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Putting Canada's Economy First: The C.D. Howe Institute's 2025 Shadow Budget

A decade of rampant government spending, chronic borrowing, and populist tax policies has sapped growth in Canadian living standards and weakened Canada in the face of US trade aggression and a more dangerous world. This Shadow Federal Budget for 2025 slashes growth in non-defence spending, making room for stronger national defence, introduces growth-enhancing tax changes, and sets the federal budget on a path toward balance. Canada's economy is its top priority.

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Putting Canada's Economy First: The C.D. Howe Institute's 2025 Shadow Budget

by William B.P. Robson, Don Drummond and Alexandre Laurin

- **Its 2024 Fall Economic Statement underlined the federal government's recent chronic fiscal irresponsibility. The Statement featured a startling overshoot of the 2023/24 budget's deficit target, further ratcheted up the path of program spending, and doubled down on growth-damaging tax measures. US trade aggression since the beginning of 2025 is raising Canada's economic weakness to the level of an existential threat. The C.D. Howe Institute's 2025 Shadow Budget responds with measures to boost defence, sets the stage for budget surpluses and a falling debt burden, and introduces growth-enhancing tax relief.**
- **A comprehensive review of non-defence spending is a centrepiece of this Shadow Budget. Encompassing tax expenditures that are spending programs in disguise, the review will make programs more effective and efficient, allow needed increases in spending on defence and border security, and limit future governments' recourse to borrowing.**
- **This Shadow Budget also addresses the many federal taxes that impose excessive economic costs and compliance burdens. It rescinds recent targeted tax hikes, and begins a badly needed shift of the tax burden from taxes that undermine work and investment to a system that will spur the investments Canada needs to bolster its economy in the near term and make it more resilient over time.**
- **This Shadow Budget's measures will reduce federal spending and borrowing, improve the effectiveness of federal programs, and make room for growth-stimulating tax relief. This Shadow Budget marks a decisive break with the recent past, putting fiscal responsibility and growth front and centre. Its goal is to restore the economic vigour Canadians need to face external threats with confidence and to improve their prospects for rising living standards.**

Overview

The government did not present its 2024 Fall Economic Statement (FES) until mid-December. The FES was late because the government closed its books for 2023/24 late. It tabled the public accounts (Canada 2024b) more than 8½ months after the March 31st close of the fiscal year, a delay that prompted adverse comment (Robson and Dahir 2024b; PBO 2025). The final numbers showed a deficit for the 2023/24

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fiscal year of $62 billion – up from $35 billion the previous year, and more than $20 billion more than the deficit projected in the 2024 federal budget. The public accounts showed the reason: spending well above forecast. The ratio of federal net debt to GDP, which the government had committed to reduce, and which should fall when the economy is not in recession, rose in 2023/24. These developments set the stage badly for the beginning of 2025, when an aggressive and unpredictable new US administration showed that it was ready to abandon longstanding US support for a rules-based trading system and western security, and targeted Canada specifically with threats of punitive tariffs.

Urgent Need for a New Fiscal Course

A responsible FES would have acknowledged (i) the pressure an over-large federal government puts on other levels of government and the private sector, (ii) the dangers of growing federal debt for future taxes, economic growth, fiscal sustainability and intergenerational fairness, and (iii) the need for reforms to address stagnation in Canadian per-person output and living standards. A responsible FES would have addressed these challenges. The actual FES pushed fiscal junk – notably a GST "holiday" on selected goods from mid-December 2024 to mid-February 2025, and a $250-per-person handout (Drummond and Robson 2024). Subsequent proroguing of Parliament killed the handout but also meant that federal fiscal policy – like much else – is proceeding without scrutiny by elected representatives, even as potential US protectionism and stagnating living standards are undermining national vitality.

This 2025 Shadow Budget marks a fundamental change in direction. It addresses major problems in the framework of federal fiscal policy. It institutes a comprehensive review of program spending, including tax expenditures. It restores the spring budget to its appropriate position as the cornerstone of the government's fiscal strategy. It prioritizes transparency about federal finances. It launches a revamp of the tax system. It takes immediate steps to enhance Canada's spending on defence, and to reverse Canada's fiscal and economic deterioration.

The Bottom Line: Fiscal Results of the Shadow Budget

Among its measures to put fiscal responsibility and accountability front and centre this Shadow Budget highlights a more transparent fiscal plan. Recent federal budgets have buried the key numbers in an annex after hundreds of pages of political messaging and often-repeated announcements – an important reason for the federal government getting a grade of C in the C.D. Howe Institute's latest fiscal accountability report card on Canada's senior governments (Robson and Dahir 2024a). This Shadow Budget puts the summary statement of transactions that reflects its proposed policy actions up front (Table 1).

This Shadow Budget restores surpluses by 2028/29. An end to the deterioration in the government's net worth makes sense. Borrowing undermines the government's capacity to deliver services without raising taxes. Responsible fiscal policy pays the bills for spending as they come due.

The improving bottom line starts the ratio of the federal government's net debt – its accumulated deficit – to GDP on a clear downward track. That ratio was 31 percent before the COVID pandemic – low enough to make debt servicing costs manageable and give the government flexibility to respond to a major health crisis. An appropriate longer-term goal is a debt ratio at or below that level. This fiscal plan lowers the debt ratio from its current level above 42 percent to 35 percent by 2029/30. The budget surpluses it envisions would shortly thereafter produce a debt ratio more consistent with fiscal stability and intergenerational fairness.

