



A Macdonald-Laurier Institute Publication

# Canada's Looming Fiscal Squeeze: Collected Essays on Solutions

Starting a national conversation about population ageing and  
Canada's public finances.

Jason Clemens and  
Brian Lee Crowley, Editors

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# Executive Summary

## Solutions for the Coming Demographic Fiscal Squeeze

As a follow up to Professor Christopher Ragan's study that calculated the size of the coming demographic deficit, which he estimated at 4.2 percent of GDP (roughly \$67 billion in today's dollars), the Macdonald-Laurier Institute collected essays by five leading Canadian thinkers on how to solve the problem described by Ragan. Below is an overview of the common solutions identified by the experts as well as some of the unique recommendations.

### 1) Need a Framework

Several of the essayists outlined the need for a regular, comprehensive review of government spending by all levels of government to ensure effectiveness. One contributor recommended the framework used by the federal Liberal Government in 1994 to comprehensively review federal spending.

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A regular, comprehensive review of government spending by all levels of government is needed to ensure effectiveness.

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Ron Kneebone, distinguished economics professor at the University of Calgary proposed a different approach, one that begins with an overarching *fiscal rule* rather than the minutia of individual policy reforms. Professor Kneebone advocates for a hard cap on the ratio of debt-to-GDP of 60 percent for governments in Canada. In addition, an annual deficit cap of 1 percent of GDP would also be imposed. Both caps would be effective in 2021. Professor Kneebone's argument is that such a fiscal rule would facilitate and create positive incentives for

governments to act on other reforms (spending and taxes) in order to live within these constraints. While Kneebone does not discuss individual reforms, his proposed fiscal rule provides a framework within which the other reforms advocated by the other essayists could be implemented and enforced.

Interestingly, economics professor Bev Dahlby's essay also warned of the need to constrain debt in Canada to avoid raising concerns about sovereign debt and the accompanying increase in interest rates associated with such concerns.

### 2) Health Care: Elephant in the Room We Can No Longer Ignore

Expected increases in health care costs along with retirement income programs explain most of the anticipated increases in spending owing



to demographic shifts. Professor Janice MacKinnon, former Saskatchewan Finance Minister and architect of the province's turnaround went so far as to say that the demographic "problem cannot be addressed without fundamentally changing our health care system and its funding". Indeed, there was broad agreement amongst the contributors that changes would have to be introduced to Canada's health care system. A wide range of suggestions were offered, which reflects a broader sentiment in Canada regarding the need for changes in health care without much agreement as to what those changes look like.

Professor MacKinnon, who has substantial hands-on experience in this area from her time at Finance in Saskatchewan offered a number of fairly specific recommendations, including diverting activity away from hospitals towards smaller private clinics, transitioning patients from emergency rooms to primary health clinics, changing the payments for doctors from fee-for-service to salaries, and re-classifying some portion of health care spending so that it is a taxable benefit for individuals.

Professor Bev Dahlby agreed substantially with MacKinnon's suggestions regarding both the need for reforming the way doctors are paid (he also included hospitals) as well as the need to make some portion of health care spending a taxable benefit.

Jason Clemens offered a broader reform idea modelled on the successful welfare reforms of the 1990s. Clemens argued that the federal government needed to first reform the health transfers to the provinces to allow the provinces greater flexibility and autonomy in the design, regulation, financing, and provision of health care while retaining the principles of universality and portability.

What is clear from the solutions provided by the contributors is that the status quo in Canada's health care system is not an option. Some changes in the regulation, delivery, and/or financing will be needed to both weather the coming demographic pressures as well as improve efficiency in the monies spent on health care.

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The problem cannot be addressed without fundamentally changing our health care system and its funding.

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### 3) Other Common Reform Suggestions

There was considerable overlap between the four essays on some areas of reform. This section highlights those areas of agreement.

#### Labour Market Reforms

There was broad support for measures to increase labour market participation, economic growth, and productivity. In particular, all four contributors mentioned the need to reform Canada's Employment Insurance program to ensure it acted as an insurance system against unplanned unemployment. In particular, several essayists argued for the need to eliminate seasonal employment biases and social programs now imbedded in the EI program.

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Eliminate seasonal employment biases and social programs now imbedded in the EI program.

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End supply management to improve economic growth and productivity.

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Other labour market reforms, such as improving access for skilled-immigrants and recognition of their credentials, better access to child care services, and improving incentives for older workers to remain in the labour market post-age 65 were mentioned by individual essayists as mechanisms by which to improve labour market participation, economic growth, and productivity in the future.

#### **Economic Growth and Productivity Improving Reforms**

Several of the essays mentioned specific policy reforms aimed at improving the country's rate of economic growth and productivity. Eliminating inter-provincial trade barriers to improve economic efficiency and potentially gain economies of scale was mentioned by several of the writers.

Ending supply management, which covers agricultural products such as dairy was also advocated as a way by which to improve economic growth and productivity. Supply management is currently a fairly high profile issue due to the elimination of the Canada Wheat Board and the trade negotiations with both the European Union and the Trans-Pacific Partnership, both of which expressed concerns about Canada's use of supply management.

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Canadian governments need to be smarter about tax policy.

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Two final recommendations that had some degree of agreement were the elimination of regional development subsidies by the federal government and encouraging greater trade through infrastructure development using public-private partnerships (P3s).

#### **4) Taxation**

There was also broad agreement that Canadian governments needed to be smarter about tax policy in the future to better balance the need to generate sufficient revenues to cover spending while minimizing the costs to the economy in the form of disincentives for work effort, savings, investment, and entrepreneurship.

Two of the contributors argued for simplifying the tax code as a means by which to both improve economic growth and increase revenues without increasing tax rates. Professor William Watson of McGill University and the Financial Post and Jason Clemens, director of research for the Macdonald-Laurier Institute both argued that tax expenditures should be thoroughly reviewed and substantially reduced. Such an action would result in higher revenues although Clemens suggested that the revenues gained be earmarked for lower marginal income tax rates, which would spur economic growth and thus tax revenues.

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Simplify the tax code to both improve economic growth and increase revenues.

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Professor Janice MacKinnon argues that the provinces and federal government need to rely on user fees to a greater extent. Economics professor Bev Dahlby of the University of Alberta along with Jason Clemens both argued that tax increases should be a last resort but that if such action was necessary, that consumption taxes like the GST (now HST) should be relied upon rather than income taxes, which both agreed imposed much higher costs on society than comparable consumption taxes.

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A broad review of Aboriginal policies is needed.

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## 5) Some Unique Recommendations

There were three substantial recommendations offered by individual essayists that were not included in other contributions. First, Janice MacKinnon urged a broad review of Aboriginal policies with a focus on education and training for Aboriginal peoples in order to afford them the proper skills and knowledge to more fully participate in the labour market in the future.



Professor MacKinnon also suggested that the federal and provincial governments aggressively undertake infrastructure investments through public-private partnerships (P3s). She argued that such mechanisms would allow for large-scale investment in needed infrastructure without burdening taxpayers with additional debt.

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Federal and provincial governments should aggressively undertake infrastructure investments through public-private partnerships.

