C.D. Howe Institute Fiscal and Tax Working Group

Communiqué #4: Stimulus Spending if Necessary, but not Necessarily Stimulus Spending

The C.D. Howe Institute has initiated a special Fiscal and Tax Working Group to provide timely expert policy advice to Canadian policymakers as they navigate fiscal policy during the recovery from the COVID-19 crisis. Co-chaired by John Manley, former federal minister of finance, and Janice MacKinnon, former minister of finance of Saskatchewan, the Working Group is comprised of experts from both the private sector and academia. The group met on January 29, 2021.

At that meeting, the group discussed the following questions: Is a new fiscal stimulus package appropriate? What form should a stimulus package take, if any? Can stimulus measures be temporary?

Overall, the group is not convinced that a large post-pandemic stimulus package is appropriate. Members argued that any further debt-financed stimulus should be temporary, essential, and targeted to improving the economy's productive capacity. With federal debt rising rapidly, members argued that any new permanent programs should be tax-financed.

Will Fiscal Stimulus Be Needed? We Don't Know, But Spend Only if Necessary

With COVID infections high and the vaccination roll-out unsteady, Canada's economy will struggle for some time. While a slow economy will prompt calls for fiscal stimulus, many members noted that Canadian governments had already spent almost $250 billion, or 12 percent of GDP, in direct aid to households and firms: one of the largest aid packages of all advanced economies. Their view was that the resulting accumulation of liquid saving is like pre-loaded stimulus, which will be spent and invested when the pandemic abates.

A key theme of the conversation was that new programs should target the problems that are holding Canada's productive capacity back – principally vaccinations and other measures to stop the spread of the virus, let people get back to work and resume other activities safely.

The Risks to the Fiscal Outlook: "Temporary" Is Absolutely Essential

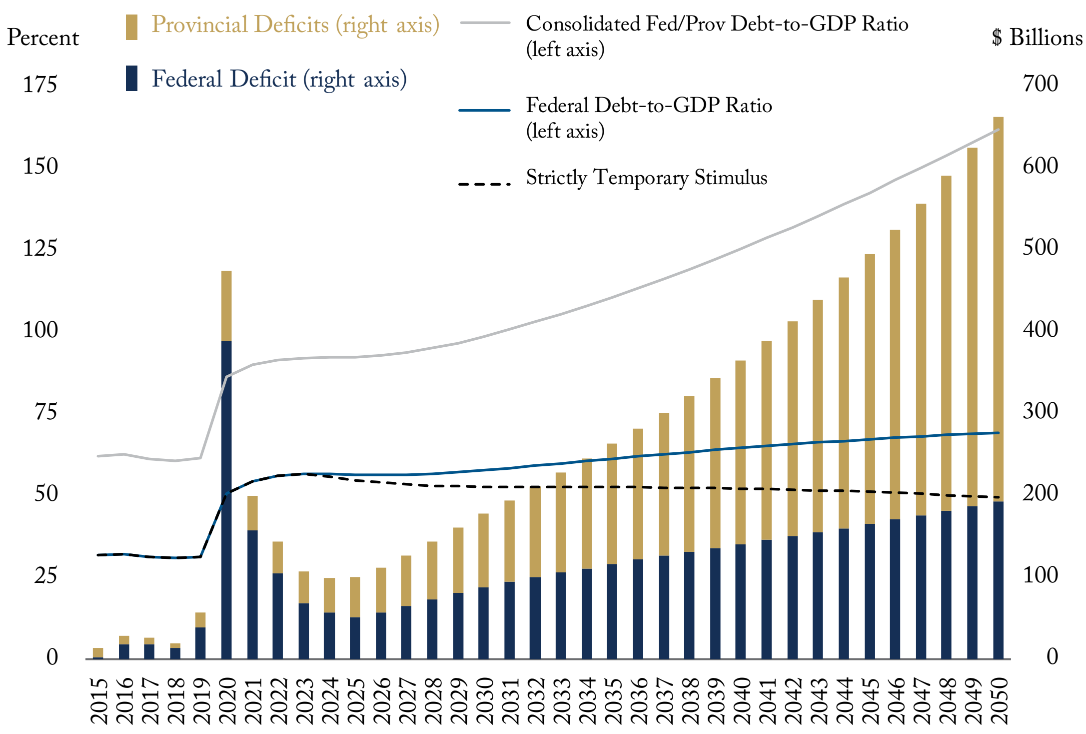
Looking at the federal government's proposal, outlined in its Fall Economic Statement, for $70 to $100 billion through 2023/24 in planned stimulus, the group noted that this proposal effectively defers the use of a fiscal anchor, a goal in the Minister of Finance's latest mandate letter. Members also pointed out that the Statement neglects some important fiscal risks.

Among the risks noted in the discussion was the requirement for the Employment Insurance program to remain self-funding over time. That implies substantial hikes in EI premiums as of 2023, which would come on top of scheduled increases in Q/CPP premiums. The effect could be to dampen job growth. Another theme in this discussion was the Statement's lack of provision for big-ticket, ongoing commitments this government has made such as the establishment of a national childcare initiative, a national pharmacare program, higher Old Age Security as of age 75, a new Canadian Disability Benefit, and a National Training Strategy.

