Fraser Alert
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FRASER INSTITUTE

February 2010

Budget Balance should be the Federal Government's Focus

Main Conclusions

- Federal revenues in 2008/09 and 2009/10 were adversely affected by the recession but are expected to rebound this year (2010/11) and then continue to grow at a robust average rate of 6.4 percent until 2014/15
- Federal spending increased significantly in 2009/10 and is expected to increase again in 2010/11 as a result of the federal government's two-year stimulus plan. However, rather than decrease in 2011/12 as the stimulus plan comes to an end, spending is expected to remain at the 2010/11 level, and then increase further over the next four years (2011/12 to 2014/15)
- The source of current and future deficits is increased government spending, not a lack of revenue
- Expected federal deficits totalling $108.5 billion over the next five years (2010/11-2014/15) will greatly hinder the federal government's ability to improve Canada's competitiveness, especially in terms of tax relief
- Empirical evidence clearly shows that stimulus spending fails to generate economic activity. On the other hand, tax relief does. Unfortunately, only 13.1 percent of the federal government's stimulus plan has been dedicated to tax relief
- Rather than "staying the course" with its current stimulus plan, the federal government should focus on balancing the budget. A prudent and realistic plan would balance the books by 2011/12
- The federal government should eliminate the remaining $10.3 billion in stimulus spending planned for 2010/11 and additional $1.1 billion for 2011/12. A reduction in remaining program spending of an additional 4.0 percent from 2009/10 to 2010/11 and 2010/11 to 2011/12 would achieve a balanced budget by 2011/12
- A balanced budget in 2011/12 and constrained spending thereafter would enable the government to implement $52.1 billion in cumulative tax relief from 2011/12 to 2014/15
- Tax relief should focus on improving incentives for Canadians to work, save, invest, and be entrepreneurial with particular focus on reducing personal income taxes and eliminating the capital gains tax

Introduction

Over the past two years, the federal government has undergone an unfortunate fiscal transformation. After running budget surpluses for over a decade, the federal government is now projecting substantial budget deficits into the foreseeable future.

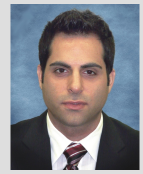
Like most governments in the developed world, Canada's federal government spent its way into deficit. While the spending increases were intended to help mitigate the impact of the collapse of financial markets and resulting economic recession, these measures turned away from Canada's recent sound fiscal management and set the nation back down the path of massive deficits and increased debt.

To stop the increases to Canada's debt burden and to improve the country's long-term competitiveness, the 2010 federal budget should swiftly improve the federal government's fiscal position. This Fraser Alert examines the source of current and future deficits, explains why the federal government should not continue its stimulus spending, and offers recommendations for a fiscally prudent 2010 federal budget.

Government spending is the source of the deficit

With an expected federal deficit of $55.9 billion in 2009/10 and further deficits totalling $108.5 billion over the next five years (2010/11-2014/15), it is important to understand the source of these deficits. Table 1 presents the federal government's revenues, spending, and deficits for 2008/09 and projections from 2009/10 to 2014/15.

Primarily as a result of the economic downturn, federal revenues are expected to decrease by $16.5 billion (7.1 percent) from $233.1 billion in 2008/09 to $216.6 billion in 2009/10. By 2010/11, however, revenues are expected to rebound to 2008/09 levels of $233.1 billion, and then continue to grow at a robust average rate of 6.4 percent until 2014/15. While the recession is clearly having an adverse impact on federal revenues, that impact is expected to be very short-lived



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(affecting fiscal years 2008/09 and 2009/10).