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Finally, Jason Clemens of the Macdonald-Laurier Institute argued for an increase in the age of eligibility for public retirement programs such as Old Age Security and the Canada Pension Plan. His argument was that such an increase could mitigate the cost pressures of

the programs over time and could be implemented slowly over a two-decade period so as to avoid displacing any age cohort. In addition, Clemens argued that such increases in the age of eligibility would reflect the marked increases in life expectancy that have not, to-date, been incorporated in retirement income programs.

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Increase the age of eligibility for public retirement programs such as Old Age Security and the Canada Pension Plan.

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## Conclusion

There can be little doubt that Canada, like all industrialized countries will soon face the full burden of an aging society. Canada will either proactively implement solutions to this coming problem or react, perhaps in crisis, when the full weight of the costs of an aging society fully confront our society. The contributors to this series have offered a series of practical, workable solutions to this coming fiscal deficit. At the very least, the problem and potential solutions of the coming demographic fiscal squeeze should be discussed and debated.

# Sommaire

## Des solutions au resserrement budgétaire à venir dû aux changements démographiques

Comme complément à l'étude du professeur Christopher Ragan qui a calculé la taille du manque à gagner qu'entraîneront les changements démographiques, estimé à 4,2 % du PIB (soit environ 67 milliards de dollars actuels), l'Institut Macdonald-Laurier a rassemblé des textes de cinq éminents penseurs canadiens sur les façons de résoudre ce problème. Voici un aperçu des solutions communes identifiées par les experts ainsi que quelques recommandations uniques.

La nécessité de mettre en place un examen régulier et exhaustif des dépenses de tous les paliers de gouvernement pour s'assurer d'une action efficace.

### 1) La nécessité d'un cadre pour agir

Plusieurs des auteurs ont soulevé la nécessité de mettre en place un examen régulier et exhaustif des dépenses de tous les paliers de gouvernement pour s'assurer d'une action efficace. Un collaborateur a recommandé le cadre utilisé par le gouvernement fédéral libéral en 1994 pour évaluer de manière exhaustive les dépenses fédérales.

Ron Kneebone, un distingué professeur d'économie à l'Université de Calgary, propose une approche différente qui débute par l'établissement d'une *règle budgétaire* globale plutôt que par l'examen détaillé de réformes spécifiques des politiques. Le professeur Kneebone défend l'idée d'imposer une limite incontournable de 60 % au ratio de la dette au PIB pour les gouvernements au Canada. De plus, une limite de 1 % du PIB serait fixée au déficit budgétaire annuel. Les deux limites seraient effectives à partir de 2021. Le professeur Kneebone soutient qu'une telle règle budgétaire inciterait

positivement les gouvernements à prendre des décisions quant à d'autres réformes (concernant les dépenses et les impôts) nécessaires pour respecter ces contraintes. Bien que M. Kneebone ne mentionne aucune réforme spécifique, la règle budgétaire qu'il propose offre un cadre au sein duquel les autres réformes proposées par d'autres auteurs pourraient être mises en œuvre.

On ne pourra pas s'attaquer aux problèmes démographiques sans modifier en profondeur le système de santé et son financement.

Il est intéressant de noter que le professeur d'économie Bev Dahlby soulève lui aussi dans son texte la nécessité d'imposer des limites à la dette canadienne pour éviter de susciter des préoccupations à ce sujet et de provoquer une hausse des taux d'intérêt associée à de telles préoccupations.



### 2) Les soins de santé : l'éléphant dans la pièce qu'on ne peut plus ignorer

Les augmentations prévues des coûts des soins de santé, de concert avec les programmes de soutien



au revenu des retraités, expliquent la majeure partie des augmentations anticipées des dépenses découlant des changements démographiques. La professeure Janice MacKinnon, qui a été ministre des Finances de la Saskatchewan et l'architecte d'un retournement majeure de situation dans cette province, n'hésite pas à affirmer qu'« on ne pourra pas s'attaquer aux problèmes démographiques sans modifier en profondeur le système de santé et son financement ».

On retrouve d'ailleurs un large consensus au sein des collaborateurs sur le fait que des changements devront être apportés au système de santé canadien. Une grande variété de suggestions ont été offertes, ce qui reflète un sentiment largement répandu au Canada en ce qui a trait à la nécessité de réformer les soins de santé, sans toutefois qu'il y ait d'accord sur la nature de ces changements.

La professeure MacKinnon, qui possède une expérience concrète considérable dans ce domaine, acquise lorsqu'elle était en charge des Finances en Saskatchewan, propose une série de recommandations relativement spécifiques, notamment : déplacer des activités des hôpitaux vers de plus petites cliniques privées; transférer les patients des salles d'urgence vers des cliniques de soins primaires; modifier la façon de rémunérer les médecins en remplaçant le paiement à l'acte par un salaire; et reclasser certaines portions des dépenses en santé pour qu'elles deviennent des avantages imposables pour les individus.

Le professeur Bev Dahlby est substantiellement en accord avec la suggestion de Mme MacKinnon en ce qui a trait à la fois à la nécessité de réformer la façon dont les médecins sont payés (il inclut également les hôpitaux) et la nécessité de transformer certaines portions des dépenses en santé en avantages imposables.

Jason Clemens offre une idée de réforme plus large qui s'inspire des réformes réussies de l'aide sociale durant les années 1990. M. Clemens soutient que le gouvernement fédéral devait d'abord réformer les transferts en matière de santé aux provinces pour permettre à celles-ci de jouir d'une plus grande flexibilité et de plus d'autonomie dans la conception, la réglementation, le financement et la prestation des soins de santé, tout en continuant de respecter les principes d'universalité et de portabilité.

Ce qui ressort clairement des solutions proposées par les collaborateurs est que le statu quo n'est plus une



option viable pour le système de santé canadien. Certains changements dans la réglementation, la prestation et/ou le financement des soins seront nécessaires pour à la fois résister aux pressions démographiques qui s'en viennent et améliorer l'efficacité des ressources consacrées aux soins de santé.

### 3) Quelques autres suggestions communes

On retrouve plusieurs points communs dans les quatre textes qui discutent de certains domaines à réformer. Cette section met en relief ces points communs.

#### Réformes du marché du travail

Des mesures pour accroître la participation au marché du travail, la croissance économique et la productivité

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Qu'on doit éliminer les avantages accordés à l'emploi saisonnier ainsi que les programmes sociaux qui sont présentement intégrés dans le programme d'AE.

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De mettre fin au système de gestion de l'offre comme moyen d'améliorer la croissance économique et la productivité.

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ont trouvé un large appui parmi les collaborateurs. Plus spécifiquement, les quatre collaborateurs ont mentionné la nécessité de réformer le programme d'assurance emploi du Canada pour s'assurer qu'il fonctionne comme un système d'assurance contre le chômage imprévu. Plusieurs auteurs ont notamment soutenu qu'on doit éliminer les avantages accordés à l'emploi saisonnier ainsi que les programmes sociaux qui sont présentement intégrés dans le programme d'AE.

D'autres réformes du marché du travail, telles qu'un accès amélioré pour les immigrants qualifiés et une meilleure reconnaissance de leur qualifications, un meilleur accès aux services de garderie, et davantage d'incitations aux travailleurs âgées à rester sur le marché du travail après 65 ans, ont été mentionnées par les auteurs comme mécanismes permettant d'améliorer la participation au marché du travail, la croissance économique et la productivité.

