



Fiscal And Tax Competitiveness

When Striking an Awkward Balance Means Striking Out: Budget 2011

By

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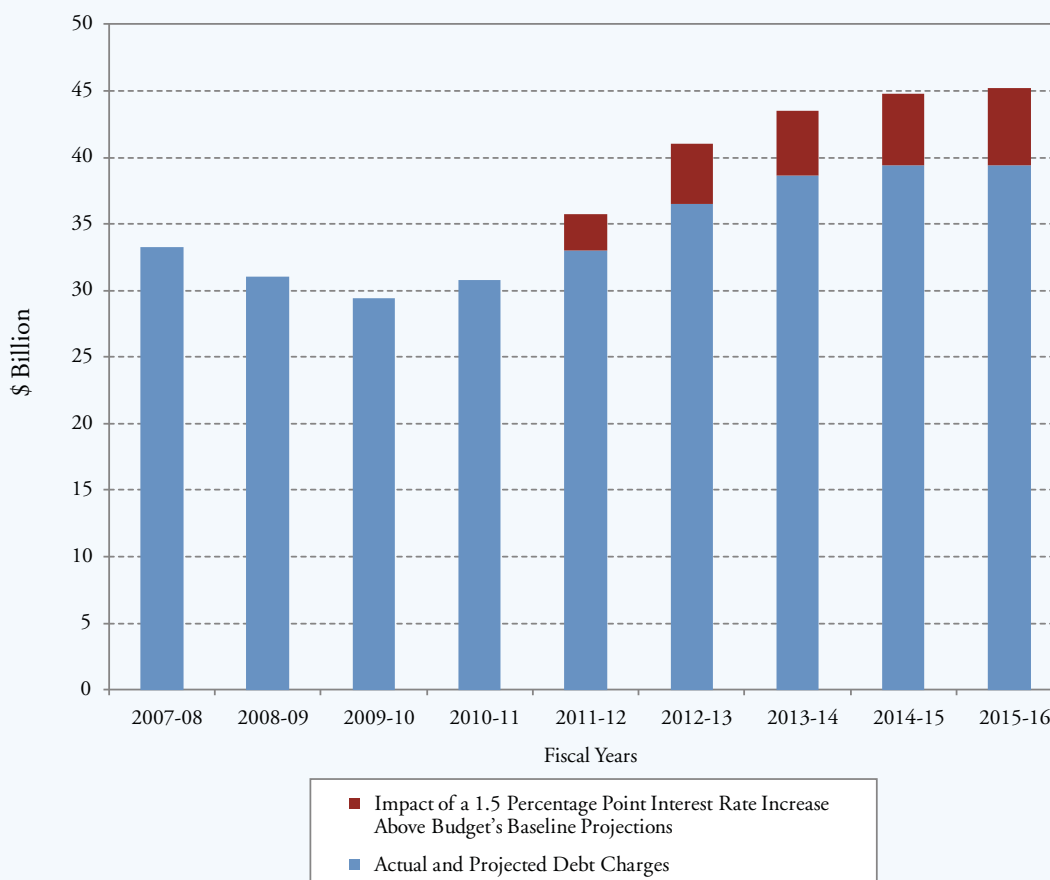
- The many minor, targeted spending initiatives and tax credits proposed in the 2011 federal budget delay a badly needed return to budget balance.
- Notwithstanding their appeal to the targeted beneficiaries, few of the proposed initiatives are sound from a tax and expenditure policy perspective.
- Keeping the budget balance near its previously scheduled path would be a respectable achievement for minority government in a time of economic uncertainty and appeals for spending.
- However, Ottawa should reinforce that framework with a revamp of tax and spending programs, taking fuller account of the net social benefits of each revenue source and program.

The 2011 federal budget, should it succeed in Parliament, would launch a new strategic spending review, alongside minor cost-cutting initiatives. The fate of the budget balance and the potential for an early return to surplus as envisioned, therefore, depend entirely on the effectiveness of these measures, which cannot be known before next year.

Meanwhile, Ottawa is directing about \$3 billion in additional annual revenue, arising from economic growth more robust than was expected last fall, mostly to finance a large number of initiatives to targeted groups. The tally for this political expedience adds up: without the continuing cost of measures announced in Budget 2011, the government would have projected a small (\$1 billion) surplus one year earlier than otherwise planned.