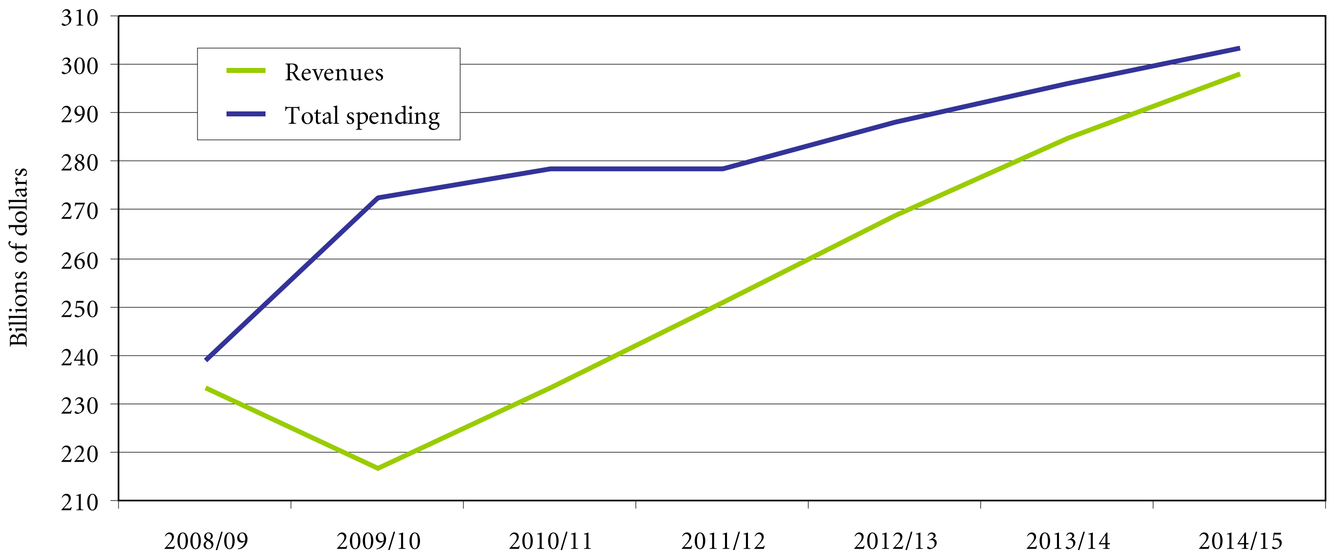
Government spending is another story altogether. In 2009/10, federal spending is expected to increase by $33.7 billion (14.1 percent) in part as a result of the federal government's stimulus plan, a temporary, two-year plan implemented to help boost the economy during the recession. Part of the increase was also due to "automatic fiscal

Table 1: Status Quo Federal Fiscal Outlook to 2014/15 (in billions of dollars)

	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
Revenues	233.1	216.6	233.1	250.9	268.7	284.7	298.2
Program spending	207.9	241.9	244.7	240.6	246.8	253.9	261.4
Debt charges	31.0	30.7	33.7	37.7	41.2	42.1	42.0
Total spending	238.8	272.5	278.4	278.3	288.1	296.0	303.4
Deficit	-5.8	-55.9	-45.3	-27.4	-19.4	-11.2	-5.2

Source: Department of Finance, Canada (2009b).

Figure 1: Status Quo Projections: Federal Revenues and Spending 2008/09 to 2014/15



Source: Department of Finance (2009b).
Revenue and spending data for 2008/09 are actual while data for 2009/10 and beyond are projections.

stabilizers," spending that automatically increases when the economy contracts.[1] Figure 1 illustrates the revenue and spending data from table 1. The figure suggests that the supposedly temporary two-year stimulus plan is anything but temporary. Rather than decrease in 2011/12 as the stimulus plan comes to an end, spending actually remains at the 2010/11 level. Thereafter spending increases for the next four years (2011/12 to 2014/15). Unfortunately, there is nothing temporary about the 2009/10 and 2010/11 stimulus spending; it is set to become permanent.

To make matters worse, the federal government was increasing spending at unsustainable levels well before the recession. For instance, between 2000/01 and 2008/09, federal government program spending (total spending minus interest payments)[2] increased at an average rate of 6.5 percent—nearly twice as fast as average inflation and population growth (3.3 percent), and faster than the average rate of economic growth (5.6 percent). All told, the federal government increased program spending from $130.6 billion in 2000/01 to $207.9 billion in 2008/09, an increase of more than 59.2 percent.[3]

