TD Bank Financial Group

TD Economics

Special Report

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3 STARS OF THE 2006 FEDERAL BUDGET

With 28 tax cuts and a similar number of spending initiatives, there should be no shortage of candidates for star selection from the federal May 2, 2006 Budget. But none of them make this list, although they do deserve honourable mention collectively for passing the transparency test. For the most part they were delivered as advertised in the Conservative's election platform. The 3 selected stars of the Budget played understated, supporting roles. But they offer considerable promise. They are, therefore, stars and top draft picks simultaneously.

The top 3 stars of the 2006 Federal Budget are:

1. The commitment to "pursue a broad approach over the coming year … to develop a strong, results-oriented agenda to promote a more competitive, productive Canada for the benefit of all Canadians" (Budget Papers, page 92) ;
2. The new approach to budget planning ;
3. The principle-based framework for federal-provincial-territorial fiscal (and economic) relations.

The first star: A More Competitive, Productive Canada

Improving the performance of the Canadian economy for the benefit of all Canadians is not at least directly one of the Conservatives' 5 priorities. As such, the goal received little attention in the election platform or the Speech from the Throne. But there it is in very concise prose in the Budget. Dare we think of creating a more competitive, productive economy as a sixth priority?

Previous governments also identified raising productivity growth as a priority but did not succeed in convincing Canadians to embrace the challenge. Perhaps Finance Minister Flaherty can succeed where others have failed.

Canada's poor productivity track record

In a recent TD Economics' report entitled *Canada's Productivity Challenge*, we noted that Canada has recorded a poor productivity performance, both relative to our own historical experience and to other countries.

- Canada's real GDP per hour worked increased by 2.1 per cent annually on average between 1960 and 2004.
- Canada's productivity growth has slowed dramatically over the past several decades, moving from 3.6 per cent per year in the 1960s to only 1 per cent annually on average since 2000.
- Canadian productivity has advanced more slowly than 18 out of 22 OECD nations since 1960 and 21 of 23 OECD nations in 2003 and 2004.
- Canada's productivity level was also lower than in most G-7 countries in 2004 and sat at a lowly 17th out of 24 OECD nations in 2004.
- Canada's public sector productivity is put at as much as 30 per cent higher than in the United States – a massive differential and dubious outcome. By stripping away the public sector, Canadian productivity is about 79 per cent of the level in the United States.

The brief discussion of productivity in the Budget may be a thin reed to grasp, but it offers hope. It demonstrates an attempt to put the productivity challenge in terms that shows Canadians why success is in their interests. It doesn't dummy down the debate by shifting to "softer" words to side step the Canadian public's wariness of the

What's in for Canadians?

While the nation's poor productivity track record has been a major subject of attention lately, it has not gripped the hearts and minds of most Canadians since it is inherently a very abstract concept. Canadians should care deeply about productivity since it is a key driver behind a rising standard of living over time.

Strong productivity gains allow for faster economic growth without leading to higher inflation. For households, the implication is additional income without loss of purchasing power. This is supported by findings from the Centre for the Study of Living Standards: labour productivity growth and real wage growth averaged 1.87 and 1.84 percent over the period 1956-2001, respectively. Moreover, strong productivity gains translate into stronger profit growth for businesses and into additional tax revenues for governments, which in turn support public programs.

term productivity. And it doesn't shy away from taking on some thorny issues where the federal government does not hold the levers like interprovincial trade barriers, provincial capital taxes and multiple-jurisdiction securities regulation.

