CALEDON INSTITUTE OF SOCIAL POLICY

Presentation to the Finance Committee Pre-Budget Consultation

by

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Guiding Principles

Thank you for the invitation to participate in this pre-Budget consultation on the fiscal surplus. Because of time limitations, we would like to take this opportunity to put forward key *principles* that we believe should guide the use of the fiscal surplus.

If time permits, we will follow this discussion of principles with several specific proposals, which provide more concrete advice to the government. Caledon has, over the years, put forward many options for improving economic and social well-being that are described at length in various reports posted to our website. For the purposes of this pre-Budget consultation, however, we have prioritized our proposals into several key areas.

The ultimate decisions about expenditure of the surplus and associated investments should be guided by a clear set of principles. These include *transparency, balance* and *purpose*.

First, we have long criticized policy-making by stealth and called for *transparency* with respect to public finances in general and the surplus in particular. In an influential recent commentary (*Ottawa's Annual Fiscal Follies*) and an op ed in the *Globe and Mail*, Caledon identified the problem of consistent under-forecasting and called for the creation of a Parliamentary Budget Office to provide independent fiscal projections to Parliament and to the public. It is only through transparency that it is possible to ensure there is reasonable debate with respect to public finances.

The second guiding principle is *balance*. It refers to relative expenditure on spending, tax reduction and debt reduction.

Over the years, Caledon has argued consistently in favour of balanced budgets, and against creating a surplus that is then used to 'pay down the debt.' We have analyzed the incremental reduction in federal government debt as a percentage of GDP resulting from paying down part of the debt and have found it has little impact. With firm federal fiscal discipline and a reasonably healthy economy, Ottawa's debt as a percentage of GDP will decline steadily without additional debt repayments from government.

Ottawa paid down a total of $52.2 billion on the debt between 1997-98 and 2002-03; the debt burden declined from 63.5 percent of GDP to 44.2 percent of GDP during that period. But if that $52.2 billion instead had been used for additional spending and/or tax reduction, the debt still would have fallen considerably to about 48 percent of GDP in 2002-03, all else being equal – only four fewer percentage points higher than with the debt repayments.

Spending billions of dollars on the debt to achieve marginal gains in the debt-to-GDP ratio is a diversion of money that is desperately needed right now to build a strong new system of social programs for Canada. But social security reform must be comprehensive, using the twin instruments of direct program spending and tax expenditures.

We would therefore split the surplus between spending and tax reduction. The principle of balance refers to the fact that we would allocate the surplus towards a combination of spending and tax relief – not necessarily on a rigidly formulaic 50-50 basis, but with at least 50 percent allocated towards program investment.

Purpose is the third principle that should direct the use of the surplus. Our policy proposals are guided by the objectives we seek to achieve. These include: reducing poverty and gross inequalities of opportunity and outcome, ensuring the healthy development of children, and enhancing self-sufficiency by investing in human and community capital formation.

To realize these objectives, Canada needs a strong and effective social security system. Our social programs were built largely during and for another time; now they are struggling to cope with profound changes resulting from powerful economic social, demographic and political forces. During its 12 years of existence, Caledon has worked tirelessly to help design and build a strong social security system for the 21st century – to create a new 'architecture of social policy.'

In making a determination between relative spending on programs or on taxes, we have asked ourselves many questions about the best ways to meet our identified goals. Certain objectives are best attained, we believe, through program expenditure while others are better achieved through reduced taxes. On the tax reduction side of the equation, in particular, two guiding principles have helped shape our work: *targeting* and *direction*.

Our emphasis on *targeting* stems from the fact that across-the-board tax cuts are expensive and blunt measures that reduce the revenues required to rebuild Canada's social security and health system. The federal government already has made substantial broad-based tax reductions that, while partly making up for past overt and covert tax hikes, are regressive in dollar terms. More of the same – tax breaks that deliver their largest benefit to well-off Canadians – would be a poor policy choice. We propose instead that further tax cuts focus on the urgent needs of low- and modest-income Canadians. Specific options are presented below.