Table 1: Medium-Term Fiscal Projections with Shadow Budget Initiatives						
	2024/25	**2025/26**	**2026/27**	**2027/28**	**2028/29**	**2029/30**
	$ billion					
Baseline Projections						
Revenues	511.3	530.3	552.8	582.6	608.6	638.0
Expenditures	559.6	579.1	589.8	616.0	639.2	663.3
Budgetary Balance before Initiatives	**-48.3**	**-48.7**	**-36.9**	**-33.5**	**-30.6**	**-25.4**
Shadow Budget Initiatives						
Program Expenses						
Non-Defence Spending		*-15.9*	*-22.8*	*-29.3*	*-36.9*	*-44.2*
Defence		*1.4*	*4.2*	*8.1*	*12.8*	*16.4*
Subtotal		*-14.6*	*-18.5*	*-21.2*	*-24.1*	*-27.8*
Budgetary Revenues	-6.8	7.1	14.5	9.4	4.3	5.1
Debt Charges' Saving		0.2	-0.8	-1.8	-2.8	-3.8
Total Impact on Budgetary Balance		***21.5***	***33.9***	***32.5***	***31.2***	***36.7***
New Budgetary Balance	**-55.1**	**-27.2**	**-3.0**	**-1.0**	**0.6**	**11.3**
Net Debt (accumulated deficit)	1,288	1,316	1,319	1,320	1,319	1,308
Percent of GDP	42	42	40	39	37	35

Sources: Authors' calculations from Canada (2024c), Tables 2 and 3 below.

The Status Quo Outlook Facing the Shadow Budget

Our starting point for this Shadow Budget and the status quo projections at the top of Table 1 is based largely on the 2024 FES. The FES featured deficits averaging about $34 billion from 2024/25 to 2029/30 and a debt-to-GDP ratio close to 39 percent in that final year. Our projections allow for some negative impact of US tariffs and Canadian retaliation in the near term, with real GDP growth being 0.6 percentage points lower in the 2025/26 fiscal year and 0.4 percentage points lower in 2026/27. We do not anticipate larger negative impacts, notably on nominal GDP, partly because many of the threatened tariffs may be of short duration or not come into effect at all, and because a lower Canadian dollar will mitigate the blow to real activity and give a one-time boost to the price level that the Bank of Canada will not counter.[1] Looking further out, we anticipate some recovery toward the baseline as Canada reacts to a

1 Effectively, we apply one-quarter of the Bank of Canada's baseline 25 percent across-the-board tariff impacts in both Canada and the United States. These impacts are scaled back to account for tariffs imposed on a smaller subset of goods and for certain commodities at a reduced rate of 10 percent. We note that the level of uncertainty remains high at the time of writing.

less hospitable US market by diversifying exports, especially of relatively high-value added fossil fuels. The resulting modified baseline appears in Table 2.

This weaker near-term outlook leads us to adjust the FES economic assumptions, anticipating slightly lower tax and EI revenues, and higher expenses stemming from increased EI benefits and inflation-indexed transfers. Overall, by 2029/30, the federal debt is $21 billion higher than in the FES. The potential for worse fiscal outcomes is especially concerning, given the possibility of higher US tariffs than assumed in our baseline and the accompanying pressure for additional income support. This is on top of Canada's ongoing need to increase defence spending, control borrowing, and provide tax relief to enhance competitiveness and growth in the face of the US threat.

Excessive spending underlies the bad results revealed in the FES and its projections of more bad results to come. Even leaving aside the net actuarial losses on federal pensions and other unfunded future employee benefits, which the government has lately shown below a provisional deficit line, program expenses in 2023/24 were $467 billion. That is up from $249 billion in 2014/15 – an annual growth rate of more than 7 percent. Add public debt charges and the actuarial losses, and federal spending grew from $278 billion to $521 billion over the decade – far outpacing growth in the Canadian economy, the tax base, and federal revenue.

The FES did not project future spending growth that rapid, but even its comparatively modest 3.4 percent growth rate between 2024/25 and 2029/30 prefigured total spending of $633 billion in 2029/30. Despite the FES's robust revenue growth projection of 4.7 percent annually, it showed the 2029/30 bottom line still badly in the red. While their recipients appreciate federal transfer payments, available indicators of service provision such as processing times for taxes, passports and immigration are unimpressive alongside such spending increases.[2] What is more, as we elaborate below, the federal government has massively overshot its spending projections every year, which casts doubt on the growth rates and the deficit and debt projections in the FES.

A New Federal Fiscal Framework

Transparency and Timeliness

The FES also highlighted some failures of fiscal transparency and accountability on the federal government's part – transparency and accountability that are all the more important when faith in public institutions everywhere is fragile. The government's budget documents, public accounts, and main estimates should be clearer, more reliable, and timelier. The federal government once earned an A-range grade in the C.D. Howe Institute's annual fiscal accountability report card. Its grade plummeted to F in 2021 – reflecting the government's failure to produce a budget for the 2020/21 fiscal year – and has been in the D-to-C range since then. Parliamentarians and Canadians should have timelier and better information about the government's fiscal plans and results.