### Réformes pour augmenter la croissance économique et la productivité

Plusieurs textes ont mentionné des réformes de politiques précises visant à améliorer le taux de croissance économique et la productivité du pays. L'élimination des barrières au commerce interprovincial, dans le but d'améliorer l'efficacité économique et d'obtenir des économies d'échelle potentielles, a été mentionnée par plusieurs des auteurs.

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Des auteurs ont aussi proposé de mettre fin au système de gestion de l'offre, qui s'applique à des produits agricoles tels que le lait, comme moyen d'améliorer la croissance économique et la productivité. La gestion de l'offre est en ce moment un sujet d'actualité à cause de l'abolition de la Commission canadienne du blé et des négociations commerciales avec l'Union européenne et le Partenariat transpacifique, ceux-ci ayant exprimé leurs préoccupations vis-à-vis la politique canadienne à cet égard.

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Les gouvernements canadiens devront dans l'avenir gérer leur politique fiscale plus intelligemment.

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Enfin, deux recommandations qui ont reçu un certain appui sont l'élimination des subventions du gouvernement fédéral au développement régional et le soutien au commerce par le développement des infrastructures en ayant recours aux partenariats public-privé (PPP).

## 4) La politique fiscale

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Les auteurs sont largement en accord sur le fait que les gouvernements canadiens devront dans l'avenir gérer leur politique fiscale plus intelligemment pour trouver un meilleur équilibre entre, d'une part, le besoin de générer des revenus suffisants pour couvrir les dépenses et, d'autre part, la nécessité de minimiser le fardeau pour l'économie sous la forme de désincitation au travail, à l'épargne, à l'investissement et à l'entrepreneuriat.

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D'une simplification du code fiscal comme moyen à la fois d'améliorer la croissance économique et d'accroître les recettes du gouvernement.

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Deux des collaborateurs ont défendu l'idée d'une simplification du code fiscal comme moyen à la fois d'améliorer la croissance économique et d'accroître les recettes du gouvernement, et ce sans augmenter les taux d'imposition. Le professeur William Watson de l'Université McGill, également chroniqueur au Financial Post, et Jason Clemens, directeur de la recherche à l'Institut Macdonald-Laurier, ont tous les deux soutenu que les dépenses fiscales devraient être revues en profondeur et substantiellement réduites. Une telle réforme entraînerait des revenus additionnels, quoique M. Clemens suggère que ces montants soient affectés à une réduction des taux marginaux d'imposition sur le revenu, ce qui encouragerait la croissance économique et hausserait en conséquence les recettes fiscales.

La professeure Janice MacKinnon soutient que les provinces et le gouvernement fédéral doivent avoir davantage recours aux tarifs d'usage. Le professeur d'économie Bev Dahlby de l'Université de l'Alberta, ainsi que Jason Clemens croient que les hausses d'impôt ne devraient être utilisées qu'en dernier recours mais que si elles s'avèrent nécessaires, il faudrait davantage avoir recours à une taxe à la consommation comme la TPS (maintenant la TVH) plutôt qu'à l'impôt sur le revenu qui entraîne des coûts beaucoup plus élevés à la société pour des revenus comparables.

## 5) Quelques recommandations uniques

Trois recommandations substantielles ont été offertes par des auteurs à titre individuel. Tout d'abord, Janice MacKinnon a fortement suggéré de procéder à un large examen des politiques à l'égard des autochtones, en se concentrant sur l'éducation et la formation de façon à ce que ces derniers puissent acquérir les compétences et connaissances appropriées pour prendre pleinement leur place sur le marché du travail.

La professeure MacKinnon a également suggéré que les gouvernements fédéral et provinciaux investissent avec vigueur dans les infrastructures par l'entremise de partenariats public-privé (PPP). Selon elle, de tels mécanismes permettraient d'entreprendre des investissements à grande échelle dans des infrastructures là où le besoin s'en fait sentir, sans accabler les contribuables de dettes additionnelles.

Enfin, Jason Clemens de l'Institut Macdonald-Laurier a soutenu qu'on devrait rehausser l'âge d'admissibilité aux régimes publics de retraite tels que le programme de la Sécurité de la vieillesse et le Régime de pensions du Canada. Son principal argument est qu'un tel rehaussement permettrait d'atténuer la pression à la hausse des coûts des programmes et pourrait être mis en vigueur graduellement sur une période de deux décennies de façon à éviter de pénaliser une cohorte d'âge. De plus, M. Clemens soutient que le rehaussement de l'âge d'admissibilité refléterait la hausse marquée de l'espérance de vie qui n'a pas, jusqu'à maintenant, été prise en compte dans les régimes de retraite.

## Conclusion

On peut difficilement douter que le Canada, comme tous les autres pays industrialisés, sera bientôt confronté aux pleines conséquences d'une société vieillissante. Ou bien le Canada mettra en œuvre d'avance, de manière proactive, des solutions à ce problème à venir; ou bien il réagira, peut-être sous l'impulsion d'une crise, lorsque les coûts du vieillissement ne pourront plus être évités. Les collaborateurs de cette série ont proposé une série de solutions pratiques et réalisables à ce déficit budgétaire à venir. Au minimum, le problème du resserrement budgétaire à venir dû aux changements démographiques, et les solutions potentielles, devraient être discutés et débattus.

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Les gouvernements fédéral et provinciaux investissent avec vigueur dans les infrastructures par l'entremise de partenariats public-privé.

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Qu'on devrait rehausser l'âge d'admissibilité aux régimes publics de retraite tels que le programme de la Sécurité de la vieillesse et le Régime de pensions du Canada.

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# Summary of Christopher Ragan's Canada's Looming Fiscal Squeeze

McGill economics professor Christopher Ragan's original paper, *Canada's Looming Fiscal Squeeze*, upon which the essays collected in this volume comment, assembled a collection of increasingly familiar demographic projections and draws the not-so familiar implications for the fiscal challenges to be faced by

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A rising share of national income will be devoted to publicly-provided health care and seniors' benefits.

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future Canadian governments. The emphasis of his paper was on the rising share of national income to be devoted to publicly provided healthcare and seniors' benefits, and the increase in public debt that will occur if future governments do not adjust their spending programs or tax rates. The paper concluded that in order to avoid a return to the high-debt situation of the mid 1990s, Canadians and their governments must soon begin thinking in a systematic and critical way about their long-term fiscal priorities.

During the baby boom that followed the Second World War, the average fertility rate in Canada was 3.6 children per woman. Partly due to the increase in women participating in the Canadian labour force, Canada's fertility rate dropped to 1.7 children per women by 2007. This change in the fertility rate is expected to continue to slow the population growth rate. Thanks to healthier lifestyles and improved technology, the average life expectancy of a Canadian has risen from 68.5 years in 1951 to 80.5 years in 2006. The combination of fewer younger people entering the population and the current population living longer will act together to increase the average Canadian's age over the next few decades.

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Canadians and their governments must soon begin thinking in a systematic and critical way about their long-term fiscal priorities.

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The aging of the baby boom resulted in a significant increase in the working-age share of the population, from 58 percent in 1962 to about 69 percent in the early 1980s. The youngest baby boomers came of age in the early 1980s, and in the subsequent three decades there were no significant changes in the working-age share of the population. But the oldest baby boomers reach 65 in 2011, and so for the next twenty years there will be an inexorable decline in the working-age share of the population, a decline that roughly mirrors the increase from thirty years earlier.