Granted, this budget marks the return of an explicit contingency for economic prudence. However, the amount budgeted – \$1.5 billion per year over the planning horizon – is small. A better approach would have been an aggressive cost-cutting plan to achieve an early end to Ottawa's red ink, as we called for in this year's C.D. Howe Institute Shadow Budget (Laurin and Robson 2011).

Figure 1: Impact of a 1.5 Percentage Point Rise in Projected Interest Rates on Public Debt Charges



Source: Author's calculations based on the 2011 federal budget plan's sensitivity analysis.

Why? There are many reasons to accelerate the return to surplus. Although Ottawa's balance sheet is better than it was 15 years ago, the time of the last serious deficit reduction program, the domestic and global environment for fiscal consolidation is less favourable: political and other disruptions in the supply of food, energy and other key commodities threaten the expansion; ballooning government debt in the developed democracies threatens default; and all the while demographic pressure will slow workforce growth and intensify demands for many government programs.

The bleak fiscal picture among major economies has not yet fully registered with investors. But if and when fears of default and inflation intensify, the environment for all borrowers, including us here in Canada, will deteriorate. Interest rates will rise – potentially much more than the federal budget anticipates – and growth will slow. Accordingly, the sooner Ottawa stops borrowing and starts repaying, the better its ability to cope with these risks.

The budget highlights the extent to which new and maturing debt issues will oblige the federal government to tap debt markets in the coming years. Ottawa's finances are increasingly exposed to interest-rate risk, at a time when interest rates are abnormally low. A sustained 1.5 percentage-point interest rate hike above the budget's baseline fiscal projections in 2012 would add almost \$6 billion to gross public debt charges in the last year of the planning horizon (Figure 1). Although the cumulative impact on the federal net debt would be somewhat attenuated by increased interest income on federal assets, such a sustained rise in interest rates, absent other measures, would add more than \$12 billion to the net federal debt by 2015. Mitigating Canada's exposure to this risk should be a higher priority.

When it comes to tax policy, the budget's most significant feature is perhaps the decision not to undermine previous progress that has been achieved in recent years with respect to corporate and personal income tax reductions. Recent research on the economic burden imposed by federal and provincial tax hikes (Dahlby and Ferede 2011) shows that, among the major taxes Canadian governments use, taxes on corporate income are undoubtedly the most economically damaging source of tax revenue.

Less happily, the 2011 Budget's numerous targeted tax credits – the Children's Arts Tax Credit, the Volunteer Firefighters Tax Credit, the Family Caregiver Tax credit, or the Hiring Credit for Small Business for example – add to the already long list of about 260 tax preferences contained in the federal government's latest assessment of tax expenditures (Canada 2010). While some preferences on that list are sound tax policy, too many convey benefits to their target groups at a cost to the broader economy.

Some credits simply subsidize activities many recipients would have done anyway, while others may prompt suppliers to increase prices, mitigating their impact on behaviour. And although, taken individually, the cost of most of these tax preferences is small, their overall burden is substantial. A rigorous review of all tax preferences to identify those failing the tests of economic efficiency and cost effectiveness would be the shrewder budget course (Laurin and Robson 2011).

Another targeted initiative, the new Guaranteed Income Supplement (GIS) top-up benefit for low-income seniors, would bring a meaningful increase in benefits too low-income seniors. And the initiative's aim – targeting seniors with no or little pension income other than Old Age Security payments – ensures the top-up will be available only to recipients of ordinary GIS benefits, therefore not expanding the number of eligible GIS recipients and helping to contain costs in the long term. On the other hand, the top-up comes with a ferocious clawback: 25 cents for every dollar of income past the \$2,000 and \$4,000 thresholds for singles and couples, respectively. This is on top of the existing clawbacks imposed on ordinary GIS benefits and several provincial benefits. By reducing the rewards from work and saving, and adversely interacting with benefits from the Canada and Quebec Pension Plans, the proposed GIS benefit top-up would discourage desirable economic activity by affected seniors and near-seniors (Milligan and Schirle 2008).

The budget's overall theme is an effort to balance significant political appeal with preservation of the course toward deficit elimination. But the balancing act means neither of these goals is satisfactorily achieved. The spending initiatives appear to be proving too numerous and too modest to achieve the near-term political goal, while the overall track to fiscal balance has barely changed since last fall. Canadians would be better off with a focus on the core task of restoring budget balance quickly, the better to meet clearly looming demographic and fiscal challenges, and to weather them as well as Canada did its most recent economic shocks.

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This *e-brief* is a publication of the C.D. Howe Institute.

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