A cornerstone of the new fiscal framework is a commitment to deliver the annual budget before the end of February. That timetable will allow parliamentarians adequate time to review the budget before the fiscal year begins on April 1. It

2 See, for example, the Canada Revenue Agency's average processing times relative to its service standards (https://www.canada.ca/en/revenue-agency/services/about-canada-revenue-agency-cra/service-standards-cra/service-standards-2023-24.html#ds2), and the passport and immigration problems that inspired the 2022 Task Force on Services to Canadians (https://www.canada.ca/en/employment-social-development/news/2022/08/members-of-the-task-force-on-services-to-canadians-ministers-ien-miller-gould-alghabra-and-fraser-provide-an-update-on-recent-work-to-improve-gover.html), which appears to have been an announcement with no follow through.

Table 2: Shadow Budget Baseline Assumptions and Projections

	2024/25	2025/26	2026/27	2027/28	2028/29	2029/30
	$ billion except as noted					
Economic Growth (*percent*)						
Real GDP	1.3	1.1	1.7	2.1	2.1	2.1
GDP inflation	3.0	2.0	2.1	2.2	2.0	2.0
Nominal GDP	4.3	3.1	3.8	4.3	4.1	4.1
Federal Revenues						
Taxes on incomes, payroll, consumption and other transactions	449.5	461.2	478.5	502.4	521.8	544.0
User fees and charges for government services and products	33.4	31.5	31.4	32.3	33.7	36.0
Investment income	28.4	37.6	42.9	47.8	53.0	58.0
Total Revenues	**511.3**	**530.3**	**552.8**	**582.6**	**608.6**	**638.0**
Federal Expenditures						
Direct program expenses	233.3	234.5	228.6	238.6	242.8	248.8
Transfers to persons and governments	256.5	272.4	283.5	293.2	305.5	318.1
Gross debt charges	69.8	72.2	77.6	84.2	90.8	96.4
Total Expenditures	**559.6**	**579.1**	**589.8**	**616.0**	**639.2**	**663.3**
Summary of Federal Revenue, Expenditure and Balance						
Taxes, fees, and other charges	482.9	492.7	509.9	534.7	555.5	580.0
Program expenses and transfers	-489.8	-506.9	-512.1	-531.8	-548.3	-566.9
Debt charges net of investment income	-41.4	-34.6	-34.7	-36.4	-37.8	-38.4
Budgetary Balance	**-48.3**	**-48.7**	**-36.9**	**-33.5**	**-30.6**	**-25.4**
Federal Debt						
Net Debt (Accumulated Deficit)	**1,281.5**	**1,330.2**	**1,367.2**	**1,400.6**	**1,431.2**	**1,456.6**
Percent of GDP	*41.9*	*42.1*	*41.7*	*40.9*	*40.2*	*39.3*

Notes: Totals may not add due to rounding. Investment income projections include expected return on average market-related value of pension plans' investments, interest income, net income from enterprise Crown corporations, foreign exchange revenues, and other returns on investment. User fees and charges include miscellaneous penalties and interests. We show debt charges gross of investment income on pension investments.

Sources: Canada (2024b); authors' calculations.

will also give provincial and territorial governments, and other transfer recipients, advance notice of changes that will affect them.

The government will table the Main Estimates simultaneously with the budget, in a format that lets parliamentarians understand each item requiring their approval in the context of the fiscal plan. Reforms to the estimates process will establish transparent, publicly available timetables that will ensure that the relevant committees have the time, and the incentive, to review and question individual items, and that their success or failure to do so will be matters of public record.

Future budgets, like this Shadow Budget, will present the key figures for consolidated revenue and expense, and the surplus or deficit and resulting change in net debt, in their first three substantive pages (that is, excluding tables of contents and other navigational material). Unlike the recent practice of burying the key numbers in an annex hundreds of pages deep, where only experts with ample time can find them, this presentation will make it easy for any interested person to find and understand the fiscal plan.

The federal public accounts for the 2024/25 fiscal year will appear before the end of September 2025, and the public accounts for subsequent fiscal years will appear before the end of June, in line with the best provinces. Earlier publication will improve the ability of parliamentarians and Canadians to understand the government's fiscal performance and to propose action to correct any problems they find.

Budgets and public accounts, and other major federal fiscal publications such as the monthly Fiscal Monitor will show all spending, including the Canada Income Support (the current GST credit) and the amortization of pension costs, in a single consolidated expense line. They will also report debt charges gross of investment income in pension accounts.

An End to Fall Mini-Budgets

The budget that precedes the beginning of the fiscal year should be the foundation of a government's fiscal plans. It is the subject of extensive consultations, gets extensive formal scrutiny by Parliament – including votes of confidence – and is a key formal statement of the government's fiscal plan.

The annual FES lets the government brief members of parliament and Canadians about the progress of its plans during the year, and any changes in circumstances that might affect the results. Lately, however, the FES has become a budget in its own right, with multiple initiatives on taxation and spending requiring legislation. This effective two-budgets-per-year cycle creates expectations and temptations that undermine consistent planning for the government and for Canadians alike (Robson, Busby and Dahir, 2024). Recent numbers speak plainly. The 2021 budget projected total expenses for the fiscal year about to end, 2024/25, at $454 billion. The 2024 FES put expenses for 2024/25 at $543 billion – a difference, after rounding, of $90 billion. The three spring budgets since 2021 accounted for $38 billion of the increase. The four FESs accounted for $52 billion of it.