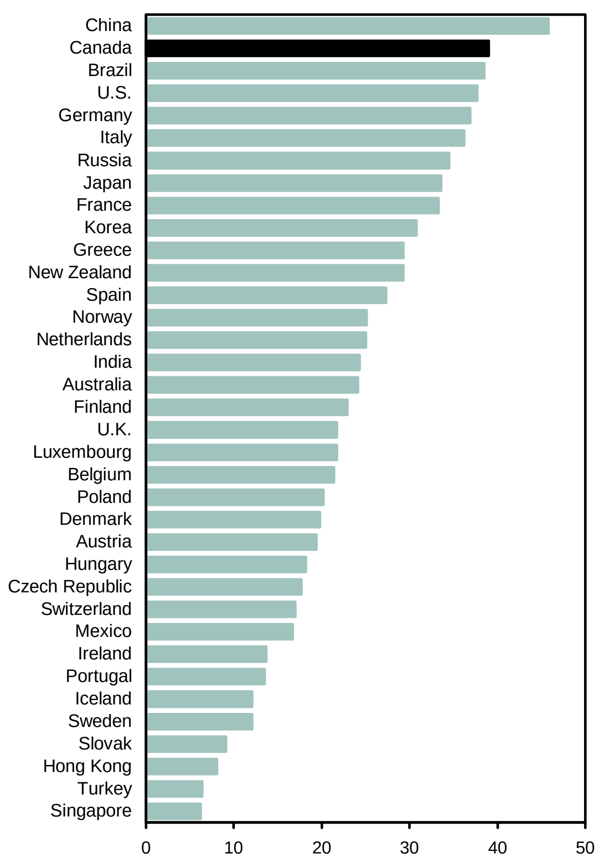
The productivity challenge needs a national champion that will not only straighten out federal policies, but entice, coerce or bully as required other players in the economy including the provinces, businesses and workers to act in the best interest of improving the performance of the Canadian economy because that is what ultimately serves everyone's best interests. Let us hope that as he pursues "a broad approach over the coming year…to develop a strong, results-focused agenda to promote a more competitive, productive Canada", Minister Flaherty, with full support of the Prime Minister and Cabinet, becomes that champion.

The first task will be to find better ways to communicate the productivity challenge. Politicians and economists too often leave Canadians thinking that raising productivity means working harder for less pay (see text box above). The opposite is the case.

The second task is to build consensus on what needs to be done. That might not be difficult because many elements of an agenda already have widespread support, including:

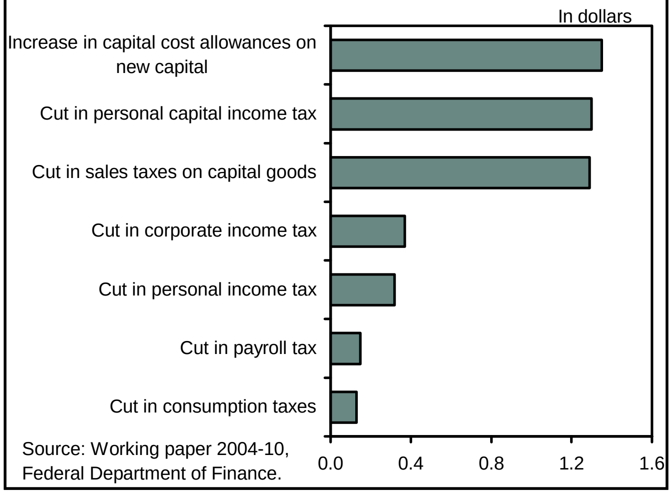
- Promoting macroeconomic stability;
  - The Bank of Canada is steadfast in pursuing the objective of low, stable inflation and the pay-off is evident in modest interest rates despite a strong national economy.
  - The 2006 Budget commits the federal government to further debt reduction and provincial debt burdens are falling as well.
- Shifting from consumption to investment;
  - Government policy should support investment through promotion of education and infrastructure.
  - All governments have re-committed to this goal in recent years after a long period of starving investment.
  - The 2006 Budget includes a number of investment initiatives.
- Sharpening the incentives to work, save and invest;
  - Canadian corporations face among the highest tax rates on capital in the world. The 2006 Budget sliced

MARGINAL EFFECTIVE TAX RATE ON CAPITAL



Source: CD Howe Institute, 2005

WELFARE GAINS PER DOLLAR OF LOST REVENUE FROM VARIOUS TAX CUTS



Source: Working paper 2004-10, Federal Department of Finance.

these rates significantly and much of the remaining problem resides with several of the provinces who heavily tax corporate income and capital and apply their sales taxes to investment. In particular, the 2006 Budget shows leadership in eliminating the federal capital tax effective January 2006. Capital taxes cause the greatest amount of economic damage because they lower the amount of capital Canadians can work with, thus lowering productivity. Unfortunately, many provinces continue to apply capital taxes, either to all industries or to the financial services industry.

