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Dr. Ellen Russell
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Dear Dr. Russell:

In response to your request, we have assessed the macroeconomic implications of your proposed budget initiatives, and summarize our findings here.

To reflect your proposals, we have used worksheets supplied by your colleagues that detail your spending and tax changes. Summarizing the overall implications, the tabulation below reports the extent to which these constitute a fiscal stimulus.[1]

AFB Direct Impact on Federal Balance			
	($ millions)		
	2005	2006	2007
Fiscal Year	-13770	-15621	-18997
Calendar Year	-10327	-15158	-18153

We understand that your view is that this amount of financial stimulus would employ Government of Canada budget surpluses that would otherwise be available given your view of the government's own fiscal posture, and that by itself, these initiatives would not produce a deficit in any of the three years. For purposes of this analysis, we assume you have otherwise established that such fiscal room exists, and focus principally on the economic consequences of the stimulus. In our findings, however, we report likely consequences for the budget accounting for the fact that the stimulus increases incomes in the economy, thereby providing additional revenues and reduced spending that would occur in the absence of your stimulus.

[1] As the modeling framework we employ represents the economy in annual terms, we have converted your Fiscal Year assumptions into calendar-year terms, assuming the 75 per cent of the stimulus in the fiscal year applies to the first and 25 per cent to the following year. Note as well that as the worksheets did not specify details for the Sectoral Development Bank, spending for this is excluded from our analysis.

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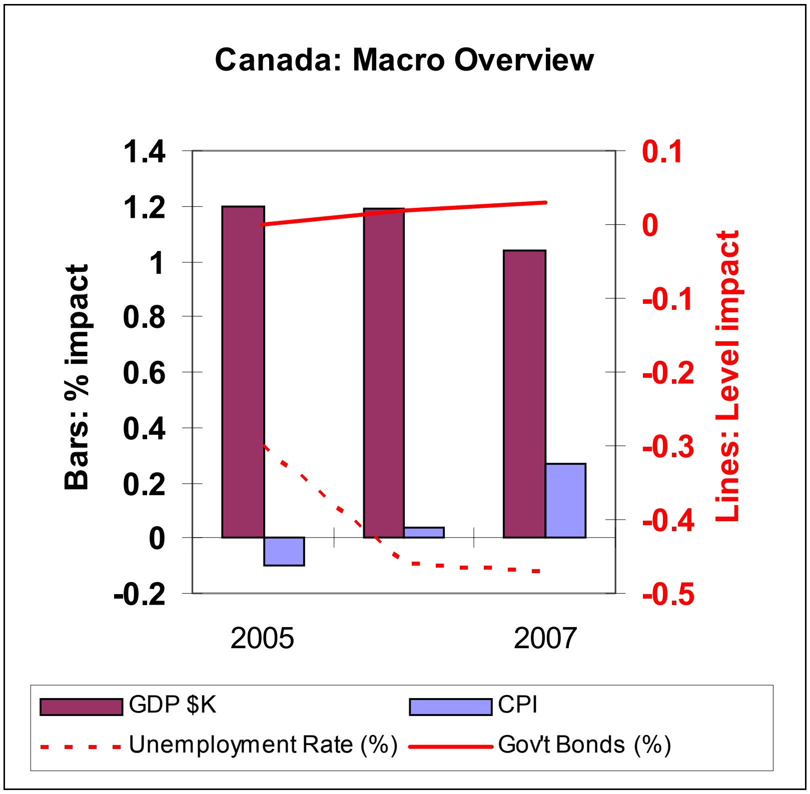

We estimate that the level of real economic activity would be increased by at least one per cent in each of the three years to which your budget initiatives apply. There should be little effect on consumer prices in 2005 and 2006, but with increased employment, there is a small addition (0.2 percentage points) to consumer inflation in 2007.

As the axis on the right of the figure specifies, the unemployment rate would be reduced by 0.3 percentage points this year and by an average of almost 0.5 percentage points in the following two. As the tabulation below indicates, this follows from both an increase in employment, and an increase in the participation rate as improved employment opportunities draw those who are otherwise discouraged back into the labour force.

