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TO: *The Next Prime Minister of Canada*

FROM: *The Caledon Institute of Social Policy*

SUBJECT: ***SOCIAL REINVESTMENT***

The case for reinvestment

In our first *Memo to the Next Prime Minister,* issued just prior to the 1993 federal election, the Caledon Institute of Social Policy called for an open, honest and comprehensive review of social programs. We felt then, and still believe today, that Canadians deserve a clear account of what is planned for our social programs. It was time for a change from the previous decade of policy-making by stealth, which profoundly – but silently and, for all intents and purposes, secretly – transformed the very foundation of Canada's social security system.

In contrast to the last dozen years of spending cuts, Ottawa now faces a new and altogether different challenge – what to do with a fiscal surplus. While it may be too early to declare final victory in the war on the deficit, victory is certainly in sight. When the deficit is vanquished in the near future, decisions will have to be made about rising government surpluses. It will not be politically feasible to sustain a policy of using all the surplus to pay down the debt.

In this second *Memo to the Next Prime Minister,* we set out a strategy for social reinvestment. But we want to emphasize that our proposals do *not* represent an attempt to resurrect the past – which was no golden age of social policy. Caledon has argued consistently that Canada's social programs require significant reform to meet changing social, economic and demographic realities.

We also have said time and time again that the deconstruction of much of our social system in the fight against the deficit has been far too painful and will have long-lasting negative effects. Billions of dollars were withdrawn from the social envelope before and after the introduction of the Canada Health and Social Transfer (CHST) in 1995. Equally serious was the loss of the Canada Assistance Plan (CAP) – the legislative base which allowed for the federal cost-sharing of welfare and social services. The war on the deficit was won largely on the backs of social programs; as a result, low-income Canadians have borne the brunt of continued cuts to federal transfers.

Nor should the brightening light at the end of the federal government's fiscal tunnel blind us to the ever-present possibility of another serious recession. To a significant extent, Ottawa has managed to insulate itself from the impact of most recession-driven increases in social spending by rescinding its share of provincial welfare and social service costs and by cinching the belt on Employment Insurance, thereby forcing many unemployed Canadians to turn to welfare. By offloading part of its responsibility for social expenditures onto the provinces, the federal government has given up an important lever of countercyclical policy. When the next recession hits, the provincial and territorial governments – which already have cut back on welfare, in some cases severely – will face the choice of either bearing the full weight of mounting welfare and social service costs or slashing benefits and even denying assistance to some groups. It is not hard to predict the outcome, since cutting welfare is always a much easier choice politically than running deficits or raising taxes.

Ottawa now has a wonderful opportunity to reinvest and rebuild – not the social system of the past, with its myriad faults and blemishes, but a new and better system for the future, geared to the economy and society facing us in the next century. Our advice to you is simple, in principle, although not so easy in execution. It is time to reinvest in making Canada a better place to live for *all* Canadians, in a fair chance for all Canadian children, in healthier, safer communities, and in reducing the growing inequality that threatens to turn our country into two nations – not the traditional *deux nations* of French and English, but the invidious two nations of affluent and poor. It is time to reinvest the peace dividend from the successful war against the deficit and rebuild the social base of our country.

In addition to rebuilding, our *Memo* speaks to the unfinished business that remains in social policy reform – especially with the new Employment Insurance program introduced in 1996, the National Child Benefit System announced in the 1997 Budget, the changes to the Canada Pension Plan made public just days before the last Budget and the Seniors Benefit slated to take effect in 2001. This *Memo* also calls upon the next Prime Minister to redress the regressive impact of various tax changes, some of which were inherited from the Conservatives and some of which have been introduced by the Liberals.

Finally, we want to make clear our support for a strong federal presence in social policy. The rush to devolve, disentangle and dismantle social programs in the name of 'less government is good government' has not been good for Canadians. A strong federal presence is required to reinforce Ottawa's crucial redistributive role and to ensure strategic investment in high-priority areas – such as employment, child poverty and health care.

The carrot-and-stick 'cooperative federalism' of the past, in which the federal government played the dominant role, is no more – ended primarily by Ottawa itself. Thanks mainly to the initiative of the provinces, the ground has been broken over the past year for a new form of cooperative federalism in which the federal government works constructively in equal partnership with the provinces to resolve pressing national problems. The National Child Benefit System announced in the 1997 Budget embodies this form of flexible federalism; it serves as a prototype for similar comprehensive reform which is needed for Employment Insurance and labour market training, income security and supports for persons with disabilities, and the tax system.

The fiscal story

The Liberal government has succeeded in putting the country's fiscal house in order – however controversial the means to accomplish that objective. The erosion of public finance in Canada was exerting continued and increasing pressure to slash social spending. The restoration of public finances is the first step in stopping this cost-cutting. But fiscal restoration is a necessary, not a sufficient condition, for social reform. Having achieved fiscal goals, there is nothing automatic about reconstructing social programs in Canada. Reconstruction will require conscious and deliberate decisions by the next government.

In the 1997 Budget, the whole issue was avoided by the simple expedient of grossly exaggerating the deficit – estimating it at about *triple* the level that it actually will be. A report by Wood Gundy Securities estimates the deficit for the 1997-98 fiscal year at $5.4 billion rather than the $17 billion stated in the Budget. If, in fact, the Wood Gundy study is right, the federal government should be reporting a surplus for 1998-99 – not the $9 billion deficit forecast in the 1997 Budget.

If the 1997 Budget proves to have seriously overestimated the deficit, then the government's fiscal policy is vastly tighter than it should be. Tight fiscal policy, by withdrawing substantial sums of money from the economy, reduces overall demand. Canada's extraordinarily tough fiscal policy has been one of the main reasons for our stubbornly high rate of unemployment.

There is no longer any rationale for such contractionary fiscal policy. There is no reason for the federal government to begin wracking up mounting surpluses. If future Budgets are on average in balance, real growth of even two percent a year will reduce the debt-to-GDP ratio by about 25 percent in ten years. More important, though, continued tight fiscal policy would aggravate persistent high unemployment by dampening any recovery of domestic demand. Tighter fiscal policy would be justified only with an escalating rate of inflation, of which there are no immediate signs.