Part of the new federal fiscal framework is a commitment that the FES will return to a mid-year update that shows progress relative to plan and reinforces, rather than undermines, confidence in the government's fiscal management. Fall statements will contain no initiatives that change revenue in the upcoming fiscal year by more than 1 percent relative to spring budget projections. The binding multi-year ceiling on program expenses described below will curtail spending of revenue windfalls and pre-election gimmicks. These constraints would not stop the government using a budgeted contingency reserve to respond to surprises such as natural disasters or US trade hostility. But it would dampen the cycle of hype and expectations that induces governments to shift priorities, ratchet spending up, and introduce late-year tax changes that create compliance and administrative burdens.

A Multi-year Ceiling on Spending

The past decade provides a fresh lesson about the temptations and costs of deficit spending. The new fiscal framework will mitigate the bias towards deficits and help Canadians hold the government accountable for fiscal sustainability, generational fairness, and the need to stabilize the economy (Lester and Laurin 2023). It will feature a legislated multiyear ceiling on non-cyclical expenses – outlays independent of the state of the economy, such as compensation of federal employees, defence, amortization of capital, and government transfers for health, education, and childcare. Not included under the ceiling would be cyclical expenses such as EI benefits and extraordinary income support in response to economic crises.

Several OECD countries use legislated multi-year spending ceilings or set them to align with fiscal targets. The Shadow Budget adopts a similar approach: a framework for a ceiling that would be binding for five years, barring major disasters such as wars, with detailed spending plans introduced in the first year of a new government (Lester and Laurin 2025). Over time, the ceiling will encourage discipline and more predictable fiscal outcomes.

Clarity about and Control of Tax Expenditures

Tax provisions such as deductions to avoid double taxation or avoid taxing income needed for non-discretionary expenses like life necessities – often termed "structural" measures (Canada 2023b) – modify the tax base to provide relief from tax that would be inefficient and unfair. Other tax credits and provisions are like subsidies or transfer payments. These "tax expenditures," netted against revenue rather than included in expenses, do not appear in budgets and public accounts, and are not subject to the same parliamentary or public scrutiny as other spending. Robson and Laurin (2017) calculated that showing them in spending would have raised reported federal expenses by about 6 percent.

The GST Credit is the single most important example of this kind of disguised spending. It is not a tax credit. Its payments are geared to income, not to GST paid by its recipients. They did not fall when the GST rate fell from 7 percent to 6 percent in 2006 or when it fell again to 5 percent in 2008. They rose during the pandemic for reasons disconnected from any changes in the GST. They will not fall to reflect the recent GST holiday. Figures in Finance Canada's latest Tax Expenditure Report (Canada 2024a) indicate that showing it as a reduction in taxes understated the amount of GST Canadians paid by more than $36 billion from 2020 to 2024 and understated how much the government spent over that period by the same amount.

This Shadow Budget renames the GST Credit as the Canada Income Support and shifts it from a deduction from GST revenues to the expense side of the ledger. The 2025 Fall Economic Statement will show the results of this change in historical data, and the 2024/25 Public Accounts will reflect it in the government's statement of operations.

This Shadow Budget launches a process for regular review of other tax provisions that are more like spending than legitimate measures to avoid inappropriate taxation. It will ensure that they appear appropriately in budgets and public accounts. Each tax expenditure will undergo review on a regular cycle to ensure its objectives are valid, and that it is operating efficiently and fairly. The default will be a three-year review schedule. If little has changed with a program since a previous review, a case can be made for less frequent evaluation. Redesigning and eliminating tax expenditures will permit less borrowing and further tax relief in future budgets.

Reform of Taxation and Tax Administration

A prime suspect behind Canada's decade-long struggle with stagnant capital investment, productivity and wages is taxation that discourages work, and individual and corporate saving and reinvestment (Robson and Bafale 2024). Personal income tax rates are too high and the thresholds at which they apply are too low – especially by comparison with Canada's principal competitor for talent, the United States. Corporate taxes distort decisions by treating different businesses and investments differently, and have also become uncompetitive internationally, particularly against the United States. Growing complexity has made tax administration and compliance harder and less predictable.

Addressing these problems incrementally is necessary but insufficient. High rates and uneven treatments themselves create pressure for more complexity. Accordingly, this Shadow Budget announces a national commission with a mandate to recommend fundamental reform of Canadian income taxes. The commission will review taxes from all sources, with the goal of making personal and corporate income taxes more supportive of work and investment and more competitive internationally. The review will consult on the split tax regimes for small and large corporations and recommend how to make the tax system less discouraging to business growth. By the end of August 2026, the commission will deliver a comprehensive tax reform report, putting forward practical solutions for the government to implement, starting with the 2027 budget.

This Shadow Budget also launches a review of the compliance and administration burdens of the Canada Revenue Agency's activities. Among the initial subjects of the review will be trust reporting rules and new taxes related to underused housing and short-term rentals. The review will also address the CRA's growing role as a deliverer of transfer payments, many of them falling into the category of tax expenditures that need reclassifying and reviewing. The CRA's ability to process Canadians' taxes accurately and on time, and to answer questions authoritatively and correctly, are of paramount importance.

Comprehensive Review of Program Spending

The federal government's expenses have outpaced Canada's economic growth for years. This Shadow Budget will make federal program spending $28 billion below the 2024 FES projection by 2029/30, bringing it to its pre-pandemic share of GDP. Meanwhile, Canada must increase defence spending to meet its 2 percent NATO commitment by the end of the projection period – requiring an additional $16 billion annually by 2029/30 compared to the FES. As a result, other program expenses will need to be $44 billion lower than projected in the FES.

