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Lasting Bang for the Stimulus Buck: Priorities for the 2009 Federal Budget

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- Canada's 2009 federal budget can accommodate $26 billion in initiatives, over the next four years, to promote recovery while keeping the country visibly on course toward its longer-term fiscal and economic goals.
- Accelerated infrastructure spending, temporary EI liberalization, relief for retirement savers and a time-limited national investment tax credit are among measures offering a short-term economic boost at controllable cost.
- Spending and tax initiatives driving deficits totalling $40 billion over the next four years could be consistent with fiscal sustainability, provided the spending is matched by offsetting surpluses in the subsequent four years.

Unusual economic and political circumstances surround the framing of the 2009 federal budget. A period of global spending outrunning productive capacity has ended with financial crisis and recession in much of the world, Canada included. The sudden slump has prompted demand for, and expectations of, fiscal action.

Although aggressive promotion of credit and money growth by the Bank of Canada and other central banks is the most promising tool to foster renewed growth, smart fiscal policy can do much to help. Canada's 2009 federal budget should serve the complementary aims of promoting recovery while keeping the country visibly on course toward its longer-term fiscal and economic goals.

A Framework for Fiscal Sustainability

An effective fiscal response in current circumstances has a critical component. Short-term measures to boost demand must preserve confidence in the country's long-term position, lest nervous households and businesses retrench in anticipation of hard times over the horizon, and compromise the effort. Over the next decade, the pressure of demographic change on Canadian governments will intensify. By 2016, population aging will push the combined cost of health, education, seniors and family programs persistently above today's levels (Robson, Forthcoming). So Ottawa needs a framework that credibly signals no sudden tax increases, painful spending cuts, or burgeoning debt and interest payments once the recession is over and the demographic pressure begins in earnest.

The federal government has made steady reductions in its own debt, and in the ratio of government debt to gross domestic product (GDP), touchstones of fiscal prudence. The impact of the current slump on Ottawa's bottom line, together with the stimulus so many Canadians expect, will raise the federal accumulated deficit in fiscal years 2009/10 to 2011/12. What is needed is a practical plan to return the accumulated deficit to its 2008/09 level by 2016/17; one that is credible enough to assure Canadians that the nation's finances are under control.

Table 1: Potential Priorities for the 2009 Federal Budget

Measure	Description	Duration	Net Budgetary Impact
Infrastructure	Accelerate infrastructure investment.	Temporary	Already budgeted; would change the timing of expenditures.
EI Benefit Reforms	Equalize benefit access and duration where the unemployment rate is less than 10 percent; scale benefits back in out-years.	Temporary	$500 million annually.
EI Premium Rate-Setting Reform	Freeze EI premium rates for 2010 and 2011.	Temporary	EI account deficit of about $1.9 billion, to be repaid after 2012.(1)
Relief for Retirement Savers	Raise contributory age limit to 73; reduce minimum drawdowns.	Permanent	Small.
Investment Tax Credit	Make national, then phase out.	Temporary/ Permanent	$2.7 billion initially, rising as prior-year credits are claimed, ultimate saving.
Tariff Reduction	Eliminate tariffs on intermediate and capital goods.	Permanent	$1.4 billion annually.
Provincial Sales Tax Incentives	Encourage provinces to adopt value-added taxes in places of retail sales taxes.	One-time	$1.0 billion.
Accelerated CIT Relief	Accelerate planned reductions in corporate income tax.	Temporary	$1.6 billion annually for the next three years.
Extended Dividend Tax Credit	Make the dividend tax credit refundable to investors in RRSPs and RPPs.	Permanent	$1.7 billion annually, phased in.
WITB Increase	Increase Working Income Tax Benefit by $250 for singles and $500 for families.	Permanent	$270 million annually.
UCCB Increase	Increase Universal Child Care Benefit by 10 percent.	Permanent	$200 million annually.
Higher PIT Thresholds	Increase all thresholds by 10 percent.	Permanent	$2.9 billion annually.
Lower PIT Rates	Decrease all rates by one percentage point.	Permanent	$5.7 billion annually.

(1) Assuming an increase in the unemployment rate to about 7.1 percent in 2009 and 2010.
Source: Authors' calculations.

The aggregate cost of 2009 budget initiatives should, therefore, not drive near-term deficits larger than surpluses could plausibly repay by 2016/17. We judge that surpluses averaging 4 percent of federal revenues from 2013/14 to 2016/17 are attainable – in which case, deficits totalling some $40 billion over the next four years, including $26 billion in new iniatives, could be consistent with longer-term fiscal stability.

