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Out on a Limb: Assessing the Fiscal Sustainability and Effectiveness of the 2009 Federal Budget

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- The medium-term federal budgetary outlook relies on optimistic assumptions that interest rates will remain low relative to recent history and that program spending will grow at a much lower pace than budgetary revenues.
- There is mixed evidence on the short- and long-term effectiveness of economic stimulus measures. Short-term impacts hinge on policy design and implementation.
- Public infrastructure investments and business tax measures would be the most likely to have a lasting positive impact on economic growth, while the federal government will need to aggressively contain spending in the coming years to reach its medium-term fiscal target.

The 2009 federal budget proposed a $40 billion economic stimulus package spanning two years and projecting a return to balanced budgets within five. The projected quick recovery of federal finances relies primarily on aggressive assumptions about future interest rates, growth of program expenditures and effectiveness of the economic stimulus plan.

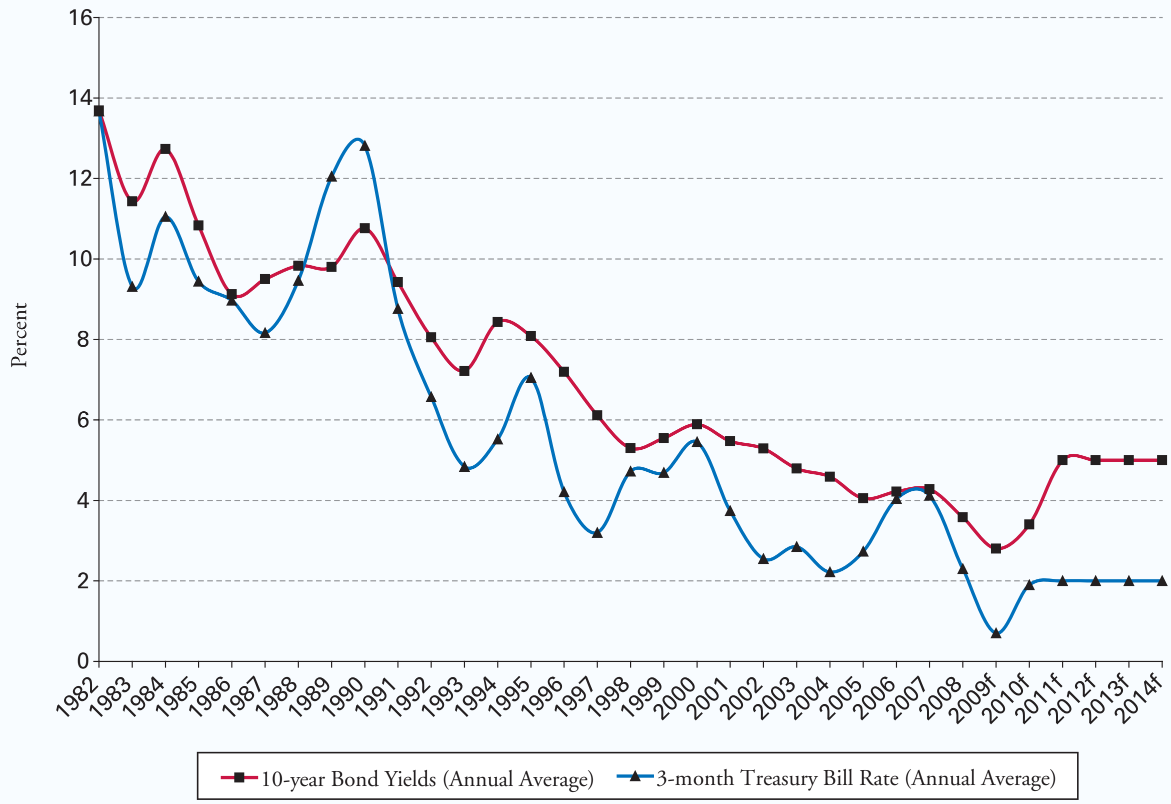
Sustainable budget plans build confidence in the future: with them, Canadians expect that tax burdens will not need to increase in the near term and public services will be maintained. Uncertainty erodes confidence, delaying private investments and shrinking the immediate impact of government initiatives on the economy. So budget implementation needs to focus on the complementary goals of prioritizing the infrastructure and tax initiatives with the best short-run effect, and ensuring that the projected return to surplus happens on schedule.

Are Deficits Here to Stay?

The recent global slowdown, given current baseline for federal revenue and spending, will likely result in underlying budgetary deficits totaling $35 billion over the next five years, adding at least $1.6 billion to annual debt charges. Meanwhile, the measures announced in Budget 2009 would add about $49 billion to the accumulated deficit, increasing annual debt charges by an additional $2.2 billion. In total, the federal accumulated deficit is projected to increase by nearly $85 billion over the next five years.