- Many Canadians face effective marginal personal income tax rates – once accounting for the loss of income-tested federal and provincial social benefits – exceeding 60 per cent. These too are among the highest rates in the world. The result is there is little incentive left to save or upgrade skills in order to increase earnings. The Budget Papers (pages 70-71) document how taking a job can often leave social assistance recipients financially worse off. In a statement overlooked by virtually all budget commentaries, Finance committed to "identify, in consultation with provinces and territories, potential measures to improve incentives to work for low-income Canadians, including through an earned income tax credit such as a WITB (Working Income Tax Benefit). One was proposed by the Liberal Government in the Fall 2005 Economic and Fiscal Update. TD Economics recommended such a program in a 2005 study on barriers to exiting social assistance (*From Welfare to Work in Ontario: Still the Road Less Travelled – September 8, 2005*). Lastly, a Task Force recently recommended the creation of a new refundable tax benefit for low-income wage earners (see text box on page 4).
- Unfortunately, lowering the marginal effective personal income tax rates is very expensive. Each percentage point off the 4 federal personal income tax rates costs the federal treasury $5.5 billion per year. Here is where a final shot at the GST rate cut cannot be resisted. Each point reduction to the GST rate has a similar cost, yet that tax cut does nothing to improve sustained economic performance. And there is a commitment to cut a further point, drawing additional resources that could be allocated to improving economic performance.

• Sharpening competition;
  - Interprovincial trade barriers and foreign competition restrictions are examples of barriers to competition that lessen the efficiency of the Canadian economy. They have no place in a modern economic structure that has to compete globally.
• Improving immigration;
  - Many immigrants of recent years are struggling economically (see accompanying text box on page 5).

Trade barriers are a drag on productivity growth

• Interprovincial and international non-tariff trade barriers are making Canada less competitive according to the Conference Board of Canada *.
• A majority of firms surveyed said that governments' non-tariff barriers increased their costs and lowered their productivity.
• The main barriers hurting firms' productivity are standards, regulations, government procurement policies, and restrictions on labour mobility.
• The study found that these barriers have a negative effect on productivity for 16 primary and manufacturing sectors in the Canadian economy.

* *Death by a Thousand Paper Cuts: The Effect of Barriers to Competition on Canadian Productivity*, The Conference Board of Canada, April 2006.

Modernizing Income Security for Working-Age Adults

On May 15,2006, the Task Force on Modernizing Income Security for Working-Age Adults released a report calling for a fundamental reform of Canada's income security programs for working-age adults. Notably, the Task Force recommend that a new refundable tax benefit should be created consisting of a basic tax credit for all low-income working-age adults and a working income supplement for low-income wage earners. This new benefit should be federally financed and administered.

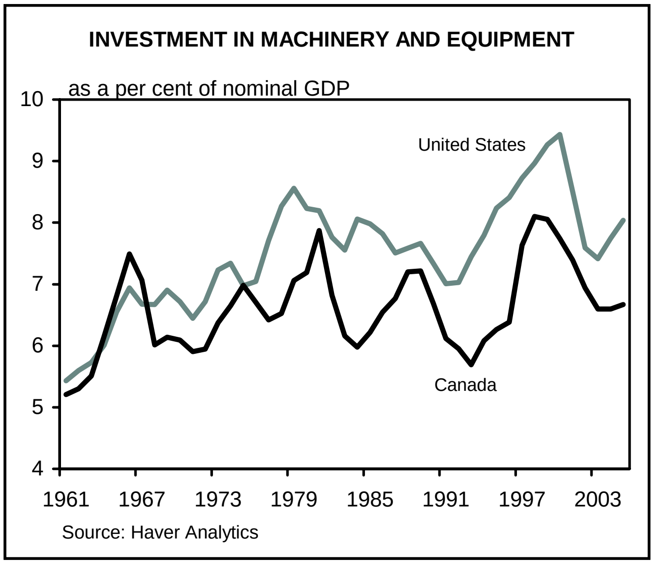
- A Basic Refundable Tax Credit**:** A new income-tested refundable tax credit for low-income working-age adults, including persons with disabilities. The maximum benefit would be $1,800/year ($150/month). It would begin to be recovered at $5,000/year in household income and would reduce to zero by $21,500/year in household income.
- Working Income Benefit: A new working income supplement delivered through the tax system**.** Minimum work hours to qualify would be 50 hours/month or a household income of $400/month or $4,800/year. The maximum benefit would be $2,400/year ($200/month). When integrated with the refundable tax credit, it would bring a single adult earning minimum wage and working average hours (32 hours/week) from an income of just under $13,000/year to an income level of approximately $16,000/year. This benefit would also reduce to zero at $21,500/year in household income.