With the ongoing aging of Canada's baby-boom generation, a growing fraction of the population will fall into these older age categories, thus reducing the economy's overall labour force participation rate. The overall participation rate is projected to decline from over 67 percent today to below 61 percent by 2040, even with the assumption that age-specific participation rates increase by up to 4 percentage points between now and 2030, and remain constant thereafter.

The falling labour force participation rate will cause a decline in the future growth rate of average living standards, as measured by real per capita GDP, leading to two policy conclusions. First, productivity growth is likely to account for more than 100 percent of growth in real per capita GDP over the next few decades, meaning that Canadians and their governments must take seriously the issue of increasing productivity. Second, the reduction in the labour force participation rate taken by itself will reduce the growth rate of real per capita GDP (for any assumed productivity growth rate) and thus reduce the growth rate of Canadian governments' per capita tax base.

The aging of the Canadian population will force Canadian governments to face a significant two-part fiscal challenge. First, the aging of the population will lead to a slowing of national income, the primary tax base for governments, thus slowing tax revenues. Second, key Canadian public spending programs will become more costly as a share of GDP, especially those providing healthcare and income support for the elderly, even as the tax base slows considerably. Confronting this fiscal challenge will likely create political tensions between provincial and federal governments and will force governments at all levels to make some difficult fiscal decisions.

Confronted with spending demands that rise faster than tax revenues, future Canadian governments will be faced with three broad choices. First, they can attempt to reduce the growth rate of overall spending. Second, they can attempt to increase the growth rate of revenues through increases in tax rates. Finally, they can choose to increase their public borrowing. Of course, the third option is not a permanent solution since the debt eventually needs to be repaid and such repayment ultimately requires a command over resources, which in turn requires either spending reductions or increases in tax revenues. In the hypothetical situation in which future governments choose to not make any adjustments in spending or taxation but merely increase borrowing, the cumulative borrowing is expected to equal 52.5 percentage points of GDP over 25 years.

The net public debt-to-GDP ratio was approximately 92 percent in 1996, and Canada was then seen by the International Monetary Fund (IMF) and others as having a serious fiscal problem. The failure to tackle the problem very soon would mean hitting the “debt wall”, with implications for declining access to global capital markets and rising domestic interest rates, just as we are now seeing in some European countries. The federal and provincial governments embarked on programs of significant fiscal consolidation. These actions, which quickly turned large annual budget deficits into modest budget surpluses, combined with a healthy economic recovery to produce a rapidly declining debt-to-GDP ratio. By the beginning of the 2008-09 financial crisis, the overall debt ratio was 37 percent of GDP, and as of the fall of 2011, it appears that most Canadian governments are on paths back to budget balance. Policy decisions must be carefully examined with avoidance of the “debt wall” in mind.

The paper addresses five non-fiscal solutions to the fiscal squeeze: increasing the immigration rate, increasing the retirement age, increasing the fertility rate, restraining the growth of healthcare spending, and increasing the growth rate of productivity. Immigrants also age over time, leading to eventual lower labour force participation and higher demands on public programs, and the immigration rate would have to at least double in order to merely continue the 2008 rate of growth of the Canadian labour force. This is politically unfeasible. Even an aggressive increase in the retirement age could not offset the impact of the large numbers of aging baby-boomers, who will inevitably drop out of the labour force and continue to require more health care. The fertility rate likely could not be raised from the current level of 1.7 children per woman to a level that would make a significant difference, and the programs required to marginally increase fertility would be prohibitively expensive. Restraining the growth of healthcare spending may be possible, but given the magnitude of the underlying demographic forces Canadian governments must recognize that even in an optimistic view of the future, there will be a significant increase in the share of national income devoted to public healthcare spending. Finally, faster productivity growth cannot be easily engineered by policy and would only help to lessen the fiscal squeeze if policy actions could somehow prevent the faster income growth from creating a similar expansion in the number or generosity of public spending programs.

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The aging of the population will lead to a slowing of national income.

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Key Canadian public spending programs will become more costly as a share of GDP.

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The inconvenient truth that Canadians and their governments must face is that the demographic forces in play and the fiscal implications that follow are so large that governments will need to respond by making fundamental adjustments to their fiscal frameworks. As is always the case, the simple arithmetic of government budgets implies that there are only two broad fiscal choices available to address the coming fiscal squeeze: spending programs can be reduced or eliminated or taxes can be increased. There is nothing else.

Government spending can be restrained in many ways, with some programs being reduced in scope while others are eliminated altogether. But such cuts are politically very difficult; one needs only to glance at the highly charged political debates going on in the United States and Europe to be reminded about how

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The adjustment can occur primarily on the spending side or primarily on the revenue side – or indeed can occur on both. But some adjustment will be necessary.

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unpopular it is to consider reductions in public spending, especially if the cuts fall on important social programs. Governments also have many choices when it comes to raising tax revenues, including personal and corporate income taxes, expenditure and sales taxes, and product-specific excise taxes. Apart from the general unpopularity of higher taxes, an important choice would need to be made concerning which taxes would be raised and by how much.

Since government debt is often incurred to provide current goods and services, but is serviced and repaid in the distant future, public debt usually involves a redistribution of income away from future generations toward current generations. In general, the more the policy changes are delayed through time, the more debt will be incurred before those adjustments take place and thus the more the burden of the fiscal adjustment will ultimately fall on Canadians who are currently young. Conversely, the more immediate are the changes in spending and taxation, the less debt will be incurred and thus the more the overall burden of adjustment will fall on the same baby boomers whose aging is the fundamental cause of the looming

fiscal squeeze. Which generation pays for the rising age-related expenditures of the baby boomers will be determined by the fiscal policy choices Canadian governments make in the coming years.

The government machine built over the past half-century was constructed during a time when the demographic forces were very advantageous: a young and fast-growing population. The implications were rapidly advancing living standards and the ability to easily fund many government programs. But as the oldest baby boomers reach 65 this year, and these demographic forces move into reverse for the next three decades, there will be a need to adjust this machine of government. The adjustment can occur primarily on the spending side or primarily on the revenue side – or indeed can occur on both. But some adjustment will be necessary. There will be a Canadian tendency for this debate about overall fiscal priorities to become focused on the division of fiscal capacity between different levels of government. A focus on the “fiscal imbalance” rather than the more general “fiscal squeeze” should be avoided as it will both cloud the central issues and needlessly politicize a debate that will in any event be fraught with difficult decisions. Canadians and their governments at all levels need to recognize that addressing Canada’s looming fiscal squeeze will require a careful and transparent examination of our fiscal priorities.

### **Solutions to the Coming Demographic Squeeze**

The Macdonald-Laurier Institute is proud to present five essays by leading Canadians on how best to address the coming fiscal deficit. Not only do the participants represent prominent voices in public policy from across the country, but each has contributed to real reforms in varying ways, providing a critical perspective on real-life reforms.



# Ronald Kneebone

University of Calgary

Professor Chris Ragan has looked ahead 28 years to 2040. It is also instructive to look at where Canada was 28 years before, in 1984. The deficit of the total government sector was 8 percent of GDP and the government debt/GDP ratio was 30 percent; twice what it was four years earlier and rising fast. Short-term interest rates were over 12 percent and the growth rate of the economy was under 2 percent.