The principle of *direction* means, in our view, that tax policy should be used for promoting environmental objectives as well as for supporting social and economic goals. Here we refer to tax incentives for clean production and the purchase of environmentally friendly products. Again, these are a form of targeted tax reduction measure intended for an explicit purpose.

With these principles as a foundation, we turn now to several specific proposals for achieving a balanced approach to spending and tax cuts.

Spending Proposals

There are countless possibilities for increased spending. We have written in the past about income security, children's services, home care, affordable housing, disability supports, skills and learning, social infrastructure for cities, investments in culture and recreation, social economy initiatives and federal/provincial transfers.

For the purpose of this pre-Budget consultation, we have prioritized this long list and have selected three key areas for increased spending: child benefits, early childhood development, and home and community supports, including assistance for caregivers.

a. Child Benefits

Child benefits are a proven and powerful instrument in tackling poverty. The introduction of the National Child Benefit in 1997, with its substantial multi-year increase in the federal Canada Child Tax Benefit, was a major advance in reducing child poverty. The Canada Child Tax Benefit at its present level cuts the incidence of poverty among families with children by one-quarter. The ongoing rate increases through 2007 reaffirmed in the 2004 federal Budget will stiffen the program's anti-poverty punch in future.

The National Child Benefit is more than an anti-poverty initiative. It is also helping to reconstruct Canada's income security system. The National Child Benefit takes a big step forward in reforming not only federal child benefits, but also the social assistance (welfare) programs operated by the provincial and territorial governments.

The first stage of the National Child Benefit reform is creating an *integrated system* of geared-to-income child benefits that replaces the previous irrational and uncoordinated collection of federal and provincial/territorial child benefits. This first stage of reform is close to completion thanks in large part to scheduled increases in the federal Canada Child Tax Benefit and unscheduled enhancements that accelerated the rate of progress.

The maximum annual Canada Child Tax Benefit for a family's first child rose from $1,625 in July 1998 to $2,719 in July 2004 and will reach a projected $3,243 in July 2007. Spending on federal child benefits will have increased in real terms (expressed in constant 2004 dollars) from $6.1 billion in 1997 to $9.6 billion in 2007 – a sizeable hike of $3.5 billion or 56.7 percent. The investments in the Canada Child Tax Benefit much more than make up for reductions in expenditures on federal child benefits in the 1980s and early 1990s: By 2007, Ottawa will be spending $9.6 billion in constant 2004 dollars, which comes to $2.5 billion or 35.0 percent more than its 1984 expenditure of $6.8 billion on child benefit programs.

But the reform of child benefits is only halfway achieved.

Caledon has proposed that Ottawa launch a second stage of reform towards an *adequate child benefit* that gradually expands the Canada Child Tax Benefit to achieve by 2010 the ultimate target of about a $4,600 (in 2004 dollars) maximum payment per child for low-income families. That $4,600 figure is a rough approximation of the cost of raising a child for a family at a standard of living above the poverty level, which we see as the foundation for an adequate child benefit and a strong income security system for Canadians families with children. Caledon soon will release a report proposing a methodology for calculating an adequate child benefit.

The initial phase of the federal-provincial/territorial National Child Benefit reform focused on rationalizing child benefits for low-income families, which makes both fiscal and policy sense. Because the first stage of reform will have removed child benefits from welfare for many provinces, further increases to the Canada Child Tax Benefit in the second stage of reform should benefit most welfare families as well as the working poor.

But additional improvements to the Canada Child Tax Benefit should not be restricted to low-income families. Such a strategy would further widen the child benefits gap between poor and non-poor families (the latter suffered losses during the reforms prior to the creation of the Canada Child Tax Benefit), including modest-income families that are above the poverty line but below average income.

The second stage of reform also should improve child benefits for non-poor families. Benefit enhancements towards the goal of a $4,600 maximum payment per child for low-income families should gradually be extended up the income ladder to improve payments to modest-income and middle-income families as well. Increases to the Canada Child Tax Benefit should, like the program itself, be geared to family income – i.e., the largest increases should go to low-income families, followed by modest-income and then middle-income families.

