

Macroeconomic and Fiscal Framework

Federal budget surpluses have been a defining characteristic of Canadian fiscal policy for the past decade. The presence of annual surpluses has changed the terrain of the policy debate from meting out short-run restraint to a fuller discussion about long-run opportunities. By and large, however, those opportunities have been squandered.

The Alternative Federal Budget has consistently argued for social reinvestment of surpluses in order to meet the many challenges facing the nation. Yet federal program expenditures remain very low by historical standards. Program spending was 13% of GDP in 2006–07, up from the all-time low hit in 1999–00 and 2000–01, but still well below levels seen over the post-WWII period. In the 1960s and 1970s, program expenditures ranged from 15–18% of GDP.¹ Importantly, program expenditures today are three to four percentage points lower than the last time Canada was in a recession.

Business lobbyists and conservative groups have called for tax cuts on the grounds that they will improve Canada's economic performance. These calls have been heard loud and clear. The 2000 and 2001 budgets delivered major mul-

ti-year tax cuts that lowered federal revenues-to-GDP from 18% in 1999–00 to just over 16% by 2005–06. New tax cuts introduced in the October Economic and Fiscal Update will reduce this share even further (*see below*).

A third option, debt reduction, has arguably been a hidden priority of budget-makers: some \$105 billion in debt reduction has occurred as a result of surpluses over the past decade. Canada's debt-to-GDP ratio fell from 68% in 1996–97 to 32% in 2006–07, partly as a result of economic growth and partly as a result of continuing budgetary surpluses.

With the delivery of a new package of major multi-year tax cuts in the October 2007 Economic and Fiscal Update (EFU), it is now possible that, irrespective of one's priorities, the debate on how to spend growing surpluses may be at an end. While official projections still call for surpluses between now and 2012–13, these surpluses are predicated on a continuation of the relatively strong economic growth that has characterized Canada for much of the past decade. Signs from south of the border point to a U.S. economy that may already be in recession, and

this recession may be longer and deeper than those in the recent past.

The good news for the federal budget is that, in the event of a serious downturn, the government has substantial room to run a deficit if it chooses. Compared to other G7 countries, Canada's net liabilities are the lowest by a fair margin, with other countries running deficits in recent years compared to Canada's surpluses.

In this section, we review the major fiscal actions in recent budgets and the October 2007 Economic and Fiscal Update. The AFB forecasts a balanced budget under the most recent economic growth assumptions from the Bank of Canada. However, if a major downturn were to occur, the budget would naturally move into a deficit position. We would let this happen and not cut spending in order to achieve a balanced budget, as such a move would worsen the underlying economic situation.

Building Whose Better Canada? 2006–07 in Review

Under the cover of "Building a Better Canada" the Harper Conservatives have set out a fiscal agenda that will continue the trend of the past decade to further shrink the size of the federal government. The two key planks of this agenda are broad-based tax cuts and proposed legislation to limit federal spending power in areas of provincial jurisdiction.

The Conservative government was actually well under its 2006–07 Budget on expenditures, by about \$5 billion, during the fiscal year. This provided the room to finance \$4 billion of expenditures announced in the 2007 budget by billing it to the 2006–07 fiscal year. Only this late surge made expenditures come close to what was originally budgeted.

Federal revenues were 16.3% of GDP in 2006–07, which is low by historical standards, and a reflection of the priority given to tax cuts in recent years. The final public accounts for the

2006–07 year recorded a large (19%) increase in corporate income tax revenues. Corporate profits have been booming in recent years, but this has not translated into substantially larger tax revenues because companies can write off prior year losses against current profits. It appears that those losses have now been fully utilized.

The diminished size of Canada's government since the mid-1990s is revealed dramatically in a recent study published in *Canadian Public Policy* by Ferris and Winer (2007). After making adjustments to national accounts frameworks in Canada and the U.S. for better comparability, they find that the size of government in Canada and the U.S. is virtually identical. There are some important differences in how funds are allocated (a much larger chunk of U.S. expenditures go to defence) but nonetheless this is indicative of how much the public sector has been reduced by both Liberal and Conservative governments.

