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How Resilient is the Federal Budget to an Economic Downturn?

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Federal budget surpluses have been a defining characteristic of Canadian fiscal policy for the past decade. The presence of annual surpluses has changed the terrain of the policy debate from meting out short-run restraint to a broader discussion about long-run opportunities. The CCPA's Alternative Federal Budget has consistently argued for social re-investment of surpluses in order to meet the many challenges facing the nation, while business lobbyists and conservative groups have called (more successfully) for tax cuts on the grounds that they will improve Canada's economic performance. A third option, debt reduction, has arguably been a hidden priority of budget-makers: some $95 billion in debt reduction has occurred as a result of surpluses over the past decade.

With the delivery of a new package of major multi-year tax cuts in the October 2007 Economic and Fiscal Update (EFU), it is now possible that, irrespective of one's priorities, the debate on how to spend growing surpluses is at an end. While official projections still call for surpluses between now and 2012/13, these surpluses are predicated on a continuation of the relatively strong economic growth that has characterized Canada for much of the past decade.

This technical paper stress-tests the Economic and Fiscal Update's numbers for the possibility of an economic slowdown or even an outright recession. The next section reviews the EFU and previous tax cuts that have depleted available surpluses. After reviewing Canada's economic outlook, budget projections are considered in the face of four scenarios that are successively more pessimistic in outlook. A key finding is that it would not take much of a drop in economic growth before the budget returned to deficit.

With an election call potentially close at hand, Canadian politicians need to be clear with the public about what they would do in the event of a slowdown or recession. If there is indeed an economic downturn coming, a conventional wisdom that frowns on deficits is cause for concern. In particular, there will be pressure to cut spending (rather than re-visit tax cuts) to balance the budget. This would only reinforce the negative economic impact of the downturn by undermining an important source of income and expenditure at precisely the time when

TABLE 1 The Cost of 2006 and 2007 Tax Cuts ($Billions)

	2007–08	2008–09	2009–10	2010–11	2011–12	2012–13
Corporate income	1.1	5.9	7.9	9.3	11.5	14.8
Personal income	12.3	10.3	10.1	10.3	10.6	11.2
GST	7.1	12.0	12.6	13.2	13.7	14.2
Total	**20.5**	**28.2**	**30.6**	**32.8**	**35.8**	**40.2**

SOURCE Economic and Fiscal Update, October 2007, Table 3.1

it is most needed. Instead, the government can and should be prepared to run a deficit, if necessary.

Tax Cuts in the Economic and Fiscal Update

Prior to the October Economic and Fiscal Update, estimates for 2007/08 and subsequent years pointed to swelling federal surpluses. However, the tax cuts announced in the EFU have greatly eroded the fiscal capacity of the federal government. These include:

- The second one-percentage-point cut to the GST cut, to 5% as Jan. 1, 2008. This move delivers on an election promise for the Harper government much earlier than anticipated.
- An acceleration and deepening of corporate income tax rate reductions. The 2007 federal corporate income tax rate of 22% will fall to 15% by 2012, a drop of one-third.
- A restoration of the 15% bottom personal income tax rate that the Liberals had tabled prior to the 2006 election, and that the Conservatives raised to 15.5% to help pay for their first-round GST cut. The basic personal exemption (the threshold for paying income tax) was increased for 2007 and 2008.[1]

The EFU tax cuts build on tax cuts announced in the 2006 and 2007 budgets. Fully phased in, the total revenue loss from the EFU is $14.7 billion per year by 2012/13. But if these previously-announced tax cuts are taken into consideration, the projected total revenue loss from Conservative tax cuts by 2012/13 is an alarming $40.2 billion per year. **Table 1** shows the revenue loss by type of tax for 2007/08 and over the subsequent five years.

While much attention has been paid to GST cuts, corporate income tax cuts (i.e., the total drop in statutory rate from 22% to 15%) will cost the Treasury more when fully phased in ($14.8 billion per year in 2012/13). This figure is greater than either the two-percentage-point cut in the GST ($14.2 billion) or the combined 2006 and 2007 personal income tax cuts ($11.2 billion). Moreover, the corporate income tax cuts are essentially an upper-income tax cut,[2] and, despite being very costly to the Treasury, they are unlikely to have any significant economic impact (more on this in the final section).