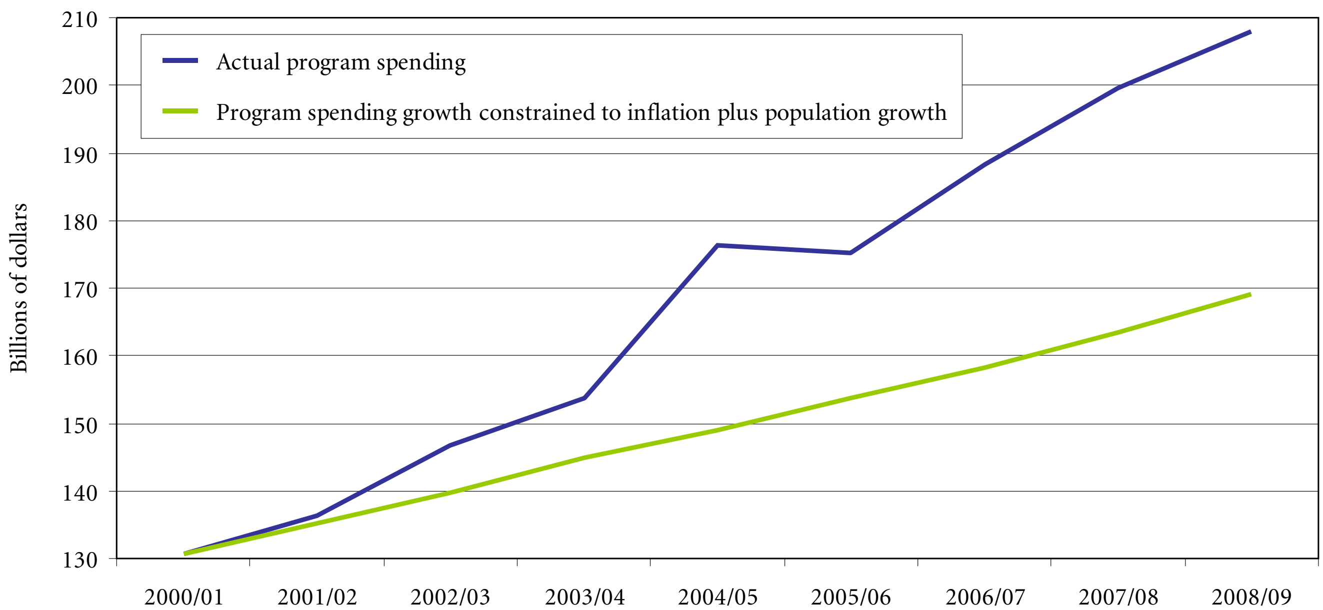
Figure 2 shows the federal government's program spending from 2000/01 to 2008/09 along with what spending would have been had the government constrained spending to inflation and population growth. Between 2000/01 and 2008/09, the federal government increased program spending by $170.1 billion more than was needed to compensate for inflation and population growth. Had it constrained its spending over the period, the government would have had an extra $38.7 billion in fiscal room in 2008/09 alone, and would have been in surplus that year, rather than in deficit.[4]

The source of the current and future federal deficits is government spending: not just the stimulus spending in 2009/10 and 2010/11, but also the unsustainable increases in spending that occurred before the economic recession. The government simply used the recession to further increase spending in the name of "temporary" economic stimulus. Unfortunately, the rapid increase in spending in 2009/10 is set to become the new base upon which the federal government will continue to grow.

Should the federal government "stay the course"?

While the federal government has made a few mild assertions that it will need to focus on the deficit eventually, it is clear that the government plans to "stay the course" and roll out yet more of its stimulus

Figure 2: Federal program spending, 2000/01 to 2008/09



Sources: Department of Finance (2009a); Statistics Canada (2009a, 2009b); calculations by the authors.

plan (Vieira, 2010). There are several reasons why the government should reconsider that decision.

Governments can't get the timing right

One main problem with government stimulus spending is that it gets implemented too late to have a positive impact on the economy during a recession (Veldhuis, 2009).

After 2009 started with two quarters of declining economic output, the economy began showing encouraging signs of recovery. Data from Statistics Canada show that economic output (gross domestic product, or GDP) increased in the third quarter of 2009 (July to September) (Statistics Canada, 2009d). Furthermore, the Bank of Canada and major Canadian banks have predicted positive growth in Canada's GDP for the fourth quarter and average growth of 2.7 per cent for 2010 (Bank of Canada, 2010; BMO Capital Markets, 2010; Lovely, 2010; RBC Economics Research, 2010; Scotia Economics, 2010; TD Economics, 2010; calculations by authors).