Priorities for the 2009 budget

Such a framework provides room for several initiatives to help the Canadian economy recover and foster growth over the longer haul. What follows (and is summarized in Table 1) is a list of measures, with cost estimates, ordered by their success in meeting the framework's criteria.

Accelerated Infrastructure Investment and Maintenance

Infrastructure investments can increase short-run demand and long-run productivity. Ottawa has already budgeted infrastructure investments in concert with the provinces, and can accelerate some of them. The scope for such action is limited, however, because large new capital projects coordinated with other levels of government are hard to bring forward. So the 2009 budget should focus on projects with faster implementation times, such as the repair and maintenance of assets under exclusive federal control.

Employment Insurance (EI) Benefit Liberalization

EI is not neutral across Canada: qualifying periods range from 420 to 700 hours of insured work, and benefits last from 14 to 45 weeks, depending on where a worker lives. Where benefits are less accessible, Canadians who lose their jobs are unfairly treated. Where they are more accessible, they discourage movement to more promising careers.

A timely intervention consistent with smart longer-term policy would, first and immediately, ease benefit access in the worst-served areas. One option for the first stage would make the duration of, and access to, benefits equal wherever the unemployment rate is less than 10 percent. This change would provide laid-off workers in low unemployment areas (a rate less than 10 percent) with benefits matching those available in higher unemployment areas. Equalizing duration would cost some $240 million in 2009; we allocate about the same amount for expanding eligibility. An accompanying reform, to take effect after three years, would gradually trim EI benefits nationwide to foster a more flexible labour market (Busby 2008).

EI Premium-Setting Reform

A second problem with EI is that premiums must rise when outlays start eroding a $2 billion reserve fund. These rules would tax jobs more heavily in the coming years when the labour market is weak. The 2009 budget, therefore, should reform the rate-setting formula. The new formula should ensure that payroll taxes do not rise before 2012, and thereafter balance the account over the cycle. Assuming the unemployment rate averages 7.1 percent in 2009 and 2010, the account would accumulate a $1.9 billion deficit, which premiums would repay in subsequent years.

Prolonging Eligibility for Tax-deferred Saving

Outdated rules preventing contributions to pension plans after age 71, and prescribing forced withdrawals from Registered Retirement Income Funds (RRIFs) and similar vehicles thereafter, threaten retirees' financial security. One immediate response is to make 73 the age at which contributions must cease. On a present value basis, the cost of this measure is small: it mainly affects the timing of federal revenue.

Liberalizing RRIF Drawdown Rules

A corollary measure would modify RRIF drawdowns. A one-year decrease in mandatory withdrawal rates, as proposed in the November 2008 *Economic and Fiscal Statement,* does not address the longer-term challenges of higher longevity and lower investment returns (Robson 2008). Liberalizing the formula to resemble its counterpart in the United States, where required distributions are about one-half those in Canada, would ease short-term financial distress and bring Canada's retirement saving provisions better into line with demographic and economic reality. While these measures will not add to demand in the short term, they will marginally reduce forced liquidations of financial assets by retirees, and associated financial-market stresses. The likely cost of this measure is small.

Investment Tax Credit

Lower profit expectations and difficult credit conditions are curbing capital investment by Canadian businesses. Lower effective tax rates on business investment would help. While more generous capital cost allowances can lower the tax bite on investment, a more attractive policy for the short and longer term would extend the current Atlantic investment tax credit (ITC) nationwide on a temporary basis, and withdraw it nationally once the economy has recovered.

The current ITC applies to new spending on buildings, machinery and equipment in the Atlantic region including the Gaspé, in farming, fishing, logging, mining, oil and gas, and manufacturing and processing. It is partially refundable for Canadian-controlled private corporations. Making it national would improve tax fairness. Making the new national ITC temporary would encourage businesses to spend now rather than later.

The refundable portion would help businesses with short-term cashflow problems; the non-refundable portion would focus support on investments that eventually prove profitable.

The expansion of the ITC implies foregone revenue of less than $3 billion in the first year, rising thereafter as credits carried forward from prior years are claimed; winding it down would ultimately boost revenue by the cost of the Atlantic ITC.