So there is one clear fiscal message. You must spend money, reduce taxes or both in this term. We certainly are not alone in saying this, but we think the implications of this position have not yet been fully assimilated. The whole *raison d'etre* of the new government must be radically different than previous governments.

It is not going to be easy to change gears. Cutting requires grit and determination, but much of the actual implementation is pretty straightforward. New spending programs, by contrast, have to be properly designed in order to be effective. Implementation must be carefully considered. Most new programs cut across departmental boundaries and will require Ministers to work together. Priorities must be established. Provinces will have to be brought into the loop for many program initiatives. The organization of government decision-making will have to be changed to accommodate these needs. The Department of Finance alone cannot continue to set priorities, design programs and implement them unilaterally under the cloak of Budget secrecy.

In the new fiscal world, one of the first issues you will face is how to draw the line between tax cuts and program spending. We acknowledge that some tax cuts are inevitable. But not all tax cuts are equal. Our advice in considering potential tax cuts can be summarized in three points:

1. Leave ample room for reconstruction of Canada's social fabric. Don't give up all your fiscal room on tax cuts.

2. Implement tax cuts that reduce income inequality rather than amplify the yawning gap in market incomes.

3. Look for innovative tax cuts that stimulate employment.

While we touch on all three points in the remainder of this *Memo,* it is the third topic to which we now turn, as it is undoubtedly the highest priority among most Canadians. How does the country get out of the seemingly inescapable trap of persistent, close to double-digit unemployment?

Employment and the macroeconomy

To reduce unemployment in Canada, we must adopt an explicit pro-employment economic policy. First and foremost, this means a less restrictive fiscal policy. We are not advocating a 'loose' fiscal policy; even with a balanced budget, Canada still will have by far the toughest fiscal policy of the G7 nations.

The deficit in 1997-98 likely will be at least $10 billion smaller than forecast in the 1997 Budget. If those funds had been spent on government-supported employment creation at an average of $50,000 a job (a level which permits construction jobs and other high-paying employment), the result would have been 200,000 more jobs, even before considering any of the spin-off in additional spending and taxes. If, beginning with the next Budget, fiscal policy eases, there will be a consequent increase in employment throughout Canada. We may not see 200,000 jobs immediately, but within the next few years, additional job creation of this magnitude could be expected.

However, fiscal policy is not the only dimension of economic policy that must be pro-employment. Other aspects of macroeconomic policy need to work in tandem. In particular, interest rates need to be lower still. Today, the main threat to low interest rates comes from south of the border – namely, possible increases in US interest rates. Although the US economy has shown remarkably few symptoms of inflation so far, there is a potential threat since the American economy is at historically high levels of capacity utilization.

Your government should engage in immediate discussions with the Bank of Canada, affirming your intention to keep Canadian interest rates independent. If the consequence is accepting a Canadian dollar temporarily trading against the US dollar at lower levels, this is a small price to pay for an independent and pro-employment monetary policy.

If Canadians are confident that interest rates will remain at a stable and low level for the next few years, there will be a large dividend in increased employment. Achieving that confidence will require one major step – forswearing the use of interest rates as a mechanism to control inflation, except in extreme circumstances. Instead, the government should state clearly its intent to use fiscal policy as its primary macroeconomic lever if there is any threat of inflation in the future.

If fiscal policy in the form of higher taxes is deployed to slow down an economy on the verge of inflation, the result is improved government budget balances and reduced after-tax income inequality. On the other hand, if increased interest rates are used to slow down the economy, the result is deteriorating government budgets, higher debt loads for everyone and greater economic inequality (since holders of financial investments will get higher returns as interest rates go up). Equally important, though, a commitment to use fiscal policy rather than interest rates in the event of inflation will permit a period of predictable interest rates.

This proposal may seem radical, but it is only in the last decade that the current vogue of using interest rates as the sole instrument to fight inflation has become an accepted norm. And this norm is already falling out of favour in Europe. In the UK, critics on both the right and the left are urging the new government to raise taxes rather than interest rates in response to early symptoms of inflation. The same rethinking of the balance between fiscal and monetary policy is occurring in other European countries as well.

We do not believe that such tax hikes will be needed here in the next four or five years, because inflation has been so thoroughly squelched in Canada. Nonetheless, just the announcement of a policy to raise taxes if inflation heats up has tremendous importance even if it never needs to be used. As the policy is understood and accepted, it will help lay the groundwork for confidence in a stable economic environment. If such a policy can be divorced from ideological doctrine, it should be welcome both by the left and by businesses that thrive on low, stable interest rates – e.g., the construction industry. This proposal is not only good economics but good politics as well.

Specific employment measures

While a pro-employment economic policy is a crucial foundation, there is also much that can be accomplished through pro-employment programs, including government support for job creation. While such support cannot be a panacea for high unemployment, it is a useful adjunct to pro-

employment economic and labour market training programs.

In periods of high unemployment, government support to build capital projects that bring useful long-term returns to society makes a lot of sense. Investment in physical infrastructure is essential; repairing the physical hardware of communities both creates jobs and sustains local economies by ensuring good systems of water, sewage and transportation.

But the opposite is true as well. During periods of low unemployment, public works plans should be scaled back until the next downturn in the economy. This selective investment not only acts as a counter-cyclical economic measure, but also builds needed public works when construction and land costs are low.

We have a striking example today in the Winnipeg Floodway. Premier Roblin was severely criticized when his government built the Floodway in the 1960s because he had to borrow the money to do so. But it is now abundantly clear that the return on this investment has been huge. We do not need to call on dramatic examples alone. Much of our university, community college and hospital capital was built with borrowed public money (mainly Canada Pension Plan funds). We need only to imagine what the GDP of Canada would have been without these investments to appreciate their substantial returns.