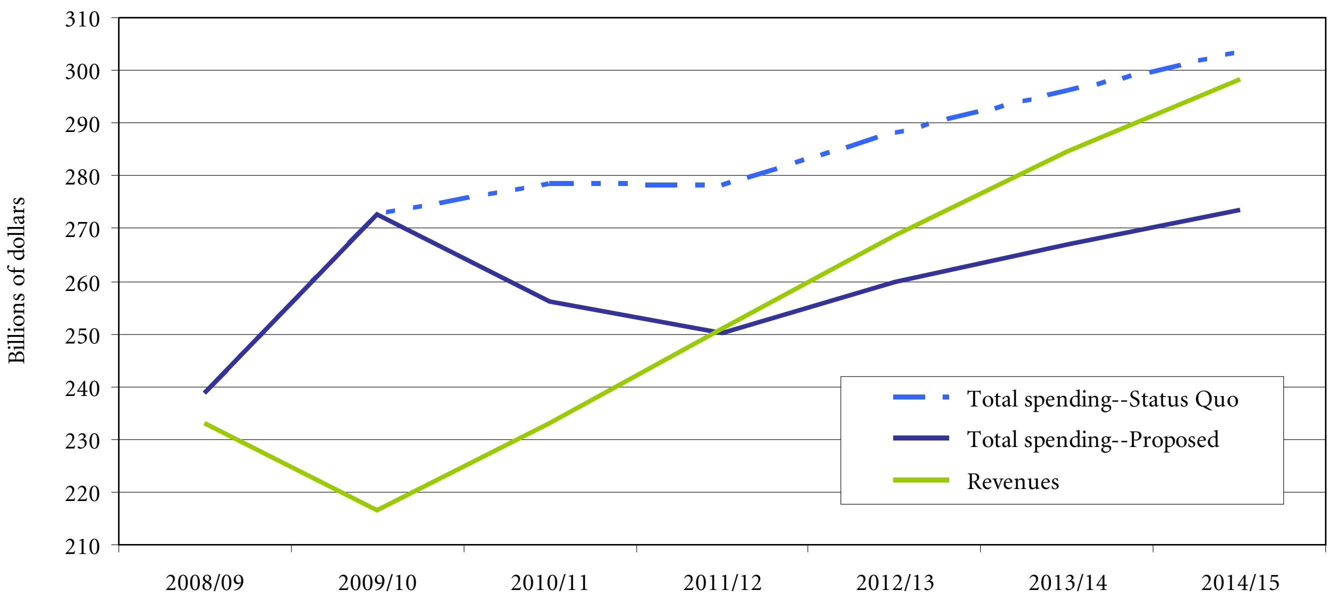
With 40.0 percent of the total federal stimulus package being devoted to infrastructure projects (Government of Canada, 2009a: 215), most of this money will not be spent until well into the coming fiscal year (2010/11) (PBO, 2009). The risk for 2010, then, is that a large portion of the stimulus spending—particularly infrastructure spending—will be spent as the economy naturally moves out of recession. As a result, the government will be competing with the private sector for resources, which will result in increased costs and fewer private sector projects than would otherwise be the case.

Stimulus spending fails while tax relief works

If increasing economic activity is the goal, the federal government should heed recent economic evidence on stimulus packages. That evidence clearly shows that stimulus spending fails, while tax relief works.

For example, a recent study by economists Andrew Mountford and Harald Uhlig assessed and compared the economic impact of various cases of deficit-financed spending, deficit-financed tax cuts, and tax-financed spending in the United States from 1955 to 2000 (Mountford and Uhlig, 2008). They found that deficit-financed tax cuts are the best form of fiscal policy for stimulating the economy. Perhaps more importantly, they found that rather than stimulate the economy, both deficit-financed and tax-

Figure 3: Proposed spending to balance the federal budget by 2011/12



Sources: Statistics Canada (2005); Department of Finance (2009b); calculations by the authors.

financed spending have the effect of discouraging private investment.

In addition, an analysis by Harvard economists Alberto Alesina and Silvia Ardagna of stimulus initiatives in Canada and 20 other industrialized countries from 1970 to 2007 found that successful stimulus initiatives—those that increase economic growth—focus on tax cuts. Unsuccessful stimulus initiatives, on the other hand, rely on government spending (Alesina and Ardagna, 2009).

Yet another piece of evidence that tax policy has a powerful influence on economic activity comes from American professors Christina and David Romer (see Romer and Romer, 2009). These authors examined the impact of tax changes on economic growth in the United States from 1945 to 2007 and found that each dollar of tax cuts has historically raised economic output (GDP) by about $3.

A major problem with the federal government's stimulus plan is that only 13.1 percent of it was dedicated to tax relief.[5]

Spending-induced deficits prevent tax relief

Finally, apart from the adverse effects of deficit-financed spending, current and future deficits hinder the federal government's ability to provide tax relief for Canadians, and thus improve this country's competitiveness. Tax relief, particularly in areas where Canada is not globally competitive, would improve the country's ability to attract investment. The sooner the government can get back to balanced budgets and constrain future spending growth, the sooner it can implement a prosperity-enhancing, multi-year tax relief plan.

