

Pre-Budget Consultations, 2009

Submission to House of Commons Standing Committee on Finance

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Executive Summary

The global economic and financial crisis has been unprecedented both in terms of its severity and high degree of synchronicity. Worldwide, demand slumped and trade plummeted. Central banks (including the Bank of Canada) aggressively cut interest rates to stimulate aggregate demand, and introduced bold and innovative measures to provide much needed liquidity to kindle the flow of credit. Governments committed substantial fiscal stimulus focused on spending and targeted tax cuts.

Significant progress has been made in stabilizing the world economy. There are signs that the recession in Canada is in its final stages, with real GDP growth expected to resume by year-end. However, the recovery is expected to be gradual, with risks tilted to the downside.

Vigilance is warranted in light of remaining downside risks and tepid growth prospects. First, the government must **implement the announced stimulus measures promptly and effectively**. In its *Second Report to Canadians*, the government indicated that “80 percent of the measures are either flowing, or there are commitments in place that will allow the funds to flow to specific projects and initiatives.”¹ Concerted effort is needed by all levels of government to ensure committed funds get out the door. Restoring confidence, growth and jobs should remain the government’s top priority.

Second, we must **chart a path back to fiscal discipline**. Rising debt and interest burdens constrain budgetary flexibility, and reduce the government's ability to act in areas that are crucial to our long-term competitiveness – in particular, tackling high marginal personal income tax rates and meeting the challenges posed by an aging population. To build confidence in the future, the government must present Canadians with a viable plan on how it will balance its books and avoid structural deficits. Repairing federal finances will not be achieved overnight. It will require significant program spending restraint, and a commitment to dedicate surpluses (once balanced budgets are achieved) to repay deficits accumulated since fiscal 2008-09.

Third, we must **lay the foundation for sustainable, long-term economic growth** by addressing long-standing structural impediments that negatively affect the operation of markets, and the capacity of businesses to operate efficiently. This entails removing all internal barriers to trade and mobility, eliminating overlapping regulations, minimizing tax administration and compliance costs, and tackling the issues that impede the full utilization of market access opportunities internationally. We must adopt sound public policies that promote work, saving and investment, encourage entrepreneurship, stimulate technological progress and boost productivity.

These guiding principles will ensure that Canada’s economy remains dynamic and flexible – capable of readily adjusting and adapting to economic shocks and circumstances.

The Canadian Chamber of Commerce wishes the House of Commons Standing Committee on Finance every success as it conducts pre-budget consultations. We are anxious to assist in every way we can to build a stronger and more prosperous Canada.

¹ Government of Canada. “Canada’s Economic Action Plan: A Second Report to Canadians.” June 2009.

Introduction

The Canadian Chamber of Commerce is Canada's largest and most broadly-based business organization – a diverse network representing 175,000 businesses and more than 325 local chambers of commerce and boards of trade. As the national leader in public policy advocacy on business issues, the Canadian Chamber's mission is to foster a strong, competitive and profitable economic environment that benefits not only business, but all Canadians.

The Canadian Chamber welcomes the opportunity to once again participate in pre-budget consultations, and to share its views on the two questions posed by the House of Commons Standing Committee on Finance:

1. What federal tax and program spending measures are needed to ensure prosperity and a sustainable future for Canadians from an economic, social and/or environmental perspective?
2. What federal stimulus measures have been effective, and how might relatively ineffective measures be changed to ensure that they have the intended effects?

1. Ensuring Prosperity and a Sustainable Future for Canadians

The global financial and economic crisis necessitated swift government action to mitigate the severity of the downturn, restore confidence and promote recovery. The government responded with a two-year, \$46.6 billion fiscal stimulus package. In the January 2009 budget, the government predicted it would run an accumulated deficit of \$83.8 billion over four years (fiscal 2009-10 to fiscal 2012-13), with a small surplus (\$0.7 billion) in fiscal 2013-14.²

Since Budget 2009, lower projections for nominal GDP (a proxy for the overall tax base) point to substantially higher deficits over the five-year horizon. TD Economics projects a cumulative deficit from fiscal 2009-10 to fiscal 2013-14 of \$167.1 billion – \$51.0 billion in 2009-10, improving to \$19.4 billion in fiscal 2013-14.³

The Office of the Parliamentary Budget Officer (PBO) is projecting a cumulative deficit of \$155.9 billion over five years – a \$48.6 billion deficit in 2009-10, improving to \$16.7 billion in 2013-14. The PBO concluded that “the budget is not structurally balanced over the medium term” implying that an expansion in economic growth cannot be counted on to generate sufficient revenue to balance the budget over the medium term.⁴

There is always a price to be paid when a deficit is incurred. Canadian will have to repay it in the future - both principal and interest⁵ - making it harder to cover program costs, like health care and education, and respond to an aging society. If deficits persist over long

² Department of Finance Canada. “Canada's Economic Action Plan.” *Budget 2009*. January 27, 2009.

