Intelligence MEMOS

From: Don Drummond

To: Finance Minister Chrystia Freeland

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Re: **SHOULD $70 TO $100 BILLION OF FISCAL STIMULUS BE USED, AND ON WHAT?**

Ottawa's Fall Fiscal Statement set aside $70 to $100 billion through 2023-24 for possible fiscal stimulus to "build a stronger, more inclusive, more innovative and more resilient economy." Careful reflection is needed on whether and how to apply the stimulus. Questions come more readily than answers.

Will the Fiscal Stimulus Be Needed?

Probably. With COVID infections high and the vaccination rollout unsteady, it is likely the economy will remain shaky for some time.

Can Effective and Efficient Measures Be Designed?

In recessions, measures designed to increase aggregate demand through higher household, business and government spending have proven efficient and effective. Combined with unprecedented steps by the Bank of Canada to solidify credit and asset markets, such measures also moved us past the financial crisis.

Such measures include personal income tax cuts, sales tax cuts or direct payments to households. But throughout this pandemic, households have been inclined to spend when physically feasible and they are sitting on massive savings. Corporations favour accelerated depreciation allowances for tax purposes and corporate income tax cuts. But business assets can already be written down quite quickly. Many corporations are failing or will face massive losses, so reduced taxation on their profitability is not top-of-mind. Government spending is already sky high and it already struggles to deliver on existing plans to increase and accelerate public infrastructure.

Any stimulus must be much more strategic and capable of reflecting the sharply differentiated impacts of the pandemic on women, lower-income workers and certain ethic groups most affected. Both aggregate demand and aggregate supply have been hit hard. Potential output has been lowered by the hit to business investment, lower immigration and weakened matching of labour demand and supply. The fall statement estimates that potential output growth 2020-2025 has been lowered to 1.4 percent, from an estimate of 1.8 percent annually prior to COVID-19. It could be lower. Pre-pandemic, Drummond et al estimated potential growth to be only 1.54 percent rather than Finance's estimate of 1.8 percent.

Present circumstances suggest that any stimulus should be geared to boosting the economy's supply side: increasing productivity; raising labour force participation; raising immigration; strengthening the foundation of the business sector and raising business investment. Many task forces have opined on how best to do this, but success remains elusive. The government's intention to enrich Employment Insurance through easier access and a higher replacement ratio of earnings could act as a work disincentive, making it harder for employers to find workers, a complaint heard often, especially in Atlantic Canada.

Labour training could help displaced workers, but what training and for what jobs? Canada still has a weak infrastructure on labour market information, poor specification of the skill requirements of jobs in demand, and ineffective means of matching labour demand and supply. With training mostly a provincial jurisdiction, there would need to be federal-provincial-territorial agreement and that could be complex and take time. Improved childcare support could increase the labour force participation rate. The age-old question surfaces of whether government should provide general business support or attempt, where it has largely failed, to pick winners.

Would the Likely Benefits of Stimulus Outweigh the Risk and Cost?

The fall statement scenario, with $100 billion of stimulus, leaves the federal net debt-to-GDP ratio above 50 percent and the deficit at $24.9 billion by 2025-26. The stimulus would defer the return to any appropriate fiscal anchor, a goal in the Minister of Finance's mandate letter. While not as dire as during the mid-1990s fiscal crisis (when the debt burden peaked at 66.6 percent), the extended fiscal imbalance is risky and raises the question whether on balance the stimulus is warranted.

The statement's fiscal projection could prove optimistic. It does not provide for billions of dollars of fiscal risk. To cite just one, if EI is to remain self-funding over time, premiums would rise substantially as of 2023, adding to the hit to household disposable income from the 20.2-percent increase in Canada Pension Plan premiums from 2019 to 2023. Before undertaking new initiatives, the government may well need to allocate the stimulus to existing pressures and offsetting policies that will hold the economy back.

Can Stimulus Measures Be Temporary?

The fall update is adamant the fiscal stimulus must be temporary to mitigate the risk to finances. Stimulating aggregate demand can be temporary but the current economic challenges are more structural and long term. It is unthinkable, for example, to offer childcare improvements for just three years. We should be aware that initiatives introduced would be ongoing and probably even expand in scope to fulfil the many unfulfilled and unfunded programs pledged in the 2015 and 2019 election campaigns and in the 2020 Speech from the Throne.

With more questions than answers, it is not clear the government should proceed with a fiscal stimulus package as large as $70 to $100 billion. One thing is clear. To justify the costs and risks, the package would have to be far more strategic than anything applied in past times of economic weakness.

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