Readers who have studied Ragan's essay will appreciate from these facts that in 1984 Canadian governments needed to act immediately to avoid very serious fiscal difficulties. Alas, our governments did essentially nothing to resolve these difficulties for 10 years. The 10 year delay worsened the fiscal reckoning that began in the mid-1990s and resulted in cuts to health care spending, retrenchments to social assistance and employment insurance, and cuts to education.

For the optimist, the lesson to be drawn from that earlier experience is that our political institutions are sufficiently responsive so that even the most serious fiscal issues can be overcome. For the pessimist, the lesson is that our institutions are only able to respond to fiscal issues after they burst into crisis and the pain of adjustment has been made far worse by the delay. There is good news in both of these views; we have good institutions, they need only be spurred into action more quickly.

How might we do that?

One approach is to do what Chris Ragan has done; namely, raise warning flags and remind politicians and voters that we have in place spending commitments on pensions and health care that obligate us to very large spending increases in the near future.

While important, that approach rarely works on its own. Everyone agrees that something needs to be done but everyone still sees plenty of scope for getting someone else to pay the price. Thus provincial politicians see federal politicians as providing the solution to the problem of health care financing; a solution in the form of large and on-going federal health transfers. That, of course, is not a solution and all of us – and it is all of us – who pay taxes to both levels of government surely recognize this. Still, it is on this hook that politicians are currently hanging their hats and it is doing absolutely nothing to solve the problem. While we wait for real solutions the price that must eventually be paid to control health spending grows steadily.

So, what would work? Economists recognize those receiving government benefits must be made to pay the tax-price required to provide them. It is in the crucible of choice – more spending or lower taxes? – that true preferences are revealed and efficient choices made. But this is not always practical. Those with high incomes pay far more for health care through the tax system than those with low incomes but all receive the same level of service. The result is an inefficient allocation of scarce resources amongst competing demands. The imposition of a price on government services needs to be imposed at a higher level than individual programs.

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Previous experience tells us governments will not make tough decisions unless they have to.

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Borrowing to pay for goods and services today, which will be paid for by others in the future must be curtailed.

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This requires governments to impose a total tax bill on the current generation of taxpayers to pay for the publicly-provided goods and services they receive. A corollary of this statement is that borrowing to pay for goods and services enjoyed only by the current generation of taxpayers must be curtailed. The source of the painful fiscal retrenchment of the mid-1990s was exactly that type of borrowing.

An effective way of curtailing excessive spending is to impose on governments an effective fiscal rule. A fiscal rule is designed to limit the short-term choices of governments to those that enable the achievement of long-term fiscal goals. A good rule is flexible enough to allow a response to unexpected events but strict enough that long-term goals can be met.

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An effective way of curtailing spending is to impose effective rules on government.

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A simple rule that would enable governments to retain flexibility and at the same time be guided along a path toward long-term fiscal rectitude is a target for the debt/GDP ratio. Such a target allows debt to grow but only at the rate of growth of GDP, our collective income. Deficits are not prohibited. On the contrary, they are required to hold a debt/GDP ratio constant at its desired level. Thus we can continue to fund current programs that benefit future generations with borrowing and so not impose an undue burden on current taxpayers. A well-designed rule would only prohibit deficits that finance expenditures solely benefiting current taxpayers.

We are fortunate in that once we fully recover from the recent recession most governments in Canada will be at or near budget balance, many with historically low debt/GDP ratios. The guess is that by that time, roughly 2016, the debt ratio for all governments in aggregate will be about 40 percent. As the fiscal squeeze works its way through government finances over the 24 years following, it will at first simply halt a fall in debt/GDP ratios but then they will start to grow. Using Ragan's assumptions, by 2021 spending will exceed tax revenue by about 1 percent of GDP and the debt ratio will be about 43 percent. If the deficit were to be held at 1 percent of GDP per year thereafter, then by 2040 the debt ratio would be about 60 percent.

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A simple but effective rule constraining government is the debt-to-GDP ratio.

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I propose that Canadian governments establish a cap of 60 percent on the debt ratio and that this be achieved by requiring annual deficits to be capped at no more than 1 percent of GDP after 2021. This ensures that the 60 percent target is approached gradually with a combination of slowly rising tax rates and moderation of spending growth. It's crucial that we implement the plan right away and in so doing force voters/taxpayers to begin confronting the fact taxes must be raised to pay for new programs.

I have been limited by space to painting with broad strokes but I have also been asked to be specific in my proposal. In walking that tightrope I have had to ignore details. That's okay because the details of this plan are less important than the ideas it represents, namely, that difficult spending choices need to be made, budgets need to be respected, and we need a rule inviolable by politicians and taxpayers alike that forces the constraint of the latter on the former. With that rule in place, our institutions will more quickly do as they have previously shown themselves capable of doing and resolve the serious and growing fiscal difficulties imposed by the coming demographic fiscal squeeze.



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## Janice MacKinnon

University of Saskatchewan

The current debate in the United States about how to tackle its fiscal problems reinforces a lesson of Canadian deficit reduction in the 1990s: a multi-faceted approach is required since neither spending cuts nor tax increases alone can address challenges like closing the fiscal gap that will emerge as the Canadian baby boomers age.

On the spending side, every four years, preferably right after an election, governments should conduct a comprehensive review of spending as is now occurring in Ottawa with the goal of phasing out programs that no longer provide tangible benefits and reducing the administrative costs of providing government services.

Difficult questions need to be asked about some departments like Aboriginal Affairs. For example, are the best interests of First Nations being served by continuing to invest in infrastructure on reserves that have no viable economic base? Instead, should that funding be redirected to invest in the education and training of First Nations, with the requisite social programs to facilitate the transition, and should such funding be provided directly to individual First Nations people?

Aboriginal people are a significant and younger part of the population, particularly in Western Canada – in Saskatchewan it is projected that aboriginal people will represent 25 percent of the population by 2030. Thus, a critical component of any strategy to address current and future labour shortages should be to work with aboriginal communities to enhance the education and skills of their members.

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Governments must comprehensively review spending and phase out ineffective programs.

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Other measures to increase the labour force and promote economic growth and productivity should be pursued, even though they alone will not solve the fiscal squeeze. The labour force should be expanded by continuing to give priority to skilled immigrants, improving daycare so as to attract and retain more women in the workforce, and providing incentives for older people to work longer, which would also reduce the costs of programs like the Guaranteed Income Supplement.

Economic growth and productivity increases should be fostered by ending inter-provincial barriers to trade, changing Employment Insurance to promote mobility, eliminating supply management, and ending regional economic development subsidies. We should also re-orient our trade to focus more on Asia by signing free trade agreements with countries in the region and by encouraging private sector plans to enhance our transportation infrastructure, including the Pacific Gateway Pipeline, so that we can maximize the value of our energy resources.

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Improve growth and productivity by eliminating interprovincial trade barriers, reforming EI, ending supply management, and abolishing regional development subsidies.

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On the revenue side, we need to expand the tax tools that we use and rely more on the user pay concept. Enhancing productivity will require upgrading Canada's aging infrastructure, estimated to cost billions of dollars, which is money that Canadian governments do not have. Hence, we need more public private partnerships and "tolls" for roads, bridges and other facilities, so that we can upgrade infrastructure more quickly without burdening public treasuries.