This Shadow Budget includes specific measures to reduce the federal payroll and contracted services, and reduce business subsidies and other transfers, that will lower planned non-defence expenses by some $32 billion annually by 2029/30. The remaining $12 billion of the $44 billion reduction will come from a thorough program review that eliminates or modifies programs that provide insufficient value for taxpayer dollars.

This program review requires a fresh start. While the current federal system for evaluating the performance of programs looks impressive, it rarely assesses value for money (Lester 2024a). The review of business subsidies, labour market development programs, and climate change mitigation/adaptation measures will apply the benefit-cost framework used for federal regulatory proposals. These programs will be ranked by their net social benefits, allowing close comparisons of peer programs and qualitative comparisons across program categories. Programs with benefits smaller than their costs will be targeted, whatever their ranking.

Social programs and other measures with a fairness goal require a more nuanced approach. Evaluations of social programs will present information on the economic impacts of measures, their fiscal cost, including administration expenses, and a description of program beneficiaries. Evaluations will also assess how the program fits into other measures providing support to the target population. This information will allow elected officials and Canadians generally to form an evidence-based opinion on the value for money of social programs.

A core feature of the restraint is containing the costs of the federal public service. Federal full-time-equivalent employment increased almost 4 percent a year on average from 2017/18 to 2023/24. This Shadow Budget would reduce departmental operating budgets for current compensation to their 2024 levels and hold them there for five years. This approach, conceptually similar to the approach suggested by Lahey (2011), will bring federal compensation better in line with private-sector compensation and curtail the growth of the federal payroll. Managers will have latitude within their budgets to reward high performers and reduce less-valuable positions. This measure lowers federal spending by $1.6 billion in fiscal year 2025/26, growing to $8.0 billion annually over the projection period.

Even as federal employment and compensation have been increasing, the government's outlays for outside services expanded by more than 70 percent from 2017/18 to 2023/24. This Shadow Budget will reduce federal outlays on outside consultants and other services to its level in 2017/18. This measure will reduce expenses by $7 billion relative to their 2023/24 total.

Financing for any new spending must come from reallocations to achieve the total targets. This Shadow Budget does not expand federal support for dental care beyond its targeted introduction. It does not expand the limited introduction of the national Pharmacare program. To address some drug affordability challenges, it proposes a reform of the medical expenses credit. Should dental care or Pharmacare be expanded, the incremental federal cost would need to be fully funded.

This Shadow Budget also initiates a transition of federal employees from the current defined-benefit plans, which put all risk related to obligations and fluctuations in the value of assets on taxpayers, to jointly governed shared-risk pension plans. This change will have no immediate fiscal impact, but will reduce the actuarial losses that have added some $112 billion to the federal government's debt over the past decade.

This Shadow Budget also implements some adjustments to the federal government's transfers to provinces and territories. These transfers create tension in the federation. While provincial and territorial governments are glad to take credit for programs without taking blame for the taxes that pay for them, the federal government's money comes with strings attached that are incompatible with the constitutional autonomy of other senior governments. Further, the blurring of accountability for the quality of the services affected, notably healthcare, is an obstacle to improvement. Especially in the aftermath of pandemic-related supports, which resulted in a far more marked deterioration in the fiscal position of the federal government than those of other governments, it is reasonable for the provincial and territorial governments to forgo some of the increased transfers prefigured in the 2024 FES.

These cuts to projected non-defence program expenses appear large, but are reasonable reversals in the explosion of spending in recent years. They will leave program expenses at 14.5 percent of GDP by 2029/30, just under the 14.6 percent recorded in 2019/20, which was well above the 13.2 percent recorded in 2015/16.

This Shadow Budget makes no provision for revenues from tariffs implemented in retaliation to potential US tariffs, nor does it make provision for expenses to provide relief to individuals and businesses affected by US or Canadian tariffs. Any retaliatory tariffs levied by Canada will need to be narrowly targeted and time-limited to avoid the adverse effects on prices, production and productivity that broader and longer-lasting tariffs will produce. The federal government will not implement measures that will create a compelling claim for relief to individuals and businesses.

Policy Actions in the Shadow Budget

Table 3 below shows the fiscal impact of the measures in this Shadow Budget. The details of the measures follow.

Meeting Canada's Defence Commitments

In 2006, countries in the North Atlantic Treaty Organization (NATO) committed to spending 2 percent of their GDP on national defence, with at least 20 percent of spending allocated to major new equipment. They renewed this pledge in 2014 after Russia's annexation of Crimea and again in 2023 after Russia's invasion of Ukraine. Canada's defence spending in 2024 was about 1.3 percent of GDP.

This neglect of defence spending has always been unwise, and with the United States appearing increasingly reluctant to support its allies, it looks rash. Canada not only lacks capacity to project power, it also relies far too much on the United States just to defend its own territory. Twenty-three of the 32 members of NATO now meet the 2 percent target, up from just six in 2021.[3] Canada should join them.

This Shadow Budget sets defence spending on a path to reach 2 percent of GDP by the end of the projection period. That interim target means that defence spending must increase by $16.4 billion relative to the current projection for 2029/30.