A More Pessimistic Economic Outlook

In spite of some troubling developments in the U.S., the possibility of an economic downturn has not been adequately considered by policy-makers in Canada. On the home front, real GDP has not dropped in Canada since 1991, and, apart from a dip below 2% growth in 2001 (a year the U.S. economy went into recession), real GDP growth has been strong for a decade. Moreover, the unemployment rate in recent years has dropped to levels not seen since the early 1970s. As the U.S. economy has sagged through 2007, the Canadian economy has continued to grow, although with some signs of slowing.

The relative strength of the Canadian economy in 2007 vis-à-vis the U.S. has led some commentators to argue that this represents a "decoupling" of the Canadian and U.S. economies — that it is a "myth that every time the U.S. sneezes, Canada catches a cold."[3] There is indeed some evidence that Canada is less dependent on the U.S. economy in 2008 than in the recent past. Exports to the U.S. as a share of GDP have been declining since 2001, and in 2007 dropped back to levels last seen in the mid-1990s. The total share of Canadian exports going to the U.S. has also declined somewhat, although three-quarters of Canadian exports are destined south of the border.[4]

While there may be some decoupling with the U.S., there is no reason to expect that Canada is fully disconnected, given such close trade and investment ties. If the U.S. economy goes into a recession, there is every reason to believe that there will be knock-on effects in Canada, and policy-makers need to prepare for that possibility.

The overall outlook for the U.S. economy is more pessimistic than for Canada, according to major private-sector forecasters. Forecasters tend to fall into two camps. Many support the view that, after a slowdown in 2007, U.S. economic growth will regain strength through 2008, and will essentially be back to business-as-usual within 12 months. Others have taken a more pessimistic line, based on the deflating housing bubble and the related and ongoing impact of the sub-prime mortgage debacle on financial markets. This latter camp puts the odds of a U.S. recession in 2008 at 50% or greater, and some believe the U.S. economy was already in recession as of the fourth quarter of 2007.[5]

For Canada, the slowdown in U.S. demand is compounded by the appreciation of the Canadian dollar by 60% (from its all-time low) in 2002. While robust global demand and high commodity prices have boosted the Canadian resource sector (most notably in Western Canada), the macroeconomic picture has not been pretty for manufacturing in Central Canada. Job losses in manufacturing by late 2007 exceeded 300,000 compared to peak levels in 2002.

Forecasters have been lowering their estimates for Canadian economic growth in recent months, and historically have tended to be excessively bullish until the economy was actually in recession. Domestic factors may also play a role in a slowdown story (the EFU sees any downside to the Canadian economy as purely the consequence of external factors). There is evidence that Canada's housing boom is easing, and this will have impacts on real estate and residential construction employment. Fortunately, Canada has not seen the excesses of the type made infamous by the U.S. sub-prime debacle, and a trend toward lower interest rates by the Bank of Canada will help. But the tally of losses by Canadian banks and pension funds from investments in U.S. sub-prime mortgages has been growing. This may lead to banks and other lenders tightening up credit and charging higher rates for mortgages and loans themselves, as has already occurred over the past year.

In December, the Bank of Canada lowered its overnight rate by one-quarter percentage point, signaling a shift (at least, temporarily) away from a narrow obsession with rising inflation to more general concerns about the state of financial markets and the overall economy. However, as discussed in the final section, this move will have little effect on longer-term rates. As unease about the state of the economy has spread among forecasters and the Bank of Canada, it has also caught the attention of Prime Minister Harper and Finance Minister Flaherty (as stated in end-of-2007 commentaries). But overall, the possibility of an economic slowdown has not been reflected in the narrative told in October's Economic and Fiscal Update.

Implications for the Federal Fiscal Framework

This section models the impact of an economic slowdown on the federal budget. The EFU itself reports that a one-percentage-point drop in real GDP would lead to a negative change in the budget balance of $2.8 billion. Given that the EFU introduces $9.4 billion in tax cuts in 2008/09, leaving a planning surplus of $4.4 billion, a slowdown could easily turn surpluses into deficits.

Table 2 shows the EFU baseline revenues, expenditures, deficits and underlying GDP growth assumptions for 2007/08 and the next three budget years. Four scenarios of slowdown are tested relative to this baseline, each increasingly more pessimistic (see **Figure 1** and, at the end of this paper, **Table 3**).[6] Growth estimates for the non-recession years of 2007 and 2010 are the same as the EFU baseline in all scenarios, with a slowdown or recession modeled for 2008 with recovery beginning in 2009.