While all of the above will help with the fiscal squeeze, the problem cannot be addressed without fundamentally changing our health care system and its funding. Diverting service delivery away from the traditional hospital model, which is expensive, heavily unionized, and therefore difficult to manage efficiently, would save dollars and provide better patient care. More services should be delivered by private clinics, since they can focus on specialty care and avoid the inefficiencies associated with having to manage various union contracts. Such clinics have reduced both wait times and costs in Saskatchewan and other provinces. Patients should also be diverted from expensive and crowded emergency rooms and other costly medical facilities to primary health clinics where family doctors – who would have to be moved from a fee for service regime to salaries – would work not as gatekeepers but as part of a team of health care professionals, such as physiotherapists, counselors, and nutritionists. Public-private partnerships should be used to build more long-term care facilities so that elderly patients can be moved from hospitals and housed in less expensive facilities more geared to their needs. More generally, governments at all levels should stress healthy living and prevention of illness and develop strategies to deal with major health problems like obesity.

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The problem cannot be addressed without fundamentally changing our health care system and its funding.

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The recent announcement by the federal government that as of 2016-17 health transfers will no longer increase by 6% per year, but will track increases in economic growth and federal revenue (with a floor of 3%) means that spending on health care will not take a bigger and bigger share of the federal spending pie, as has occurred provincially. The provinces have long-term predictable funding commitments, albeit at a lower level and will now have to turn their attention to aligning their health care costs with their revenue growth.

Interestingly, the Premiers at their recent meeting in Victoria discussed ways that they could work together to reduce health costs. For instance, studies have shown that since 2004, while some of the 6 % increase in federal money for health care has gone to reduce waiting lists, a significant amount of it has been spent on increasing the salaries and benefits of doctors, nurses and other health care professionals. Hence, the proposal that provinces could co-operate to limit such

salary increases, as opposed to competing with each other, is one of many ways in which inter-provincial co-operation could reduce health care costs.

Provinces should also consider revenue measures to address the gap between health care costs and revenue growth. The decision by the federal government to reduce the GST means that there is “tax room” that the provinces could occupy. However, rather than raising sales taxes, the provinces should implement the recommendation of Tom Kent, Prime Minister Pearson’s policy advisor when medicare was created. Kent recommended that 25% of the costs of health care should come from making health care a taxable benefit. Such a policy would be fair since what one pays would be related directly to income, caps can be established, and provisions can be made for those who have special medical problems.

This proposal would link funding for health care with use of the system, which would mean that more of the future health care costs would be paid by aging baby boomers, as opposed to burdening younger working age Canadians with higher taxes. Also, the taxable benefit model would alleviate the crowding out problem: health care costs have been increasing at a faster rate than the revenue growth of governments. Thus, health care spending has been crowding out funding for priorities like social programming, education, and the environment, all major determinants of the overall health of the population (which helps to explain why our spending on health care is high but our health outcomes are mediocre).

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More services should be delivered by private clinics.

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None of the above will be easy, but Canadians know from past experience the importance of addressing fiscal challenges before they become crises.



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# William Watson

McGill University

The problem we are asked to address is a federal deficit of 4.2 percent of GDP, forecast for 2040. Forgive me for doubting, but would it have been reasonable had fiscal planners in 1912 taken action to offset concerns about possible fiscal difficulties in 1940? Unbeknownst to them, rather larger problems than deficits of two or three or even four percentage points of GDP were about to intrude on their planning horizons: a Great War, a Great Depression, the collapse of the world trading and financial system, blitzkrieg and the beginning of a second Great War, and so on.

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Tax rates should be low and tax bases broad.

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We may hope – we may pray – that our own path will not be similarly arduous. We will, if we are lucky, eventually get to the long run. If when we’re closer it looks to be turning out badly, our own recent history suggests we can make even quite large fiscal corrections in historically short order, i.e., three to five years. Such corrections may not be neat but, as the late Herbert Stein wrote, “If something cannot go on forever, it will stop.”

But if Canadians could be persuaded on the basis of a 28-year forecast to mobilize in ways that in the mid-1990s only the spectre of imminent default persuaded them to do, how should they go about it?

Start with the tax system and then examine federal spending. Economists have an unvarying view of taxes: rates should be low, bases should be broad and, beyond that, where taxpayers have a choice of how to declare their income, the system should not push them in one direction or another for at bottom a buck is a buck. Some will argue that under fiscal duress, tax rates should be raised. Calculating the optimal tax rate – providing the perfect balance between equity and efficiency – is not at all easy. That said, my own view is that given both Canada’s mediocre productivity growth in recent years and the still substantial marginal tax take even at not very grand incomes we can be reasonably confident our taxes aren’t too low.

That doesn’t mean more revenue couldn’t be raised, however. Every year, the federal government publishes a list of tax expenditures, that is, carve-outs from tax obligations that have been granted to some or all taxpayers for various reasons of fairness, consistency, or aggressive lobbying. On the personal tax side there are more than 100 such carve-outs (see <http://www.fin.gc.ca/taxexp-depfisc/2011/taxexp11-eng.asp>). Not all come with dollar estimates. Many we probably would not want to eliminate or even reduce. For instance, at \$28.5 billion, the largest is for the “Basic Personal Amount,” which is exempt from tax because basic considerations of fairness dictate we not tax people on income they use to buy the necessities. But other personal tax expenditures seem less justifiable. For instance:

- \$150 million for personal public transit tax credits. How many taxpayers don’t drive because of them and how many merely pocket a tax credit for choosing a transportation option they would have chosen anyway?
- \$115 million for first-time home buyers. Very recent history has shown the perils of excessive investment in housing. Why is Ottawa encouraging more of it?
- \$2.3 billion age credit. The baby-boom generation that is about to take advantage of it has largely caused the problem of a rising structural deficit.

- \$3.2 billion for employer-paid medical and dental benefits. Do they cease to be income simply because they are not paid in cash?
- \$115 million for the Child's Fitness Tax Credit. Does it really encourage new fitness activities or merely reward activities already undertaken?

There are fewer tax expenditures on the corporate side, "only" five dozen or so, but many of them raise similar questions:

- \$3.7 billion for the Scientific Research and Experimental Development Investment Tax Credit. The goal of such credits seems not to be to encourage basic science but to develop profitable economic activity. Why should this form of seeking profit be privileged over others?
- Why is there an Atlantic Canada Investment Tax Credit (\$273 million)? Is it good for the economy – or the country, for that matter – to tilt investors in the direction of a particular region?
- \$3.6 billion for the lower tax rate offered to small businesses. Why should the state favour a particular size or form of business? And how many small businesses exist mainly to allow their owners to pay the small business rate on what amounts to their personal income rather than their (in most cases) higher personal income tax rate?
- Why is there an investment tax credit for child care spaces as well as direct assistance to parents for child care?
- \$255 million for the Film or Video Production Services Tax Credit and the low tax rate for credit unions. Why are these favoured activities?

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Does the Child Fitness Tax Credit encourage new activities or simply reward existing ones?

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Bottom line? I don't have a precise dollar value for how much we could save by eliminating or reducing some of the 170 different tax expenditures available at the federal level alone. But it should run into the billions, possibly even the tens of billions, of dollars.