This projected rebalancing of federal finances is crucial, before fiscal pressures from demographic change intensify over the next decade. Lower debts free up resources currently spent on debt charges and better enable the country to deal with the fiscal pressures of population aging. Robson (2009) recently estimated that, by 2057, population aging will be a significant strain on the finances of governments in Canada. The current discounted value of this implicit liability is $1.5 trillion.

Figure 1: Actual and Projected Interest Rates on Government Debt, 1982 – 2014



Note: f = Budget forecast.
Source: Bank of Canada.

The main risks to the new medium-term fiscal outlook lie with budgetary expenditure assumptions. First, the combination of mounting market debt levels and low interest-rate assumptions means that debt charges are increasingly exposed to interest-rate risk. Second, growth of program expenses will have to be restrained for several years to balance the books in five.

Investment initiatives, such as the Insured Mortgage Purchase Program, loans to the auto industry, and other elements of the proposed Extraordinary Financing Framework, will contribute more than $150 billion of new market debt by the end of next year.[1] In four years, federal market debt will have increased by more than 60 percent, or $240 billion, to finance underlying deficits, budget initiatives and financial investments.

Interest rates on government debt – such as treasury bills and bonds – currently sit at historically low levels (Chart 1), and are projected to remain relatively low reducing the overall cost of servicing the debt and making new debt issues affordable. As governments worldwide fund their stimulus packages,[2] however, the global supply of new issues of government debt will escalate, putting upward pressure on interest rates. In response to the crisis, moreover, governments and central banks worldwide have significantly eased monetary conditions, injecting liquidity and keeping short-term interest rates low. Once growth resumes and inflationary expectations intensify, long-term interest rates – which are more difficult to influence through monetary policy – could increase more than expected. Table 1 shows the cumulative budgetary impacts from rising interest charges and its

1 Importantly, these investments – government purchase of financial assets – are expected to yield investment income sufficient to cover their interest cost, therefore not increasing the accumulated deficit.

2 For example, the American Recovery and Reinvestment Bill of 2009 proposes US$825 billion (CAD$1 trillion) in fiscal stimulus spending, the European Commission recommended 200 billion Euro, (CAD $320 billion) while China proposed 4 trillion Yuan (CAD $700 billion).

Table 1: Projected federal budgetary balance from a 200 basis points interest rates increase in 2010, followed by a sustained 100 basis points decline in 2012. (billions of dollars)

	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14
Budgetary Balance (Budget 2009)	-1.1	-33.7	-29.8	-13	-7.3	0.7
Budgetary Balance (with rising interest rates)	-1.1	-33.7	-31.0	-16.2	-11.9	-4.9

Sources: Authors' calculations from The Budget Plan 2009, sensitivity analysis.

importance to the credibility of the medium-term outlook.

Some $5 billion of the stimulus package – mostly income tax measures – will be permanent. In addition, interest charges on the accumulated deficit will yield another $4 billion expense, resulting in about $9 billion of total annual incremental expenses. To balance the books and fund this incremental spending, budgetary projections show program spending growing at about 3.8 percent on average – without accounting for the cost of stimulus initiatives – starting in 2010 once the recession is over. This growth is about 2.7 percentage points lower than average projected budgetary revenue growth over the same period and about 1.7 percentage points lower than average program spending growth in the last 11 years of budgetary surpluses. The challenge for the years ahead will be to keep program spending growth well below that of revenues and recent experiences.

Rating the Effectiveness of Stimulus Measures

Budget stimulus measures can be readily assessed based on two overarching criteria: their immediate ability to provide an immediate boost to the domestic economy; and their consistency with long-term economic growth and fiscal sustainability. Table 2 presents a quick assessment of how well these criteria are met, as well as potential implementation problems.

Our evaluation of effectiveness relies on theory, empirical evidence and measure-specific judgements – the effects of such measures elsewhere are uncertain,[3] and estimates vary by country and evaluation methods (Perotti 2004).

Empirical evidence is mixed on the immediate impact of government investment spending in the first year, but shows it stimulates more growth 1.5 years later (Perotti 2004). Government transfers to lower levels of government for infrastructure have larger multipliers than other transfers (Elmendorf 2009). Targeted subsidies to firms have lower multipliers than other stimulus measures (Spilimbergo et al., 2008), and countercyclical tax cuts have had no measurable impact on GDP growth in the United States within the first six months, but after two years a one percent of GDP tax reduction leads to a 1 to 3 percent increase in GDP (Romer and Romer 2008).

We find that many of the initiatives have at least some potential to immediately contribute to the domestic economy if done right. In the longer term, few initiatives – particularly public infrastructure investments and business tax measures, which account for more than one-third of the total package – seem likeliest to have a lasting positive impact.

In theory, public works spending is likely to have the most reliable immediate impact on the economy through increased aggregate demand and wages. With $17 billion in new construction and infrastructure expenditures over two years, the short-term impact depends critically on the amount of current capacity utilization in these sectors.