While there are some who might view a $4,600 child benefit as unattainable, research undertaken by the Caledon Institute has shown that the UK government is already paying more than this level of benefits to its low-income families. The UK has committed to firm goals for reducing child poverty and has already met its first goal of reducing child poverty by one-quarter by 2004. It is well on its way to meeting its second goal of reducing child poverty by one-half by 2010. If the UK can do it, so can Canada.

b. Early Childhood Development

Opportunities are created, or denied, in children's critical early years when their development is forged along multiple dimensions – physical, emotional, social, linguistic and intellectual – that significantly shape their destiny as adults. A strong system of early childhood development services for families – including child care and early childhood learning, pregnancy and early parenting services, and parenting and community supports – makes both economic and social sense.

Early childhood development has been shown to improve children's subsequent performance in school, lessen the learning risks linked to low income and enhance parents' childrearing and coping skills. And early childhood development is not just for families whose parents are in the workforce: Such services also can help families that care for their children at home.

While child care is only one among several components of early childhood development services, it is a crucial element. The large majority of Canadian families, including those with preschool children, have both parents in the workforce. Most single parents also work. Child care is necessary if parents are to work or train. Child care is essential for poor families struggling to climb the welfare wall and find and keep jobs.

Unfortunately, Canada's early childhood development services are deficient in supply, affordability and quality control, as a recent OECD report confirmed. Services are uneven between and, in most cases, within provinces and territories: There is nothing approaching a national system. Most families rely on unregulated child care bought or traded on the market (typically from neighbourhood providers) or provided by relatives.

The federal government has made clear its commitment in the most recent Throne Speech to increase substantially its financial contribution to child care and early education, building upon a series of financial commitments made in recent Budgets that total a cumulative $4.6 billion from 2000-01 through 2007-08: Another $5 billion over five years is expected. In return for its larger financial investment, the federal government should negotiate bilateral agreements with each province and territory so that strategic investments can be made towards planning and building a comprehensive child care and early childhood development system in accordance with guiding national principles. These include comprehensiveness, universality, accessibility, quality and accountability.

These bilateral agreements should be, in essence, detailed plans to create over several years an early childhood development system, respecting the individual jurisdiction's priorities but guided by and respecting the broad national principles. These agreements should be subject to public consultation and input *before* they are signed. If a province or territory does not wish to develop such a plan at this time it need not do so, but Ottawa should then set aside the financing that would have gone to that jurisdiction for 'safekeeping' so that the funds will be available when and if it decides to proceed and establish a plan consistent with national priorities. Ottawa should not feel compelled to enter into loose agreements that hand out funds ostensibly for child care, but that have no substantive and lasting impact on the availability and quality of child care.

Objectives and exemplary practices should be developed and operationalized jointly by both levels of government, and innovations and lessons learned should be shared widely throughout the early childhood community. Immediate priority should be placed upon expanding the supply of licensed child care spaces.

c. Home and Community Supports

Caledon has called over the years for an investment in personal supports for care at home and independent living. At times, we have referred to an investment in 'disability supports' in recognition of the fact that they are essential for persons with disabilities. But sometimes we use the term 'personal supports' to acknowledge that most Canadians will require some form of assistance as they age. Personal supports refer to a range of goods and services – technical aids and equipment, home care, homemaker services and attendant care – that help mitigate the effects of a functional limitation. These supports help individuals live at home and participate in the community.

Many Canadians with disabilities who require assistance to live independently or who want to participate in education, training or the labour market are unable to do so because they have limited access to these supports. Forty-four percent of persons with disabilities are not in the paid labour force; they cite barriers and other disincentives, such as lack of supports, as the reason. One-quarter of Canadians with disabilities on income support programs, such as social assistance, point to loss of supports as a reason for not looking for work.

There are several ways to invest in the supply of home and community supports. One possibility is to craft a federal-provincial/territorial agreement based on national principles along the lines already in place for medicare and being negotiated for early childhood education and child care. The federal, provincial and territorial governments already invest in a wide range of personal supports.

A home and community supports fund would help generate new and continued investment over a sustained period of time in the provision of a range of personal supports. The federal investment could lever similar provincial/territorial contributions derived from a combination of sources: provincial/territorial revenues, municipalities, community funds and geared-to-income fees.

