

TAX AND EXPENDITURE LIMITATIONS FOR CANADA'S FEDERAL GOVERNMENT

A Primer

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Executive Summary

The debate over federal government finances in the wake of the COVID-19 pandemic must focus also on fiscal balance. Restoring balance between revenues and expenditures is technically a simple matter of either reducing expenditures, raising tax revenues, or some combination thereof. However, when it comes to spending, restraint has proven difficult for many governments, in practice raising the issue of whether some type of institutional redesign of the policy process can be developed that places limits on either spending or taxation. Such mechanisms are referred to as Tax and Expenditure Limits (TEs) which serve as tax and expenditure rules.

Tax and expenditure limits restrict the growth of either revenues or expenditures or both by either setting them at a fixed dollar amount or by limiting the growth rate by linking them to the growth of specific economic variables. As of 2020, 33 US states had some type of TEL in place. A key perceived benefit of TELs is that they serve as a restraint on politicians and bureaucrats who often have little incentive to restrain spending in response to pressures from interest groups. A second benefit of TELs is that smaller government can be associated with higher rates of economic growth. For instance, research shows that keeping government expenditure to GDP ratios between 20 percent and 32 percent has historically maximized growth.

One noteworthy type of TEL is a strict restriction on tax or expenditure levels, or, more commonly their rates of growth. This is generally a formula driven approach and the most common mechanism involves restricting expenditure growth to the pace of personal income, GDP, or combined population and inflation growth. Another method is restricting expenditures to a percentage of projected revenue, maintaining a cushion in case revenues fall short of projections. Evidence suggests that effective TELs need to have a high degree of transparency in their construction with tight and clear definitions and few exemptions. As has been noted for the United States, TELs designed and put into place as laws or rules by legislative bodies have tended to be much less effective than those initiated and approved by citizens as part of a change placed into a constitution.

The simulations in this paper model two scenarios for TELs at the federal level in Canada. The first scenario involves a fixed growth rule for expenditures so that they cannot exceed growth in population plus inflation (while assuming a no COVID world). Under this approach, federal expenditures grow from \$295.5 billion in 2015–16 to reach \$393.2 billion by 2025–26, which is a much smaller increase in spending relative to the projections contained in Budget 2021. Federal finances would improve over time from a deficit of \$2.9 billion in 2015–16 to a budget surplus of \$39.9 billion by 2025–26.

Of course, such a smooth and simple projection of the path of future fiscal developments does not consider that the economy and fiscal projections are rarely smooth and never simple given the potential for unplanned economic fluctuations. Indeed, over recent years we have experienced both the 2008–09 financial crisis and recession as well

as the COVID-19 pandemic which have created large economic shocks that have affected revenues and expenditures. However, it is possible to structure a TEL that allows for a temporary suspension of the expenditure growth rule in the face of an economic shock.

The second scenario ties expenditure growth to changes in real GDP while accommodating an emergency response when an economic shock such as a recession or COVID-19 occurs. Had the federal government followed this approach since 2015, it would achieve an annual surplus of \$4 billion by 2025–26 rather than the current projected deficit of \$30.7 billion. Put differently, it was possible for the federal government to deliver the exact same amount of COVID-19 fiscal support as laid out in the 2021 federal spring budget and balance the budget by 2025–26 if it had been more prudent managing finances since 2015.

The simulation shows that at the federal level in Canada, even a modest TEL or fiscal rule can yield a lower trajectory for government expenditure growth, smaller deficits, and lower accumulated deficits relative to a world without the discipline provided by such rules. Moreover, such fiscal rules can even be designed to accommodate the fiscal shocks arising from severe recessions or emergencies. For these reasons, the fiscal performance of the federal government would be better in the presence of TELs or similar rules.

Introduction

In the wake of the COVID-19 pandemic and the surge in government deficits and debt, putting Canada's public finances back on a sustainable long-term path will be a major challenge, including for the federal government. According to the spring 2021 federal budget, Ottawa will continue to run deficits through 2025 and will in that year have accumulated over \$686 billion in deficits, with the federal net debt rising from \$812.9 billion in 2019 to reach \$1.529 trillion in 2025. While some of the fiscal response to deal with the pandemic was indeed necessary, it has become increasingly a matter of concern that the fiscal stimulus provided by the Canadian government may be excessive as the economy has performed better than expected.

