canada Pension Plan (CPP) to protect it against serious solvency problems. While the changes have achieved their stated goal of saving the public pension system, new problems are on the horizon. Specifically, a growing surplus of assets being held by the CPP Investment Board (CPPIB) has caused some groups to muse about how the CPPIB "surplus" should be used. For example, there is a growing movement to impose "socially responsible investment factors" on the existing criteria for investment.

The challenge to the CPP in the longer term comes in the form of higher than expected rates of return from the CPPIB. In addition, the removal of the foreign property rule in the 2005 Budget should allow for even higher rates of return in the future since the CPPIB will be able to pursue greater international diversification, which should increase the risk-adjusted rate of return. The increased rates of return mean that the CPPIB will have more monies than are required to fund current benefit levels fully and properly in the future.

The federal government, along with the provinces, must clearly lay out its plan for the growing surplus of assets. Most importantly, Canadian governments must continue to insure that CPPIB focus on a single goal: maximize rates of return while balancing risk. In addition, monies above what is required to fund current benefit levels fully and properly in the future should be used to reduce contribution rates. Leaving CPP contribution rates higher that needed is unfair to workers, especially young workers who are facing much higher average contribution rates than older workers.

Introduce experience rating in the Employment Insurance program

Canada's unemployment rate has consistently been over 3 percentage points higher than in the United States for the past two decades (Grubel, 2004). One of the most important reasons for this is the change made to the Canadian EI system in the early 1970s that introduced very generous benefits at low levels of weeks worked (especially in high unemployment regions) and encouraged repeated use of the program. In the United States however, all employment insurance programs incorporate some form of experience rating to help curb repeat use (Nakamura and Diewert, 2004). That is, premiums are higher for companies whose workers repeatedly rely on the employment insurance system. For this reason, the federal government should introduce experience rating for the Employment Insurance program.

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