Scenario 1 models a moderate slowdown. Nominal GDP growth in 2008 eases from the EFU forecast of 4.8% to 3.0%, then recovers somewhat in 2009 to 3.5% before resuming the EFU forecast of 4.4% growth in 2010. In this case, the surplus largely disappears in 2008/09, although the budget balance is still in the black at $831 million, or 0.1% of GDP. But in 2009/10, the budget does turn to a deficit of $2.4 billion, before recovering to a very small surplus of $600 million in 2010/11.

Scenario 2 represents a major slowdown, though not outright recession. Nominal GDP growth slows to 2.0% in 2008, recovers to 3.0% in 2009, and reverts to the EFU baseline of 4.4% in 2010. In this scenario, the budget turns to a deficit of $1.5 billion in 2008/09, growing to $6 billion in 2009/10 before falling back to $3.2 billion in 2010/11.

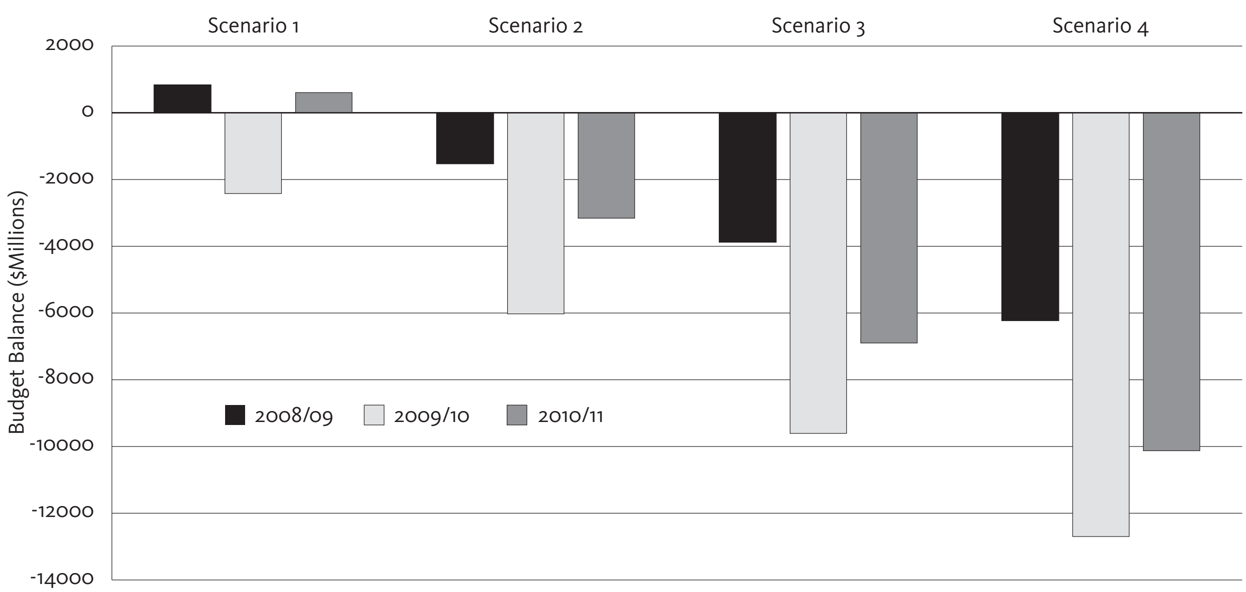
Scenarios 3 and 4 model actual recessions rather than slowdowns. Technically, a recession is a drop in real (or inflation-adjusted) GDP for two or more consecutive quarters. We model changes in nominal GDP because the federal budget is also presented in nominal terms. Thus, a 1% nominal growth rate in 2008 translates into a -1% real growth rate if inflation is 2%. There is some variability inherent in estimating inflation rates in the course of a downturn. For example, a consumer-led

TABLE 2 Baseline Projections from Economic and Fiscal Update

	Actual		Forecast					
Budgetary Transactions ($Millions)								
	2005–06	**2006–07**	**2007–08**	**2008–09**	**2009–10**	**2010–11**	**2011–12**	**2012–13**
Revenue	222,203	235,966	243,895	245,780	255,400	266,695	277,810	288,905
Program Spending	175,213	188,269	198,365	207,625	216,970	225,145	233,695	242,880
Debt Service	33,772	33,945	34,000	33,700	34,200	34,000	33,900	33,300
BUDGET BALANCE	13,218	13,752	11,530	4,455	4,230	7,550	10,215	12,725
Closing Debt (Accumulated Deficit)	481,499	467,268	455,738	451,283	447,053	439,503	429,288	416,563
Macroeconomic Indicators								
	2005	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Nominal GDP	1,375,080	1,446,307	1,531,639	1,605,158	1,680,600	1,754,547	1,831,747	1,912,344
Annual Growth	6.2%	5.2%	5.9%	4.8%	4.7%	4.4%	4.4%	4.4%
Budgetary Indicators as Percentage of GDP								
	2005–06	**2006–07**	**2007–08**	**2008–09**	**2009–10**	**2010–11**	**2011–12**	**2012–13**
Revenues/GDP	16.2%	16.3%	15.9%	15.3%	15.2%	15.2%	15.2%	15.1%
Program Spending/GDP	12.7%	13.0%	13.0%	12.9%	12.9%	12.8%	12.8%	12.7%
Debt/GDP Ratio	35.0%	32.3%	29.8%	28.1%	26.6%	25.1%	23.4%	21.8%