Tombe (2021) notes that the spring 2021 federal budget was not intended to provide stimulus but rather was a “bridge” to get Canadians through the pandemic. Yet, an additional \$100 billion in spending measures were detailed in that budget as explicit stimulus despite mounting evidence that Canada's economy was recovering briskly such that output and employment would soon return to pre-COVID levels. While some of this additional spending earmarked in the 2021 budget may be warranted in areas such as indigenous communities, health, or public transit, there was and remains little justification for more macroeconomic fiscal stimulus. Moreover, the massive deficits and rapidly growing federal debt suggest the time has come for a more reasoned debate on government spending priorities. Unfortunately, the recent federal election campaign saw all the major parties promise many billions of dollars in additional spending without recognizing the risks stemming from the significant fiscal damage done by the COVID-19 shock.

Indeed, we appear to be in a new phase of inexorable government expenditure growth, a trend that was already apparent pre-pandemic. At all levels of government, Canada has moved markedly away from the era of fiscal responsibility that emerged in the wake of the fiscal crisis of the mid-1990s. With much of the new spending being fueled by added debt and unprecedented levels of public sector borrowing, governments have been lulled into a false sense of security by the temporary lure of exceptionally low interest rates, raising the prospect of disruptive austerity should interest rates rise. Worryingly, governments appear to have lost sight of the long-term detrimental relationship between public sector size, taxes, and economic growth. [1] And there are efficiency issues as governments provide services on a monopolistic basis, deploying spending that faces little incentive to keep costs as low as possible. This can only result in higher taxes down the road that, in turn, will affect the business climate. [2]

[1] Using international data, Di Matteo (2013) shows that rates of economic growth are optimized at public sector sizes approaching 30 percent of GDP.

[2] For an overview see Stallman et al. (2017: 199–201).

Part of the debate over federal government finances in the wake of the COVID-19 pandemic must focus also on returning to something resembling fiscal balance. Restoring balance between revenues and expenditures is technically a simple matter of either reducing expenditures, raising tax revenues, or some combination thereof. However, when it comes to spending, restraint has proven difficult for many governments to practice, while in taxation governments often overlook their distortionary and damaging incentive effects that can reduce growth and slow capital formation. Moreover, any long-term adherence to fiscal rules and limits on government spending and deficits seems particularly difficult to maintain in liberal democracies such as Canada, which raises the issue of whether some type of institutional redesign of the policy process can be developed that places limits on either spending or taxation. Such mechanisms are referred to as Tax and Expenditure Limits (TELS) which serve as tax and expenditure rules. The need for constraints on government spending and borrowing to rein in Leviathan and restore fiscal discipline is one feature of public choice economic theory as represented by the work of Brennan and Buchanan (1977, 1978, 1980). In addition, the fact that the current federal government has been reluctant to specify a fiscal anchor both pre-pandemic and since early 2020 makes the case for TELS as a framework for a credible fiscal anchor.

What are TELs?

In general, a TEL is a rule that limits the flexibility of governments with respect to its taxation and expenditures. Tax and expenditure limits restrict the growth of either revenues, expenditures, or both by either setting them at a fixed dollar amount or by limiting the growth rate by linking them to the growth of specific economic variables such as population, inflation, or income (Tax Policy Center, 2020). However, there are various interpretations of what constitutes a tax and expenditure limit, meaning that they can be essentially viewed as being on a continuum with the borders being “hard” and “soft” limits.

A “hard” TEL can be defined as constitutional and/or statutory restrictions on government taxing and spending authority (Mullins and Wallin, 2004). [3] For a purist, constitutional and/or statutory limitations on government spending and taxation growth represent the only sensible way to discipline government tax and expenditure decisions by binding governments to rules. A “soft” TEL represents a set of guidelines designed to keep spending under control either in terms of growth boundaries for expenditures or other types of voluntary and self-imposed fiscal rules. Any fiscal or tax rule can in principle be implemented as either a hard or a soft TEL. However, while “soft” TELs may be viewed by some as more realistic with respect to how governments operate in a world subject to economic shocks and shifting political preferences, it is also the case that they can be even less effective in keeping spending under control in the long run. Another view would argue that constitutional limits are more in keeping with a “hard” TEL and statutory with a “soft” TEL as the latter can be more easily modified or rescinded (Deller and Stallman, 2007: 501).