The Liberal government's infrastructure programs have been useful, but they have been put together in a hurry with short-term horizons. There is a huge backlog of public infrastructure projects, especially in the environmental and transportation areas, as well as in health, social services, research and education that would generate substantial payback for future generations. But the planning for these projects cannot be undertaken in the three- or four-month horizon typical of big, national 'job creation' programs. We propose that the federal government, provinces and municipalities get together *now* to design a program, including financial responsibilities, to kick in automatically under defined economic conditions. This program also should initiate the development of a national inventory of 'pre-approved' plans, subject to a careful screening process to ensure adequate rates of return, that could start up quickly when the defined economic conditions occur.

Infrastructure means far more than the physical hardware of communities. There is also valuable social infrastructure in the form of human services such as child care, education and personal care for the elderly and persons with disabilities. Investment in social infrastructure will help create jobs in human services, which have suffered greatly in recent years due to layoffs forced by cutbacks in government funding.

Direct financial support of scientific and biomedical research and development (R&D) fosters the creation of jobs in the high-knowledge, high-wage economy. Direct support of the high-knowledge sector helps create good jobs with a future which, in turn, add value to the economy and make Canada more competitive internationally.

Investment by government in the physical, social and R&D infrastructure of the country is very different from the trickle-down approach to job creation in which tax cuts are claimed to increase consumer spending and thereby stimulate employment growth. The problem with the 'come-what-may' strategy to job growth is that tax breaks can be spent in any number of ways – e.g., on foreign-made consumer goods, paying off debt or more investment in RRSPs. While these may be positive outcomes for the individuals involved, they have little if any impact on unemployment. The trickle-down theory of job creation by tax cuts is suspect: There is neither enough 'trickle' nor enough 'down' to justify the resulting loss in government revenues.

In addition to high unemployment on a national scale, Canada remains vexed by tremendous variations in joblessness among different regions and communities. One response is to reject big regional development programs that have been discredited as ineffective political pork barrels and to focus instead on the 'social economy.' The social economy

includes co-operatives and various forms of activity known as 'community economic development' (CED), referring to locally-controlled efforts in which community members play the primary role in running the business venture. The social economy is a vibrant and promising sector of the economy overall.

Self-employment is a rapidly-growing component of CED. There is a range of activity under way throughout the country to promote small business through various forms of 'micro lending' – the provision of small loans to creditors who usually are considered too high risk by the traditional banks. Most micro credit organizations lack initial investment capital and access to technical assistance. The federal government could provide fmancial support in this area to help kickstart the economy of local communities that have been hit hard by recession, loss of manufacturing jobs as a result of free trade, downsizing of the public sector, and cuts to health and social services.

But while microenterprise and CED can open doors to opportunity, we are also concerned that these can be precarious forms of employment. *The insecure work that may be associated with the social economy and self-employment, and the wide and growing gaps in labour market income, underscore the crucial redistributive role of government through social programs and income taxes.* Government should not use the growing social economy and role of communities as an excuse to weaken its commitment to income security, social services and other crucially important social programs.

It is also be time to begin serious exploration of redistributing existing work. While such redistribution does not create new jobs, it tries at least to apportion existing work more equitably between those working and the underemployed and unemployed.

Another innovative measure is to redesign intelligently the Employment Insurance payroll tax system, rewarding firms that reduce the standard work week, or that otherwise adopt employment-enhancing and socially desirable measures. One idea that has been put forward is to create a category of 'Charter employers' which agree to follow a number of employment- and equity-enhancing measures, such as reducing the work week and bringing in family- and environment-friendly policies. Hiring young people in 'entry level' positions might also be part of the responsibilities of a Charter firm. Charter firms would be entitled to lower Employment Insurance contributions .

In addition to encouraging firms to redistribute work and expand employment opportunities, Canada needs to invest in skills development. In future, most jobs will require some form of post-secondary education. Even many low-skill service jobs are beginning to deploy modern technology and call for increasingly sophisticated skills. While a post-secondary degree is certainly no guarantee of employment in today's high-unemployment economy, it is still a necessary passport without which the chances of gaining a secure foothold in the labour market are slim. Most young people who drop out without finishing high school will be doomed to a life of peripheral, low-paid and insecure employment no matter what the jobless rate. Even if there were a great new demand for workers, less-educated Canadians could not fill that demand. There would be unemployment in the midst of labour shortages. This problem is truly the biggest deficit we are leaving for our children, with enormous costs in everything from lost economic growth to greater social spending, social disintegration and crime.

In the early 1900s, Canada recognized that basic literacy and numeracy were requirements for employment in the 20th century. The result was a concerted effort to provide high-quality, free – indeed compulsory – primary and secondary schooling to every child. The 21st century presents a similar challenge, but not for children. It is now essential to reconstruct our post-secondary system so that virtually all young people obtain some form of high-quality post-secondary education. Otherwise, we will be facing generations of unemployable Canadians.

Education is not a federal responsibility. Nonetheless, education remains a national concern that is

linked intrinsically to future prosperity and fuller employment. Federal programs to provide direct assistance to students are well within Ottawa's jurisdiction. Innovations are possible, such as enhanced funding for direct grants for low- and modest-income workers (including older Canadians who want to upgrade their skills) to pursue post-secondary education. For example, Campaign 2000's creative idea of a federal 'endowment' of $20,000 for lower- and middle-income students is an initiative well within federal jurisdiction which could contribute to increased participation in higher education. Unless we improve our performance in this area, there will continue to be far too many young Canadians entering a lifetime of marginal citizenship.

Employment Insurance

Unemployment Insurance (UI) has been cut several times since the early 1990s. The new Employment Insurance (El) introduced in 1996 scaled back the program even more in three key ways – extending the work time required to qualify, lowering benefits and reducing their maximum duration. The drastically reduced El system, coupled with a changing labour market, have given rise to a serious problem regarding income stabilization. Many Canadians no longer can rely upon El to carry them through until they find a new job if they become unemployed.