The second broad thrust of fiscal policy, the notion of limiting federal spending power in areas of provincial jurisdiction, amounts to short-term political opportunism vis-à-vis the province of Quebec. While it may appear that the federal government is moving ahead based on principle, this is at odds with other proposed moves that would exercise federal powers to harmonize provincial regulations. In the fall 2007 Speech from the Throne, the federal government appeals to respecting provincial jurisdiction as a justification for restricting federal spending on social programs. But right after this, the Throne Speech invokes an often-repeated but highly dubious claim about interprovincial trade barriers in order to use federal powers to challenge provincial jurisdiction to meet local needs through public interest regulation. The Conservatives' principles seem less about respecting federal and provincial jurisdiction and more about whatever measure will act to further reduce the size of government.

On reflection, in the decades after the Second World War, the federal government used its

TABLE 1 The Cost of 2006 and 2007 Tax Cuts (\$billions)

	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Corporate income	1.1	5.9	7.9	9.3	11.5	14.8
Personal income	12.3	10.3	10.1	10.3	10.6	11.2
GST	7.1	12.0	12.6	13.2	13.7	14.2
Total	20.5	28.2	30.6	32.8	35.8	40.2

SOURCE Economic and Fiscal Update, October 2007, Table 3.1

taxation power to set a national social agenda, including cost-shared programs in health care, post-secondary education, and social welfare. Much of Canada's social infrastructure to this day is rooted in a few decades of productive co-operation between federal and provincial governments. While the federal government has retreated from that role in recent decades, it would be foolish to give up on use of federal spending power to forge a stronger nation.

A reduction in taxes and social spending will not build a better Canada for most Canadians, but rather will extend the gains made by the very top income earners in the country, and leave the federal government standing on the sidelines as the score piles up. The AFB sets out a different set of policy options and demonstrates that budgets can reflect choices that truly make a difference in Canadians' lives.

Tax Cuts in the Economic and Fiscal Update

Like the Liberal governments before it, the Conservatives, in tabling Budget 2007, greatly understated the size of available surpluses — a bias towards debt reduction. A look at the 2006 Budget is revealing. The projected surplus at budget time for 2006-07 was \$3.6 billion (mostly earmarked for debt reduction). By the time of the 2007 Budget, that number grew to \$9.2 billion. And upon release of the year-end public accounts, it was revealed that the surplus was \$13.8 billion (a new accounting rule makes it \$14.2 billion, as some media have reported). This surplus is about 1.0% of GDP.

This landscape has now shifted dramatically with the Canadian economy slowing down and the delivery of multi-year tax cuts in the Economic and Fiscal Update. At the time, it was the presence of large and looming surpluses that gave the impetus for tax cuts. More recently, the Finance Minister has changed his tune arguing that the tax cuts were a pre-emptive measure against the downturn itself, though no quotes can be found around the time of the EFU indicating that this was his intention. Ask the question any way you like and the answer usually comes out the same: tax cuts.

The tax cuts announced in the EFU have greatly eroded the fiscal capacity of the federal government. These include:

- The second one-percentage-point cut to the GST cut, to 5% as Jan. 1, 2008. This move delivers on an election promise for the Harper government much earlier than anticipated.
- An acceleration and deepening of corporate income tax rate reductions. The 2007 federal corporate income tax rate of 22% will fall to 15% by 2012, a drop of one-third.
- A restoration of the 15% bottom personal income tax rate that the Liberals had tabled prior to the 2006 election, and that the Conservatives raised to 15.5% to help pay for their first-round GST cut. The basic personal exemption (the threshold for paying income tax) was increased for 2007 and 2008.²

The EFU tax cuts build on tax cuts announced in the 2006 and 2007 budgets. Fully phased in, the total revenue loss from the EFU is \$14.7 billion per year by 2012–13. But if these previously-announced tax cuts are taken into consideration, the total revenue loss from Conservative tax cuts by 2012–13 is an alarming \$40.2 billion per year. Table 1 shows the revenue loss by type of tax for 2007–08 and over the subsequent five years.