Charting a different course: back to balanced budgets

Rather than continue to roll out its two-year stimulus plan, the government should focus on balancing the budget. A prudent and realistic plan would balance the books by 2011/12.

Fortunately, the current government has a precedent to follow in its efforts to eliminate the deficit. The austerity reforms initiated by former Prime Minister Jean Chrétien and then Finance Minister Paul Martin during the 1990s balanced the budget within three years (Department of Finance, 2009a). While it took Chretien and Martin three years, the deficit they faced (4.8 percent of GDP) was larger than the current one (3.7 percent of GDP) (Department of Finance, 2009a; 2009b; Statistics Canada, 2009c; and calculations by the authors).

To balance the budget by 2011/12, the federal government should eliminate the remaining $10.3 billion in stimulus spending planned for 2010/11 and the additional $1.1 billion earmarked for 2011/12. A reduction in remaining program spending of an additional 4.0 percent from 2009/10 to 2010/11 and 2010/11 to 2011/12 would achieve a balanced budget by 2011/12.

Figure 3 presents total federal government spending under this scenario; program spending growth after 2011/12 is held to the rate needed to compensate for inflation and population growth. Figure 3 also presents federal revenues and total spending under the government's most recent status-quo fiscal projections. A balanced budget in 2011/12 and constrained spending thereafter would enable the government to implement $52.1 billion in cumulative tax relief from 2011/12 to 2014/15.

Refocus on tax relief

Once the government balances its budget, it should implement a multi-year tax relief plan focused on improving the incentives for Canadians to work, save, invest, and be entrepreneurial. Of particular concern are Canada's high marginal personal income tax rates on middle and upper income Canadians that apply at relatively low levels of income. In fact, Canada maintains among the highest marginal personal income tax rates on middle and upper income earners among the G7 countries (Department of Finance, Canada, 2006; 2007).

The government should also implement one of its prominent 2005 election commitments: to eliminate the capital gains tax for individuals on the sale of assets when the proceeds are reinvested. The capital gains tax is one of the most damaging taxes in Canada. It encourages the owners of capital to hold on to their investments and has a detrimental impact on entrepreneurship. The complete elimination of the tax would result in a much more innovative, dynamic, and prosperous economy than is now the case (Veldhuis et al., 2007).

Finally, the government should accelerate its recent reductions to the corporate income tax rate, with the goal of reducing the rate to 11 percent, the preferential rate levied on small businesses. Doing so would dramatically improve the incentives for business investment by eliminating the disincentive for small businesses to grow beyond the threshold for the preferential rate (Clemens and Veldhuis, 2005). Reductions to the corporate income tax rate would also signal to investors that Canada is a desirable place to invest.

Conclusion

Canadians need the 2010 federal budget to provide a clear and effective fiscal vision. This Fraser Alert presents two recommendations to help Canada strengthen its fiscal condition. The first is to balance the books by 2011/12. From there, the government should exercise spending restraint and refocus its economic priorities on improving Canada's long-term competitiveness through a multi-year tax relief plan.

Acknowledgements

The authors would like to thank Jason Clemens, Director of Research at the Pacific Research Institute, and Nadeem Esmail, Fraser Institute Senior Fellow, for their review and comments on this Alert.

Notes

1 The main automatic stabilizer is the employment insurance system—as the economy declines and unemployment increases, more Canadians claim Employment Insurance benefits, which automatically increases federal spending (Department of Finance, Canada, 2009c: 208).

2 It is important to examine program spending rather than total spending (program spending plus interest payment on the debt) as governments have little impact on interest payments in the short run. In other words, while governments can easily increase or decrease program spending in the short run, influencing interest payments on debt requires significant changes in the government debt.

3 As table 1 indicates total spending was $238.8 billion in 2008/09 consisting of program spending ($207.9 billion) and interest payments on the debt ($31.0 billion). With revenues of $233.1 billion, the resulting deficit in 2008/09 was $5.8 billion.

4 Had the government constrained program spending from 2000/01, that spending would have been $169.2 billion rather than $207.9 billion in 2008/09. With $31 billion in interest payments, total spending would have been $200.2 billion and produced a surplus of $32.9 billion (revenues were $233.1 billion).

5 See "Table 1.1: Canada's Economic Action Plan"in *Canada's Economic Action Plan—A Fourth Report to Canadians* (Government of Canada, 2009b: 11).

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ISSN

ISSN 1714-6720

Date of Issue

February 2010

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