SOURCE Finance Canada, Economic and Fiscal Update, October 2007. Budget date from Tables 2.3, 2.4, and 2.5; economic growth projections for 2007 forward from Table 1.1.

FIGURE 1 Impact of Economic Slowdown on Federal Budget



downturn will have the effect of lowering inflation, but, if the price of oil continues to climb, it may put upwards pressure on inflation. It is fair to assume a 2% rate of inflation going forward as this is the mid-point of the Bank of Canada's target range.

Scenario 3 models a mild recession in 2008, followed by a recovery in 2009 and 2010. Nominal GDP growth falls to 1% in 2008, recovers to 2.5% in 2009, and then resumes the EFU baseline of 4.4% for 2010. In this scenario, the deficit is $3.9 billion in 2008/09, grows to $9.6 billion in 2009/10, and then falls to $6.9 billion in 2010/11.

Finally, scenario 4 is the most pessimistic of all. It models zero nominal GDP growth in 2008, and 2.2% growth in 2009 (in real terms, this would represent a rather strong recession in 2008 followed by a year of zero real growth) before resuming 4.4% growth in 2010. Accordingly, deficits are larger, at $6.2 billion in 2008/09, rising to $12.7 billion in 2009/10, and then falling to $10.1 billion in 2010/11.

In terms of tipping the fiscal balance, a nominal GDP growth rate in 2008 under 2.65% will lead to a deficit for the 2008/09 fiscal year. The policy question, of course, is what should be done in response to a recession.

Fiscal Policy in a Downturn

With an election call imminent, it is important that political leaders tell the public what their plans are should the economy go into a slowdown or outright recession. In particular, what fiscal actions should be taken in terms of taxes and spending, and would they run a deficit if necessary? The prospect of a downturn puts the recent tax cuts into sharp relief: should the government hold the line on its tax cuts as its primary policy response? And what would happen to the Tax Back Guarantee — a gimmick that converts savings on debt interest payments arising from surpluses into tax cuts — should surpluses turn to deficits (i.e., does it become a Tax Increase Guarantee)?

In response to a downturn, the government should be prepared to run a deficit. Personal and corporate income tax revenues, and GST revenues, will minimally slow, and possibly decline. Automatic stabilizers, such as the Employment Insurance program, have been greatly weakened since the mid-1990s, but in the face of a downturn they will push the budget towards deficit. EI surpluses have already shrunk a great deal due to rate cuts, from a $4 billion excess of premiums paid over benefits paid in 2001/02 to an estimated $2 billion in 2007/08. If unemployment were to rise, the EI account would turn to deficit rather quickly.

Two points of conventional wisdom in Ottawa need to be questioned, given the probability of a downturn. The first is a deep antipathy towards deficits under any circumstances. Having saved for a rainy day, the federal government should be prepared to use the umbrella of deficit-spending, if need be. Canada's debt-to-GDP ratio fell from 68% in 1996/97 to 32% in 2006/07. The bulk of this reduction is due to economic growth, rather than surpluses. Nonetheless, the government has substantial room to run a deficit if it so chooses. Compared to other G-7 countries, Canada's net liabilities are the lowest by a fair margin, and other countries have been running deficits in recent years compared to Canada's surpluses.

There is much work to be done on climate change, poverty, transportation, etc., that make a compelling case for public spending as the vehicle for action. Federal expenditures have recovered somewhat, to 13.0% of GDP from the low of 12.1% in 20001, but even this amount is three to five percentage points of GDP lower than the levels that prevailed up to the early 1990s. To put this into dollar terms, four percentage points of GDP amount to about $60 billion, a considerable sum.

