Intelligence MEMOS

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To: Canadians Concerned About the Recovery

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Re: **Cornerstones for a Realistic Fiscal Plan**

The pandemic-induced economic shutdown has created a deep crater in Canada's fiscal position, federally and provincially. Exceptional spending programs, combined with shrinking government revenues, will mean massive fiscal deficits and much higher public debt that will likely spill into one or more subsequent years.

As the economy begins to restart, fiscal policy will need to be re-anchored if the emerging recovery is to be sustained while successfully managing those deficits and that debt.

We propose four cornerstones for realistic and credible fiscal management in the coming period.

1 Exceptional times demand nimble and prudent fiscal planning.

The recovery has begun. Economic growth in the coming months will build slowly and unevenly across regions and sectors. Mitigating a significant relapse through ubiquitous testing and tracing, having a widely available vaccine, and providing effective and efficient treatment for the coronavirus are essential for a complete re-opening of the economy domestically and internationally.

In view of the exceptional degree of uncertainty, governments should share the full range of scenarios they are developing for fiscal planning purposes. A Fiscal Update would be an ideal occasion to show Canadians the potential way forward.

Prudent economic projections should be used. The federal government and many provinces rely on a consensus of private forecasts for projections of nominal GDP (the expected change in real GDP plus the outlook for inflation), which drives the revenue forecast for governments. Private sector forecasters are currently projecting a deep Canadian GDP contraction in this quarter and then a return to growth in the third and fourth quarters of 2020. For the year, a 6 to 7 percent contraction in real GDP in 2020 is being projected, with muted inflation of 0.5 percent or lower. This will shrink government revenues, in addition to the fiscal cost of the exceptional spending programs. Real GDP growth of 6 to 7 percent is being projected for 2021, with inflation at around 1 percent.

2 Exceptional spending will be needed for a while longer.

The forced shutdown has thrown three million Canadians out of work and the unemployment rate soared to 14 percent, with women and young people particularly affected. The combination of Employment Insurance, the Canada Emergency Response Benefit and the wage subsidy have helped to cushion the blow.

Jobs are returning as the economy is gradually re-opened. The exceptional labour market support programs should be scaled back, but agile labour market policy will continue to be needed if long-term scarring is to be minimized. A forward-looking policy mix would encourage people to further their education, invest in improving labour market skills, support worker mobility, and provide some direct employment opportunities where required. These measures will all require funding from governments.

Some ongoing support for business will also likely be required, particularly for SMEs, notably through credit from Crown financial institutions as well as targeted government programs.

3 Governments need to look for money.

To help contain fiscal deficits and debt, and then re-establish a downward pathway for the public debt burden, governments should be examining options for generating more revenues in the immediate period. Without added revenue, debt ratios could become stuck at an elevated level. Further increases to personal and corporate income tax rates are to be avoided since they could stifle the recovery by adding to work and investment disincentives. Instead, innovative areas such as taxation of digital transactions and cash-flow taxes could be considered. Consumption taxes are generally very efficient in raising revenue without having a significantly negative macroeconomic impact. While often perceived to be regressive, they can be designed to be progressive. We fully recognize, however, that increasing consumption tax rates has been a populist flashpoint.

4 Announce fiscal and debt anchor points.

The pandemic-induced shutdown and support programs will result in a massive fiscal deficit this year and a significant increase in public debt; federal debt alone could increase by nearly 50 percent and reach 45 percent of GDP by the end of the fiscal year next March 31. Realistically, large federal deficits will be generated for at least another fiscal year as the economy recovers, increasing the debt-to-GDP ratio further. Provinces will also have higher debt burdens as consequence of the shutdown.

To build credibility and confidence that public finances will be brought back under control, Canadian governments should define a desired downward pathway for debt-to-GDP for the coming period. They may also want to highlight and target the share of debt service relative to fiscal spending and/or revenues, a more immediate guide to the debt being carried by governments.

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