On the expenditure side there is also room for cutting. Looking at the big picture, the federal government spends money on seniors (\$35.6 billion in 2010-11), the military (\$21.3 billion), the unemployed (\$19.9 billion), the provinces (\$53 billion) and debt interest (\$30.9 billion). Interest on the debt can't really be touched, though alert debt management can save substantial amounts of money. With government debt the world round falling to double-A and lower, Canadian government debt may be expected to sell at a premium over the next few years, thus at least marginally reducing borrowing costs.

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Why should the state favour a particular size or form of business?

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In recent decades income-conditioned spending has helped reduce the poverty rate among seniors to low single-digit levels, an important national achievement. On the other hand, spending that is not income-contingent can be expected to decline in importance as private savings, particularly those encouraged by tax relief, account for a growing share of seniors' incomes.

Unemployment insurance is an important function of government in an economy with considerable labour mobility. But Canada's unemployment insurance program increasingly is neither insurance-based nor about unemployment, but rather is used to pursue various social goals. If it were operated on insurance principles,



thus ending implicit subsidies to seasonal employment, and returned to its core function of protecting against involuntary spells of unemployment, it could almost certainly be operated at less cost.

Recent increases in spending on Canada's military have increased Canadians' respect for men and women in uniform and our understanding that "soft power" may have limited usefulness in a world that continues to offer hard challenges to international order. However, the Canadian Forces operate with what may well be an unnecessarily large headquarters staff and are no less prone than other countries' militaries to infatuation with new weapons systems. It should therefore be possible to reduce the rate of increase in spending on the military without undermining the important gains in morale and effectiveness that have been made.

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Canada's unemployment insurance program increasingly is neither insurance-based nor about unemployment.

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Some federal transfers to the provinces, i.e., equalization, are all but mandated by the constitution, even if the mandate is quite general and can probably be satisfied with lesser spending. The last couple of decades have seen repeated attempts to establish an equalization formula satisfactory to all while still working within the traditional "fiscal-deficiency" model. Repeated failure to find a sustainable and implementable version of that model suggests it may be time to look at other models, including the so-called "macro" model, which would target GDP or income gaps, rather than differences in fiscal capacity.

Other major federal transfers are the result of "negotiations" between the federal and provincial governments that often consist of the 13 premiers and territorial leaders shaming the federal government into increasing its grants. Sometimes this tactic has worked. The federal government's recent unilateral announcement of its own funding formula for healthcare grants is an interesting attempt to short-circuit the negotiations and cut straight to a formula that will strike enough Canadians as reasonable that a provincial-territorial public relations counter-offensive will fail. It would serve efficiency better if the provinces were to raise their own funds for most of their social programs, following the general principle that one makes better decisions spending one's own money than someone else's. The same would be true of municipalities, as well. The only qualification to this general argument is that there may be countervailing efficiencies in reducing the number of different taxes to which taxpayers are subject.



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# Bev Dahlby

University of Alberta

Chris Ragan's report contains a strong warning to Canadians of the "fiscal crunch" we will face in coming decades. This message is not new. Since the late 1970s, when the Economic Council of Canada issued its report *One in Three*, we have known that the combination of a declining birth rate and increasing longevity would create economic and fiscal pressures in the first half of the 21st century. What has changed is the amount of time that we have to implement the policies that will allow us to navigate this period without converting the fiscal crunch into a fiscal crisis.

First, we need to consider the role that public sector borrowing might play in helping to finance the projected fiscal gap. The current fiscal crisis in the European Union should make everyone aware of the grave dangers that high levels of public sector debt can have for economic stability. The appropriate role for debt policy should be to allow us to make a smooth adjustment in expenditure programs and tax rates to a sustainable fiscal policy.

In the coming decades we can anticipate significant shocks to our fiscal system. We should take advantage of unforeseen short-term positive shocks to run fiscal surpluses and reduce debt. Short-term negative shocks, such as increases in world interest rates or trade disruptions, may necessitate deficit financing in some years. In order to ensure that this safety valve is available to us, we will need to ensure that our debt to GDP ratio is not high enough to provoke concerns about sovereign debt defaults, which leads to escalating interest rates. In the coming decades many countries, including China, will be faced with aging populations and declining national savings rates. We cannot assume that the current period of low real interest rates, which makes government borrowing seem attractive, will continue in the future.

The fiscal adjustments that Canadian governments achieved in the mid-1990s have been held up by the IMF as exemplar policies. Two key features of that period of fiscal adjustment stand out. First, the public was solidly behind the need for a period of fiscal austerity to eliminate deficits, to move the fiscal accounts to surplus, and to reduce public sector debt. Second, the first priority in the fiscal adjustment was reviews of public expenditure programs at all levels of government to ensure that they were fulfilling important economic and social needs in an efficient and effective manner.

Health care spending is the largest public expenditure program, and there will be upward pressure on spending in this area because of population aging and the continuing technological changes that make the care and treatment of a wider range of health problems possible. Improving the efficiency of health care spending should be the highest priority of government. It is encouraging that a number of recent reports, such as Don Drummond's *Therapy or Surgery?* have highlighted areas where reforms that could lead to high quality, cost effective health care. Reforms include greater use of information technologies and programs to improve health status through diet, exercise, and lifestyle changes and more emphasis on provision of chronic care services within special institutions and patients' homes rather than the hospital system. Reforms should be made to the payment of doctor and hospital services, as well as pharmaceuticals.

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Current European crisis should provide warnings about the dangers of high public sector debts.

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First priority of fiscal adjustment is to ensure effectiveness of current spending.

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Health care cannot escape reform given it is the single largest expenditure area.

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Consideration should also be given to co-insurance arrangements that could be administered through the income tax system, whereby medical and hospital services are treated as a taxable benefit with annual limits on payments based on an individual's income. This would help to make the cost of health services at least part of the individual's utilization decisions. Because the contributions would be linked to income, it could improve the progressivity and inter-generational equity in financing the increases in health care spending that will undoubtedly occur even with the widespread adoption of cost-saving and efficiency-enhancing measures.

Maintaining labour force participation rates and promoting productivity improvements will also be key to successful fiscal adjustments. Reforms to the Employment Insurance programs will have to be made to ensure that labour markets allocate workers to the most productive jobs and provide appropriate work incentives. We will need to ensure that the participation tax rate, which is the difference between what an individual can receive through public assistance and employment insurance programs and the after-tax wage rate that they can earn, does not inhibit individuals from seeking employment. Using experience rating to determine employer contributions to the EI fund would provide an incentive for employers to avoid layoffs and would allocate more of the cost of the EI program to those industries and firms that make frequent demands on the system by laying off employees. This may reduce employment in seasonal and highly cyclical industries and shift employment to industries and regions with higher productivity and more stable income generation.

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Reforms to EI will have to be made.