Much of the literature on TELs deals with the United States, where it has a long history going back to the era of the Great Depression. It has grown rapidly since the 1970s, with California’s Proposition 13 to limit property taxation a significant watershed event (Stallman et al., 2017). The United States has had a much-studied history of tax revolts and the modern approach has taken the form of political action to bring about tax and expenditure limitations (Deller and Stallman, 2007). As of 2020, 33 US states had some type of TEL in place, including those states with voting rules requiring supermajority legislative votes to implement new taxes or other revenue sources (Tax Policy Center, 2020). [4] TELs are also a feature of municipal public finance in the United States and often take the form of property tax limits of one type or another (Stallman et al., 2017).

[3] It should be noted that there is a large difference between a constitutional and legislative TEL. The latter is generally modifiable in a straightforward manner by changing existing laws. Altering a constitution is a much larger endeavor.

[4] Deller and Stallman (2007) note that 46 states have some sort of constitutional or statutory limitation on local or state governments, with the oldest being a property tax growth rate limit in Missouri going back to 1875.

Indeed, the diversity of the budgetary process at the state and local level in the United States has yielded many studies of TELs, some of which have included empirical attempts to measure their effectiveness. Some US studies have found that state-level TELs can restrain the growth of state revenues and expenditures as well as expenditures per capita (Bails and Tieslau, 2000; Bae and Gais, 2007). On the other hand, Kousser et al. (2008) found that TELs have not curtailed state spending in the vast majority of states where they were employed.

Blom-Hansen, Baekgaard, and Serritzlew (2014), in a study on municipal level TELs in Denmark, found that TELs caused a shift by municipal governments to greater reliance on intergovernmental aid as part of a general trend to move away from taxes that were limited. As a result, the restraining effect on overall expenditures was not deemed effective. Joyce and Mullins (1991) in their study of the TEL movement in the United States also found that there had been a shifting of functions to state governments from the local government in the wake of TELs.

While this can be interpreted as TELs having been more effective at the local level, it also suggests the importance of implementing TELs at higher tiers of federal systems if they are ultimately to be effective in their overall impact on aggregate government expenditures. This is certainly the case in Canada's federal system given the existence of a highly developed intergovernmental transfer system. If sustainable fiscal policy is to be successful in Canada, it is important to have it occur at the federal level and provincial levels given that federal cash transfers account for approximately 20 percent of provincial revenues and both federal and provincial transfers provide around 40 percent of municipal revenues. It is also noteworthy that in Manitoba, Quebec, and the Atlantic provinces, federal transfers represent a larger proportion of revenues than in Ontario and the rest of western Canada.

How do TELs Differ from Other Approaches to Government Spending Restraint, such as Fiscal Rules or Balanced Budget Legislation?

Balanced budget legislation is often perceived as a form of TEL but in practice it is considered different in that it simply attempts to achieve budget balance so that debt stops being accumulated. Such legislation is not necessarily designed to constrain the rate of growth of government spending—nor to limit the size of the public sector (Clemens et al., 2003). Some balanced budget laws prohibit deficits in any given year while others may seek to balance budgets over the course of the business cycle. In the end, an emphasis on balancing the budget without consideration for the actual size of government and the pace of spending growth can lead to a larger public sector that in the long run dampens economic growth even if the annual government budget is balanced.

Indeed, according to Clemens et al. (2003) the adoption of balanced budget laws in Canada, which by the early 2000s existed in eight out of ten provinces, coincided with increases in government spending and taxation as measured by real per-capita consolidated provincial and municipal spending. Restrictions on borrowing by sub-national

governments as a constraint also may be seen as representing a form of TEL. However, such approaches in the end represent fiscal rules that often offer wide scope for exceptions, such that ultimately the rule is circumvented when it matters most. Nevertheless, some evidence suggests that in Canada, balanced budget legislation has been somewhat successful (Mou and Hing, 2021; Mou, Atkinson, and Tapp, 2018; Atkinson, Mou, and Bruce, 2016).

Eight out of ten provinces currently have balanced budget legislation—only Newfoundland and Labrador and Prince Edward Island do not, though British Columbia explicitly abandoned its balanced budget law in the wake of the pandemic at least for the next three years (Hunter, 2020). At the same time, Atkinson et al. (2016) find that even in the wake of the Great Recession, provincial balanced budget legislation was not an “abject failure”. Mou, Atkinson, and Tapp (2018) find that over the period 1981 to 2013, provinces with stronger balanced budget rules (BBL) had better debt and deficit outcomes overall. [5] Chu (2021) finds that the eight provinces with balanced budget legislation or fiscal rules over the period 1981 to 2020 have substantially fewer fiscal deficits than either Newfoundland and Labrador or Prince Edward Island.