The amounts proposed are modest, but they have the potential to make a real difference to people living at very low income levels. This new adult tax benefit meets the goals the Task Force set out:

- to provide provincial social assistance recipients with an increase in income in a non-stigmatizing way outside social assistance. It would also help prevent some people from having to apply for social assistance in the first place.
- to reduce the financial penalties incurred when moving from social assistance into the labour force, thereby reducing the number of people on social assistance. To avoid creating a new barrier in the form of increased marginal tax rates, both parts of the new benefit reduce to zero at the point where child benefits and several other benefits begin to be reduced, or roughly $21,500/year in household income.
- to provide the beginning of a decent standard of living of at least $15,000 a year for wage earners living in low income.

The 2006 Budget provides funding for settlement and credential recognition and this should ameliorate the situation. But consideration needs to be given to more wholesale change. In particular, immigration could be a more effective answer for growing Canadian labour shortages if it became less of a passive system (merely receiving applications from those choosing Canada) to a pro-active one searching and marketing for certain types of workers. Presently there is not even an electronic register of the qualifications of the applicants in the queue. Further, it can take up to 5 years before an application makes its way to the top of the pile to be considered.

- Businesses need to invest and trade more;
  - The Canadian economy's ratio of machinery and equipment investment to hours worked is only 55 per cent that in the United States. The difference can certainly not all be explained by taxation. Canada's research and development as a share of GDP was 14th within the OECD countries in 2003 and below the OECD average despite governments support through its R&D spending and the tax credit. And while we think of Canada as a trading nation, almost 50 per cent of our exports comes from 50



Labour market integration is difficult for immigrants

A study by Statistics Canada* reveals that the earnings gap between immigrants and Canadian-born was eliminated after working twenty years in Canada for immigrants that started working in the late 1970s. This study also reveals that the earnings gap at the entry level has been increasing between the immigrant cohort of the late 1970s and the 1990s. Moreover, the earnings of immigrants in the 1990s did not fully catch up to those of Canadian-born: new immigrants earned 55 per cent that of the Canadian-born at the entry level in the 1990s, compared to 70 per cent after 6 to 10 years in the workforce. Several statistics provide clear-cut evidence of challenges immigrants are facing:

- The proportion of recent immigrants with family incomes below the low-income cutoff rose from 25 per cent in 1980 to 36 per cent in 2000.
- One year after arrival, the employment rate among immigrants aged 25 to 44 was 58 per cent, 23 percentage points lower than the national rate among this age group.
- According to the 2001 Census, the unemployment rate of recent immigrants aged 25 to 44 was still twice that of the Canadian-born population, 12.1 per cent compared with 6.4 per cent.

* *The Deteriorating Economic Welfare of Immigrants and Possible Causes: Update 2005,* Statistics Canada, June 2005.

Export-oriented firms more productive

Canadian manufacturing companies that participate in export markets show superior labour productivity gains and innovation than those which don't, according to Statistics Canada*. Annual labour productivity growth in export-oriented firms was 0.6 percentage points higher than non-exporters during the past two decades. Moreover, the annual growth in shipments and wages of exporters was 0.3 and 0.6 percentage points higher, respectively. Particularly, exporting facilitates the transfer of knowledge across countries and enhances the innovation process in the Canadian economy. As such, exporters make greater use of advanced technologies.

* *Trade Liberalization: Export-Market Participation, Productivity Growth and Innovation*, Statistics Canada, December 2004.

companies and about 80 per cent of small and medium-sized businesses do not export at all. A recent Statistics Canada study showed that productivity is much lower in Canadian firms that do not trade relative to those that trade (see text box).