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To the extent possible, the fiscal adjustment should be made through expenditure restraint, but some tax rate increases may be necessary in light of the magnitude of the coming fiscal gap. If tax increases are contemplated, tax policy should reflect the advice in a 2010 OECD report, *Tax Policy Reform and Economic Growth*, which warns against trying to solve fiscal adjustment problems through increases in corporate and personal income taxes, which are the most economically damaging taxes because they inhibit investment and economic growth. Instead, the OECD advises governments to increase general sales taxes and real property taxes. Currently, Canada is less reliant on sales taxes than other OECD countries, but increasing the GST and HST will not be popular. It will be necessary to explain to the Canadian public the importance of shifting our tax mix more towards consumption in order to sustain economic growth and investment during a period when the demographic pressures will make maintaining employment and productivity growth a priority. Enhancing the tax credits provided to low income individuals could alleviate concerns about the distributional impact of these tax measures. Additionally, greater emphasis on consumption taxation will help to shift more of the tax burden caused by population aging to members of the baby boom generation who will use pension income and other financial assets to finance their consumption in retirement. This helps in part to reduce the tax burden that is imposed on the current working generations to fund the spending increases that are driven by population aging.

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If tax increases are necessary, only increases in consumption and property taxes should be considered.

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In summary, in facing the coming demographic challenges, Canadian governments should try to limit reliance on deficit financing to smoothing the changes in the level of expenditure programs and tax rates. Public debt levels should be kept at a relatively low level to allow a safety margin so that we can absorb unanticipated adverse fiscal shocks. The focus of the fiscal adjustment to population aging should be on expenditure restraint. Improvements to the public health care system and financing should be the priority. An increased emphasis on public sector pricing policies, as a source of finance and as a way to improve incentives for resource allocation, could help in many areas. Personal and corporate tax rate increases should be avoided to the

extent possible. Increases in the federal GST, the provincial HSTs, and local property taxes should be the main sources of additional tax revenues.



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## Jason Clemens

**Macdonald-Laurier Institute**

Canadian governments are facing a 4.2 percentage point deficit by 2040, which is roughly \$67 billion in today's money, due to a combination of lower tax revenues (borne from slower economic growth) and higher spending on age-related programs and healthcare in the future.

Canadian governments can act in a proactive manner now or in a reactionary mode later, but they will have to act. The policy options available are fairly simple: (1) raise taxes, (2) cut spending, (3) increase debt, and/or (4) introduce reforms that increase economic growth.

Ragan suggests a number of policy changes that could contribute to narrowing the gap. We should not underestimate the impact of these changes or ignore them simply because they may not solve the entire problem. Indeed, many of these policy reforms make sense in and of themselves without considering their contribution to eliminating the future deficit.

In brief, Canada should pursue changes in the immigration system that (a) better ensure workers coming to Canada have their credentials recognized, (b) facilitate a process for private companies to more easily bring in needed foreign workers, and (c) that a higher percentage of total immigration is work-related rather than based on family re-unification. Increasing the likelihood of productive and working immigration can contribute to a broad solution.

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Governments can act proactively now or reactively in the future, but they will have to act.

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A more productive and effective immigration system is part of the solution.

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Similarly, there are changes in a host of labour market programs that could be implemented to encourage and increase overall labour market participation. Reforms to Employment Insurance, reductions in marginal effective tax rates for low- and moderate-income families, more generous treatment for child-care related expenses, and greater flexibility with respect to receipt of retirement benefits could all facilitate improvements in labour market participation.

These and other policies discussed by Ragan can mitigate the expected gap between future government revenues and spending. It will not, however, close the gap, leaving a real risk of permanent deficits and accumulating debt.

One measure that would mitigate spending while encouraging more seniors to remain in the labour force longer is increasing the age of eligibility for both early and standard public retirement programs. Programs and transfers aimed at low-income seniors like GIS should be exempt since changing the age of eligibility would only shift costs from the federal government to the provinces. There is a direct link between the projected deficit and the increase in life expectancy. For example, life expectancy for males born in 1966 when the Canada Pension Plan (CPP) was introduced was 69 (4 years of benefits). It is now roughly 79, which represents a marked increase in the cost of benefits.

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Increasing the age of eligibility for public retirement income programs should be introduced slowly over the next two decades.

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Raising the age of eligibility for public retirement programs like the CPP to 70 over the next two decades is a reasonable response to the demographically-based deficit. A slow approach to increasing the age of eligibility could be made, perhaps by one month each quarter for the next two decades (4 months per year), which means no disruption for those in retirement now and a gradual approach over time that mitigates disruption for older workers.

Reforming Canada's health care system to ensure better value-for-money also has to be part of the solution. To begin such a process, the federal government should rely on the lessons from welfare reform in the 1990s. The federal government reduced transfers to the provinces while according them more flexibility in delivering social assistance by eliminating most national standards. The result was an explosion of experimentation and innovation across the provinces with a determined focus to actually deal with the underlying problems of dependency rather than simply throwing more money at it.

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More flexibility to the provinces to experiment and innovate is the first step in health care reform.

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The same framework would work for healthcare. The federal government could reduce transfers, even slightly, while affording the provinces greater flexibility to innovate and experiment in the design, regulation, and delivery of healthcare within a universal, portable framework. Such a reform would begin the process of improving the nation's health care system.

Once such a framework is established, the key for the provinces will be to learn lessons from other universal health care countries that spend the same or less than Canada but enjoy better results. Particular focus should be on countries like Switzerland, Sweden, and Australia.

The focus of the remaining measures should be on how to reform and reduce spending. The framework for such a review is best provided by the federal Liberal government's experience with Program Review in 1994. In the review, no area of government spending was protected. Everything the government did was reviewed.

The government applied six tests to evaluate spending:

- 1) Serve the public interest.
- 2) Necessity of government involvement.
- 3) Appropriate role for the federal (or provincial) government.
- 4) Scope for public/private partnerships.
- 5) Scope for increased efficiency.
- 6) Affordability.

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Governments should rely on systematic evaluations of all existing spending.

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Relying on these tests to rationalize and reform spending at the federal and provincial levels will ensure that savings are achieved but also that such changes are done in a prioritized, methodical manner.

One cannot reasonably evaluate the solutions available for the coming fiscal gap without also discussing taxation. Two points are important to consider. First, the Canadian tax system has become much more complicated over the last decade. A myriad of new tax credits have been introduced covering things like tradespeople's tools, children's fitness, employment, and children generally. The cost of tax expenditures has increased by more than 42 percent since 2001.

A better approach to taxation, and one that could increase rates of economic growth by improving incentives for work effort, investment, and entrepreneurship, is to simplify the tax system by eliminating many of these tax credits while lowering marginal tax rates.

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Tax simplification could spur economic growth.

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If the combination of these policies still fell short of solving the projected deficit, which is highly doubtful, any additional tax revenue raised in the form of actually increasing tax rates should be reserved exclusively for the GST. The GST, or now HST, is, if not the best, one of the best taxes in the country due to its efficiency and simplicity. Put differently, relying on the GST for additional revenues would impose the least costs on the economy.

However, the combination of policies summarized above coupled with the spending reductions and reforms should more than suffice in eliminating the long-term budget gap between government revenues and spending without increasing tax rates.



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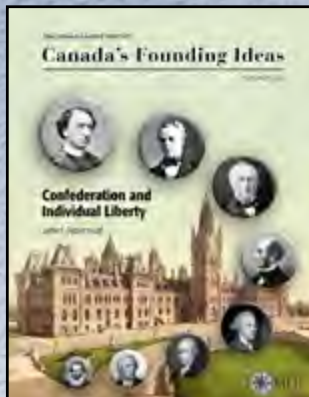
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