

# A TALE OF TWO STIMULUS PACKAGES

Jeremy Leonard

Whether on purpose or by accident, the stimulus measures in the 2009 budget tabled by Finance Minister Jim Flaherty have fallen into the trap of doing what the Americans do, but on one-tenth the scale. But Canada's economic challenges are different — and more manageable — than those south of the border, and require different solutions. The fundamental problem is a long-term structural erosion of competitiveness magnified by a short-term cyclical economic and credit downturn. The budget should have focused its guns more squarely on these two issues, but almost half of the \$40-billion stimulus will do little to address them.

Délibérément ou pas, les mesures de relance contenues dans le budget 2009 du ministre des Finances Jim Flaherty souffrent d'une erreur classique : le Canada emprunte la voie des Américains, mais avec un dixième de leurs moyens. Nos problèmes économiques — différents, mais aussi moins complexes que ceux de nos voisins du Sud — exigent des solutions adaptées à notre réalité. C'est à l'érosion structurelle de notre compétitivité à long terme et, dans le court terme, à la crise du crédit et au ralentissement économique cyclique que le budget aurait dû s'attaquer. Mais près de la moitié des 40 milliards de dollars d'investissements ne sont pas destinés directement à faire face à ces problèmes fondamentaux.



**E**conomic stimulus is in the air across North America. Here in Canada, the Harper government has acknowledged economic and political reality by tabling a budget that includes a \$40-billion stimulus package over the next two fiscal years. Scarcely two weeks after it was approved in the House of Commons, the US House of Representatives and Senate agreed on a US\$787-billion package to try to jump-start the moribund American economy. The parallels are striking: a synchronized global recession not seen since the early 1980s, a credit crunch not seen since the 1930s, and a sense that massive government intervention is necessary to stave off a rerun of the Great Depression. There was clearly pressure for Jim Flaherty to think big.

But bigger isn't necessarily better for Canada. It is easy, but wrong, to assume that Canada's economy is about one-tenth the size of that of the United States (true) but otherwise identical in terms of the challenges it faces (false). This leads to the erroneous conclusion that appropriate policy for Canada is to do what the Americans do on one-tenth the scale.

Canada's economy is on much stronger short-term footing than its American counterpart, but suffers from sluggish productivity growth that has eroded competitiveness over the past decade or more — Canadian manufacturers are 20 percent less productive than their American counterparts. A well-planned economic recovery package

should reflect this reality, but the 2009 budget falls short in many respects.

**N**otwithstanding the doomsday headlines and the sea of negative economic numbers on both sides of the border, the economic and fiscal contexts in the two countries are a study in contrasts. The story is told succinctly in figure 1, which shows the evolution of total employment in Canada and the United States. Seen in this light, the large Canadian job losses in January, while record-setting in absolute numbers, simply bring total employment back to the levels of a year ago. It is also interesting to note that the largest *increase* in employment occurred just three months ago, just as Canada was unofficially falling into recession. If we smooth those monthly gyrations, employment has fallen on the order of just over 1 percent — painful indeed for those affected but far from a nosedive.

The jobs story on the other side of the border is much direr and wears the title of "nosedive" more easily. Employment has fallen by 3.6 million, or 2.6 percent, since peaking in December 2007, which is the main reason that the National Bureau of Economic Research, the semi-official arbiter of US business cycles, declared that the recession started in January 2008. Many journalists have pointed out that this decline is worse (even in percentage terms) than

the deep 1981-82 recession, but they fail to note that the 1974-75 recession was worse in terms of both percentage declines and average monthly job losses. And we are certainly a far cry from the Great Depression, when employment dropped by more than a quarter.

First, it has stopped US consumer spending growth dead in its tracks. Economic research consistently shows that when consumers feel richer, they spend more, to the tune of 5 to 10 cents for every additional dollar of real estate wealth. The double-digit wealth

standards and relatively low exposure to assets backed by high-risk mortgages, banks are hesitant to lend.