- Reducing the regulatory burden;
  - According to the Canadian Federation of Independent Business, Canadian businesses spend $33 billion a year to comply with government red tape. 65 per cent of firms surveyed identify government regulation and paper burden as their greatest concern, second only to the overall tax burden (82 per cent).
  - R & D provides an interesting example of how regulatory practices can be as important as policy parameters. On paper, Canada has one of the most generous R & D tax credits. Yet few small and medium size companies use it and when they do, they often go through an intermediary who takes as a fee a good chunk of the value of the credit. Allegedly this is because of the perceived complexity of the program's regulations and administration.
  - As cited in the 2006 Budget, the multiple jurisdictions for securities regulation is another hit to the efficiency of the Canadian economy.
  - In recent years federal and provincial governments have been driving down small business income tax rates, claiming small businesses are the backbone of the economy. Yet we do want businesses to grow and larger firms, on average, are more productive and pay higher wages with more benefits. We should be concerned that the jump in tax rates and certain regulatory provisions that kick in as a business grows do not become obstacles to economic growth.
- Promoting a culture of lifelong learning and training;
  - Canadian firms do not fare well internationally in the amount of training provided and many workers do not act on the need to update and elevate their skills over time (see text box on page 7). It is no longer sufficient to heavily invest in someone's education until the age of the early 20s and then let that human capital rundown subsequently. Massive government subsidies should not be required. It is more a matter of demonstrating that training and lifelong

Private employee training in Canada lags the United States

Canadian organizations are under-investing in employee training, and are failing to allocate their training dollars in ways that lead to stronger business performance according to the Conference Board of Canada*. Canadian organizations spent an average of $914 per employee in 2004, compared to $824 in 2003 and $776 in 1998. By sector, the not-for-profit, financial services, government and communication sectors averaged the most investment in training. At the other end of the spectrum, wholesale and retail, health and education sectors reported the lowest levels of training per employee. Despite the uptrend observed in labour training investment in Canada, U.S. firms averaged per employee expenditures of C$1,135. Moreover, Canada's international ranking fell from 12th in 2002 to 20th in 2004 in the Institute for Management Development's Competitiveness Survey, which compares the priority that organizations place on employee training.

* *Learning and Development Outlook 2005: Moving Beyond the Plateau—Time to Leverage Learning Investment,* The Conference Board, 2005.

learning are in companies' and workers' best interests.

- Canada's shockingly high adult illiteracy rate is an obstacle to lifelong learning that receives inadequate attention. Training cannot be effective if people lack the basic reading, writing and numeracy skills.

The third and final task in a competitiveness-productivity agenda is to ensure action in the most promising areas. Here is where the skills of a champion will be most tested because in many cases the lever required will not be in the federal tool kit. Rather, provinces, companies or individuals will need to be convinced to respond.

The second star: The New Approach to Budget Planning

There are 3 positive aspects to the new approach to budget planning:

a) Abandoning the "economic prudence" factor;

b) Adopting a view on spending independent of the simple test of whether it risks deficits; and

c) Promising a new expenditure management system

Changes in telecom industry's structure to enhance productivity gains

With the fast evolution of telecommunications technologies over the last decade, Canada's regulations and policies related to the telecom industry need to be fundamentally reformed. Moreover, the adoption of information and communication technologies (ICT) leads to productivity gains. Indeed, a study by the Bank of Canada* suggests that the rate of productivity growth in the United States was significantly higher than that in Canada during the second half of the 1990s because of greater utilization of ICT by Americans firms. This is in part why the Telecommunications Policy Review Panel, established by the Ministry of Industry a year ago, conducted a review of Canada's telecommunications framework and made recommendations in a report released in March 2006.

In a nutshell, the report's recommendations aim to adapt the telecom industry to the new environment by relying on market forces rather than regulation and by strengthening ICT adoption. Notably, the Panel recommends the creation of a tax credit to increase the pace of adoption of productivity-enhancing telecom technologies by businesses. For individuals, the Canadian government should have the goal of providing broadband Internet coverage in all regions of the country no later than 2010. Another key recommendation for the federal government is to ease foreign ownership restrictions for telecom players that are not broadcasters, i.e. Canadian phone and cable companies. Liberalization of the restrictions on foreign investment would enhance competitiveness and productivity of the Canadian telecom industry.

* *Trends in Productivity Growth in Canada*, Bank of Canada Review, Spring 2002.

It may seem counter-intuitive to pick reduced prudence as a budget star because this is perhaps the aspect of the budget that has been most criticized. The claim is that the new approach raises the risk of running a deficit. Of course that is true. The new Government has stripped out the economic prudence factor which was $1 billion in the first year of a budget plan and $2 billion in the second year. This change was to be expected because the factor was missing in the fiscal plan of the Conservative's election platform.

