Intelligence MEMOS

From: Benjamin Dachis, Alexandre Laurin, Janice MacKinnon, John Manley, and William B.P. Robson

To: Members of Parliament

Date: July 19, 2021

Re: **Federal Budgets Should Support Growth and Mitigate Debt Risks**

The 2021 federal budget featured overly optimistic projections for growth and federal debt, and too many measures supporting current consumption rather than investment and productivity.

Its commitment to contain the size of the federal debt relative to GDP is helpful in principle, but history suggests Ottawa may not hold itself to that anchor. Without early and serious restraint in spending once the pandemic is clearly behind us, both federal and provincial governments are on a path that threatens a debt squeeze and growth-inhibiting tax hikes or politically painful program cuts.

The C.D. Howe Institute's Fiscal and Tax Working Group first convened in the summer of 2020, to meet the need for current expert commentary on the extraordinary fiscal challenges related to the COVID-19 pandemic. At its final meeting in June, the Working Group discussed the current state of national finances, notably the federal budget released in April. While the Group noted that the federal government's commitment to reduce the federal debt as a share of the economy over the medium-term – a fiscal anchor the Group had endorsed – it judged that the government must do more to bolster growth and ensure fiscal sustainability over the long term.

One key concern about the federal budget was its focus on the short term. While measures such as support for innovation, Indigenous peoples, and childcare may enhance economic growth, the Working Group noted that almost none of the budget's many new spending measures, whether permanent or temporary, were covered by new revenues. Concerns previously expressed by the Working Group about unfunded, ongoing spending threatening the long-term sustainability of public finance in Canada are as acute as ever.

While the budget presents two long term scenarios in which the federal debt declines from its current peak of over 50 percent of GDP to 40 percent or 30 percent of GDP by 2055, group members noted that these reassuring paths depend on economic growth assumptions that are more optimistic than past projections, without any obvious reasons for the upgrade.

Canada's population is aging, resulting in a lower share of the population working. Canada's resource sector is also less likely to boost productivity and growth as it did the past two decades. The federal budget did little to counter Canada's decline in business investment compared to our major competitors. The Group noted that Canada's public-debt reductions starting in the mid-1990s – with sharp and disciplined reductions in program spending, including provincial transfers – benefited from economic tailwinds, such as an improving workforce-dependents ratio, the introduction of the GST and free trade with the United States, a falling interest rate that supported Canadian competitiveness. The post-pandemic environment, by contrast, presents headwinds.

A related concern is that the budget's reassuring debt-to-GDP scenarios depend on the assumption that low interest rates keep federal debt service costs from rising faster than the economy and federal revenues. If governments and taxpayers truly thought economic growth would endlessly outpace growth in their interest payments, why not borrow twice – or three times – as much? A more reasonable assumption would be that Ottawa's debt service costs will vary, but tend towards economic growth rates over the long term.

The Group also noted that Canada's provinces have major fiscal challenges, and debt burdens that will prove harder to rein in than the federal debt burden. Federal transfers are a major source of funds for provinces, and Ottawa is and will continue to be called upon to help them – something for which the budget made little provision. By continuing to spend and borrow, Ottawa will leave no room for tax cuts that could create fiscal room for provincial tax increases. In this context, the budget's anticipation of a new cost-shared childcare program with the provinces – for which the provinces would have to provide an estimated $8 billion annually – looks unwise.

The Group's concerns about national vulnerability to escalating debt also stemmed from the indebtedness of Canadian households. Canada's public finances, though worse than they were, are still better than those in many other advanced economies. But the level of private debt in Canada is high relative to other economies.

While we appreciate that the federal budget highlights the ratio of federal debt to GDP as a fiscal anchor, its projections are too sanguine about the road ahead, and its measures did too little to improve our chances of seeing a happy outcome on that front. Parliamentarians and Canadians generally need to prepare for more prudent fiscal measures in the next federal budget and its successors – with their centrepiece being a path for spending that protects Canada from unsustainable public debt and tax hikes.

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