Crisis Working Group Report

COMMUNIQUÉ

September 22, 2020

C.D. Howe Institute Fiscal and Tax Working Group

Communiqué #2: Federal Finances Vulnerable to Adverse Shocks, Have Negligible Room for More Unfunded, Ongoing Spending

The C.D. Howe Institute has initiated a special project to rapidly provide expert policy advice to Canadian policymakers as they navigate fiscal policy during the COVID-19 recovery. The Institute's Fiscal and Tax Working Group is co-chaired by John Manley, former federal minister of finance, and Janice MacKinnon, former minister of finance of Saskatchewan, and comprised of a group of experts in both the private sector and in academia. The group's second meeting was held on Thursday, September 17th, 2020. This communique reflects the conversations held at the meeting.

The group discussed and debated the question of whether the federal government's fiscal trajectory is sustainable, given already announced plans. Overall, the consensus[1] of the group was that the crisis will leave federal finances vulnerable to significant downside risks, and there is negligible fiscal room for major post-crisis federal initiatives without further raising taxes. Any significant levels of new spending would need to be accompanied by broad-based tax increases that will affect the average taxpayer.

Downside Risks to the Outlook

The group looked at different federal finance scenarios. To start, the group looked at a, perhaps unrealistically favourable, status-quo scenario in which all spending measures announced this year do not extend into future years, and in which pre-pandemic spending plans resume starting next year. This scenario, helped by persistent low interest rates, would lead to recurring annual deficits in the order of around $40 billion over the long run (next 10 years) and a stable (if not slightly decreasing over the long term) debt-to-GDP ratio.

For a variety of reasons – including the election cycle and the fact that historical spending grew faster than status-quo projected spending – many group members suggested that a more realistic baseline scenario would see greater spending and therefore greater deficits, sending the debt-to-GDP ratio on

1 Consensus denotes agreement amongst a large share of members, not unanimity..

an upward trend. For example, if unfunded, ongoing federal program spending permanently increased by $30 billion over the pre-crisis planned level, the recurring annual deficit over the next 10 years would nearly double, to around $75 billion.

Most members, but not all, felt that such a trajectory is unsustainable, unless taxes are raised. Some members argued that there is little appetite in the population for the spending restraint that would be needed to shrink the debt-to-GDP ratio immediately. For example, simply to send the debt ratio downward on a one percentage point per year trajectory would require a permanent 5 percent reduction of pre-crisis planned program spending, starting in 2022/23.

That being said, some felt that while federal transfer payments to individuals and provinces should be left untouched, there is room to reduce operating costs in the federal government, such as compensation levels. Tighter spending controls are not the equivalent of austerity.

This outlook leaves the federal government vulnerable to future shocks, and to rising interest rates. The Bank of Canada's buying of government bonds at the moment is helping to keep interest rates low, but one member pointed to the limitations of this strategy over the longer term, given the free flow of international capital. Members pointed out that interest rate movements present a one-sided risk, in that they are as low as they can go. Furthermore, as governments look to finance new debt, they are likely looking at having to borrow at longer terms, which will increase the underlying borrowing rate.

Other members mentioned that there are strong headwinds working against future GDP growth, notably the hard hit to the resource sector and the reduction to hours of work and labour force participation of parents, particularly mothers. Lower revenues due to lower GDP than projected would have an upward effect on the debt ratio.

That said, others felt that the risks to the outlook are overblown, particularly interest rate risks, and therefore there is room for increasing the size of the federal government without increasing taxes, especially if new program spending addresses the economic problems that were induced or more clearly revealed by the crisis. If interest rates rise in the future, that will be a gradual process, and the federal government will have runway to react, both in terms of how it sets spending and/or raises revenue.

Immediate Crisis Response: Growth-Enhancing Investments

The group mentioned that the immediate focus should be on spending that promotes growth and incentivizes a return to work more broadly; for example, parents leaving the workforce is a glaring example of both a social and economic problem and investments in daycare could be seen as meeting the criteria. Others mentioned that more needs to be done to dismantle labour force barriers to participation in the economy for disadvantaged and racialized groups, and women in particular.

Investments in the country's infrastructure can also provide an immediate boost to the economy. To that effect, the federal government should concentrate on investing in its own capital infrastructure. Investments in tangible capital are amortized over long periods, and raise the government's service capacity without producing large deficits.

The federal government has other policy levers as well to boost the country's economy and the tax base. A return to pre-COVID immigration levels, and a clear focus on economic immigrants, for example, would increase the population base needed to increase tax revenues.

Limited Room for Major Permanent Spending Initiatives

Looking at future scenarios for the federal government's finances, members noted that absent spending reductions, there will be a prolonged period of program expenses (expenses excluding debt charges) exceeding revenues. Providing more services for the revenue collected over a long period of time risks obscuring the perceived relative value of publicly provided versus privately provided goods and services.

The key is that any new major spending initiatives must be important enough for the broad population to be willing to pay for them through tax increases felt by all. Public discussions around the introduction of a generous guaranteed annual income is a case in point. Such initiatives are inevitably costly, and there is no room in the current fiscal outlook to finance them unless we are prepared to raise taxes more broadly.

Conclusion

Most members of the group agreed that federal government's finances face significant downside fiscal risks, and that there is negligible fiscal room for major ongoing post-crisis federal initiatives without broad-based tax increases. Further, many members felt that the current long-term trajectory for federal finances leaves the country vulnerable to adverse shocks and is likely not sustainable. Others felt that the current trajectory could be sustained for the time being with investments in growth-enhancing programs.

The next meeting of the Fiscal and Tax Working Group will discuss the most efficient ways for governments (federal and provincial) to raise additional revenues post-crisis should the need arise.

Fiscal and Tax Working Group Members Present at the Meeting Included:

Janice MacKinnon, Co-Chair, former Minister of Finance, Province of Saskatchewan.

John Manley, Co-Chair, former Government of Canada Minister of Finance.

Robert Asselin, Senior Vice-President, Policy at the Business Council of Canada.

Paul Boothe, Faculty Director at the Ivey Academy.

Bev Dahlby, Research Fellow, C.D. Howe Institute.*

Heather Evans, Executive Director and CEO of the Canadian Tax Foundation.*

Luc Godbout, Titulaire Chaire en fiscalité et en finances publiques, École de gestion, Université de Sherbrooke.

Glen Hodgson, Senior Fellow, C.D. Howe Institute.*

Michael Horgan, Senior Advisor, Bennett Jones.*

Stéfane Marion, Vice President and Chief Economist, National Bank of Canada.

Jack Mintz, Senior Fellow, C.D. Howe Institute.*

Jennifer Robson, Associate Professor, Arthur Kroeger College, Carleton University.

Bill Scarth, Research Fellow, C.D. Howe Institute.

Lindsay Tedds, Associate Professor and Scientific Director, Fiscal and Economic Policy, School of Public Policy, University of Calgary.

Peter van Dijk, Senior Fellow, C.D. Howe Institute.

Mark Zelmer, Senior Fellow, C.D. Howe Institute.

*Did not attend meeting on September 17th.

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