Applauding the reduced degree of protection against deficits does not mean that the new approach is superior to the system devised by the Liberals. Conditions have

Literacy and productivity: learn to read versus read to learn

Literacy is more than just reading and writing. It is the ability to identify, understand, interpret, create, communicate and compute. Despite its importance, the 2003 International Adult Literacy and Skills Survey reveals that 42 per cent of Canadians do not have the literacy skills for coping with the rapidly changing skill demands of a knowledge-based economy and society. This high proportion of Canadians with low literacy skills was virtually unchanged compared to 1994.

Public and private spending towards the improvement of literacy skills is justified by several studies, which suggest that literacy matters for economic well-being:

- The 2003 International Adult Literacy and Skills Survey shows that Canadians with lower levels of literacy have lower rates of employment and lower earnings.
- Investment in human capital, such as education – including literacy education – and skills training is three times as important to economic growth over the long run as investment in physical capital.* Furthermore, a 1-per-cent increase in average literacy rates would yield a permanent 1.5-per-cent increase in income per person and a permanent 2.5-per-cent increase in productivity.**
- The Conference Board of Canada estimated that a male and a female with higher literacy skills may be expected to earn an additional $585,000 and $683,000, respectively, over a lifetime, compared to a counterpart with poor literacy skills.***

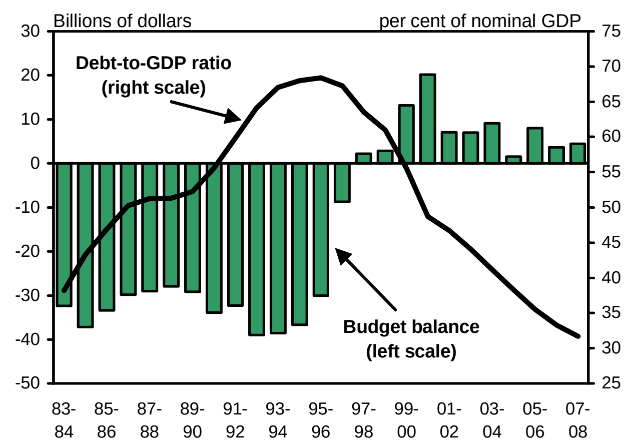
Among 20 industrialized countries, Canada ranks among the top countries in prose literacy (5th) but is in the middle of the pack for document literacy (8th) and quantitative literacy (9th). There is one area, however, where Canada lags behind OECD countries. In 2003, Canadian adults had weaker literacy skills for adults compared to other OECD countries. While the net advantages (benefits of literacy on productivity growth less short-term costs) of investments in literacy are sizeable in the long run for youth, this remains unclear for adults. There is a lack of costs/benefits studies related to training adults in needs of literacy skills.

* *Literacy scores, human capital and growth across 14 OECD countries*, Statistics Canada, 2004.
** *Public Investment in Skills: Are Canadian Governments Doing Enough* ? C.D. Howe, 2005.
*** *The Economic Benefits of Improving Literacy in the Workplace,* Conference Board of Canada, 1997.

changed and policy needs to adapt. The Liberals introduced the two-tiered system of a contingency reserve and economic prudence after decades of previous governments persistently under-predicting deficits. The deficit at the time exceeded $40 billion and the debt-to-GDP ratio was about 70 per cent. The large buffers played a role in turning those deficits into surpluses and while the debt reduction "by stealth" may not have been as transparent as it could have been, there is no doubt that a greater good was accomplished. The federal government will record its 9th consecutive surplus in 2005-06 and the debt-to-GDP ratio will be 35.5 per cent, about half what it was a decade ago.

The buffers in the budget process had become a liability to good budget planning. As an allergy developed to large debt paydowns, the larger–than–anticipated surpluses were used to finance large end-of-year spending sprees. The Conservative Government's intention to tap $3.3 billion from the 2005-06 surplus for immediate provincial-territorial pressures suggests they feel the same itch. As the economic prudence was not going to debt repayment, it became an apparatus to keep tax burdens high in order to fund last-minute spending splurges. As such, good riddance to it.

FEDERAL GOVERNMENT DEBT AND BUDGET BALANCE



Source and forecast: Department of Finance Canada

FEDERAL BUDGET BALANCE SENSITIVITIES		
In billions of dollars		
	Year 1	Year 2
Impact of a one-year, 1 per cent increase in real GDP	2.7	2.3
Impact of a one-year, 1 per cent increase in GDP inflation	2.0	1..5
Source: 2006 Federal Budget		

The 2006 Budget also drops the formal label for the $3 billion contingency reserve. However, as the commitment remains to pay down at least $3 billion of debt each year, this change seems to be largely semantic.