Alternatively, the federal government could include discussions of the wide range of home and community supports in negotiations with provinces and territories over home care. Even though home care dollars have increased in recent years, the slice of funding for supports at home and in the community is miniscule relative to the overall health care pie.

An investment in these supports not only would relieve the burden on the health care system. It would help de-link home supports from income programs so that there is no need to remain on these programs in order to receive these crucial supports. Welfare recipients have access to these essential goods and services; the working poor generally do not.

But these measures focus upon the individuals who require the supports. There is precious little assistance for informal caregivers who provide 85 to 90 percent of care at home. A home supports initiative should include funds for respite or reprieve from caregiving responsibilities.

Reprieve can derive from a number of possible interventions delivered within or outside the home, such as temporary breaks, personal emergency systems, information on care receiver needs, adult day care for the care receiver, housekeeping, outdoor home maintenance, counselling and peer support. Even being able to work in paid employment a few hours or days a week is a form of relief for some caregivers who may worry about their financial circumstances or the security of their jobs.

Respite is not simply a service to caregivers, it should be understood more appropriately as an *outcome* for caregivers. We believe that support for caregivers is best provided through program rather than tax expenditure, which we discuss below.

Tax Reductions

On the tax reduction side of the equation, we propose that future tax cuts be targeted towards low- and modest-income Canadians. The principle of targeting leads us to select specific reductions that are consistent with our identified objectives: reducing poverty and inequality of opportunity and outcome, ensuring healthy child development, and enhancing self-sufficiency by investing in human and community capital formation.

There are several areas that could be considered in respect of these objectives that involve possible changes to income taxes, payroll taxes and the GST credit.

Low-income Canadians have benefited from both targeted and general income tax reductions in recent years. Moreover, improvements in child benefits have raised the taxpaying threshold for families with children. But single people still begin to pay federal income tax way down the income ladder – a mere $8,430 in earnings during the 2004 taxation year, which is just over half the poverty line ($16,347 for a single person living in a metropolitan area of 500,000 or larger).

Ottawa could follow its own example and reinstate a version of the low income supplement put in place in 1998 to ease the income tax burden on lower-income Canadians. This targeted tax break raised the basic personal amount, spousal amount and spousal equivalent amount by a relatively modest $500, though with considerable impact: Some 400,000 low-income Canadians were removed from the federal tax rolls and income taxes reduced for another 4.6 million lower-income taxpayers.

Ottawa also could consider reviving the old employment expense deduction, though this time in the form of a geared-to-income tax credit targeted to the working poor and modest-income earners. The purpose of this measure would be to help lower-wage earners with the cost of employment-related expenses, such as clothing and transportation.

We were pleased to see the announcement in the last federal Budget of a disability supports deduction, which drew from the work of the Technical Advisory Committee on Disability Tax Measures. The disability supports deduction is an important new building block in Canada's social policy architecture. It expands the range of education and employment items that currently may be claimed as medical expenses. As a result of the measure, persons with disabilities who are attending school or working will benefit through lower income taxes and higher disposable incomes.

Finally, in respect of the self-sufficiency objective, the federal government might consider enhancing the tuition and the education amount for postsecondary education. We struggled with this proposal because an investment in higher education is probably better directed towards postsecondary educational institutions and helping them to reduce their costs.

The problem is that Ottawa has no control over how its transfers to the provinces/territories are spent in postsecondary education, and it would be impossible to ensure that the funds went for the intended purposes. Rather than putting more money into university research, which the federal government typically does as a direct Ottawa-to-university contribution, we feel that it would be preferable to help students and families with the high and rising costs of postsecondary education. Moreover, federal research funding has provided little or no support to community colleges, which are a vital part of our postsecondary system.

Another way to pursue the income redistribution and self-sufficiency objectives is to focus upon the reduction of payroll taxes for lower-income workers.

We applauded the shift from pay-as-you-go to partial funding of the Canada Pension Plan (CPP) to secure the fiscal and political foundations of the plan. But the change had one unfortunate result: Workers and self-employed people with below-average earnings carried a proportionately heavier burden of this payroll tax increase as the contribution rate rose rapidly between 1997 and 2003 (after which it will remain at a steady state, combined employee/employer rate of 9.9 percent of pensionable earnings). Although Employment Insurance (EI) premiums are lower than Canada Pension Plan contributions and have gone down in recent years, workers with below-average earnings still bear a heavier relative burden than those with above-average earnings.