³ TD Bank Financial Group. “TD Economics' 5-Year Federal Fiscal Forecast.” *Observations*. TD Economics. June 2, 2009.

⁴ Office of the Parliamentary Budget Officer. “Economic and Fiscal Assessment.” July 6, 2009.

⁵ Public debt charges are projected to reach over \$40 billion by fiscal 2013-14 (up from \$33.3 billion in fiscal 2007-08), absorbing about 15 cents of each dollar of revenue collected by the federal government. To put this into perspective, \$40 billion is roughly what the federal government collected in corporate income taxes in fiscal 2007-08.

periods of time, Canadians and Canadian businesses will face a higher tax burden, and our competitiveness will be threatened. Therefore, rebalancing the federal books is crucial.

Recommendation 1: *The Canadian Chamber calls on the federal government to present Canadians with a viable plan on how it will balance its books and avoid structural deficits.⁶*

A plan is necessary to build confidence in the future. “Questions about debt sustainability would undercut the near-term effectiveness of policy through adverse effects on financial markets, interest rates and consumer spending.”⁷

Repairing federal finances will not be achieved overnight. The ability of the government to rapidly eliminate the deficit and reduce interest rate exposure on outstanding debt rests in limiting program spending growth to historical low levels.⁸ We must avoid raising taxes – a move that would weaken our global competitiveness.

Recommendation 2: *The Canadian Chamber calls on the federal government to contain annual increases in program spending to two-to-three percent (in line with growth in inflation plus population) starting in fiscal 2012-13 when more solid economic conditions emerge, and the output gap (i.e. the difference between actual and potential real GDP) is absorbed.*

However, even under this scenario, the government is unlikely to balance the budget until fiscal 2015-16, at the earliest. It is imperative that the federal government continue to review all direct program spending and operating costs to determine where the payoffs are the greatest, identify areas where spending can be reduced or eliminated, and evaluate whether activities or spending should properly remain at the federal level or be undertaken by the provinces/territories.

Recommendation 3: *Once balanced budgets are achieved, the Canadian Chamber calls on the federal government to use surpluses to repay deficits accumulated since fiscal 2008-09.*

Besides doing whatever we can to mitigate the severity of the downturn and speed recovery, the government must ensure Canada’s economy remains internationally competitive over the long term. It must focus on building the most skilled and competitive workforce in the world; eliminating internal barriers to trade and mobility; creating new market opportunities for Canadian companies; implementing the Competition Policy Review Panel’s recommendations with respect to the *Investment Canada Act*; establishing

⁶ It is important to distinguish between cyclical deficits (that result from cyclical fluctuations in business activity, i.e. an economic downturn) and structural deficits (i.e. the deficit that remains after temporary business-cycle effects are discounted).

⁷ Spilimbergo, Antonio, Steve Symansky, Olivier Blanchard, and Carlo Cottarelli. “Fiscal Policy for the Crisis.” *IMF Staff Position Note*. International Monetary Fund. December, 29, 2008.

⁸ Growth in federal government program spending has increased six to eight percent per year since the late 1990s.

a Canadian strategy that reconciles our need for secure and affordable energy with our desire for a clean and healthy environment; significantly improving our scientific and technological capacities; improving our ability to move research breakthroughs out of the laboratory to the marketplace; eliminating overlapping regulations; developing national accreditation standards; ensuring the coordinated and timely maintenance and development of our border resources to meet the commercial and security needs of the Canada-U.S. relationship, and make Canada a competitive gateway for North America; developing and implement an objective-based National Transportation Strategy that embodies a North American vision; and championing a strong intellectual property rights regime. It is imperative that the government not lose sight of these longer-term issues.