The Working Group considered some numbers, summarized in the figure below. It charts a scenario in which the one-time $100 billion is spent over the next three years, including the interest cost of the associated increase in debt (which the Fall Economic Statement excluded). It also shows a scenario with $20 billion in increased annual spending becoming permanent thereafter. Ongoing, unfunded spending would send the federal debt-to-GDP ratio steadily upward.

On a consolidated basis, federal/provincial net debt could surpass 100 percent of GDP within the next 10 years and continue to grow. The Working Group saw this kind of scenario as problematic for many reasons, including the limits of potential lenders' appetites for Canadian government debt. Among the observations from members were that provinces would be wise not to sign on to any shared-cost programs in the face of such numbers, that stimulus decisions should come only once Canada is clearly into a post-pandemic world, and that any new permanent initiatives must be accompanied by associated tax measures to fund them while preserving economic growth.

Figure 1: Long-Run Federal and Provincial Fiscal Outlook



Notes: C.D. Howe Institute's modelling based on the Fall Economic Statement 2020 and PBO's long-term projections. The federal effective interest rate on the debt is assumed to gradually increase over the projection period to reach the level of potential GDP growth in 2050. The federal stimulus assumptions are: $30 billion in 2021/22, $50 billion in 2022/23, and $20 billion in 2023/24. The net level of program spending is raised by $20 billion (increasing with GDP) starting in 2024/25 reflecting the permanent nature of most of Ottawa's stated policy commitments.

In the view of members, the federal financial outlook should acknowledge more of the risks the economy faces in the future. Any economic forecast is highly uncertain and added debt from stimulus would add to the existing risk. Members cautioned that Canada could easily have another recession in this decade, significantly worsening an outlook that is already shaky. Furthermore, inflation and higher interest rates may return sooner than generally assumed. A future financial crisis could result in future deficit and debt problems. As a result, retaining fiscal firepower would be prudent. Federal debt is only a portion of the current debt risk to Canada, and the contagion risk of one province having debt difficulties could spread across the country.

What Form Should a Stimulus Package Take, If Any?

Present circumstances suggest that any stimulus should be geared to boosting the economy's supply side: increasing productivity; raising labour force participation; raising immigration; strengthening the foundation of the business sector, and raising business investment. But governments' record on the productivity front is not good, noted members, and temporary measures are less likely to help than permanent ones.

Among the challenges near-term measures could address, the Working Group emphasized preserving the country's economic capacity and avoiding lasting damage to our labour force. While the wage subsidy program has helped preserve jobs, the government now needs to transition away from it. Workforce training is mainly in the provincial realm, and it is likely that provinces and territories would want outstanding federal-provincial irritants, especially the declining federal share in healthcare costs, addressed before signing on to something new. Some members argued that Ottawa should channel support directly to businesses, which are best placed to support training and retraining for the skills they require, and support workers taking on work through an enhanced Canada Worker's Benefit, a federal tax program that subsidizes wages for low-income workers. Such help is needed given the government's intention to enrich Employment Insurance through easier access and a higher replacement ratio of earnings, which could act as a work disincentive.

Canvassing options for supporting women, lower-income workers and others disproportionately affected by COVID's economic impact, the group observed that childcare is another area of provincial jurisdiction, which means that any national programs would require provincial cooperation and agreements, hence delaying implementation. The federal government could more readily support families through an expanded Canada Child Benefit.

The group noted that the pandemic has made the importance and benefits of the digital economy abundantly clear. Public investments in the infrastructure required to connect all parts of Canada to high-speed and reliable internet networks should be part of any stimulus package. Because they can be truly temporary, other infrastructure investments, including in climate-change adaptation, and in Indigenous communities, are candidates for a growth-oriented stimulus package.

On the tax side, corporate income tax reductions may be less effective in the immediate term since many businesses are failing or will face massive losses, so reduced taxation on their profitability is not top-of-mind. A temporary refundable investment tax credit could work better. Getting more business investment in Canada is even more critical given the continued lagging in domestic investment relative to international competitors, especially the US. The GST could be used; ie., cut to provide a temporary stimulus in the short-term; and increased to finance permanent initiatives in the long run.

One member reminded the group that stimulating the economy is not just about spending tax dollars. Pro-growth regulatory improvements, such as removing inter-provincial trade barriers, are essential. Business confidence is the cheapest stimulus – and some Working Group members expressed concern that the tone of federal communications is not helpful to business confidence.

Bottom Line

The members of the Working Group are not all convinced that a large post-pandemic fiscal stimulus package is necessary at this point. Federal spending should focus on getting us through the pandemic as quickly and unscathed as possible. Longer term, policies should be geared towards improving the economy's productive capacity. Risks to the fiscal outlook abound, so any new permanent initiatives should be funded. Stimulus, if any, should be tightly targeted and strictly temporary.

The Working Group thanks Don Drummond, Stauffer-Dunning Fellow in Global Public Policy and Adjunct Professor at the School of Policy Studies at Queen's University as well as a Senior Fellow, C.D. Howe Institute, for giving introductory remarks.

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