Cutting Tariffs on Intermediate and Capital Goods

Tariffs on imports of intermediate inputs and capital goods are archaic taxes that hurt production in Canada. Eliminating them would flow some $1.4 billion to businesses that are producing and investing. The objection that some of this foregone revenue would result in higher import volumes should not stand in the way of a measure that would boost Canadian competitiveness, helping secure production in Canada in the near and longer terms.

Provincial Sales Tax Harmonization

Replacing provincial retail sales taxes in the five provinces that maintain them with value-added taxes akin to the Goods and Services Tax would also lower the cost of business investment. Federal support for reform similar to the 1997 Harmonized Sales Tax implementation in Nova Scotia, New Brunswick, and Newfoundland and Labrador would require transfers to these provinces of some $1 billion over four years (Dachis, 2008). This move – helpful in the short and long runs alike – would rank higher if the reluctance of the provinces, especially Ontario, did not preclude its adoption in 2009, when it would do most to alleviate the slump.

Corporate Tax Rate Reductions

Reduced corporate income tax (CIT) rates would help economic growth now and in the future. Accelerating reductions in the general CIT rate – now scheduled to reach 15 percent by 2012 – by one percentage point would reduce revenue by approximately $1.6 billion annually for the next three years.

Extending the Dividend Tax Credit

Many current or soon-to-be retirees have suffered from the financial crisis, and sponsors of defined-benefit pensions face pressure to fund their plans with cash they could otherwise use to pay workers and suppliers, and make capital investments. The existing dividend tax credit (DTC) provides relief for taxable investors receiving dividends when the business has paid tax prior to distribution, but dividends paid into retirement saving plans get no equivalent relief.

Extending the DTC to retirement savings plans receiving dividends from tax-paying businesses will alleviate some need for new saving by individuals and plan sponsors in the short run, and remove a distortion in Canada's tax system in the long run. The annual cost would be some $1.7 billion – since assurance of assistance over time matters for saving behaviour, the 2009 federal budget can phase it in over three years to reduce the up-front cost.

Table 2: Summary of Fiscal Projections

	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17
					Billions of dollars				
Taxes, Fees and Other Charges	228.9	232.9	243.0	254.8	266.7	280.2	294.7	309.9	325.8
Investment Income	10.1	13.1	13.3	13.4	13.6	13.0	13.2	13.4	13.6
Total Revenue	*239.0*	*246.0*	*256.3*	*268.2*	*280.3*	*293.2*	*307.9*	*323.3*	*339.4*
Program Expenditure	207.6	218.6	226.8	232.9	240.5	250.6	259.3	268.4	277.8
Gross Debt Charges	31.6	32.0	35.3	38.7	39.7	39.8	39.6	38.9	37.6
Total Expenditure	*239.2*	*250.5*	*262.1*	*271.7*	*280.3*	*290.4*	*299.0*	*307.3*	*315.4*
Primary Balance	21.3	14.4	16.2	21.8	26.1	29.6	35.3	41.4	48.0
Net Debt Charges	21.5	18.9	22.0	25.3	26.1	26.8	26.4	25.5	24.0
Budgetary Balance	*-0.2*	*-4.5*	*-5.8*	*-3.5*	*0*	*2.8*	*8.9*	*15.9*	*24.1*
Initiatives	**0.0**	**-7.8**	**-8.6**	**-7.6**	**-2.4**	**-0.4**	**0.3**	**0.9**	**1.6**
Total Balance after Iniatives	***-0.2***	***-12.3***	***-14.4***	***-11.1***	***-2.4***	***2.4***	***9.2***	***16.9***	***25.6***
Accumulated Deficit	**457.8**	**470.1**	**484.5**	**495.5**	**497.9**	**495.5**	**486.3**	**469.4**	**443.8**
As percent of GDP	*28.6*	*29.4*	*29.0*	*28.1*	*27.0*	*25.6*	*24.0*	*22.0*	*19.8*

Notes:

1. Projections include initiatives announced in the November 2008 *Economic and Fiscal Statement.*

2. Initiatives reflect amounts for revenue and spending changes as detailed in Table 3.

Sources: Authors' calculations based on the December 2008 *Update to the Economic and Fiscal Statement.* For years 2008/09 to 2013/14, the budgetary balance is about half-way between the average and low scenarios set out in the November 2008 *Economic and Fiscal Statement.* Budgetary revenues are based on December 2008 *Update* nominal GDP projections. For years 2014/15 to 2016/17, nominal GDP was assumed to grow at 5 percent annually, and program expenditures at 3.5 percent annually.