While much attention has been paid to GST cuts, corporate income tax cuts (i.e. the total drop in statutory rate from 22% to 15%) will cost the Treasury more when fully phased in (\$14.8 billion per year in 2012–13). This figure is greater than either the two-percentage-point cut in the GST (\$14.2 billion) or the combined 2006 and 2007 personal income tax cuts (\$11.2 billion). Moreover, the corporate income tax cuts are essentially an upper-income tax cut,³ and despite being very costly to the Treasury, they are unlikely to have any significant economic impact.

AFB Fiscal Framework

Because tax cuts mostly kick in starting in 2008–09 and gain strength thereafter, the fiscal impact is not obvious in the current year. We revise the estimate of growth for 2007 downwards based on the most recent Monetary Policy Report from the Bank of Canada. Yet, we still project that the federal government will end the 2007–08 year with a surplus of \$11 billion (*see Table 2*). The AFB puts this surplus into a fund for capital or infrastructure projects of strategic importance (public transit infrastructure, social housing and child care facilities) over the next three years.

We estimate a three-year planning framework for 2008–09 to 2010–11, based on January's Bank of Canada updated GDP forecasts.⁴ For 2008–09 and the next two fiscal years, we estimate latent surpluses of \$1 billion, \$3 billion and \$6 billion. AFB revenue and expenditure recommendations are then added to the base

case (*see Table 3*), such that the federal budget is roughly balanced in each year (technically, small surpluses exist if economic growth is in the forecast range).

Fiscal Policy in a Slowdown

In spite of some troubling developments in the U.S., the possibility of an economic downturn has not been adequately considered by policy makers in Canada. On the home front, real GDP has not dropped in Canada since 1991, and apart from a dip below 2% growth in 2001 (a year the U.S. economy went into recession), real GDP growth has been strong for a decade. Moreover, the unemployment rate in recent years has dropped to levels not seen since the early 1970s. As the U.S. economy has sagged through 2007, the Canadian economy has continued to grow, although with some signs of slowing.

The relative strength of the Canadian economy in 2007 vis-à-vis the U.S. has led some commentators to argue that this represents a “decoupling” of the Canadian and U.S. economies — that it is a “myth that every time the U.S. sneezes, Canada catches a cold.”⁵ There is some evidence that Canada is less dependent on the U.S. economy in 2008 than in the recent past. Exports to the U.S. as a share of GDP have been declining since 2001 and in 2007 dropped back to levels last seen in the mid-1990s. The total share of Canadian exports going to the U.S. has also declined somewhat, although three-quarters of Canadian exports are destined south of the border.⁶

While there may be some decoupling with the U.S., there is no reason to expect that Canada is fully disconnected given such close trade and investment ties. If the U.S. economy goes into a recession, there is every reason to believe that there will be knock-on effects in Canada, and policy makers need to prepare for that possibility.

TABLE 2 Updated Status Quo Fiscal Framework

	2007-08	2008-09	2009-10	2010-11
Macroeconomic Indicators				
Nominal GDP	1,521,515	1,583,897	1,667,844	1,741,229
Annual growth	5.2%	4.1%	5.3%	4.4%
Budgetary Transactions (\$millions)				
Revenue	243,442	242,336	253,512	264,667
Program Spending	198,365	207,625	216,970	225,145
Debt Service	34,000	33,609	33,527	33,305
BUDGET BALANCE	11,077	1,103	3,015	6,216
Closing Debt (accumulated deficit)	456,191	455,088	452,073	445,857
Budgetary indicators as percentage of GDP				
Rev/GDP	16.0%	15.3%	15.2%	15.2%
Budget balance/GDP	0.7%	0.1%	0.2%	0.4%
Debt/GDP ratio	30.0%	28.7%	27.1%	25.6%
Effective interest rate on government debt	7.37%	7.37%	7.37%	7.37%

NOTES Base cases use Bank of Canada's January 22 Monetary Policy Report for revised GDP estimates for 2007, 2008 and 2009. For 2010, Economic and Fiscal Update estimate is used. Revenues are estimated by keeping constant the revenue-to-GDP ratio as set out in the EFU. EFU estimates are used for program spending. Debt service figures are recalculated based on the effective interest rate on government debt in 2007-08 to adjust for changes in the closing debt.