The coverage of UI/EI has shrunk substantially in recent years as a result of various belt-tightening changes to the eligibility rules. In 1989, 87 percent of unemployed Canadians received regular UI benefits. By February 1997, UI coverage had plummeted to 50 percent of the unemployed. From Ontario west to BC, fewer than half of jobless Canadians received UI benefits in 1995.

Moreover, the changing labour market has excluded many workers from qualifying for Employment Insurance. The self-employed are not eligible for El. People working on a sporadic basis may not be able to accumulate sufficient working time to qualify – especially with tighter eligibility rules.

The 1996 announcement of a shift from a weeks-based to an hours-based entrance requirement will have conflicting results. El now covers part-time workers who were formerly excluded under the minimum 15-hour work requirement. But extended coverage is more than offset by tougher entrance requirements. The minimum number of hours to qualify for El benefits is 420 and can be as many as 700 if the claimant lives in a region of low unemployment. The result is a 133 percent increase in the minimum length of work required for eligibility – and a dramatic drop in the percentage of unemployed Canadians able to collect benefits. (A recent amendment to the program makes it easier for East Coast fishermen to be eligible for benefits. As of June 1997, they will have to work only 420 hours or earn $2,500 to qualify for El.)

Employment Insurance's 'intensity rule' is a cutback of a different kind. Frequent claimants will have their benefits reduced by a percentage point for every claim. This rule assumes that frequent El use can be minimized by making each successive claim less attractive. But lowering benefits does nothing to alter the most important determinant of repeated El use – the large number of seasonal industries that comprise the Canadian economy.

The El program also significantly reduces and freezes the Maximum Insurable Earnings (MIE) – i.e., the highest level of earnings upon which employer/employee premiums are levied. The MIE was reduced from $42,380 in 1995 to $39,000 in 1996 and frozen at this level until the year 2000; its value will decline steadily because it no longer is indexed to the increase in the average wage. A lower MIE reduces the maximum level of benefits – a loss that falls more heavily on lower-income El recipients. Moreover, it narrows the wage base on which El premiums are collected, requiring a higher premium rate which also falls more heavily in proportionate terms on lower-wage earners.

Coupled with the extension of premium coverage on the first hour of employment, the decision to reduce the MIE and steadily lower its value each year by suspending indexation increa-

singly will shift more of the Employment Insurance premium burden from middle- and high-wage workers to low-wage workers and those in unstable jobs.

A lower MIE also creates an incentive for employers to use overtime rather than hire extra workers because premiums do not apply on hours worked over the MIE. Once an employee is above the MIE, no further premiums are levied. It is cheaper to pay more to existing staff than to hire new staff – precisely the wrong consequence for an El system.

As a result of cumulative cutbacks and some decline in the unemployment rate, the deficit in the UI account was eliminated in 1995. Annual surpluses of $5 billion were accumulated in 1996 and 1997. And the money collected through El premiums is counted as federal government revenue and thus helps reduce the deficit. El premiums are now second only to personal income taxes as a source of federal government revenue; in 1997-98, Ottawa will collect $66.5 billion from personal income tax, $19.3 billion from Employment Insurance premiums, $17.5 billion from the GST and $16.2 billion from corporate income tax. The surplus in the El account for this year and the next two years will reach $19 billion.

We urge your government to use the El fund for the purpose for which it is intended – to protect unemployed workers. We recommend that you employ some of the surplus to restore El coverage by raising the MIE to its former level, fully indexing the MIE and liberalizing eligibility requirements. Once the integrity of the program has been restored, we urge your government to begin gradually lowering the El payroll tax or introducing other innovative and targeted El tax decreases, while still maintaining an adequate surplus.

The El changes took effect at the same time that Ottawa was negotiating labour market agreements to devolve employment programs (El's 'active' employment measures and some federal labour market services) from the federal government to the provinces and territories. Several agreements already have been signed which, in theory, will reduce duplication and fragmentation of services. But if the federal dollars transferred to the provinces under these agreements are restricted to El recipients, many jobless Canadians who need help from some form of employability program will be left out because they do not qualify for El.

It is unlikely that most provinces will have sufficient resources to devote to employment supports for those who do not qualify for El or who fall outside of federally designated groups. Provinces also face increased demand for welfare resulting from tighter El eligibility. At the same time, they have been hit hard by reductions in federal financial support for welfare as a result of the CHST. In theory, the labour market agreements are a positive development because they are intended to encourage more effective program delivery. In practice, serious problems could arise from lack of funds and access to programs.

Unemployment Insurance was a complex program which repeatedly was criticized on the grounds that it tried to accomplish too many objectives under one umbrella. The program has been modified and adjusted countless times in an attempt to meet widely divergent unemployment problems and regional needs. But the newly-introduced El program does not resolve this basic problem.

We urge your government to explore with the provinces a more fundamental restructuring of income and work-related supports for unemployed Canadians. During the Social Security Review, Caledon proposed a comprehensive reform in which the federal government would retain responsibility for a core program of Unemployment Insurance for short-term occasional recipients, thereby returning the program to its original purpose. The provinces could assume responsibility for a new system of Employment Assistance for workers who have exhausted their UI benefits and for employable welfare recipients. The new Employment Assistance program could provide various forms of training and other employment development services, as well as income-tested financial assistance. It could be integrated with labour market programs as the latter are devolved to the provinces.

The devolution of labour market policy to the provinces does not preclude federal involvement in information sharing and coordination. Provincial delivery of programs should take place within the context of national (not federal only) planning. Joint discussions also should explore the financing of the El and our proposed Employment Assistance programs and the role of associated social programs, such as the recently-announced National Child Benefit System.

National Child Benefit System

The CHST withdrew billions of dollars from human services and left in its wake a far less stable social foundation. Caledon has documented extensively our concerns about the fall-out of this arrangement on health, post-secondary education, welfare and social services. The only bright light in recent years was the National Child Benefit System announced in the 1997 federal Budget.