However, Simpson (2012) concluded for western Canadian provinces that their balanced budget legislation had no discernible effect on restraining government expenditure growth and that such legislation in the end was only as effective as the political and public will available to support it. It should also be noted that, given provincial reliance on federal cash transfers that account for about 20 percent of provincial government revenue, a substantial portion of provincial budgeting is influenced by the federal government. This of course again reinforces the point that ultimately, there is a case for TELs as something to be applied first and foremost at the federal level in the Canadian context.

[5] When a province had no BBL, the chances of balancing a budget were very low, regardless of economic conditions (13 percent in normal times and 8 percent during recession and recovery periods). In the presence of a BBL, however, provinces balanced their budgets much more often: 64 percent of the time during normal economic periods, and 28 percent of the time in recession and recovery periods.

What Are the Benefits and Costs of TELs?

A key perceived benefit of TELs, based on public choice literature rooted in the Brennan-Buchanan approach, is that they serve as a restraint on politicians and bureaucrats who in response to pressures from interest groups often have little incentive to restrain spending, and may choose to operate as budget maximizers given that government represents a coercive monopoly (Stallman et al., 2017). Indeed, as noted by Peacock and Wiseman (1961), even if spending rises in response to a legitimate economic shock, it may well persist because the rate of growth of public expenditures is driven by what taxpayers consider to be tolerable levels of taxation and this tolerance is greater during times of national or social crisis and is exploited to support higher spending afterwards.

A second benefit of TELs is that smaller government can be associated with higher rates of economic growth. Di Matteo (2013) and Di Matteo and Summerfield (2020) use international data to estimate Scully Curve relationships between public sector size and economic growth. [6] They find that government expenditure to GDP ratios between 20 percent and 32 percent were historically growth maximizing. Related to economic growth and development is that the implementation of tax and expenditure limits may also boost business confidence and investment as they provide a signal regarding public sector efficiency and future taxation levels—although it must be said that the empirical evidence as to the effects on economic growth and activity for US states has been mixed. Ultimately, the literature suggests that lower taxes in general may increase economic growth but there are large variations in the range of the effects, with the growth impacts more limited at local levels (Stallmann and Deller, 2010, 2011; Deller and Stallman, 2007; Deller, Stallman, and Amiel, 2012).

At the same time, this argument can also be problematic. A low spending government can be inefficient in how it spends taxpayer money while a high spending government might be efficient given the spending level. Indeed, the argument has been made that TELs have a hidden cost in that they can distort government budgeting and spending by creating incentives to raise tax rates on those that are not constrained by a TEL (Stallmann et al., 2017). This would suggest that when implementing TELs, the rule needs to be broadly applied to capture all taxation revenue sources or expenditure categories as opposed to being limited to certain types of taxes or expenditures.

Another potential cost of TELs that has been raised in the US literature is the operation and effect of TELs during economic downturns, particularly in the case of

[6] The Scully Curve, also known as the BARS/Scully Curve, is an inverse U-shaped relationship between public sector size and economic growth (Armey, 1995; Rahn and Fox, 1996). As government grows, there is a positive effect on economic growth as government provides growth complementing infrastructure. However, beyond a point the negative effects of higher tax rate on economic growth begin to dominate. The Scully Curve formulation of this relationship defines optimal economic growth-maximizing size of government as the peak of the hump-shaped curve (Scully, 1989, 1991, 1994, 2000).

their implementation with respect to property taxation. In the case of US state and local revenues, some empirical evidence has suggested that TELs at the state and local levels force a reliance on more income-elastic revenue sources such as income taxes, which are more sensitive to GDP fluctuations, creating revenue instability (McCubbins and Moule, 2010). This may be an issue specific to the United States given the ability of lower tiers such as municipalities to use local income taxes, thereby allowing them to shift revenues away from property taxes in the presence of TELs. [7] At the same time, this makes the case that TELs should be broadly applied to expenditures and revenues as opposed to specific tax or expenditure instruments in order to forestall this type of shifting.