SOURCES Bank of Canada; Finance Canada.

TABLE 3 Summary of AFB Measures (\$millions)

	2007-08	2008-09	2009-10	2010-11
Revenues				
Base Case	243,442	242,336	253,512	264,667
AFB Tax Measures		15,099	24,377	28,558
Total	243,442	257,435	277,889	293,224
Program Spending				
Base Case	198,365	207,625	216,970	225,145
AFB measures		16,202	26,975	33,211
Total	198,365	223,827	243,945	258,357
Debt Service	34,000	33,609	33,609	33,609
Balance	11,077	0	335	1,260

The overall outlook for the U.S. economy is more pessimistic than for Canada, according to major private-sector forecasters. Forecasters tend to fall into two camps. Many support the view that after a slowdown in 2007 U.S. economic growth will regain strength through 2008, and will es-

entially be back to business-as-usual within 12 months. Others have taken a more pessimistic line, based on the deflating housing bubble and the related and ongoing impact of the sub-prime mortgage debacle on financial markets. This latter camp puts the odds of a U.S. reces-

TABLE 4 AFB Spending Measures (Increases from current proposed spending) (\$millions)

	2008-09	2009-10	2010-11	Total
SECTION 1 Securing Our Common Wealth				
Aboriginal Peoples				
Health, education & housing	750	1,550	1,900	4,200
Eliminate 2% cap	429	400		829
Family support services	129	129	130	388
Skills & training	40	40	40	120
Environmental Stewardship	114	114	114	342
Urban centres	25	30	35	90
Friendship centres	5	11	16	32
Child Care and Early Learning	1,100	2,200	3,300	6,600
Cities & Communities				
Social Economy Initiative	44	44	44	132
Building Communities fund	3,977	6,356	6,556	16,889
Equality for Women				
Funding to Status of Women Canada	50	50	50	150
Equality Enhancement Fund	10	10	10	30
Gender Equality Commissioner	3	3	3	9
Health Care				
Non-insured health benefits (NIHB)	200	463	527	1,190
Skills upgrade & tuition relief	200	400	600	1,200
Pharmacare	900	1,800	3,000	5,700
Housing				
Affordable housing initiative	1,000	1,500	2,000	4,500
Social housing maintenance fund	10	10	10	30
Residential Rehabilitation Program renewal		128	128	256
Homelessness Partnering Strategy renewal		135	135	270
Post-Secondary Education				
Post-secondary Education Transfer	432	1,700	2,400	4,532
Federal Grant Program	440	1,000	1,800	3,240
Post-secondary Student Support Program	233	233	233	699
University research funding	200	200	200	600
Poverty Reduction Fund	500	1,200	2,000	3,700
Retirement and Seniors' Benefits	600	612	624	1,836

TABLE 4 (CONTINUED) AFB Spending Measures (Increases from current proposed spending) (\$millions)

	2008-09	2009-10	2010-11	Total
SECTION 2 Environmental Stewardship and Climate Change				
Just Transition Fund	50	100	100	250
Low-income housing retrofits	100	100	100	300
Energy Efficiency	300	567	567	1,433
Public Transit Supplement	600	800	1,000	2,400
Renewable Energy Strategy	250	388	388	1,027
Green Investment Fund	200	500	500	1,200
Transfers to municipalities & First Nations	100	200	300	600
Action on Nature	200	200	200	600
Great Lakes and St. Lawrence River	450	900	900	2,250
Agriculture	250	250	250	750
SECTION 3 Sovereignty, Democracy and Identity				
Canadian Culture				
Museums	75	75	75	225
International support	25	25	25	75
Mentorship	0.5	0.5	0.5	2
Development	460	802	1,200	2,462
SECTION 4 Changing Nature of Work and the Economy				
Value-Added Development Agency	1,750	1,750	1,750	5,250
Total Expenditures	16,202	26,975	33,211	76,388

sion in 2008 at 50% or greater, and some believe the U.S. economy was already in recession as of the fourth quarter of 2007.