The $850 million that Ottawa has committed to raise and restructure what as of 1988 will be called the Canada Child Tax Benefit – increasing its total spending on the program from $5.1 billion to just under $6 billion – may appear to be a back-door recovery of only a small part of the $8 billion that has been cut from federal transfers to the provinces under CAP. But the changes to federal child benefits announced in the 1997 Budget hold out the promise of a far-reaching and long-sought reform of Canada's social security system – lowering the 'welfare wall' that prevents many families from moving off welfare into the workforce, and putting in place the foundation for a guaranteed income for children.

Ottawa and the provinces and territories are working together to create a National Child Benefit System aimed at strengthening income supports and services for all low-income families with children. By increasing the national base of income support delivered through the Canada Child Tax Benefit, the federal government will free up resources that the provinces/territories currently spend on welfare benefits for children. All provinces and territories, in turn, have agreed to reallocate these savings to help fund their own programs for low-income families with children, such as income-tested child benefits (like the innovative BC Family Bonus), wage supplements, in-kind assistance like pharmacare or dental care, and services such as early childhood education and child care.

While the 1997 federal Budget marked a significant step forward in addressing child poverty, it is only the first step in building a National Child Benefit System. Much work remains to be done by both levels of government, individually and together. More specifically, an effective National Child Benefit System must meet several tests and requirements.

Most important is the fact that additional investments are required over the next few years by both the federal and provincial/territorial governments to reach the estimated $2 billion or more to fund a mature National Child Benefit System that will replace benefits currently paid by welfare in respect of children with equal benefits for *all* low-income children – in the order of $2,500 per child. The 1996 and 1997 federal Budgets made the first installment – $850 million in total. An additional $1 billion at least is required from Ottawa as the second installment on its investment in a National Child Benefit System.

The second, longer-term objective must be to increase child benefits for all low-income families, including those on welfare, to make progress towards the long dreamed of goal of a guaranteed income for children. In future years, additional investments will be required to strengthen the Canada Child Tax Benefit. The federal government not only can afford this investment; *it can't afford not to make this investment.* The human, social and economic costs of child poverty have been amply documented. It is time for action.

Another key objective is to ensure that neither welfare families nor middle-income families lose any income benefits under the new child benefit system. Financing improvements to child benefits by reducing welfare for adults or lowering federal child bene-

fits for middle-income families is unacceptable. To the contrary, future development of the National Child Benefit System should raise the income foundation for all low-income families with children so that those on welfare receive larger child benefits. And both levels of government should fully index their child benefits (both benefits and income thresholds) to protect them from the corrosive effect of inflation.

A National Child Benefit System is only one component of a broader strategy needed to combat poverty in Canada. There must be ongoing federal-provincial work towards a comprehensive 'children's framework;' children's advocates, social groups and experts from outside government should play a key role in this collective effort. While the 1997 Budget announced increases for Health Canada's Community Action Program for Children and the Canada Prenatal Nutrition Program, $100 million over three years is far too modest given the urgency of the requirement. Other supports and services are required, including an investment in high-quality child care.

Child care

Most Canadian parents are now in the labour force. Finding and paying for high-quality child care is one of their biggest concerns. If the lack of adequate and affordable child care is a problem for many couples with children, it is often an insurmountable obstacle for single-parent families – many of which are on welfare only because they have no access to subsidized child care. Single parents need child care to work, or to enroll in the educational upgrading or training they require to improve their employment skills and credentials.

Employers also suffer the consequences of an inadequate supply of quality child care. Parents who worry about their children are often distracted at work and are less productive employees with an above-average rate of absenteeism. The economy as a whole suffers from lost productivity.

But child care is much more than a babysitting service for parents who are working or furthering their education. Good quality child care promotes the physical, intellectual, social and emotional development of young children and can supplement the care provided at home. The need for high-quality, affordable care has been documented in countless reports over many years.

Despite its recognized importance, child care has been noticeably absent from the public agenda in recent years. Moreover, the impact of the CHST upon child care is particularly severe. Licensed child care spaces are being lost in response to the substantial decline in federal transfers. Child care also was hurt by the dismantling of the Canada Assistance Plan; under certain CAP provisions, Ottawa could share only in the cost of nonprofit social services. This condition was crucial for child care, in particular, because of the strong documented links between nonprofit delivery and high-quality care.

We recognize that the federal government can no longer use conditional grants offered to the provinces to establish a national child care system. The federal government has said that it will not use its spending power in areas of provincial jurisdiction without approval of the majority of provinces. However, if Ottawa made a substantial sum available for building an affordable supply of high-quality child care throughout the country, we believe that agreement from most provinces could be obtained. The current federal approach to child care – providing tax breaks for receipted expenses and child care vouchers for those enrolled in employability training – does nothing to build a solid child care infrastructure across Canada.

Seniors Benefit

The 1996 federal Budget introduced a new Seniors Benefit which will combine Old Age Security and the Guaranteed Income Supplement as well as the age and pension income tax credits into a single, geared-to-family-income program. Caledon supports the Seniors Benefit – having proposed and

advocated such a reform since 1993. A firm and fair foundation of elderly benefits is necessary for Canada's retirement income system. It must be able to withstand the growing demands that will result from the combination of population aging, the lack of private pension coverage for most workers and the insecurelabour market. In future, increasing numbers of Canadians will rely upon the Seniors Benefit and the Canada/Quebec Pension Plan for most or all of their retirement income.

The proposed Seniors Benefit will improve benefits by a small amount ($120 a year) for all poor seniors and many modest-income seniors. Elderly households with incomes less than $40,000 – just over the average income for senior couples and twice the average income of single seniors – will get either more or the same as they do now. Nine in 10 single elderly women will get more. Only Canadians with above-average incomes will experience a loss or elimination of their elderly benefits.