[7] It should be noted that in the wake of Proposition 13, California has become increasingly dependent on income tax revenues. Between 1977 and 2017, the share of state and local revenue in California from personal income taxes rose from an average of 10 percent to 19 percent (Auxier, Gordon, and Rueben, 2020).

Examples of Different Types of TELs

Full disclosure rules and truth in taxation measures are one form of TEL and ultimately the least restrictive. Essentially, this approach uses legislation that requires public discussion and some type of legislative approval prior to any tax rate increase. This approach simply tries to provide greater transparency when it comes to taxation. It is problematic given that in the case of transparency rules, they can be easy to interpret creatively, thereby circumventing their original intent.

Interestingly, in the Canadian case, there is research on balanced budget laws (BBLs) to examine their transparency in terms of rule formulation and stringency. Mou and Hing (2021), studying fiscal rules for Canadian provinces from 1980 to 2018, found that more stringent BBLs did not imply less transparency, while higher transparency requirements appear to reduce the effect of stringent BBLs on the budget balance, possibly because transparency rules deter creative accounting. They conclude that in practice, a transparent budgeting process is as important for achieving fiscal goals as stringent fiscal targets are. One can hypothesize that similar results could apply to TELs.

Limits on expenditure or tax revenue increases which take the form of strict tax or expenditure levels, or more commonly their rates of growth, is another approach. This is generally a formula-driven approach and in the United States, which has had a great deal of experience with TELs, the most common mechanism involves restricting expenditure growth to the pace of personal income, although some states include population and inflation growth in the formula. Other states use a formula to limit spending at a set level, as in Idaho, for example, which limits expenditures to 5.33 percent of state personal income (Tax Policy Center, 2020). In effect, this allows expenditures to grow at the same rate as the economy. Another method is to restrict expenditures to a percentage of projected revenue, maintaining a cushion in case revenues fall short of projections. At the municipal level, limits on assessment increases or property tax limits are also common.

What Makes for an Effective TEL?

Much of the evidence seems to suggest that for TELs to be effective there needs to be a high degree of transparency in their construction with tight and clear definitions and few exemptions. [8] As well, effectiveness can depend on whether the new rules are mandated by legislation or enshrined in a constitution. As has been noted for the United States, TELs designed and put into place as laws or rules by legislative bodies have tended to be much less effective than those initiated and approved by citizens as part of a change placed into a constitution (New, 2010). It has also been suggested that even more stringent rules, that can include that surpluses are returned to taxpayers as a rebate or saved in a rainy day fund, can also be part of the equation. [9]

In the case of Canada, this latter approach is indeed more difficult given that under Canada's different institutional environment provinces have their powers set forth by the national level constitution and do not have the latitude to make their own constitutions or constitutional changes. At the same time, according to Clemens et al. (2003), it is possible to implement a constitutional amendment creating a TEL in Canada under the bilateral amendment provisions of section 43 of the 1982 Constitution Act requiring both the interested provinces and the federal government to pass legislation. [10] While this is possible, the likelihood of a TEL being implemented in Canada via the constitutional change route is likely to be small.

Clemens et al. (2003: 6) provide their own summary list of what might characterise the optimal TEL at the provincial level, with the list including citizen initiation and approval via a referendum with placement via a constitutional change, an application to both expenditures and revenues with spending growth limited to the rate of inflation plus population growth, the inclusion of municipal spending and revenues, tax refunds of any surpluses, and being comprehensive in design in terms of definition and coverage of what constitutes spending and revenues.

[8] Transparent, clear, and tight definitions ultimately are a function of political environments and often require a non-partisan consensus on the importance of fiscal sustainability. For example, there has been over the last two decades in Quebec more acceptance of the goal of balanced budgets and fiscal sustainability across party lines than has been the case in adjacent Ontario. As a result, Ontario has been characterized by continual deficits and a rising net debt-to-GDP ratio, whereas Quebec began to balance its budgets and actually began reducing its net debt to GDP ratio before the pandemic.

[9] See Tax Policy Center (2020).