Transfers to Individuals

Increasing the working income tax benefit (WITB) would boost the spending power of low-income households in the short run and reduce distortions created by uneven marginal effective tax rates on labour income for the affected families (Robson et al., 2008). Increasing the Universal Child Care Benefit (UCCB) would boost incomes for all families of young children. Increasing the WITB amounts for singles and families by $250 and $500 respectively would raise spending by about $270 million. Increasing the UCCB by 10 percent would raise spending by about $200 million.

Personal Income Tax Relief

Personal income tax (PIT) relief raises disposable income, and encourages work, saving and investment. But the fiscal cost of major relief is high: lowering PIT rates one percentage point would reduce revenue by about $5.7 billion annually. Increases in the thresholds for PIT rates fit more easily into the fiscal framework: for example, raising all thresholds 10 percent has a cost of about $2.9 billion annually.

Table 3: Impact of New Initiatives on Federal Budget Balance per Fiscal Year

	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17
				Billions of dollars				
Infrastructure Acceleration	-0.30	-0.60	-0.30	0.00	+0.30	+0.30	+0.30	+0.30
EI Benefit Reforms	-0.50	-0.50	-0.50	0.00	+0.60	+0.85	+1.10	+1.10
EI Premiums Rate-Setting Reform	-1.17	-0.70	0.00	+0.25	+0.50	+0.75	+1.00	+1.50
Relief for Retirement Savers	-0.13	-0.13	-0.08	-0.04	0.00	0.00	0.00	0.00
Investment Tax Credit	-2.70	-3.20	-3.70	-1.00	-0.33	-0.20	-0.07	-0.08
Tariff Reduction	-1.40	-1.40	-1.40	-1.40	-1.40	-1.40	-1.40	-1.40
Provincial Sales Tax Incentives		-0.43	-0.40	-0.17	-0.05			
Accelerated CIT Relief	-1.60	-1.60	-1.20					
Sub-total of Above Items	**-7.80**	**-8.56**	**-7.58**	**-2.36**	**-0.38**	**+0.30**	**+0.93**	**+1.58**
Extended Dividend Tax Credit	-0.57	-1.13	-1.70	-1.70	-1.70	-1.70	-1.70	-1.70
WITB Increase	-0.27	-0.28	-0.28	-0.29	-0.29	-0.30	-0.31	-0.31
UCCB Increase	-0.20	-0.20	-0.20	-0.20	-0.20	-0.20	-0.20	-0.20
Higher PIT Thresholds	-2.90	-2.90	-2.90	-2.90	-2.90	-2.90	-2.90	-2.90
Lower PIT Rates	-5.70	-5.70	-5.70	-5.70	-5.70	-5.70	-5.70	-5.70

Source: Authors' calculations.

The Way Forward – Short-Term Help; Long-Term Sustainability

As noted already, not all of these initiatives are affordable. Most, however, can be larger or smaller, or phased in or out at different rates. The ease with which the framework can accommodate them will depend on what happens elsewhere to spending and revenue. The November 2008 Statement committed to cap growth of Equalization transfers, which would reduce program spending by $26 billion over the five-year planning horizon, and to restrain other spending, generating further savings over the period of $15 billion. Assuming this restraint is realized, the fiscal projections for the next 8 years are as shown in Table 2.

Under this framework, deficits totalling about $40 billion over the next four years are tolerable, since subsequent surpluses would reduce the accumulated deficit below its current level by 2016/17. Relative to the post-Statement baseline, $26 billion of room is available for initiatives from 2009/10 to 2012/13. The potential timepath for the initiatives just described, distinguishing those that fit straightforwardly into the framework from those that do not, is detailed in Table 3.

Should the initiatives not readily affordable within this framework appear desirable, or should Ottawa need more revenue for bailouts and other ad hoc crisis responses, gaining further fiscal room would require dramatic measures after 2011/12 – much deeper spending restraint, or even raising the recently reduced Goods and Services Tax rate.

Canada entered the financial crisis in enviable shape. Its strong fiscal track record creates scope to cushion the downturn without undermining household and businesses confidence in its longer-term prospects. The key task for the 2009 budget is responding to the slump in ways that are effective in the short run, while serving the complementary long-run goals of sustainable fiscal balances and robust economic growth.

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