

Boomers, Infrastructure Will Force Redesign of Canada's Fiscal Federalism

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Several issues of fiscal policy were highlighted in the recent federal election campaign, including budget deficits, spending on infrastructure, changes in tax rates for middle- and upper-income Canadians, and reforms to child-benefit programs. But one issue absent from the debate was a longer-term challenge: the return of Canada's "fiscal imbalance" between the various levels of government.

Let's begin with the aging of the baby boomers, those Canadians born from 1946 to 1965. The oldest boomers turned 65 in 2011, and over the next several years, there will be a flood of retirements as they enter their golden years.

There are three fiscal implications of this aging of the population. First, as the boomers drop out of the labour force and stop producing income, there will be a natural slowing of government tax revenues. Second, they will collect Old Age Security (OAS) and the poorest of them will receive the Guaranteed Income Supplement (GIS). Third, most of them will put serious demands on the public health-care system.

Forecasts from the Organization for Economic Co-operation and Development suggest that Canada's public health-care spending will rise by about 3.5 percentage points of gross domestic product between now and 2040. And Canada's chief actuary forecasts that spending on elderly benefits will rise by roughly half a percentage point of GDP over the same period. So the aging of the baby boomers will increase government spending from its current level of about 30 per cent of GDP to approximately 34 per cent by 2040.

The necessary fiscal adjustment can take many forms. The generosity of our health-care system can be reduced, other public programs can be scaled back or various taxes can be increased. All of these will be unpopular. But the one approach that should not be followed is to ignore the problem and simply run larger budget deficits. Sustained deficits of this magnitude over 25 years would return our debt-to-GDP ratio to its heights from the mid-1990s, and nobody should want a repeat of that situation.

Now consider a second problem: the poor state of our public infrastructure. Mayors across the country worry about this constantly, and they are right to do so. Especially in our older cities, our roads, bridges, sewers and water-treatment systems are badly in need of repair. And in our fastest-growing cities, the demands for new infrastructure put additional strains on the system.

In 2007, the Federation of Canadian Municipalities estimated that our cities' combined infrastructure deficit was \$123 billion, just less than 8 per cent of GDP. The number is probably larger today.

To finance that infrastructure deficit over 10 years would require a decade-long increase in public spending by roughly 1 per cent of GDP annually. These funds could come from cuts to other programs, from new taxes or from some combination of the two.

What do these two challenges have to do with a “fiscal imbalance”? The fundamental problem is that the level of government currently in the best fiscal condition – the federal government – is not the one directly responsible for most of these necessary expenditures. The federal government is on track to have small budget deficits over the next few years and will probably see its debt-to-GDP ratio continue falling, to well below 30 per cent.

In contrast, the provincial governments provide almost all of the public health-care services in this country, and this largest of their budget items is also the fastest growing. And most of them are in worse fiscal shape than the federal government. Ontario and Quebec each have debt-to-GDP ratios well above the federal ratio and little or no room to increase income-tax rates.

In addition, Canadian cities are responsible for the vast majority of the country’s infrastructure investments, and must finance that spending either from their property-tax revenues or from transfers from the cash-strapped provinces.

Canadians and their policy-makers need to recognize the scale of these significant fiscal pressures. And they also need to think carefully about how fiscal capacity can best be transferred from the federal government to the provinces and cities.

The coming fiscal imbalance will involve some sort of redesign of Canada’s system of fiscal federalism. This is hardly a hot topic for most dinner parties, but getting it right will be a key issue in our economic future.

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