Labour Markets

	2005	2006	2007
	% Impact		
Unemployment Rate (%) (a)	-0.3	-0.5	-0.5
Labour Force (000s)	0.3	0.6	0.6
Participation Rate (%) (a)	0.2	0.4	0.4
Employment	0.7	1.0	1.1
(000s Level Impact)	109	172	185

(a) Level Impact

As the tabulation below reports, the larger economy, with your personal tax cuts and subsidies to households (e.g., transfers to support those in post-secondary schooling, increased funding for social assistance, and increased OAS and GIS benefits) should result in a significant increase in the disposable income of Canadians, rising to 2.7 per cent in 2007 after accounting for effects on consumer prices. The contribution to this result from the strengthened economy is provided by increased wage income and from dividend and other property income that would be associated with improved corporate

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returns. You may wish to note that although you propose a number of tax increases on persons, the overall effective tax rate on persons is reduced with this derived largely from the increases in the Canada Child Tax Benefit and the value and threshold of the GST credit.

Incomes

	2005	2006	2007
	% Impact		
Disposable Personal Income	1.3	2.2	2.9
Effective Personal Tax Rate (%) (a)	-0.2	-0.4	-0.6
Disposable Personal Income ($1997 Mns)	1.4	2.2	2.7
Personal Saving Rate (% of Disposable Income) (a)	0.2	0.4	0.4
Pre-tax Corporate Profits	2.9	1.9	0.9
Government Balances ($Mns Nominal)			
Federal (a)	-6604	-10425	-13332
Provincial & Local (a)	2223	3727	4149
Current Account Balance (a)	-7244	-10538	-12232

(a) Level Impact

In a budget context, you should note two interesting features of the result.

- There are benefits for the federal budget of a strengthened economy. There is a fiscal offset from the improved economy of $3.7 billion in 2005 rising to almost $5 billion in the following two years. Put another way, the extent of the budget surplus required to support your initiatives without putting the balance into deficit is reduced from $10 billion in 2005 to a little less than $7 billion with similar such adjustments for the following years.

- Also notable is the positive effect of your fiscal program on provincial and local government balances with this following from both your federal transfers to the provinces and increased economic activity that benefits fiscal outcomes of those jurisdictions. Our economic results indicate that the positive effects on economic activity would be approximately the same for each province so you may infer that benefits to provincial and municipal budgets would be similar across the country.

In using these results, we recommend that you regard them as directionally correct with reasonable magnitudes of impact, rather than as a report of precise impact. This follows from the following considerations.

- Precisely how budget related changes to the incomes of persons, governments and businesses will affect their spending behaviour is uncertain. We have recognized that because your tax and subsidy changes are targeted on those with relatively low incomes, most of this income would likely be used by recipients for consumption rather than saved.[2] We have assumed that your increase in corporate taxes will have a negative effect on business investment, although increased demand in the economy more than offsets this assumed effect.

- Perhaps most uncertain is the extent to which transfers to provinces and municipalities will “cause” these jurisdictions to further channel the funds as spending to your sense of the intended purposes. As a rule, we have assumed this will be the case, but in degree as the benefiting jurisdictions might use the funds simply to reduce their own deficits, then the economic impacts we report would be reduced.

- We have assumed, as appears to be customary in budget reporting by successive federal governments, that the fiscal initiatives do not change interest rates or the exchange rate. There may be reasonable disagreement about the assumption for interest rates, but at least the minor effect on inflation (and this only in the third year) suggests little reason for monetary authorities to react. The substantial impact (1.5 to 2 per cent) on domestic final demand does sharply increase imports and reduce the size of the Current Account surplus that is otherwise expected to continue to be large by historical standards. Arguably, this would put downward pressure on the value of the Canadian dollar with the magnitude of this effect again arguable. In any event, in the current context, when it is widely recognized[3] that the sharp appreciation of the currency in 2003 and 2004 has had negative effects on Canadian trade and manufacturing jobs, you might reason that any such impact would be a “positive” outcome.

Yours truly,

Carl Sonnen
President

[2] Notwithstanding this, you may note that we estimate that overall, saving of households would be increased.
[3] And asserted by representatives of the manufacturing and other sectors.