The second bit of conventional wisdom that should be discarded is the mythos of powerful central bankers at the helm, steadily adjusting course based on their measurements and understanding of the economic seas. Should the bears be correct, fiscal policy can and should do more of the heavy lifting, as monetary policy may have limited effects on moderating the downturn if financial markets remain clogged and asset prices fall. In such a scenario, a monetary easing may be part of the solution, but it is unlikely that rate cuts by the Bank of Canada and other central banks would be sufficient. Overnight rate reductions do not reduce long-term interest rates by a corresponding amount, and have little effect on consumer credit (in fact, long-term rates could rise due to the credit crunch even as short-term rates fall). An important reason to cut rates, of course, is the high dollar; if the spread widens between Canadian and U.S. interest rates any more, it could aggravate today's manufacturing crisis.

Beyond running a deficit, the government should also be prepared to reconsider the recent tax cuts. Deficit-financed tax cuts are one fiscal response to a downturn, but they are not the best response. Personal income tax and GST cuts do provide savings to low- and middle-income earners, so some caution is required. An alternative approach could be to introduce measures that improve tax fairness and address climate change, while providing revenue for an expansion of public spending. These include: adding a new income tax bracket for upper-income earners; taxing capital gains at their full realized value; and introducing a carbon tax. These issues are described in more detail in other AFB technical papers.

Corporate tax cuts, in particular, are poorly attuned to the specific challenges facing the nation. Corporate tax cuts are justified on the grounds that they will increase investment in Canada. This is a dubious claim, as corporations invest for so many other reasons: access to resources (think oil patch), access to markets, availability of skilled labour, and energy costs are the main drivers. If Canadian rates were way out of line, there might be some justification for cutting corporate rates, but this is not the case.

Prior to the current tax-cut exercise, Canadian corporate income tax rates were already lower than in the U.S., and back in the heyday of high investment and productivity growth in the 1960s, the federal rate was 40%, or close to double the 2007 rate. It is often pointed out that the Nordic countries tax capital relatively lightly and make up their revenues elsewhere. While this is a real-world example that must be kept in mind, there is little evidence that Canadian rates are high in comparative terms.

A related claim is that Canada's rates on the margin for new investment are too high. This is the marginal effective tax rate (METR) claim, advanced by the C.D. Howe Institute and the Department of Finance. There are some questionable methodological issues in how these rates are calculated and how comparable they really are across countries.[7] Even on its own terms, recent targeted measures (e.g., accelerated depreciation for manufacturers) have greatly reduced Canada's METR so that we are no longer "uncompetitive." Finally, in maintaining lower rates than the U.S., it should be kept in mind that the subsidiaries of U.S.-based corporations are taxed in the U.S. based on their global profits. Increasing those profits by lowering Canadian taxes will simply leave them paying the tax to the U.S. treasury instead of the Canadian treasury.

Most importantly, at a time when there are major challenges facing the country, the Economic and Fiscal Update squandered an important opportunity. Tax cuts will not build any affordable housing, will not reduce poverty, will not make it easier to get to work in the morning, will not improve the life chances for our children, will not improve conditions on First Nations reserves, and will do nothing to tackle climate change. Infrastructure developments, such as a major roll-out of public transportation and affordable housing, would be particularly well-timed in a downturn, especially if the construction sector is hard-hit. Strengthening EI and providing targeted assistance to hard-hit sectors would also deliver greater bang for the buck than tax cuts.[8]

If anything, the Harper tax cuts emulate a U.S. Republican "starve the beast" strategy, in which tax cuts deplete surpluses, and deficits are fought by spending cuts — precisely the opposite direction that is required. This approach would only worsen the core economic problem and would do double damage by worsening inequality. A deficit that precipitated spending cuts would be a grave mistake should there be a major economic downturn or recession.

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Notes

1 This is a temporary tax cut, as the value of the basic personal exemption was already tied to inflation. The EFU's ways and means section clarifies that the exemption is increased by about $671 in 2007, $298 in 2008, and a mere $6 in 2009, above what it would have otherwise been. The value to taxpayers in each year would be 15% (the bottom bracket rate) of the respective amount.

2 My recent tax incidence study for Canada notes that corporate income tax is a progressive tax, as the ownership of corporate Canada is fairly concentrated at the top of the income distribution. Lee, Marc. 2007. *Eroding Tax Fairness: Tax Incidence in Canada, 1990 to 2005*. Ottawa: Canadian Centre for Policy Alternatives, November.

3 Comment by Douglas Porter, economist at BMO Nesbitt Burns, cited by Barrie McKenna (2007), "Economic Train Wreck in the US would hit Canada, Decoupled or not" in *The Globe and Mail*, December 4.