The fiscal contexts could not be more different. The US federal government has been living beyond its means for at least the past 10 years, whereas Canada, true to its reputation as a prudent and cautious nation, has been living well within them. Figure 3 shows the federal budgetary balance in the two nations since 1993. Both eliminated large deficits during the latter part of the 1990s —

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The second important contrast is in real estate markets, which have fallen off a cliff in the United States since 2006 (figures 2A and 2B). Housing starts are down a whopping 70 percent, and growth in household wealth has turned sharply negative for the first time since data collection began, in 1952. The drop in housing starts has strong negative effects on a relatively circumscribed part of the economy — construction, furniture, appliances and other industries that feed into building and furnishing residences. But the drop in household wealth has broader, more nefarious effects.

increases of 2004-06 fuelled hundreds of billions of dollars of home-equity-financed consumption. But the same principle holds in the other direction, and because no one knows where the bottom of the US housing collapse is, US consumer spending is likely to decline throughout 2009.

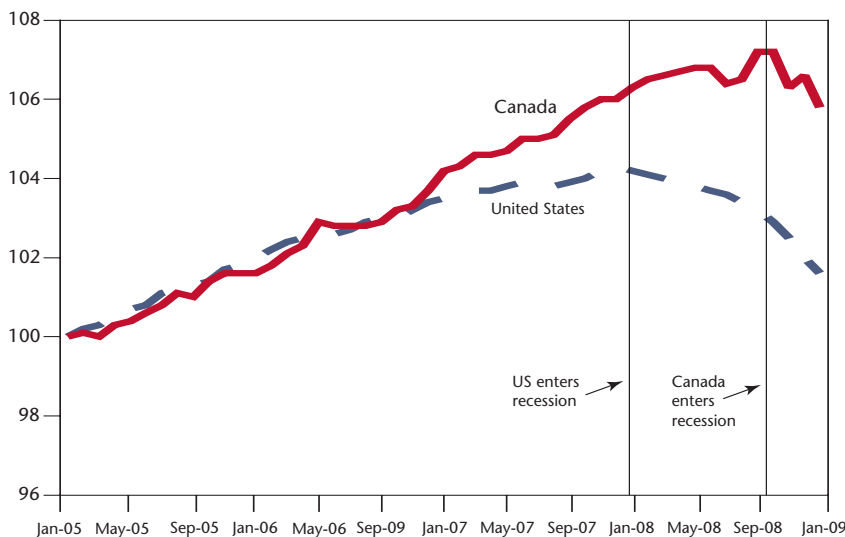
Second, and more relevant for Canada, the packaging of US mortgages (particularly those carrying high risk levels) into opaque hard-to-value securities precipitated the global financial crisis, which has tightened credit around the globe. In this respect, Canada is an innocent victim, because despite our tighter mortgage lending

Canada's achievement was due in part to the fiscal discipline imposed by Finance Minister Paul Martin — but both countries benefited from an economic boom that saw 4 percent-plus annual GDP growth and a concomitant increase in tax receipts.

By the turn of the millennium, patterns had diverged sharply. Both countries enacted broad-based tax cuts that returned some of the revenue windfall to taxpayers. The 2000 budget and fiscal update reduced Canadian personal and corporate income taxes by an aggregate \$100 billion over five years, which shaved about 1.5 percentage points from federal revenues' share of GDP. But the commodities boom and strong export markets buoyed the Canadian economy (keeping tax revenues strong even at lower rates), and continued spending restraint kept Ottawa well in the black, allowing successive governments to retire over \$100 billion of outstanding federal debt.

In the United States, the "millennial" tax cuts were much deeper and broader. The *Economic Growth and Tax Relief Reconciliation Act* signed by then-President Bush in 2001 reduced taxes by an estimated US\$1.6 trillion over 10 years, and subsequent legislation in 2003 accelerated the phase-in of many of its provisions. The resulting hole in federal revenues had reached 3 percent of GDP by the mid-2000s, double the equivalent gap in Canada. At the

FIGURE 1. TOTAL EMPLOYMENT IN CANADA AND THE UNITED STATES, JANUARY 2005-JANUARY 2009 (INDEX JANUARY 2005 = 100)



Source: Statistics Canada and US Bureau of Labor Statistics.

same time, US federal spending rose substantially in dollar terms and as a percent of GDP, because of both massive increases in military spending related to the wars in Iraq and Afghanistan and expansion of publicly funded health care (including Medicare and Medicaid), which, unlike in Canada, is not capped by a global funding envelope. These two line items accounted for almost 60 percent of total US federal spending growth from 2000 to 2008. The sagging economy and massive public spending on financial bailouts and economic stimulus will balloon the deficit to nearly 10 percent of GDP next year, compared with just 2 percent of GDP in Canada.