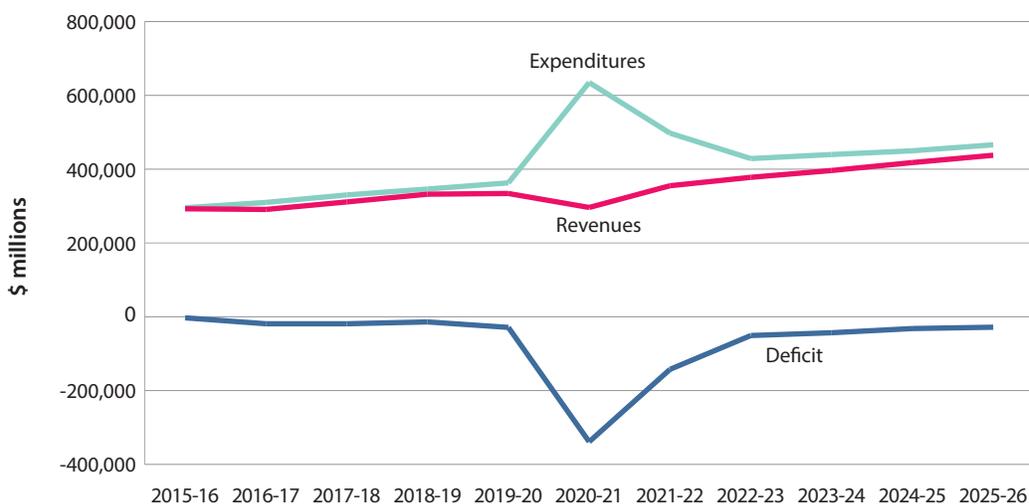
[10] According to Clemens et al. (2003: 6), "under section 43 of the Constitution Act, 1982, is a bilateral amendment to the Constitution of Canada. This option requires both the provincial government interested in the amendment and the federal government to pass legislation" There is a second option: "under section 45 of the Constitution Act ... a unilateral amendment to the constitution of a province. This formula permits the provincial government unilaterally to alter the portion of the constitution affecting it by a simple act of legislation." This latter approach was deemed less permanent because it can be just as easily overturned at a future date.

Using TELs in Canada: A Theoretical Policy Example

Perhaps the best way to illustrate the implementation of a simple TEL and assess its impact and effectiveness is via an example that makes use of recent federal public finance data. **Figure 1** presents a base scenario picture of federal public finances plotting revenues, expenditures, and the deficit based on data from the 2020 Fiscal Reference Tables and the 2021 Federal Spring Budget (Canada, 2020, 2021). The data for 2015–16 to 2019–20 is from the Fiscal Reference Tables while the 2020–21 to 2025–26 data points are from the 2021 Budget (table A1.4).

The base scenario presented in figure 1 shows revenues rising from 2015–16 to 2019–20, followed by a decline due to COVID-19's impact and then a recovery in revenues starting in 2021–22. From 2015 to 2025, figure 1 shows revenues growing from \$292.6 billion to \$437.7 billion—an increase of 50 percent. Over the period from 2015 to 2019, revenues rise at an average annual rate of 4 percent, which is also the average going back to 2010. Over the period 2022 to 2025, revenues using this data show an average annual growth rate of 5 percent.

Figure 1: Base Scenario for Federal Finances: Actual 2015–16 to 2019–20 and Under the Budget 2021 Scenario, 2020–21 to 2025–26



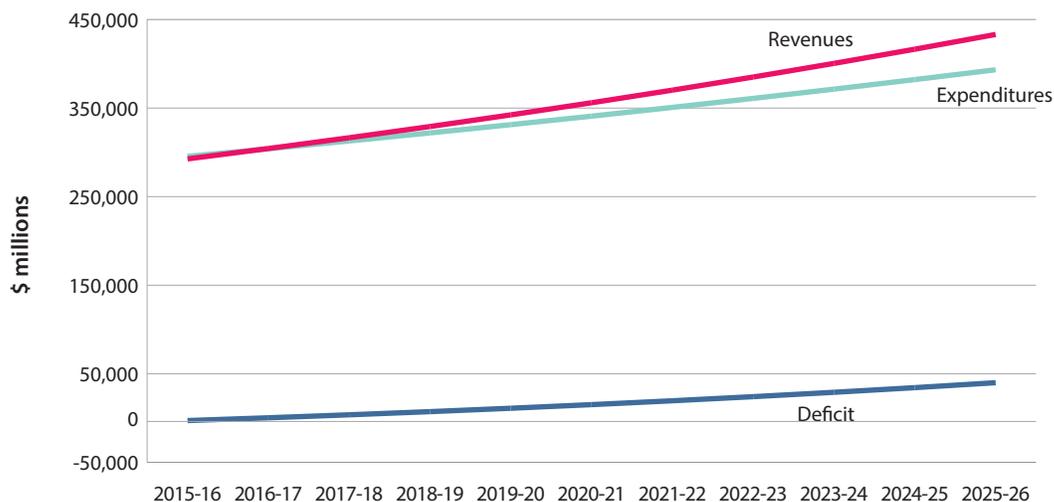
Source: Canada, 2020, 2021.

