

# Intelligence MEMOS



From: Alex Laurin and John Lester

To: Federal Budget Observers

Date: March 28, 2023

Re: **TODAY'S FEDERAL BUDGET MUST CORRECT COURSE BY SHOWING DISCIPLINE,  
SMARTER TAXES AND SPENDING**

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Today's federal budget is an opportunity for Ottawa to show real fiscal discipline and to demonstrate a commitment to improving Canada's business investment and productivity performance. This will require a new approach to fiscal policy, smarter taxation, and smarter spending.

Surging inflation since the summer of 2021 has provided provinces and the federal government with a surprise deluge of revenue. True to form, the federal government spent a sizeable portion of its windfall on new measures announced in the Fall Economic Statement. Including those new programs, spending forecasts for the fiscal year 2024-25, long after COVID-related measures are gone, have grown roughly \$12 billion every six months from pre-pandemic projections in 2019 to the latest fiscal update.

The finance minister describes the federal fiscal framework as prudent and fair, pointing to a projected decline in the debt-to-GDP ratio as proof. However, in our recent [C.D. Howe Institute E-Brief](#), we demonstrate that there is a material risk that the debt ratio will rise, rather than fall, over the long run. The government's projection assumes almost 30 years of uninterrupted growth. Our approach recognizes that recessions are inevitable over such a long time period, and that the government will respond with policy measures to support incomes and the economy, putting upward pressure on debt. We do not know when, how often, or how hard recessions will hit federal finances. So we generated 1,000 probabilistic scenarios in which future recessions and government responses to them are similar to those experienced over the prior 60 years.

Our simulations allow us to estimate the probability that the debt ratio will rise, instead of fall, from its 2027/28 level over the 30-year projection period. For a fiscal plan to qualify as prudent, the probability of failing to achieve a declining debt ratio should be low. For example, the International Monetary Fund recommends a 20 percent probability threshold. Our analysis shows that the federal government has to undertake more fiscal consolidation to respect this threshold: there is at least a 1-in-4 chance that the debt ratio will rise from its value in 2027/28 over the projection period.

Incurring debt to finance economic stabilization measures during the pandemic was sound public policy. But the economy has since recovered, and [fairness](#) requires that the government pay down the debt before the generation that did not benefit from the spending starts paying taxes. Achieving this objective with high probability would require a substantial increase in the amount of fiscal consolidation by 2027/28.

Our analysis demonstrates that the federal government's fiscal plan is neither prudent nor fair. Given the government's lack of fiscal discipline, these objectives can only be achieved if the government [surrenders some of its fiscal policy flexibility](#). One approach would be to enshrine specific fiscal rules in legislation, as is done in many countries. But a better approach would be to legislate a set of guiding principles for fiscal policy while allowing a high degree of discretion in their application and requiring an independent assessment of compliance with the principles. One important guiding principle would be to require that gaps between prudent and actual or projected debt levels be eliminated over a reasonable time period. In addition, the government should be required to set out a rolling multiyear ceiling on non-cyclical spending, so that revenue windfalls are saved, not spent.

A prudent and fair fiscal plan requires more fiscal consolidation. How the required debt reduction is achieved matters. It is possible to grow the tax base, and potential revenues, while implementing fiscally prudent policies. Reallocating money spent from distortionary uses (for example, targeted business subsidies and the [soaring cost of personnel and outside consultants](#)) to more productive policies (for example, [federal economic infrastructure and a general investment tax credit](#)) can grow the tax base while easing the path to a fiscally sustainable future.

All taxes have a discouraging effect on economic growth, but some more than others. The tax system [needs to be reviewed](#) for opportunities to simplify and rebalance it to incentivize stronger productivity growth. Business taxes are particularly harmful, so the starting point should be to [reduce corporate income taxes](#), and to fund future commitments with increases in underutilized consumption taxes.

Today's budget must correct course by instituting a sustainable path for public spending and debt. It must be leaner than recent ones, combat inflationary pressures, promote growth, and avoid passing the bill forward to future generations.

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