For Canada, the slowdown in U.S. demand is compounded by the appreciation of the Canadian dollar by 60% (from its all-time low in 2002). While robust global demand and high commodity prices have boosted the Canadian resource sector (most notably in Western Canada), the macroeconomic picture has not been pretty for manufacturing in Central Canada. Job losses in manufacturing by late 2007 exceeded 300,000 compared to peak levels in 2002.

Forecasters have been lowering their estimates for Canadian economic growth in recent

months, and historically have tended to be excessively bullish until the economy was actually in recession. Domestic factors may also play a role in a slowdown story (the EFU sees any downside to the Canadian economy as purely the consequence of external factors).

There is evidence that Canada's housing boom is easing, and this will have an impact on real estate and residential construction employment. Fortunately, Canada has not seen the excesses of the type made infamous by the U.S. sub-prime debacle, and a trend toward lower interest rates by the Bank of Canada will help. But the tally of losses by Canadian banks and pension funds from investments in U.S. sub-prime mortgages

has been growing. This may lead to banks and other lenders tightening up credit and charging higher rates for mortgages and loans themselves, as has already occurred over the past year.

In recent months, the Bank of Canada lowered its overnight rate by one-half a percentage point, signaling a shift (at least, temporarily) away from a narrow obsession with rising inflation to more general concerns about the state of financial markets and the overall economy. However, this move will have little effect on longer-term rates.

If there is a downturn, the federal budget will naturally turn towards deficit, and federal policy should not be to cut spending to balance the budget. If anything, federal fiscal policy can and should be more stimulative.

In response to a downturn, personal and corporate income tax revenues and GST revenues will minimally slow, and possibly decline. Automatic stabilizers, such as the Employment Insurance program, have been greatly weakened since the mid-1990s, but in the face of a downturn they will push the budget towards deficit. EI surpluses have already shrunk a great deal due to rate cuts, from a \$4 billion excess of premiums paid over benefits paid in 2001–02 to an estimated \$2 billion in 2007–08. If unemployment were to rise, the EI account would turn to deficit rather quickly.

Having saved for a rainy day, the federal government should be prepared to use the umbrella of deficit-spending if need be. In addition to measures like EI that put money into the hands of people who will need it, there is a compelling case to be made for additional measures that could absorb slack in the labour market as it develops. There is much work to be done on climate change, poverty, transportation, etc. that make a compelling case for public spending as the vehicle for action.

Notes

1 Even the 13% in 2006–07 is an overstatement due to an accounting charge of \$2.8 billion (reflecting bad debts on the accounts receivable front and one-time costs associated with a change to public service pensions). Take out this adjustment, which exists only on the books, and the 7.5% increase in program spending is actually a 5.8% gain — it also would make the underlying surplus closer to \$17 billion.

2 This is a temporary tax cut as the value of the basic personal exemption was already tied to inflation. The EFU's ways and means section clarifies that the exemption is increased by about \$671 in 2007, \$298 in 2008, and a mere \$6 in 2009, above what would have otherwise been. The value to taxpayers in each would be 15% (the bottom bracket rate) of the respective amount.

3 A recent tax incidence study for Canada notes that corporate income tax is a progressive tax, as the ownership of corporate Canada is fairly concentrated at the top of the income distribution (Marc Lee, 2008. *How Resilient is the Federal Budget to an Economic Downturn?* AFB Technical Paper #2, January 2008. <http://www.policyalternatives.ca/Reports/2008/01/ReportsStudies1800/index.cfm?pa=BB736455>).

4 This includes the downward revision of 2007 growth (5.2% for 2007 compared to 5.9% in the EFU) contained in the January 22 Bank of Canada Monetary Policy Report. This has a knock-on effect on revenues in future years relative to the EFU.

5 Comment by Douglas Porter, economist at BMO Nesbitt Burns, cited by McKenna (2007).

6 Based on calculations done by Stephen Gordon on Statistics Canada data, http://worthwhile.typepad.com/worthwhile_canadian_initi/2007/12/on-the-canada-u.html