One way to reduce the regressivity of payroll taxes is to redesign the nonrefundable tax credits for CPP contributions and EI premiums to put them on a geared-to-income basis. Such a change would provide more tax relief to contributors with below-average earnings.

To ease the burden of the GST on lower-income consumers, Ottawa should beef up the refundable GST credit, which is targeted to low- and modest-income families and individuals. It should be remembered that the refundable GST credit was created to ease the increased tax burden from the newly-created GST on low-income Canadians; it was not intended to fully remove the GST burden on the poor, and does not do so now.

The government also has said that it intends to provide more support to caregivers – possibly through additional tax relief. We always have opposed any increases to the caregiver credit, the infirm dependant credit or the eligible dependant credit. These are loosely defined measures whose objectives are unclear and whose eligibility criteria are impossible to understand and to monitor. The description in the attached endnote is an obvious message in itself. [1]

At the very least, there is a need to fix the complexities in the existing measures. We are concerned, however, that their respective policy objectives are not clear enough – whether the tax relief is intended to offset somewhat the costs involved in care for the care receiver or whether they are intended to help purchase some relief for the caregiver, or both.

In our view, the needs of care receivers are better addressed through direct programs and through the medical expense tax credit, which recognizes itemizable costs. The needs of caregivers are met more effectively through home and community supports intended explicitly for care receivers and through respite intended explicitly for caregivers.

Finally, we want to say a word about the *direction* principle. Our focus in this limited time has been upon the attainment of social and economic objectives. However, we believe that the tax system is an important instrument for achieving key environmental objectives as well.

In considering possible ways to spend the surplus, the federal government should provide tax measures to encourage increased investment in research and development that supports the creation of 'green' technologies. It also can create incentives for consumers to purchase environmentally friendly products that already have been developed.

The Bottom Line

For this and future federal Budgets, the bottom line is expected to be thick and black. A surplus represents a fortunate set of circumstances, but needs to be spent carefully and strategically. More than ever, an approach guided by clear principles is required.

Endnote

1. The caregiver credit gives tax relief to individuals providing in-home care for an adult dependent relative with an infirmity, or a parent or grandparent age 65 and over. For 2004, the maximum credit amount is $3,784 for such a dependant, which provides a federal tax reduction of up to $605 (16 percent of $3,784). The credit amount is reduced dollar for dollar when the dependant's net income exceeds $12,921 and is fully phased out when the dependant's net income reaches $16,705. The caregiver credit was claimed by almost 120,000 Canadians in 2001, the latest year for which data are available. The Department of Finance projects that this credit will provide $50 million in tax relief in 2004.

The infirm dependant credit affords tax relief to individuals providing support to an adult dependent relative with an infirmity. The dependant may live in a separate residence. For 2004, the maximum credit amount is $3,784, which gives a federal tax reduction of up to $605 (16 percent of $3,784). The credit amount is reduced dollar for dollar when the dependant's net income exceeds $5,368 and is fully phased out when it reaches $9,152. Close to 15,000 individuals claimed the infirm dependant credit in 2001. The Department of Finance projects that this tax measure will provide $10 million in tax relief in 2004.

The eligible dependant credit provides tax relief to individuals providing in-home support to a parent, a grandparent, an adult relative with an infirmity or a dependent child under 18. The dependant must reside with the supporting taxpayer, and must be wholly dependent for support upon that person at some time during the year. For 2004, the maximum credit amount is $6,803, resulting in a federal tax reduction of up to $1,088. The credit is reduced when the dependant's net income exceeds $681 and is fully phased out when the dependant's net income reaches $7,484.

The eligible dependant credit can be claimed only by individuals who are single, separated, divorced or widowed. Persons who are married or have a common-law partner cannot claim the eligible dependant credit. The purpose of the credit is to recognize that a taxpayer without a spouse who is supporting a dependent child, parent or grandparent is less able to pay tax than a similar person with the same income and no such dependant.