The Seniors Benefit, predictably, has attracted criticism. Some critics allege that the new program will cut benefits for middle-income elderly people. Some view the $120 increase in benefits for the elderly poor as paltry, leaving poor single seniors in particular with incomes far below the poverty line. Others disagree with the decision to use family income as the basis for the Seniors Benefit, arguing that pensions belong to individuals and that women in upper-income couples whose husbands deny them access to the family income will be penalized since they will lose their pensions – their sole source of independent income. Yet another criticism is that the Seniors Benefit will substantially increase the marginal tax rate on middle-income seniors and thus will penalize the thrifty and discourage savings in RRSPs.

We find some of these arguments to be exaggerated and misrepresented. They typically misunderstand the design of both the current and new systems – especially regarding the role of the Seniors Benefit in the overall retirement income system. Moreover, the critics often fail to compare elderly benefits before and after reform, which is essential to assessing the impact of the new system.

Nonetheless, the Seniors Benefit is a major change in social policy and should be tested by its critics and defended by its supporters. It is not too late to make modifications to what we think is a sound basic design; the legislation has yet to appear in the House of Commons and the Seniors Benefit does not take effect until 2001.

The issue of the Seniors Benefit's impact on marginal tax rates, in particular, merits further study and careful consideration of alternatives. One option is to ease the proposed 20 percent reduction rate, whereby the Seniors Benefit will be reduced for 20 cents on every dollar of net income above $25,921. In our original proposal for a new elderly benefits system, presented before the Seniors Benefit was announced, Caledon suggested a 12.5 percent reduction rate for benefits above $25,921. The next government should seriously consider lowering the proposed reduction rate to soften the impact of the new Seniors Benefit on upper-middle-income seniors.

Another way to address the problem of high marginal tax rates is to add another tax bracket between the first and second tax brackets (17 percent and 26 percent of taxable income, respectively) in the current income tax system. This option is discussed more fully below under the section on 'taxation.'

CPP reform

Caledon strongly supports the Canada Pension Plan (CPP) because of its unique protections and the critical role it plays in providing retirement income for low- and middle-income Canadians. In fact, the Canada Pension Plan is more important than ever because of the country's increasingly insecure labour market and the failure to extend private pension and RRSP coverage beyond a minority of Canadians, mainly in the upper-income range.

With all the fanfare about problems with the CPP, its strengths have been largely forgotten. The Canada Pension Plan, and its counterpart the Quebec Pension Plan, offer a number of features which outclass private pension plans and are

especially beneficial to women in particular and workers with below-average earnings in general – most of whom work for employers who do not offer private pension plans and cannot afford to put much, if anything, into RRSPs. The C/QPP's importance has grown over the years as more women have joined the paid labour force.

The C/QPP covers every employee and every self-employed Canadian for every job – part-time or full-time, for any size and type of employer, in every part of the country – throughout her or his years in the labour force. The C/QPP allows a portion of years of low or no earnings (e.g., due to unemployment, disability, school attendance), as well as time spent raising children under age 7, to be excluded from the calculation of average lifetime earnings used to determine the level of benefits. It is a defined benefit pension plan, assuring a retirement benefit calculated as a percentage of average lifetime earnings. The C/QPP provides for equal division of pension benefits between spouses at death, retirement or divorce, and actuarially adjusted pensions as early as 60 and as late as 70.

The C/QPP offers important benefits in addition to retirement, including survivor, death, orphans and children's benefits. It also provides income protection in the event of a severe and prolonged disability that interferes with an individual's capacity to perform any substantially gainful occupation. The C/QPP is the only pension plan that affords this protection regardless of the medical history of the contributor.

Just days prior to the 1997 Budget, the Finance Minister announced changes to the CPP that resulted from a national consultation and negotiations carried out by Ottawa and the provinces. Various options had been proposed in an *Information Paper for Consultations on the Canada Pension Plan.*

Caledon supports the major change made in this round of reform – the move from pay-go to partial funding by increasing the total contribution rate from 5.6 percent of contributory earnings in 1996 to achieve a 'steady state' rate of 9.9 percent for 2003 and beyond. Partial funding promises to help restore public confidence in the CPP. It will help ease the perception of intergenerational unfairness and should reduce the long-term burden of CPP contributions – a special advantage to Canadians with average earnings or below.

But there also will be some troubling, though generally unrecognized, fall-out from this financing change. The rapid rise in contributions between 1997 and 2003 will hit hardest in relative terms contributors below the Year's Maximum Pensionable Earnings (YMPE), which is $35,800 in 1997. The decision to freeze the Year's Basic Exemption (YBE) – the earnings level below which no contributions to the Plan are made – will only exacerbate the regressivity problem. The real level of the Year's Basic Exemption will decline steadily every year, thereby shifting the burden of contributions that eventually will weigh heaviest on Canadians with the lowest earnings.

The federal and provincial governments also put forward for public discussion a number of options to reduce CPP benefits. While the announced benefit reductions are smaller than feared, their impact is still regressive. For example, new retirement pensions and the earnings-related portion of the disability and survivor benefits will be based on the average of the last five years' YMPE instead of the last three years. The death benefit has been cut back to a maximum $2,500 and frozen at that level so that it will shrink in value over time – a regressive (and miserly) way to save money. These changes will result in benefit losses that will hit low-income earners hardest.

As in the case of retirement benefits, disability benefits will move to a five-year-YMPE-average rule, resulting in a drop in the value of benefits. It will be more difficult to qualify because workers now must contribute to the CPP for four of six years to be eligible for disability benefits (changed from the current two of three years or five of ten). Retirement pensions for disability beneficiaries will be reduced by changing the method of calculation. Their pensions now will be based on the YMPE at the *time of disablement* (regardless of when this occurred) and subsequent price indexing.

Caledon is studying ways to deal with the regressive impact of the move to partial funding and urges governments to do the same. One solution is to redesign the tax credit for CPP contributions into an income-tested benefit that provides greater tax relief for lower-income contributors. Another option put forward in a Quebec discussion paper is a 'progressive Year's Basic Exemption' which would decline as earnings rise; while intriguing, unfortunately this change would increase the burden of contributions on lower-wage workers as well.