Meanwhile, expenditures rise from \$295.4 billion to \$466 billion for an increase of 58 percent. Over the period from 2015 to 2019, the average annual growth rate of federal spending was 5 percent while over the longer 2010 to 2019 period it was 3 percent. After the COVID-19 expenditure bump has been fully digested with declines of 22 percent in 2021–22 and 14 percent in 2022–23, expenditures according to the 2021 federal budget are expected to grow at an annual average of 3 percent.

Even before the COVID-19 pandemic, a structural gap had opened between federal government revenues and spending given that revenues grew at 4 percent and expenditures at 5 percent annually over the 2015 to 2019 period. As a result, the deficit rose from \$2.9 billion in 2015–16 to reach \$29.8 billion in 2019–20. The expenditure increases associated with the pandemic combined with the revenue drop brought the federal deficit to \$338.7 billion in 2020–21, after which it is projected to gradually decline to \$28.3 billion by 2025–26—essentially a return to the status quo antebellum that existed at the start of the pandemic. The accumulated federal deficit over the entire period 2015–16 to 2025–26 comes in at a staggering \$719 billion.

Figure 2 presents *Scenario 1* which is a TEL model that is essentially a fiscal growth rule starting in 2015–16 and assuming a no COVID world. As well, revenues are assumed to grow at the annual average of 4 percent while expenditures are limited to no more than the sum of the rate of growth of population (1.11 percent) and the rate of CPI inflation (1.75 percent) over the period 2010 to 2020 for a total of 2.9 percent. Under this scenario, revenues grow from \$292.6 billion to \$433.1 billion—an increase of 48 percent. Expenditures grow from \$295.5 billion in 2015–16 to reach \$393.2 billion by 2025–26, an increase of 33 percent. As a result, from a deficit of \$2.9 billion in 2015–16, the budget has a surplus of \$39.9 billion by 2025–26 and an accumulated surplus over the 2015 to 2025 period of \$181.3 billion dollars.

Figure 2: Scenario 1, Federal Finances 2015–16 to 2025–26; Fiscal Rule TEL with No COVID-19



Source: See figure 1; calculations by author.

Of course, such a smooth and simple projection of the path of future fiscal developments does not consider that the economy and fiscal projections are rarely smooth and never simple given the potential for unplanned economic fluctuations. Indeed, over the last few years we have experienced both the 2008–09 financial crisis and recession as well as the COVID-19 pandemic, which have created large economic shocks that have affected both federal government revenues and expenditures. However, it is possible to structure a TEL that allows for a temporary suspension of the expenditure growth rule in the face of an economic shock. In this regard, tying the suspension to criteria related to the rate of growth of real GDP is a reasonable proposition, though implementation will be challenging given that Canada's quarterly and annual GDP estimates are subject to substantial revisions.