Because of budget accounting differences, it is exceedingly difficult to compare the US stimulus package with the 2009 Canadian federal budget, but it is possible to get a sense of their overall relative magnitude and major priorities (summarized in table 1).

The most important difference is that in the US, detailed budget projections are made over a 10-year horizon, rather than the 2-year horizon common in recent Canadian budgets. Work by the US Congressional Budget Office indicates that only about US\$520 billion of the US\$787-billion stimulus will actually kick in in the first two years. So the US package isn't really orders of magnitude larger than its Canadian counterpart over a comparable time period. Furthermore, the bulk of the stimulus comes in 2010, when most forecasters (perhaps too optimistically) see the US beginning to recover.

Table 1 also shows that the mix of spending and tax cuts is similar in the two countries, with a heavy emphasis on the former. There are even strong parallels in some of the key big-ticket items, with both nations banking on infrastructure spending to create jobs in the immediate term and sweeten benefits available to unemployed workers. One might conclude from the table (admittedly grossly simpli-

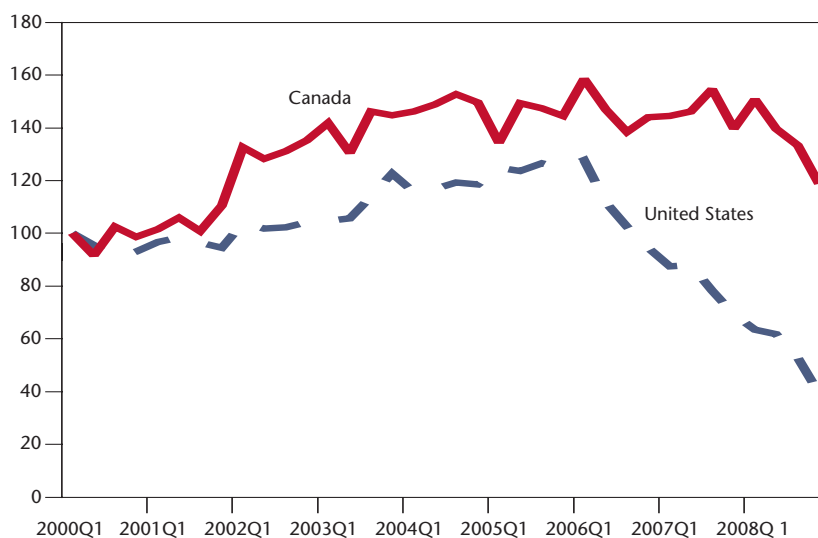
fied) that Canada has in fact fallen into the trap of doing one-tenth of what the Americans do.

But the proper way to judge "Canada's Economic Action Plan" (as the 2009 budget is billed) is to assess its ability to address Canada's economic problems, not America's. The short-term cyclical problems are related to tight lending conditions and the loss of purchasing power (and human

hardship) associated with unemployment. The long-term structural problems are related to Canada's lagging productivity and competitiveness, particularly in the export-intensive manufacturing sector.

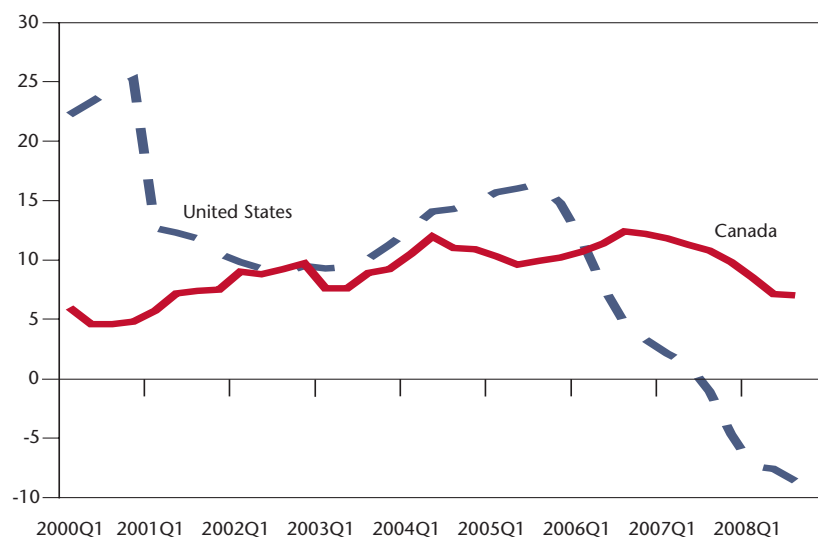
With regard to the short term, the most important actions in the budget weren't even included in the official "fiscal stimulus" and were