Improving the Efficiency and Fairness of the Tax System

Spurring growth requires relying less than Canada currently does on taxes that discourage work, saving and investment.[4] To shift the tax burden appropriately, this Shadow Budget proposes to raise the GST rate two percentage points: 1 point on July 1, 2025, and another point on July 1, 2026. Over time, higher revenue from the GST will create fiscal room for substantially lower personal and corporate income taxes. An alternative would be to cut spending more deeply, notably by reducing federal transfers to provinces for funding their programs more dramatically than this Shadow Budget proposes to do. This would leave it to the provinces to raise more of their own revenues, ideally through their HSTs and other consumption taxes, but such a fundamental change would be better achieved with a longer lead time and more consultation. The revenue from the higher GST helps balance the budget and finance higher outlays on defence, and also creates fiscal room for badly needed cuts in personal and corporate income taxes that will enhance Canada's tax competitiveness against the United States, and boost work, investment and growth.

The need to balance the budget limits scope for personal income tax relief in the near term, but a downpayment on further progress is possible. Personal marginal effective tax rates tend to be much higher at mid-income levels due to income-tested reductions of cash benefits (Laurin and Dahir 2022), so targeting middle-income levels makes sense.[5] This Shadow Budget would lower the tax rate for the second tax bracket from 20.5 percent to 19 percent in 2026, then to 17 percent in

3 https://www.atlanticcouncil.org/blogs/econographics/whos-at-2-percent-look-how-nato-allies-have-increased-their-defense-spending-since-russias-invasion-of-ukraine/#:~:text=Out%20of%20the%20thirty%2Dtwo,of%20Ukraine%20in%20February%202022.

4 A review of Organisation for Economic Co-operation and Development (OECD) data reveals that Canada's reliance on personal and corporate income taxes, as a share of the economy, exceeds most other OECD countries. In contrast, Canada ranks among the lowest in terms of reliance on consumption taxes.

5 The Parliamentary Budget Office found that individuals in the second-bracket range responded significantly to the 2016 "middle class tax cut" by increasing their taxable income (PBO 2019).

Table 3: Fiscal Impact of Shadow Budget Initiatives

	2024/25	2025/26	2026/27	2027/28	2028/29	2029/30
			$ billion			
Baseline Revenues	**511.3**	**530.3**	**552.8**	**582.6**	**608.6**	**638.0**
Raise the GST Rate in 2025 and 2026		9.5	23.1	27.5	28.6	29.8
Lower Personal Income Tax Rates		-0.9	-4.6	-8.9	-14.2	-14.8
Lower the Corporate Income Tax Rate		-0.9	-4.4	-7.1	-6.8	-6.7
Eliminate the Atlantic Investment Tax Credit		0.1	0.4	0.4	0.4	0.4
Incentivize Innovation, Adoption and Commercialization		-0.2	-0.6	-0.6	-0.7	-0.7
Rescind the Capital Gains Inclusion Rate Proposals	-6.8	-1.0	0.1	-2.5	-3.7	-3.7
Encourage Charitable Donations		-0.1	-0.1	-0.1	-0.1	-0.1
Incentivize Start-ups		-0.1	-0.1	-0.1	-0.1	-0.1
Phase Out the Tax Credit for First-Time Homebuyers		0.1	0.1	0.1	0.1	0.1
Eliminate the First Home Savings Account		0.5	0.5	0.5	0.6	0.6
Eliminate the Tax Credit for Labour-Sponsored Venture Capital Corporations		0.2	0.2	0.2	0.2	0.2
Limit Effect of Inflation on Tax Burdens		-0.1	-0.2	-0.2	-0.3	-0.4
Withdraw Recent Counterproductive Taxes		-2.6	-2.7	-2.7	-2.7	-2.7
Let Canadians Save More for Retirement		s	s	s	s	s
Reduce Minimum Withdrawals from RRIFs		s	s	s	s	s
Allow Life Annuities to Be Held in TFSAs		-0.1	-0.1	-0.1	-0.1	-0.1
Provide More Generous Tax Treatment of Medical Expenses		-0.6	-0.6	-0.6	-0.6	-0.7
Rationalize the Age Credit		3.3	3.4	3.6	3.8	3.9
Impact of Shadow Budget Revenue Initiatives	***-6.8***	***7.1***	***14.5***	***9.4***	***4.3***	***5.1***
Baseline Expenditures	**559.6**	**579.1**	**589.8**	**616.0**	**639.2**	**663.3**
Contain the Costs of the Federal Public Service		-1.6	-3.1	-4.7	-6.3	-8.0
Rationalize Business Subsidies		-4.0	-4.2	-4.3	-4.5	-4.7
Reduce Reliance on Outside Consultants and Other Services		-2.0	-2.5	-3.5	-5.5	-7.0
Reduce the Growth of Government Transfers		-3.6	-7.1	-7.7	-8.2	-8.9
Saving to be Identified in Program Review Exercise		-2.0	-3.0	-6.0	-9.0	-12.0
Restructure Support for R&D		0.2	0.2	0.3	0.3	0.3
Increase the Age of Eligibility for Public Pension Benefits Starting 2030						s
Rescind the 10 percent increase in OAS payments to recipients aged 75 and above		-3.0	-3.2	-3.4	-3.6	-3.8
A New and Improved Program of Real Return Bonds		s	s	s	s	s
Meet Our NATO Commitments		1.4	4.2	8.1	12.8	16.4
Debt Charges' Saving		0.2	-0.8	-1.8	-2.8	-3.8
Impact of Shadow Budget Expenditures Initiatives		***-14.4***	***-19.3***	***-23.0***	***-26.9***	***-31.6***
Budgetary Balance before Initiatives	-48.3	-48.7	-36.9	-33.5	-30.6	-25.4
New Budgetary Balance	**-55.1**	**-27.2**	**-3.0**	**-1.0**	**0.6**	**11.3**
Net Debt (Accumulated Deficit)	1,288	1,316	1,319	1,320	1,319	1,308
Percent of GDP	*42.1*	*41.7*	*40.2*	*38.6*	*37.0*	*35.3*

Sources: Authors' calculations. Notes: "s" stands for small impact on a present-value basis. PIT cut estimated using an Elasticity of Taxable Income (ETI) of 0.47, conforming with previous findings (PBO 2019). CIT cut estimated with an ETI ranging from 0.08 to 0.28, a conservative assumption based on the findings of Finance Canada (Canada 2014).