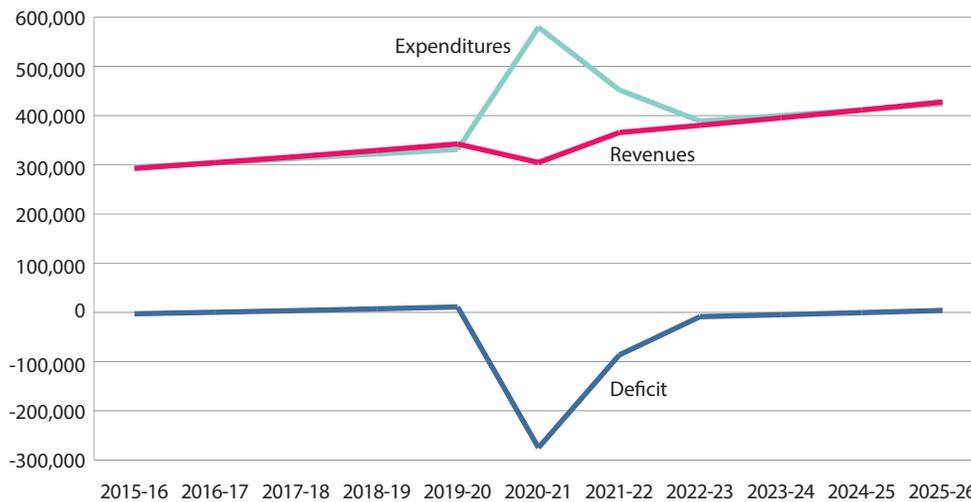
Over the fifty-year period from 1970 to 2020, there have been 5 years with negative real GDP growth—1982, 1990–91, 2009, and 2020. In these years, annual real GDP growth has ranged from just under 0 to about -6 percent. Indeed, of these years, the recent pandemic presents the most extreme contraction of real GDP. As a result, a TEL that allows for suspension of the 2.9 percent expenditure growth rule could be tied to GDP performance and projections that are in the negative range. While there might be some concern that government could try to game these rules, the professional integrity of economic forecasters and the strength of our democracy and public service would probably make it difficult for governments to deliberately forecast years of negative real GDP growth or reconfigure statistics to circumvent the rules.

In **figure 3**, a second and final scenario is presented that attempts to take the pandemic into account by having the expenditures and revenues in the pandemic year remain in place as currently laid out in the spring 2021 federal budget. This scenario assumes that revenues grow at 4 percent annually for the 2015–16 to 2019–20 period and then from 2023–24 onwards. As well, the scenario assumes that the TEL was designed to accommodate the need for an emergency fiscal response tied to a rule related to the size of the real GDP drop. [11] There is the COVID revenue decline of 11 percent in 2020–21 and then a rebound of 20 percent as currently laid out in the spring 2021 budget. Expenditures are assumed to grow at 2.9 percent annually from 2015–16 to 2019–20 and then from 2023–24 onwards. As well, there is assumed a COVID induced expenditure surge of 75 percent in 2021–21 followed by the projected reductions of 22 percent in 2021–22 and 14 percent in 2022–23. [12]

[11] Unexplored here is the design of any such rule—for example, that percent increases in expenditures during a national emergency be set on a graduated scale tied to the size of the real GDP drop.

[12] It should be noted that revenues and spending as discussed here are nominal amounts whereas the GDP benchmark is a real variable.

Figure 3: Scenario 2, Federal Finances 2015–16 to 2025–26; Fiscal Rule TEL with Negative GDP Growth Suspension Rule



Source: See figure 1; calculations by author.

The results show that revenues rise from \$292.6 billion in 2015–16 to \$427.7 billion by 2025–26 for a total increase of 46 percent. Meanwhile, expenditures rise from \$295.5 billion in 2015–16 to reach \$423.7 billion by 2025–26 for an overall increase of 43 percent. By 2025–26 there is an annual surplus of \$4 billion but an accumulated federal deficit of \$352.2 billion for the 2015–16 to 2025–26 period, which is essentially half of the deficit accumulated over the same period in the base scenario. In other words, even with a TEL as structured under this scenario, it would have been possible for the federal government to deliver the exact same amount of COVID-19 fiscal support as laid out in the 2021 federal spring budget, balance the budget by 2025–26, and only accumulate half the deficits, meaning that the federal gross debt would also be substantially lower than is currently projected.

The simulation shows that at the federal level in Canada, even a modest TEL or fiscal rule can yield a lower trajectory for government expenditure growth, smaller deficits, and lower accumulated deficits relative to a world without the discipline provided by such rules. Moreover, such fiscal rules can even be designed to accommodate the fiscal shocks that arise from severe recessions or emergencies. We therefore conclude that the fiscal performance of government is better in the presence of TELs or similar rules.

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Acknowledgments

The author wishes to thank the anonymous reviewers for their comments, suggestions, and insights. Any remaining errors or oversights are the sole responsibility of the authors. As the researcher has worked independently, the views and conclusions expressed in this study do not necessarily reflect those of the Board of Directors of the Fraser Institute, the staff, or supporters.

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ISBN

978-0-88975-673-1

Citation

Di Matteo, Livio (2020). *Tax and Expenditure Limitations for Canada's Federal Government: A Primer*. Fraser Institute. <<http://www.fraserinstitute.org>>.

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