Despite the announced changes, CPP reform is far from complete. Other issues identified in the *Information Paper for Consultations on the Canada Pension Plan* are still 'on the table' – e.g., partial pensions, survivor benefits, credit splitting, the possibility of raising the YMPE, and the stacking of pensions and El benefits. We urge the next government to assess any proposed reforms against a regressivity benchmark test. Their impact should never be hardest on low- and modest-income workers who need the program most.

Medicare

The basic principle of medicare is that all Canadians should have access to necessary health services based only on their medical needs, not on their financial circumstances. When medicare was created a generation ago, hospitals and doctors were far and away the most important types of medical attention that people needed. But medical techniques are changing rapidly. Today, drugs and care in the home are becoming increasingly impor-tant to medical treatment. If we want to preserve the basic principles of medicare, drugs and home care will have to become part of the health care system – fully covered for everyone – as recommended by the National Forum on Health.

Implementing this recommendation will require a substantial shift from private spending to public spending, accomplished through some form of taxation. Overall, Canadians will be better off, despite the increase in taxes. They will have more secure and equal access to a fuller range of necessary health services. Moreover, the total cost should be reduced somewhat as government makes use of its new market power to obtain better deals on drugs.

Insuring drugs and home care also makes good economic sense. Health benefit expenses in the private sector are escalating. Employers should welcome the mtroduction of expanded medicare coverage. Medicare is already important for Canadian exporting industries in reducing their costs compared to the US. Coverage of drugs and home care will give firms in the tradeable goods sector a further advantage over their American competitors.

As with education, health services are a provincial responsibility. There is no simple way for Ottawa to set up a national initiative to cover drugs and home care under medicare. The provinces likely would be skeptical of conditional grants m this high-cost area, given the recent cuts in federal medicare funding. One avenue that might be explored is direct federal payments to individuals, rather than to provinces. Whether through this means or another approach, we believe that a serious discussion with the provinces, health experts and consumer groups could result in innovative mechanisms for a federal initiative to include drugs and home care m medicare.

Of course, the main reason for provincial skepticism about federal cost-sharing for innovations in medicare is the deep cuts in federal funding under the CHST. Cash payments under the CHST are scheduled to drop from $12.5 billion in the 1997-98 fiscal year to $11.8 in 1998-99 and $11.1 billion m 1999-2000. The National Forum on Health recommended freezing CHST cash payments to the provinces at the 1997-98 level. The Liberal government has responded to this suggestion, proposing that the cash floor under the CHST remain at its 1997-98 level of $12.5 billion and not be reduced as originally scheduled.

We support the proposed floor of $12.5 billion in cash transfers to the provinces under the CHST.

Moreover, federal cash transfers should be indexed. Medicare m Canada cannot be protected and reformed unless there are sufficient funds to ensure the availability and delivery of high-quality services throughout the country. There can be no comprehensive, accessible health care with funds continually bleeding out of the system.

We also have contended that it is not possible to enforce the conditions of the Canada Health Act without the presence of substantial federal *cash* m the system, a point made as well by the National Forum on Health. We emphasize cash because additional investment in the system in the form of increased tax points has no enforcement clout at all. The federal presence in medicare is exercised by its ability to withhold funds in the event of a province contravening the conditions of medicare. There is no way to enforce national conditions in medicare if the federal government pays no cash transfers. Provinces cannot be held accountable for promises over the long term because one legislature cannot bind a future legislature. In other words, should the federal government hand over its cash in the form of tax points to the provinces in exchange for commitments to maintain national principles, the commitment will last only until the next provincial Premier is elected.

We acknowledge that there is no guarantee that provinces will spend their CHST entitlement on health care. But they would be hard-pressed not to – given the growing demands on the system and the reality that health care is the one area in which almost all Canadians support increased expenditure.

The next government also should resolve the unfair distribution of the CHST among the provinces. When the CHST was introduced, provincial entitlements were to be allocated in the same proportion as under the former Established Programs Financing and Canada Assistance Plan. The financing of these arrangements was fraught with difficulties which led to serious inequities among the provinces; we see little merit in perpetuating this irrational distribution.

Persons with disabilities

Caledon has written extensively about the negative impact of the CHST upon persons with disabilities. The now-defunct Canada Assistance Plan contributed to the cost of attendant services that help people with disabilities live independently by assisting them with the activities of daily living – eating, bathing, dressing and grooming. CAP shared the cost of medically-prescribed diets and medical supplies for certain individuals. It also paid for wheelchairs, special eyeglasses and prosthetic appliances for people unable to purchase this disability-related equipment. It shared the cost of respite services – i.e., occasional relief for parents caring at home for children with severe disabilities.

The lack of available supports forces many people with disabilities to go on welfare and declare themselves unemployable in order to gain access to the help they require. Often the supports that individuals need to live independently or to participate in the labour market simply do not exist. As a result, many Canadians with disabilities must rely on various income programs.

Eligibility for most income programs is determined by the nature, type and degree of disability rather than the need for income assistance. The problems in the disability income 'system' have been recognized in a long string of reports produced over the past 15 years – the most recent being the 1996 report of the federal Task Force on Disability Issues. But there have been some positive developments on the provincial front. In their 1996 *Report of the Ministerial Council on Social Policy Reform and Renewal,* the provinces stated their interest in discussing the possibility of a newly-structured income benefit for persons with long-term, severe disabilities, though they did not advocate any particular design.

Caledon believes that such a system should operate along the same lines as the new National Child Benefit System. The federal government

would assume responsibility for the income component of the program, effectively removing persons with long-term, severe disabilities from welfare. The provinces would reallocate funds currently spent on welfare benefits for persons with disabilities towards a range of personal supports. The proposed benefit likely would leave intact certain major income programs for persons with disabilities, such as provincial workers' compensation and automobile insurance.