FIGURE 2A. HOUSING STARTS IN CANADA AND THE UNITED STATES, 2000Q1-2008Q4 (INDEX 2000Q1 = 100)



Source: Statistics Canada and US Bureau of the Census.

FIGURE 2B. HOUSEHOLD REAL ESTATE WEALTH IN CANADA AND THE UNITED STATES, 2000Q1-2008Q3 (YEAR-OVER-YEAR PERCENT CHANGE)



Source: Statistics Canada and US Federal Reserve Board.

under-appreciated in the ensuing public debate. The government will use the Extraordinary Financing Framework to buy an additional \$50 billion of insured mortgage assets from banks, bringing the total amount to \$125 billion. This transfers risk associated with those assets from banks to the government, removing an impediment to boosting consumer and business lending. If those assets are bought at today's market prices, the government may well break even or earn a small positive return. Furthermore, additional lending authority on the order of \$13 billion will be granted to Crown corporations such as Export Development Canada and the Business Development Bank, and an additional \$12 billion will be used to underwrite loans for motor vehicles and business equipment, two classes of products for which lending has been particularly tight.

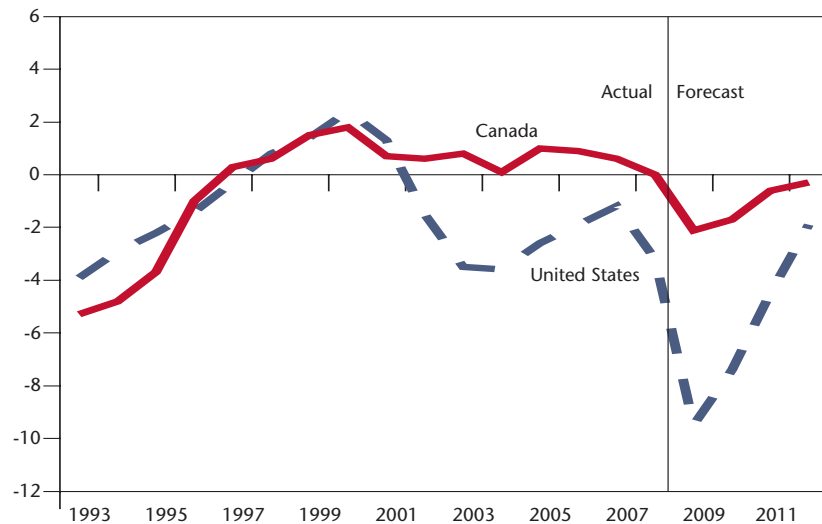
With regard to the second short-term challenge of maintaining purchasing power and reducing hardship for the unemployed and under-employed, the budget was decidedly less aggressive. Employment insurance benefits are extended by five weeks, and the Working Income Tax Benefit — a refundable tax credit that tops up low incomes — was expanded. Finally, modest changes to the personal exemption, tax bracket thresholds and the Canada Child Tax Benefit will reduce income taxes for those who hold on to their jobs. But these measures amount to only about \$8 billion over two years, a small fraction of the \$40-billion total stimulus. EI contribution rates will be frozen at current levels, but this will provide no direct benefit to those who lose their jobs.

The government missed a golden opportunity to return employment insurance to its core mission of sustaining purchasing power for those temporarily without a job. The current system has a complex web of differential eligibility rules based on regional labour market conditions. Thus areas of the country that have

had relatively low unemployment rates in recent years (such as Alberta, British Columbia and Ontario) have much tighter eligibility requirements, to the point where fewer than 40 per cent of unemployed workers in those

three provinces actually receive benefits. But these are precisely the provinces that have so far borne the brunt of the current recession. Such regional disparities in eligibility requirements have always been bad

FIGURE 3. FEDERAL BUDGETARY BALANCE IN CANADA AND THE UNITED STATES, 1993-2012 (PERCENT OF GDP)



Source: Finance Canada and US Congressional Budget Office.