The immediate effect of measures intended to boost consumer spending are more ambiguous since individuals base their decisions to spend not only on conditions today but also on expectations of future tax burdens. Low-income Canadians, however,

3 For a survey of the recent literature, see Spilimbergo et al. (2008).

Table 1: Assessing Budget Iniatives

Budget Measure	Cost ($B)	Immediate Impact	Lasting Impact
Government Investment			
Public Works Projects	12.7	Positive, contingent on idle resources in suppliers, and on speed of applications and approvals. Repair and maintenance is most timely. Empirical evidence on immediate economic benefits of public infrastructure investment varies by country (Perotti 2004).	Positive. Builds public infrastructure capacity supporting long-term growth if spent on productive assets. Perotti (2004) finds that GDP growth for government investments in Canada is highly positive 1.5 years after spending.
Social Housing	2.0	Positive, contingent on idle resources in construction industry. Fewer approvals needed than for many public infrastructure projects, but coordination among governments is a problem.	Negative. Hard for federal government to extricate itself from this area, because of intergovernmental pressure.
Stimulus for Consumers			
Income Tax Changes	5.0	Somewhat positive, since low-income Canadians are likely to spend a larger proportion of their after-tax income.	Mixed. Lower marginal tax rates for many people improve labour supply. But permanent fiscal cost raises concerns about sustainability, potentially damping boost to growth.
Construction and Homebuilding	3.5	Positive. Private, small scale investment does not require lengthy approval process. Tax credit implementation may be difficult on large scale.	Negative. Permanent tax reduction measures for first-time homebuyers further skew the tax system towards favouring home ownership, and create continuing fiscal costs.
Job Retraining	2.3	Little effect. Developing criteria for coverage of non-EI beneficiaries will slow implementation. Evidence from provincial retraining programs suggests low initial take-up.	Negative. Ongoing cost raises concerns about sustainability. Government-sponsored training programs have poor record of building human capital (Poschmann and Robson, 2001).
EI Benefit Extension	1.4	Somewhat positive, since affected individuals may feel more able to spend.	Mildly negative. Will be difficult to reverse, but ongoing costs are internal to EI program, promising little lasting impact on Ottawa's bottom line.
Working Income Tax Benefit	1.2	Marginally positive. Stimulates consumption by targeting low-income individuals with the highest propensity to consume.	Mixed. Encourages greater labour market participation. Ongoing fiscal cost raises concerns about sustainability.
Stimulus for Firms			
Industry Supports	4.9	Negative. Targeted subsidies to firms have lower multipliers than than other stimulus measures (Spilimbergo et al 2008); help to one firm hurts domestic competitors.	Negative. Sustaining industries in decline diverts resources from more promising uses. Subsidies create constituencies for more subsidies, raising concerns about long-term impact on Ottawa's bottom line.
EI Premium Rate Freeze	4.5	Positive. Stimulates consumption and lowers cost of labour.	Marginally negative. Future premiums will have to rise to cover upcoming costs, but requirement to balance EI account reduces concerns about long-term sustainability.
Regional Supports	1.6	Negative. Targeted business subsidies have lower multipliers than other stimulus measures (Spilimbergo et al 2008), and noneconomic criteria affect grants (Mintz and Smart 2003).	Negative. Subsidies are hard to withdraw, diverting resources from more promising uses and threatening continued impact on Ottawa's bottom line.
Corporate Income Tax Changes and Tariffs Reductions	1.0	Likely positive. Profitable industries will be in a better position to utilize the accelerated depreciation, reducing scope of total effect.	Positive. Broad corporate tax reductions, such as tariff elimination on business inputs, will boost investment, more than offsetting concerns about lasting impact on federal revenue.

Source: The Budget Plan 2009.

have pressing needs and are likely to spend a larger proportion of income; hence, the rationale for targeted measures such as EI benefit extensions and lower taxes for low-income households.

Recommendations

Business measures, unlike consumer-based measures, should be broad-based and not targeted at specific industries and regions. Governments have a bad record of picking winners and losers, and subsidies are hard to withdraw. Resources employed at sustaining industries in decline tend to be diverted from more effective and promising use. The 2009 budget proposed over $6 billion in targeted industry and regional supports. On the other hand, broad corporate tax reductions, such as elimination of tariffs on business inputs, have a lasting impact on economic growth through their effect on investment.

Ultimately, the ability of the federal government to rapidly eliminate the deficit rests in limiting program spending growth to historically low levels. Given the risks posed by population aging, the need to control spending in the coming years and reduce overall exposure to interest rate movements appears essential to achieving medium-term fiscal sustainability. Once balanced budgets are achieved, surpluses should be put towards quickly eliminating the deficit accumulated over five years – rather than passing it on to coming generations. The greater Canadians' confidence on this score, the greater the likelihood that the economic stimulus in the 2009 federal budget will foster an early recovery.

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