What about the charge the Conservatives have raised the odds of slipping into deficit? First, as argued above, the protection they have removed has simply become an artificial way of propping up tax burdens. Second, you cannot simply infer from a fiscal plan whether a deficit will occur. If economic circumstances deteriorate such that significant and persistent deficits appear likely, the Government can change the fiscal plan. Of course, tightening fiscal policy as the economy deteriorates is easier said than done.

Finally, and here comes a thought that will strike many as economic heresy, elevating "thou shall never run deficits" to the status of an eleventh commandment has no ground in economic or fiscal policy. In an economy of over $1 trillion of output annually a small, occasional deficit that is offset over the business cycle is only meaningful in a political sense. And providing ironclad protection against it ever happening does carry a price tag – excessively high tax burdens.

The 2006 Budget commits the President of the Treasury Board to report this fall on a new expenditure management system. In language federal fiscal watchers have come to understand, the new approach amounts to an ongoing Program Review whereby programs are constantly evaluated against purpose, results, value for money and federal responsibilities. Such reviews in the past have been periodic and in the meantime each new program stacked on top of the existing base. Hopefully the new system will also recognize that every time a new spending priority is announced, by definition existing programs slip to a lower rung on the priority ladder and should be trimmed in order to finance the new initiatives.

The announcement by the President of the Treasury Board this fall is to include details of how $1 billion of spending cuts will be achieved in 2006-07 and 2007-08. It is commendable that there is an objective to finance at least a part of the new spending internally, but the amounts targeted are well below the implicit cuts set out in the Conservatives' election platform ($22.5 billion cumulatively over 5 years). Further, the record of previous governments in delivering on booked, but unspecified cuts is dismal. However, given that the Conservatives have delivered on most of their campaign promises, we should keep the faith until the fall on this promise.

The third star: The Principle-Based Framework for Federal-Provincial-Territorial Relations

Canadians must be highly confused about the so-called "fiscal imbalance" which in its popular form is taken to mean that the federal government has "excess" revenues while the provinces do not have adequate revenues to meet their responsibilities. This year's round of provincial budgets reveals that only 2 provinces are in deficit – Ontario and Prince Edward Island – and Ontario has a plan to restore balance over their planning horizon (see table below). The 2006 federal budget shows that above the commitment to pay down $3 billion of debt each year, the planning surpluses are a mere $0.6 billion this year and $1.4 billion next year. The planning surpluses could grow in later years, but much of that would be grabbed by the commitment to knock another percentage point off the GST

FEDERAL & PROVINCIAL SURPLUS/DEFICIT				
In millions of dollars				
fiscal years	04-05	05-06	06-07	07-08
N.&L.	-473	77	6	96
P.E.I.	-40	-18	-13	N/A
N.S.	88	151	72	189
N.B.	112	117	22	N/A
Que.	-664	0	0	0
Ont.	-1,555	-1,369	-2,350	-1,500
Man.	314	3	3	3
Sask.	382	299	102	100
Alb.	5,175	7,375	4,096	1,715
B.C.	2,575	1,475	600	400
Federal	1,600	8,000	3,600	4,400
Total	7,514	16,110	6,138	5,403
Federal less debt payments	1,600	0	600	1,400
Source: federal and provincial governments				

Upcoming report on Equalization

In the 2006 Budget, the federal government set equalization payments at $13.3 billion for the fiscal year 2006-07 and promised that a new approach for these fiscal arrangements will be set out for fiscal year 2007-08. The Expert Panel on Equalization, established a year ago to review the actual formula, is expected to submit a report this spring to the Federal Minister of Finance, which is likely to recommend:

- a return to formula-driven equalization so that payments respond to changes in provincial disparities
- a 10-province standard rather than the current 5-province benchmark
- somewhere between 0 and 100 per cent inclusion of revenues from non-renewal resources
- a cap (in conjunction with the resource recommendation) such that no equalization-receiving province can have a higher fiscal capacity than a non-receiving province
- equalization objectives be accomplished through that dedicated program rather than being built into other federal payments (such as the associated equalization with the Canada Health Transfer)
- data revision affect equalization payments going forward but not alter previous years' payments.

rate. Given the numbers, it is difficult to understand why speculation continues over whether the federal government will transfer tax room to the provinces. How could it in light of the fact mentioned above that a mere 1 percentage point off each of the 4 federal personal income tax rates would cost the federal treasury $5.5 billion per year? The answer is that it couldn't (that is, unless you consider the GST rate cuts as tax point transfers) unless federal spending was first cut to create the fiscal room. But as cuts to federal spending might shift responsibilities onto provincial-territorial shoulders, such a move would not necessarily be the financial windfall the provinces and territories are looking for.