TABLE 1. COMPARISON OF CANADIAN AND US ECONOMIC STIMULUS PACKAGES

	Canada	United States
Total direct fiscal stimulus (\$)	\$40 billion over 2 years	US\$520 billion over 2 years; US\$787 billion over 10 years
As percent of GDP (2009)	1.5	1.2
As percent of GDP (2010)	1.1	2.5
Spending increases (% of total)	72	65
Tax cuts (% of total)	28	35
Selected big-ticket provisions	<ul style="list-style-type: none"> <li>● Infrastructure spending (mainly transport and housing)</li> <li>● 5-week extension of EI benefits</li> <li>● Investment in training programs</li> <li>● Home renovation tax credit</li> <li>● Grants for regional economic adjustment</li> </ul>	<ul style="list-style-type: none"> <li>● Infrastructure spending (mainly transport and environmental restoration)</li> <li>● 33-week extension of unemployment insurance and increased benefit levels</li> <li>● Transfers to state governments</li> <li>● Homebuyers' tax credit</li> </ul>

Source: Finance Canada and US House Appropriations Committee.

economic policy, but in the current context they are bad politics as well.

The budget also hit the mark with a few provisions that will shore up productivity and competitiveness while stimulating economic activity in the short term. As a complement to modest increases in income security, the government plans to invest \$1.9 billion in new training initiatives.

Infrastructure investment is an effective way to create jobs (particularly when there is idle capacity, as is currently the case in the construction industry), but if chosen well, it can also significantly enhance the cost competitiveness of Canadian firms. Research consistently shows that investments in road, highway and bridge maintenance and construction and upgrading of sewage and water-distribution facilities have the biggest payoff, up to double that of private investment. A 10 percent increase in infrastructure spending (which is on the order of what federal and provincial governments have committed to in recent years) would boost manufacturing productivity by 5 percent per year, and have positive ancillary effects on employment as well. But a careful balance must be struck between spending quickly and spending wisely.

The temporary tax relief for business investment in computers and equipment is good policy as well, though it should have been made permanent. Per unit of output, Canada employs only half as much capital as the United States, with the deficit particularly acute for the machinery and information technology investment that is so critical for making business operations more efficient. Notwithstanding the corporate tax rate reductions over the past several years, the effective tax rates on equipment of all kinds (and IT equipment in particular) remain high by international standards. As

with infrastructure, this tax relief will create jobs directly in equipment-producing industries as well as enhance the competitive posture of firms that use it. And contrary to popular belief, firms that invest more hire more.

But these training, infrastructure and tax initiatives, worthy as they are, amount to only \$14 billion over two years. If we add to this the \$8 billion worth of income security and tax relief measures outlined above, this means only about half of the total anticipated stimulus spending is target-

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ed to measures that are likely to best serve the budget's stated goals. Their effect will be diluted by a much larger number of measures that will do little to improve competitiveness and have questionable short-term impact as well.

The much-vaunted \$3-billion home renovation credit over two years is one example. Canada is not in the midst of a housing collapse, and the idle resources in the construction industry would be more productively used in needed upgrading and repair of infrastructure. Furthermore, most of the subsidy is likely to go to households that would have undertaken

renovations in any event (the present author included). Finally, it is grossly inequitable, because only the two-thirds of Canadian households that own their homes (and that on average have significantly higher incomes and assets than renters) are eligible.

Other measures that are labelled as measures to enhance competitiveness look more like regional development programs, which have a checkered past in terms of their ability to spark sustainable economic restructuring. A case in point is the Southern Ontario development agency. That the "Golden Horseshoe" — still Canada's most prosperous and diversified economic node — would be in need of nearly \$500 million over the next two years (on top of the billions in loans to the Big Three automakers) stretches the limits of economic logic.

The budget can't prevent recession in Canada. But if it had focused its guns more squarely on the fundamental problem of business competitiveness with policies that boost economic activity and strengthen income security in the short term, it could have ensured the next best thing: minimize the economic hardship for unemployed Canadians while building the foundations for a strong recovery. Instead, nearly half of

the "stimulus" will be funnelled into activities of dubious short-term and long-term merit. One would have said the budget includes everything but the kitchen sink, but with the home renovation credit, even that has slipped in.

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