A federal benefit for persons with severe disabilities would not be stigmatizing, unlike welfare. Benefits could be paid on the basis of a simple and anonymous income test, like the Child Tax Benefit and the refundable GST credit, not the complex and intrusive needs test used by welfare to scrutinize applicants' assets, needs and individual circumstances. Moreover, such a program would ensure portability and consistency throughout the country, unlike welfare. The fact that the benefit would be available at the same rate throughout Canada would promote equity and make it easier for beneficiaries and their families to relocate if necessary. Naturally, difficulties could arise around the definition of disability and who would qualify for the new benefit. However, a concerted effort by Ottawa and the provinces could resolve these issues.

A new income benefit would not replace federal investment in personal and work-related supports. Canadians with disabilities must continue to have access to these supports – through tax-related measures or through special initiatives, such as a fund for personal supports similar to the home care investment that the current government is now considering. There are also several steps that can be taken in the short term to remove work disincentives from existing income programs and to support labour force participation, such as the possibility of partial CPP disability benefits.

Taxation

The Liberals inherited and retained the Tories' stealthy and regressive changes to the tax system. The personal income tax system was partially indexed; tax brackets (the bands of income subject to increasing rates of taxation) and credits (e.g., the personal, married, age and disability credits) no longer are adjusted each year to keep pace with inflation. Instead, tax brackets and credits are adjusted only by the amount of inflation over three percent a year.

Partial indexation results in a steady decline in the level of tax brackets and the value of credits. If inflation runs more than three percent, then tax brackets and credits decline in value by three percent. But even if inflation is less than three percent, tax brackets and credits fall in value by the rate of inflation (e.g., if inflation is two percent, they lose two percent in value).

Partial indexation of the personal income tax system harnesses the power of inflation to impose hidden and regressive income tax increases on taxpayers. Some taxpayers suffer from 'bracket creep'; although their income remains the same from one year to another, they move into a higher tax bracket because the latter falls steadily in value. All taxpayers are hit by hidden tax increases caused by eroding credits, which increase their taxable income year after year.

Partial indexation results in a steady decline in the taxpaying threshold – i.e., the income level above which taxfilers owe income tax – and adds more and more working poor Canadians to the tax rolls each year. The federal taxpaying threshold for a single person under age 65 has fallen from earnings of $10,167 in 1980 to $6,753 in 1997. Provincial income taxes, which are based on the federal system (with the exception of Quebec which operates its own income tax system), also increase as a result of partial indexation. Certain provinces offer tax relief to some low-income taxpayers, though, of course, only for provincial income tax.

Partial indexation also weakens the refundable GST credit for low-income Canadians. The GST is a highly regressive tax, since every consumer pays the same amount of GST on an item regardless of income. The Conservative government recognized this problem and included with the GST a refund-

able credit which reduces, though does not remove, the burden of the tax on poor families and individuals.

Unfortunately, the Tories built the GST in the form of a Trojan horse – partial indexation of both the credits and the family income threshold for maximum benefits. With each passing year, the value of the GST credit declines in the same way as the value of income tax brackets and credits – by three percent if inflation is more than three percent or by the rate of inflation if the latter is less than three percent.

To make matters worse, the income threshold for the maximum GST credit also falls steadily each year, which reduces the number of poor people eligible for maximum tax relief. As the value of the refundable GST credit erodes and the number of low-income people eligible for the maximum credit decreases, the burden of the GST automatically increases for poor Canadians – the only group that faces a GST increase each year, and the group least able to afford it.

Partial indexation of the personal income tax system allows the federal and provincial governments to stealthily impose income tax increases that affect all taxpayers, the poor included. But at least partial indexation of the income tax system affects all taxpayers. Partial indexation of the GST credit saves Ottawa money on the backs of the poor alone.

One way to redress the rising tax burden is to re-index the personal income tax system. But such a proposal would not go very far. The revenue gains to governments from partial indexation of the personal income tax system are so significant that any suggestion to return to the pre-1973 era of full indexation doubtless would fall on deaf and amused ears at the Department of Finance.

Another option is to index the personal income tax system on inflation *below* three percent but not allow indexation for inflation *above* three percent – i.e., there would be a three percent ceiling on indexation of income tax brackets and credits. Placing such a ceiling on indexation of the personal income tax system is a good way to stem inflationary pressures; it acts as an automatic fiscal stabilizer in the economy by withdrawing large amounts of spending power from consumers if inflation rises above the ceiling. Reining in inflationary pressures through a reduction in overall demand (explained earlier) is preferable to using monetary policy which depresses the overall economy through higher interest rates.

A cheaper alternative would be to stem the rising income tax burden on low-income Canadians only, by creating a fully-indexed low income tax credit. This reform would target tax relief to those least able to bear the annual hidden income tax hikes imposed by inflation. It would remove one of several disincentives that discourage people from moving off welfare into the workforce – the fact that they have to pay income taxes on very low earnings. It would improve the disposable incomes of the working poor, who struggle to get by on incomes made even lower by income and payroll taxes.

The solution to the problem of partial indexation of the GST credit is straightforward: Fully index the credit and its family income threshold. At the same time, the credit and threshold should be adjusted upwards to make up for ground lost to inflation since 1991.

We urge you to work with the provinces to consider the feasibility of an integrated tax credit which could cover federal and provincial income taxes, the GST and provincial sales taxes. Such a common tax credit would replace the hodgepodge of tax reductions and credits offered by some provinces, though the new tax credit could be tailored to take into account differences in provincial tax systems.

Your government also should consider the possibility of broader tax reform. You might begin by examining various non-refundable tax credits deemed to have a ‘social purpose’ (e.g., the disability tax credit; the tuition expenses tax credit) to determine the feasibility of turning them into refundable credits. The costly and regressive tax deductions for contributions to RRSPs and Registered Pension Plans also could be converted into credits.

You should explore the possibility of adding another tax bracket between the 17 and 26 percent levels – possibly at 21 percent of taxable income. This change would help reduce the income tax burden on low- and modest-income households and would lessen the impact on marginal tax rates of income-tested programs, such as the new Seniors Benefit.

Conclusion

Caledon has proposed an ambitious agenda for social reinvestment to improve the economic and social well-being of all Canadians. There may never be a better time.

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