2027. In 2028, it will go to 15 percent – the same rate as for the lowest bracket – reducing the number of federal tax brackets from five to four.

This Shadow Budget would lower the general corporate income tax rate by two percentage points: one in 2026 and another in 2027. Lower corporate income tax rates will lead to more capital investment and increase economic growth in the long term. The Atlantic Investment Tax Credit would disappear in 2026. These changes will reduce growth-inhibiting tax distortions and signal the government's intent to continue with tax reforms that will boost productivity and wages over the medium and long term.

Canada has long had a record of low levels of research and development from the business sector, despite incentives from programs such as the SR&ED tax credit. The Shadow Budget would increase the effectiveness of that credit by:

- Applying a 20 percent credit rate to large and small firms (raising the large firm rate from 15 percent while decreasing the small firm rate from 35 percent, in recognition that most of the research is done by large firms).
- Making the credit refundable and delivering it independently of the tax system so its benefits are more predictable and come sooner after the outlay on research. Refundability will be phased in over ten years to reduce the cost (Lester 2024b).

To incentivize the creation and commercialization of intellectual property, this Shadow Budget would lower the corporate income tax rate on income from patents and other intellectual property generated by activity in Canada (Lester 2022). This measure will take effect in 2026.

To further encourage the development and commercialization of IP and hence raise productivity, it would introduce an exemption from taxation on capital gains realized on the sale of certain publicly traded small-business shares. As under similar provisions of the US *Small Business Jobs Act*, investors will qualify for this capital gains tax exemption if they hold qualified small business shares for at least five consecutive years, encouraging the kind of patience needed to grow small and medium-sized enterprises (Schwanen et al. 2019).

Revoking Inefficient and Unfair Tax Measures

Taxes cause the least economic damage when their bases are broad, and when individuals, companies, and activities that are comparable are taxed equally and fairly. Treatment that is economically illogical and violates principles of equity promotes further damage, undermining confidence in the integrity of the system and encouraging lobbying for more special treatment.

This Shadow Budget would pause or eliminate several recent problematic measures.

- It clarifies that the legislation to increase the inclusion rate on many categories of capital gains income and other changes to capital gains taxation will not be reintroduced.
- It rescinds the temporary exemption of home heating oil from the carbon tax.
- It revokes the "luxury tax" on cars, boats and airplanes.
- It revokes income surtaxes and taxes on inter-corporate dividends imposed on financial institutions.
- It reinstates the inter-corporate dividend deduction for financial institutions on Canadian shares held as mark-to-market property to avoid double or multiple taxation of the same income.
- It revokes the tax on share buybacks.
- It phases out the tax credit for first-time homebuyers and the First Home Savings Account. Both measures stoke demand and contribute to high prices for housing. The second violates basic tax principles by providing deductions on contributions yet allowing tax-free withdrawals.
- It discards proposed reforms to the alternative minimum tax as they apply to the treatment of charitable donations.
- It does not include revenue from the new digital services tax, assuming that Canada will suspend this tax as part of its negotiations with the United States.

To encourage charitable donations, this Shadow Budget would relieve more donations of private company shares and real estate from capital gains tax (Aptowitzer 2017).

The personal income tax system is only partially indexed to inflation, so rising prices and wage increases that merely match inflation raise real tax burdens. Examples of parameters without indexation include the federal government's pension income credit and the maximum education and tuition credits that tax filers can transfer to spouses or parents (Robson and Laurin 2023). The Shadow Budget would index these parameters.

The current medical expense tax credit applies only to expenses exceeding 3 percent of net income or $2,834, whichever is lower, and is calculated at the bottom tax rate. The Shadow Budget would lower the threshold on such expenses to 1.5 percent of net income, or $1,420, whichever is lower, relieving more income needed for nondiscretionary expenses from taxation. This measure will to a degree fill the affordability objectives of a national Pharmacare program, which this Shadow Budget does not expand beyond its very limited introduction.

Limits on tax-deferred saving in Canada put savers in defined-contribution pension plans and RRSPs at a disadvantage relative to participants in defined-benefit plans (Robson 2017). This Shadow Budget would raise the limit for contributions to the former plans by three percentage points of income per year – from the current 18 percent to 30 percent of earned income – over four years. This Shadow Budget also proposes to relieve pressure on people to liquidate those savings too early. It proposes an immediate one-percentage-point reduction of minimum withdrawals from Registered Retirement Income Funds (RRIFs) mandated for each age, beginning with the 2025 taxation year.

Given the increasing importance of Tax-Free Savings Accounts (TFSAs) in Canadians' retirement saving, it makes sense to ensure that options for savers in RRSPs and other vehicles are also available to savers in TFSAs. This Shadow Budget would provide greater flexibility in savings vehicles, notably making it possible to buy life annuities within a TFSA.