2. The Effectiveness of Fiscal Stimulus Measures

While it is reasonable for the Finance Committee to enquire about the effectiveness of fiscal stimulus measures, it is difficult to determine the precise impact of each measure on real GDP, and more so in the face of unusual economic circumstances. The Canadian Chamber shares the federal government's view that "there is considerable uncertainty surrounding any assessment of fiscal stimulus. The main source of uncertainty is the so-called multiplier effect – the relationship between amounts injected in the economy on the one hand and the change in real GDP and employment, on the other hand."⁹

Infrastructure spending – the centerpiece of the federal government's fiscal stimulus package – is predicted to have the largest bang-for-the buck. The short-term multiplier for infrastructure spending is estimated to be relatively high (i.e. 1.0) meaning that one dollar in budgetary expenditure generates one dollar in real output in the short term. This should not be surprising since infrastructure investment boosts GDP directly (by putting idle resources to work) and indirectly (since the businesses that are granted the contracts and the individuals put to work will have extra income to spend). However, the amount of money that will actually flow will depend, to a large extent, on the capacity of other levels of government to finance and contribute their required shares in partnership with the federal government.

A reduction in personal income taxes has a lower multiplier in the short run (0.4) reflecting the likelihood that a portion of the tax cut will be saved rather than spent immediately, and consumers may spend the extra disposable income on imports rather than domestically produced goods. "However, in the case of permanent tax reductions, tax multipliers increase gradually as households and businesses adjust spending patterns and behaviour to lower taxes and higher permanent income."¹⁰ By the second year, personal income tax measures have a multiplier effect of 1.0.

By and large, it is too early to pass judgement on the effectiveness of the fiscal stimulus package. There are always significant time lags associated with the implementation of fiscal policy actions.¹¹ There is also a response lag – the time between enactment of a fiscal stimulus measure and its actual effect on the economy.

⁹ Department of Finance Canada. "Canada's Economic Action Plan." *Budget 2009*. January 27, 2009.

¹⁰ *Ibid.*

¹¹ The implementation lag for monetary policy is generally much shorter than for fiscal policy. The response lag tends to be shorter for fiscal policy compared to monetary policy. There are long and variable

The overwhelming fiscal policy response is expected to gather traction by year-end and reach full force in 2010. In general, it takes about one year for a change in taxes or government spending to have a full effect on the economy. To be sure, there are signs that Canada's economy has begun to stabilize and that the recession may be on its last legs, but we will not get official confirmation until Statistics Canada releases quarterly GDP data for the third and final quarters of 2009.¹²

The risk to the economic outlook is the declining trade balance, exacerbated by the sharp rise in the Canadian dollar. This goes to illustrate that in a small, open economy like Canada's, there is only so much the government can do. Many forces are external and beyond our control. Even if the fiscal stimulus measures have their intended effect, external forces will have a significant influence on our economy.

Conclusion

The federal government (alone, and in partnership with the provinces and territories) has undertaken an unprecedented, concerted fiscal expansion to stimulate demand, foster confidence and support economic recovery. The up-front cost of these measures, combined with slower revenue growth, has resulted in a significant deterioration in the government's fiscal position. After recording eleven consecutive annual budgetary surpluses, a string of deficits is expected both in the near term and over the medium term.

Long term, permanent structural deficits must be avoided. Along with spiralling costs of interest payments on the debt, they soak up national savings that can be put to more productive use. It is crucial that we rebalance the government's books sooner rather than later to regain the fiscal flexibility needed to tackle areas that are crucial to our long-term competitiveness – in particular, high marginal personal income tax rates (especially as they apply to individuals with modest incomes), and the challenges posed by an aging society. Post 2011, the cost of financing the needs of an aging population will be increasingly shouldered by a shrinking percentage of workers.

Preserving the public's trust in the sustainability of public finances is essential. Implementing policies that promote work, saving and investment, encourage entrepreneurship, stimulate technological progress, boost productivity and economic growth, and enhance our long-term competitiveness is smart. While we keep an eye on reviving the economy, we must focus on the long term, and implement policies with an eye on the future.

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lags – six to eight quarters – between changes in monetary policy and their effects on inflation and the economy. Economists estimate that the response lag for fiscal policy is approximately one year.

¹² Q3 and Q4, 2009 Canadian Economic Accounts will be released on November 30, 2009 and March 1, 2010, respectively.