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Intelligence MEMOS

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From: Colin Busby and Nick Dahir
To: Canadian Fiscal Observers
Re: THE TOUGH CHOICES THAT LOOM OVER OUR NEW 5-PERCENT DEFENCE TARGET

Having finally reached the North Atlantic Treaty Organization's 2-percent target of GDP defence spending – set in 2014 – Canada now faces a far steeper, and more critical climb.

Raising that share to 5 percent by 2035 and boosting military capabilities in an increasingly insecure world is not a marginal adjustment. It will fundamentally reshape federal finances and force a reconsideration of what Ottawa spends – and how it pays for it.

Our new C.D. Howe Institute **report** lays out the scale of Canada's commitment and its fiscal consequences.

The results are striking.

Under Ottawa current fiscal plans defence spending would surge past direct non-defence program spending, and could rival transfers to other levels of government.

The 5-percent pledge has two components. First, core defence spending would rise from the current 2-percent benchmark to 3.5 percent of GDP. Second, an additional 1.5 percent would go toward "dual-use" investments – areas such as infrastructure and capabilities that support military readiness but were not previously counted under NATO definitions. That new Arctic road, for instance.

According to the 2025 budget, Canada expects to meet this latter component. Putting this aside for now, the main challenge lies in scaling up core defence spending.

We project that, in meeting our NATO pledge, defence spending should nearly triple over the next decade, approaching $150 billion by 2035. That would make it one of the largest spending items in the federal budget. Accommodating such an increase without relying heavily on borrowing will require some hard choices.

Although higher defence spending should generate some broader economic benefits – recent research does find some positive effects, but the size is uncertain – any spillover benefits are unlikely to be large enough, or materialize soon enough, to meet the defence target without having to make other hard fiscal choices.

Put simply, Ottawa cannot meet this challenge and maintain its current fiscal anchor – a declining deficit-to-GDP ratio over time. Nor can Ottawa debt-finance this expansion without exposing Canada to the risks that come with persistently higher debt loads – reduced fiscal flexibility, greater vulnerability to interest rate shocks, and an increased burden on future taxpayers. That leaves two broad levers: Raising revenues or restraining other spending.

Neither is easy. Canada's weak productivity growth and modest economic outlook limit the room for large tax increases without undermining competitiveness. At the same time, demographic pressures – particularly population aging – are already pushing up spending on social programs while slow workforce growth limits our economic expansion. Layer on global uncertainty and trade conflicts, and the fiscal squeeze becomes even tighter.

In this context, a mixed approach is the most pragmatic path forward. Modest, broad-based revenue measures – such as a one-point increase in the GST, from 5 to 6 percent could generate as much as $17 billion annually by 2035, combined with slower growth in non-defence spending, would help create the fiscal room needed.

On the spending side, one area for scrutiny is the level of yearly growth in transfers to the provinces and territories. The federal government alone is responsible for financing and for organizing military readiness and capabilities. The provinces and territories, however, are responsible for delivering most healthcare and education services. A reduction in the growth rate of provincial and territorial transfers could, for example, be achieved with the federal government encouraging the provinces to increase their HST by one point. This would acknowledge the pressure on Ottawa, free up additional resources for them to fund defence capabilities and at the same time encourage the provinces to more clearly take responsibility for financing Canada's key social programs.

There is ultimately only one taxpayer in Canada. A balanced financing approach spreads the burden, avoids over-reliance on revenue increases or spending reductions, and preserves the overall structure of Canada's tax and transfer system, albeit at a leaner scale.

Reaching the 2-percent benchmark after years of falling short is worth celebrating. But that milestone, while important, is only the beginning. The 5-percent target represents a far more ambitious commitment that will test the country's fiscal capacity and political will. Meet this challenge we must, as the world is more dangerous than it has been in more than half a century.

A credible fiscal plan is valuable to both inform difficult decisions, and equip the Department of National Defence with a reliable frame for planning multi-year equipment and personnel decisions. A strong plan would also be meaningful to any organization considering multi-year investments in Canada's domestic defence industrial capacity, many of whom have been bruised by broken defence spending promises in the past.

Meeting the spending pledge while maintaining fiscal discipline will require more than incremental adjustments. It demands a clear-eyed assessment of priorities and a willingness to make difficult choices about both spending and taxation to get the job done.

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