The 2006 Budget paper "Restoring Fiscal Balance in Canada" goes some way in clarifying the issues. Not that this seems to have had much of an impact on the debate so far. For starters, notice that the term "fiscal imbalance" seems to have morphed into "restoring fiscal balance". Second, consider the issues the budget document identifies:

- Concerns over transparency in federal fiscal planning;
- Concerns over blurred accountability due to reduced clarity in roles and responsibilities;
- Concerns over predictable, long-term funding for fiscal arrangements; and
- Concerns over a competitive and efficient economic union;

We have already discussed the first and fourth points. The second point really cuts to the core of any "fiscal imbalance". The federal government has been using its spending power, backed by a thick wallet from unanticipated surpluses, to venture into areas that traditionally have been provincial, territorial or municipal responsibility. The result has been blurred accountability and program inefficiency. Consider as an example the Canada Millennium Scholarship Fund, introduced in 1998. The new federal initiative virtually replicated provincial bursary programs so it should not have been a surprise that many provinces withdrew their support for students dollar-for-dollar with the federal injection (they subsequently committed to leaving the money in the PSE field). The "fiscal imbalance" debate typically revolves around revenue sources. But the Budget document shows the issue must start at the other end – defining respective federal, provincial, territorial and municipal responsibilities. The revenue side will only come into play if the federal government exits from provincial-territorial-municipal areas sufficiently to create fiscal room to finance a tax transfer. But as argued above, this would not necessarily be a fiscal windfall for the provinces, territories and municipalities because they might need to spend more money in areas the federal government exits.

The issue of greater predictability in fiscal arrangements is also legitimate. The federal government has a history of increasing spending in areas beyond its jurisdiction but leaving the other levels of government hanging when things get tough. Further, equalization payments have been subject to huge revisions which destroy provincial fiscal planning.

The 2006 Budget promises that a new approach to fiscal arrangements will be set out in the 2007 Budget. This provides less than a year to complete a debate that could fundamentally alter the nature of the federation. It may be decided that some responsibilities should be "up-loaded" to the federal government while others are "down-loaded" to the provinces, territories and municipalities and others are co-managed. Only after the responsibilities have been assigned should the question of transfers of tax points be considered. This does not preclude, however, debate over the allocation of revenues sources. There is some rationale that taxation of the most mobile forms of income, such as corporate income, could be at the national level and a harmonized sales tax system around the GST would be vastly superior to the deeply flawed provincial sales tax regimes.

The 2006 Budget does not allow much time for the debate over fiscal arrangements especially considering that the most interested parties either have profoundly different views on what the subject matter is or are just plain confused. The release within the next few weeks of the federal task force report on equalization and territorial funding will demonstrate again how difficult and divisive this important debate will be (see text box on page 9). That report will undoubtedly prove that equalization has been so damaged in recent years that it will be impossible to repair it without offending some interests, including the federal government's (for example, the report is unlikely to support the Conservatives election pledge not to include any royalty revenue in equalization).

The 2006 Budget papers subtly, but correctly shift the parameters for the debate on fiscal arrangements. The next step should be more explicit communication of what the federal government intends to consult on and debate. Otherwise the present state of confusion on the subject will become permanent.

The Work Has Just Begun

Some budget commentators noted that it must have been hard work to put together a budget with so many measures in a few months. But this will likely pale against the work that will be required to fulfill 3 key promises in the Budget. For the 2007 Budget, which could be just 9 months away, the Minister of Finance has undertaken to develop an agenda for a more competitive, productive Canadian economy and a new approach to fiscal (and economic) arrangements. The President of the Treasury Board is to unveil by this fall a new system of expenditure management. These undertakings will prove to be far more difficult that the myriad of tax cuts and spending increases in the budget. But if done well, they will also have a much greater impact on the well-being of Canadians.

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