A New and Improved Program of Real Return Bonds

In 2022, the federal government stopped issuing Real Return Bonds (RRBs) – bonds indexed to inflation. It is time to reverse this decision and reintroduce RRBs with improvements.

Because their principal rises with the consumer price index, RRBs protect their holders from inflation. For the government, issuing RRBs can be cost-effective, if – as is normally the case – investors accept lower yields in exchange for inflation protection. Since issuing RRBs signals the government's commitment to its inflation target, it can reduce yields on the government's regular bonds as well.

The government justified cancelling RRBs with reference to low demand, but the government's management of the program undermined demand. It only issued 30-year bonds, and in small amounts, meaning institutional investors such as pension funds and insurance companies bought and held nearly all the bonds issued making for an illiquid market. A C.D. Howe Institute survey of major institutional investors, managing over $2.4 trillion in assets, showed strong opposition to the cancellation and support for an expanded RRB program (Robson and Laurin 2024).

Globally, inflation-linked bonds are widely used. Countries such as the UK, Sweden, France, Italy, and the US have issued proportionally more inflation-linked debt, fostering liquid markets and strong demand. The fresh threat of price increases because of tariffs will make inflation protection all the more valuable to savers.

This Shadow Budget announces a new RRB program. The government will recommence issuing 30-year bonds and also launch 10-year RRBs. Its initial target will be $1 billion of each per quarter. It will also change its auction approach – using multiple-price auctions, as with other bonds, rather than single-price auctions – to improve liquidity in the RRB market.

Over time, a larger float of RRBs will benefit savers, strengthen financial markets, and reaffirm Canada's commitment to low and stable inflation. A more liquid market will also raise the price and lower the yields of RRBs, which will help contain federal debt service costs.

Reducing Excessive Program Expenses

In addition to savings from the program review described above, this Shadow Budget proposes the following specific spending cuts.

Business subsidies have increased 125 percent since 2015, rising from $17 billion to $37.4 billion (Lester 2024c). The FES prefigured more increases. Some are not intended to address market failures but rather redistribute income. In the process, they lower output due to the distortions they cause in market-determined allocation of economic activity. The review process will examine subsidies more broadly, but this Shadow Budget would:

- Cap the growth of spending on business subsidies to a pace one-half that of growth in nominal GDP, instead of rising more than 3 times faster than GDP.
- Eliminate all subsidy programs to the supply-managed sector.[6]
- Eliminate the tax credit for Labour-Sponsored Venture Capital Corporations (LSVCC). The LSVCC distorts savings and investments and is an ineffective, inefficient way of encouraging innovation (Fancy 2012).

The cap on business subsidies will save more than $4 billion annually.

This Shadow Budget would phase in increases to the normal age of eligibility for Old Age Security, which would rise in monthly increments from 65 at the beginning of 2030 to 67 in 2054. The actuarial adjustments that penalize or reward early and later commencement of benefits would apply from the new ages, ensuring that people who cannot work past the current earliest age of eligibility could still collect reduced benefits, while further encouraging later receipt by people willing and able to work and save for longer.

Seniors are now the age group in Canada least likely to live in poverty, making the historical emphasis on preferential taxation of the elderly inappropriate. The more generous treatment of medical expenses described above will assist those with greater health needs. The Shadow Budget would reduce the base amount of the age credit from $9,028 to $4,000. As further personal income tax relief, through lower rates and higher thresholds, becomes possible, the age credit will phase out.

The Shadow Budget also rescinds the 10 percent increase in OAS payments to recipients aged 75 and above for a saving of $3.8 billion by 2029/30 as scarce tax dollars should not be allocated to a cohort with a lower incidence of low-income than many others.

This Shadow Budget will reduce the escalator in the Canada Health Transfer by half for the 2025/26 and 2026/27 fiscal years. It will freeze the Canada Social Transfer at its 2024/25 level for those same two years. Both transfers will recommence escalating at their planned rates in 2027/28 and beyond. This Shadow Budget will also eliminate the floor in the federal equalization program that increases transfers beyond the levels calculated by the equalization formula (Lévesque

6 Supply management in Canada's agriculture sector raises food prices through restrictions in output and high tariffs on imports. It also fragments the internal market, since production quotas are not transferrable among provinces. This Shadow Budget anticipates that international and internal trade negotiations will eliminate supply management. Any compensation to producers would come from temporary levies on dairy and poultry products that are outside the scope of this Shadow Budget.

2024), which is expected to reduce payments by $1 billion in 2026/27 and gradually increasing amounts thereafter. It will freeze federal transfers for childcare at their 2024/25 levels, and phase out the Community Building Fund over the projection period. These changes will reduce federal outlays by $9 billion annually by 2029/30.

Conclusion

The measures in the C.D. Howe Institute's 2025 Shadow Federal Budget respond to Canada's long-standing challenges in enhancing productivity and boosting growth and to the more immediate threats emanating from the United States. The Shadow Budget puts the federal government on a path to balance its books and reduce the debt-to-GDP ratio. It also sets new standards for transparency and timeliness in federal fiscal policy, increases defence spending, reins in growth in other program spending and tax expenditures, eliminates harmful and arbitrary taxes, and initiates reductions in personal and corporate income taxes. This is a stark and timely change of direction, setting the stage for renewed growth in productivity, competitiveness and living standards, and making Canada stronger whatever the United States may do. It is the "economy-first" budget Canada needs from the federal government in 2025.

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