4 Based on calculations done by Stephen Gordon on Statistics Canada data, http://worthwhile.typepad.com/worthwhile_canadian_initi/2007/12/on-the-canada-u.html

5 Prominent bear Nouriel Roubini remarks that a growing number of private sector and academic economists are in the "hard landing" camp to varying degrees. See http://www.rgemonitor.com/redir.php?sid=3&tgid=0&cid=231693

6 Baseline revenue-to-GDP figures from the EFU are taken as given for all scenarios. Note that nominal GDP figures are used, not real GDP, as the budget estimates are presented in nominal terms.

7 For a good critique of the METR concept, see Joe Ruggeri and Jennifer McMullin (2004), *Canada's Fiscal Advantage*. Ottawa: Caledon Institute, November.

8 See a recent analysis by Chad Stone and Kris Cox for the Center on Budget and Policy Priorities, *Economic Policy for a Weakening Economy: Principles for Fiscal Stimulus*. January 8 2008.

TABLE 3

	Scenario 1: Moderate slowdown				**Scenario 2:** Major slowdown			
Macroeconomic Indicators								
	2007	**2008**	**2009**	**2010**	**2007**	**2008**	**2009**	**2010**
Nominal GDP	1,531,639	1,577,588	1,632,804	1,704,647	1,531,639	1,562,272	1,609,140	1,679,942
Annual Growth	5.9%	3.0%	3.5%	4.4%	5.9%	2.0%	3.0%	4.4%
Budgetary Transactions ($Millions)								
	2007–08	**2008–09**	**2009–10**	**2010–11**	**2007–08**	**2008–09**	**2009–10**	**2010–11**
Revenue	243,895	242,156	248,750	259,751	243,895	239,805	245,145	255,986
Program Spending	198,365	207,625	216,970	225,145	198,365	207,625	216,970	225,145
Debt Service	34,000	33,700	34,200	34,000	34,000	33,700	34,200	34,000
BUDGET BALANCE	11,530	831	(2,420)	606	11,530	(1,520)	(6,025)	(3,159)
Closing Debt (Accumulated Deficit)	455,738	454,907	457,327	456,721	455,738	457,258	463,283	466,442
Budgetary Indicators as Percentage of GDP								
	2007–08	**2008–09**	**2009–10**	**2010–11**	**2007–08**	**2008–09**	**2009–10**	**2010–11**
Rev/GDP	16.0%	15.3%	15.2%	15.2%	16.0%	15.3%	15.2%	15.2%
Budget Balance/GDP	0.8%	0.1%	-0.1%	0.0%	0.8%	-0.1%	-0.4%	-0.2%
Debt/GDP ratio	29.8%	28.8%	28.0%	26.8%	29.8%	29.3%	28.8%	27.8%

	Scenario 3: Recession				**Scenario 4:** Major recession			
Macroeconomic Indicators								
	2007	**2008**	**2009**	**2010**	**2007**	**2008**	**2009**	**2010**
Nominal GDP	1,531,639	1,546,956	1,585,629	1,655,397	1,531,639	1,531,639	1,565,335	1,634,210
Annual Growth	5.9%	1.0%	2.5%	4.4%	5.9%	0.0%	2.2%	4.4%
Budgetary Transactions ($Millions)								
	2007–08	**2008–09**	**2009–10**	**2010–11**	**2007–08**	**2008–09**	**2009–10**	**2010–11**
Revenue	243,895	237,454	241,563	252,246	243,895	235,103	238,472	249,018
Program Spending	198,365	207,625	216,970	225,145	198,365	207,625	216,970	225,145
Debt Service	34,000	33,700	34,200	34,000	34,000	33,700	34,200	34,000
BUDGET BALANCE	11,530	(3,871)	(9,607)	(6,899)	11,530	(6,222)	(12,698)	(10,127)
Closing Debt (Accumulated Deficit)	455,738	459,609	469,216	476,115	455,738	461,960	474,659	484,786
Budgetary Indicators as Percentage of GDP								
	2007–08	**2008–09**	**2009–10**	**2010–11**	**2007–08**	**2008–09**	**2009–10**	**2010–11**
Rev/GDP	16.0%	15.3%	15.2%	15.2%	16.0%	15.3%	15.2%	15.2%
Budget Balance/GDP	0.8%	-0.3%	-0.6%	-0.4%	0.8%	-0.4%	-0.8%	-0.6%
Debt/GDP ratio	29.8%	29.7%	29.6%	28.8%	29.8%	30.2%	30.3%	29.7%

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